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China's Economic Conditions

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Outlook for China's Economy

China's Economic Conditions

SUMMARY

Since the initiation of economic reforms in 1979, China has become one of the world's fastest growing economies. From 1979-2000, China's real GDP rose at an average annual rate of 9.5%; real GDP is projected to rise by 7.2% in 2001. Many economists speculate that China could become the world's largest economy at some point in the near future, provided that the government is able to continue and deepen economic reforms, particularly in regards to its efficient state-owned enterprises (SOEs) and state banking system. Progress in reforming these sectors in recent years has been somewhat mixed.

After many years of negotiations, China became a member of World Trade Organization (WTO) on December 11, 2001. WTO accession commits China to significantly reducing a wide variety of tariff and non-tariff barriers. Legislation (H.R. 4444) granting permanent normal trade relations (PNTR) status to China (once it joins the WTO) was enacted into law on October 10, 2000 (P.L. 106-286). A main concern for Congress is to ensure that China fully complies with its WTO commitments once it accedes.

China's accession to the WTO would likely have a significant impact on China's economy. The level of Chinese trade protectionism would be greatly diminished, and nearly all sectors of China's economy (including agriculture, manufacturing, and services) would be subject to increased competition (or in some cases, competition for the first time) from foreign firms, which in many instances, would be given the same treatment and opportunities afforded to Chinese firms. Several of China's heavily protected industries, such as autos, and certain agricultural sectors, would likely be hurt by China's WTO entry. China's labor-intensive industries, especially textiles and apparel, would likely significantly expand with China's WTO accession.

Chinese government leaders have stated that WTO accession will force Chinese firms to become more productive and competitive and hence will boost China's long-term economic growth. However, such officials are also greatly concerned that WTO accession will cause employment disruptions in several sectors, which could result in social unrest. A major challenge for the government is to develop an adequate social safety net to assist laid-off workers.

Currently, China's short-term economic outlook is unclear. Economic slowdowns in Asia and the United States in the beginning of 2001 have hurt China's export industries, and the September 11, 2001 terrorist attacks against the United States will likely further dampen foreign demand for Chinese products and could reduce the level of planned foreign investment in China. The Chinese government has used public spending in recent years to boost the economy, and it is likely that it will continue to maintain such policies until the global economy begins to recover.

Most Recent Developments

On December 19, 2001, Chinese trade officials estimated foreign direct investment (FDI) in China would reach $45 billion in 2001, compared to $40.7 billion 2000.

On December 11, 2001, China entered the WTO. China's WTO membership was formally approved on November 10, 2001, and on November 11, 2001, China notified the WTO that it had formally ratified the WTO agreements, allowing China to join the WTO 30 days later.

On July 1, 2001, in a speech commemorating the 80th anniversary of the founding of the Chinese Communist Party (CCP), Chinese President Jiang Zemin urged the CCP to lift its membership ban against entrepreneurs from the private sector.

Background and Analysis

An Overview of China's Economic Development

China's Economy Prior to Reforms

Prior to 1979, China maintained a centrally planned, or command, economy. A large share of the country's economic output was directed and controlled by the state, which set production goals, controlled prices, and allocated resources throughout most of the economy. During the 1950s, all of China's individual household farms were collectivized into large communes. To support rapid industrialization, the central government during the 1960s and 1970s undertook large-scale investments in physical and human capital. As a result, by 1978 nearly three-fourths of industrial production was produced by centrally controlled state-owned enterprises (SOEs) according to centrally planned output targets. Private enterprises and foreign invested firms were nearly non-existent. A central goal of the Chinese government was to make China's economy relatively self-sufficient. Foreign trade was generally limited to obtaining only those goods that could not be made or obtained in China.

Government policies kept the Chinese economy relatively stagnant and inefficient, mainly because there were few profit incentives for firms and farmers, competition was virtually nonexistent, and price and production controls caused widespread distortions in the economy. Chinese living standards were substantially lower than those of many other developing countries. The Chinese government hoped that gradual reform would significantly increase economic growth and raise living standards.

The Introduction of Economic Reforms

Beginning in 1979, China launched several economic reforms. The central government initiated price and ownership incentives for farmers, which enabled them to sell a portion of their crops on the free market. In addition, the government established four special economic zones for the purpose of attracting foreign investment, boosting exports, and importing high

technology products into China. Additional reforms followed in stages that sought to decentralize economic policymaking in several economic sectors, especially trade. Economic control of various enterprises was given to provincial and local governments, which were generally allowed to operate and compete on free market principles, rather than under the direction and guidance of state planning. Additional coastal regions and cities were designated as open cities and development zones, which allowed them to experiment with free market reforms and to offer tax and trade incentives to attract foreign investment. In addition, state price controls on a wide range of products were gradually eliminated.

China's Economic Growth Since Reforms: 1979-2000

Since the introduction of economic reforms, China's economy has grown substantially faster than during the pre-reform period (see **Table 1**). Chinese statistics show real GDP from 1979 to 2000 growing at an average annual rate of 9.5%, making China one the world's fastest growing economies. The World Bank estimates that China's economic reforms have raised nearly 200 million people out of extreme poverty. DRI-WEFA, an economic consulting firm, projects China's real GDP growth at 7.2% in 2001 and 7.0% in 2001.

Table 1. China's Average Annual Real GDP Growth Rates: 1960-2000 and Estimates for 2001-2002

Time Period	Average Annual % Growth
1960-1978 (pre-reform)	5.3
1979-2000 (post-reform)	9.5
1990	3.8
1991	9.3
1992	14.2
1993	13.5
1994	12.7
1995	10.5
1996	9.7
1997	8.8
1998	7.8
1999	7.1
2000	8.0
2001 (projection)	7.2
2002 (projection)	7.0

Sources: Official Chinese government data reported by the World Bank, *World Development Report* (various issues), and DRI/McGraw-Hill, *World Economic Outlook,* various issues. Data for 2001 and 2002 are DRI-WEFA projections made in December 2001.

Causes of China's Economic Growth

Economists generally attribute much of China's rapid economic growth to two main factors: large-scale capital investment (financed by large domestic savings and foreign

investment) and rapid productivity growth. These two factors appear to have gone together hand in hand. Economic reforms led to higher efficiency in the economy, which boosted output and increased resources for additional investment in the economy.

China has historically maintained a high rate of savings. When reforms were begun in 1979, domestic savings as a percentage of GDP stood at 32%. However, most Chinese savings during this period were generated by the profits of SOEs, which were used by the central government for domestic investment. Economic reforms, which included the decentralization of economic production, led to substantial growth in Chinese household savings (which now account for half of Chinese domestic savings). As a result, savings as a percentage of GDP has steadily risen; it was 42.7% in 1998, among the highest savings rates in the world.

China's trade and investment reforms and incentives led to a surge in foreign direct investment (FDI), which has been a major source of China's capital growth. Annual utilized FDI in China grew from $636 million in 1983 to $40.7 billion in 2000 (FDI is projected to total $45 billion in 2001), making China, in recent years, the second largest destination of FDI (after the United States). The cumulative value of utilized FDI at the end of 2000 reached $349 billion. Nearly half of FDI in China has come from Hong Kong. The United States is the second largest investor in China, accounting for 8.3% ($30 billion) of total FDI in China from 1979 to 2000 (see **Table 2**). U.S. FDI in China for 2000 was $4.4 billion, accounting for 10.7% of FDI for that year.

Table 2. Major Foreign Investors in China: 1979-2000

($ billions and % of total)

Country	Cumulative Utilized FDI: 1979-2000		Utilized FDI in 2000	
	Amount ($billions)	% of Total	Amount ($billions)	% of Total
Total	348.6	100.0	40.7	100.0
Hong Kong	171.0	49.1	16.2	39.8
United States	30.0	8.3	4.4	10.7
Japan	28.1	8.1	3.2	8.0
Taiwan	26.2	7.5	2.4	5.8
Singapore	16.9	4.9	2.1	5.1

Source: Chinese government statistics.

Several economists have concluded that productivity gains (i.e., increases in efficiency in which inputs are used) were another major factor in China's rapid economic growth. The improvements to productivity were largely caused by a reallocation of resources to more productive uses, especially in sectors that were formally heavily controlled by the central government, such as agriculture, trade, and services. For example, agricultural reforms boosted production, freeing workers to pursue employment in more productive activities in the manufacturing sector. China's decentralization of the economy led to the rise of non-state enterprises, which tended to pursue more productive activities than the centrally controlled

SOEs. Additionally, a greater share of the economy (mainly the export sector) was exposed to competitive forces. Local and provincial governments were allowed to establish and operate various enterprises on market principles, without interference from the central government. In addition, FDI in China brought with it new technology and processes that boosted efficiency.

Measuring the Size of China's Economy

The actual size of the China's economy has been a subject of extensive debate among economists. Measured in U.S. dollars using nominal exchange rates, China's GDP in 2000 was $1.0 trillion; its per capita GDP (a commonly used living-standards measurement) was $875. Such data would indicate that China's economy and living standards were significantly lower than those of the United States, Japan, and Germany (see **Table 3**).

Many economists, however, contend that using nominal exchange rates to convert Chinese data into U.S. dollars substantially underestimates the size of China's economy. This is because prices in China for many goods and services are significantly lower than those in the United States and other developed countries. Economists have attempted to factor in these price differentials by using a purchasing power parity (PPP) measurement, which attempts to convert foreign currencies into U.S. dollars based on the actual purchasing power of such currency (based on surveys of the prices of various goods and services) in each respective country. This PPP exchange rate is then used to convert foreign economic data in national currencies into U.S. dollars.

Because prices for many goods and services are significantly lower in China than in the United States and other developed countries (while prices in Germany and Japan are higher than those in the United States), the PPP exchange rate raises the estimated size of Chinese economy to $5.7 trillion, significantly higher than Japan's GDP in PPP ($3.0 trillion) and Germany's ($1.8 trillion), and slightly over half the size of the U.S. economy. PPP data also raise China's per capita GDP to $4,743; however, this figure falls far below the PPP per capita GDP levels of the major developed countries.

The PPP data appear to indicate that, while the size of China's economy as a whole is quite large and currently could be the world's second largest, its living standards are quite low. (To illustrate, the World Bank estimates that nearly 30% of China's population live below the international poverty level of $1 per day.) The International Monetary Fund estimates that (using PPP measurements) China could surpass the United States as the world's largest economy as early as the year 2007. Yet, even if that were to occur, it would take China significantly longer to achieve U.S. standard of living levels.

Table 3. Comparisons of U.S., Japanese, German, and Chinese GDP and Per Capita GDP In Nominal U.S. Dollars and PPP: 2000

Country	Nominal GDP ($Billions)	GDP in PPP ($Billions)	Nominal Per Capita GDP	Per Capita GDP in PPP
U.S.	9,966	9,966	36,148	36,148
Japan	4,614	2,953	36,372	24,463
Germany	1,867	1,748	22,678	231,248
China	1,006	5,694	875	4,743

Source: Standard & Poor's DRI, *World Outlook*, Volume I First Quarter, 2001, p.A27-A28.
Note: PPP data for China should be interpreted with caution. China is not a fully developed market economy; the prices of many goods and services are distorted due to price controls and government subsidies.

China's Trade Patterns

Economic reforms have transferred China into a major trading power. Chinese exports rose from $14 billion in 1979 to$249 billion in 2000, while imports over this period grew from $16 billion to $225 billion. China's ranking as a trading power rose from 27th in 1979 to 7th in 2000. In 2000, China's exports rose by 27.8%, while imports increased by 35.8%, over 1999 levels (see **Table 4**). Historically, China has run trade deficits in some years and surpluses in others. However, over the past 8 years, China has run trade surpluses; in 2000 that surplus was $24.1 billion. Merchandise trade surpluses and large-scale foreign investment have enabled China to accumulate the world's second largest foreign exchange reserves, estimated to have reached $180 billion by the end of August 2001. China's exports and imports are projected to grow by 6.3% (to $265 billion) and 7.5% (to $241 billion), respectively.

Table 4. China's Merchandise World Trade: 1979-2001

($ billions)

	Exports	Imports	Trade Balance
1979	13.7	15.7	-2.0
1980	18.1	19.5	-1.4
1981	21.5	21.6	-0.1
1982	21.9	18.9	2.9
1983	22.1	21.3	0.8
1984	24.8	26.0	-1.1
1985	27.3	42.5	-15.3
1986	31.4	43.2	-11.9
1987	39.4	43.2	-3.8
1988	47.6	55.3	-7.7
1989	52.9	59.1	-6.2
1990	62.9	53.9	9.0
1991	71.9	63.9	8.1
1992	85.5	81.8	3.6

	Exports	Imports	Trade Balance
1993	91.6	103.6	-11.9
1994	120.8	115.6	5.2
1995	148.8	132.1	16.7
1996	151.1	138.8	12.3
1997	182.7	142.2	40.5
1998	183.8	140.2	43.6
1999	194.9	165.8	29.1
2000	249.2	225.1	24.1
2001 (estimate)	264.9	242.0	22.9

Source: International Monetary Fund, Direction of Trade Statistics and official Chinese statistics. Data for 2001 are projections by DRI-WEFA.

China's Major Trading Partners

China's trade data often differ significantly from those of its major trading partners. This is due to the fact that a large share of China's trade (both exports and imports) passes through Hong Kong (which reverted back to Chinese rule in July 1997, but is treated as a separate customs area by most countries, including China and the United States). China treats a large share of its exports through Hong Kong as Chinese exports to Hong Kong for statistical purposes, while many countries that import Chinese products through Hong Kong generally attribute their origin to China for statistical purposes.

According to Chinese trade data, its top five trading partners in 2000 were Japan, the United States, the European Union (EU), Hong Kong, and South Korea (see **Table 5**). Chinese data show the United States as China's largest destination for its exports and the fifth largest source of its imports.

Table 5. China's Top 10 Trading Partners: 2000
($ billions)

Country	Total Trade	Exports	Imports	Trade Balance
All Countries	474.3	249.2	225.1	24.1
Japan	83.2	41.7	41.5	0.2
U.S.	74.5	52.1	22.4	29.7
EU15	69.0	38.2	30.9	7.3
Hong Kong	53.9	44.5	9.4	35.1
S. Korea	34.5	11.3	23.2	-11.9
Taiwan*	30.5	5.0	25.5	-20.5
Singapore	10.8	5.8	5.1	0.7
Australia	8.5	3.4	5.0	-1.6
Russia	8.0	2.2	5.8	-3.6
Malaysia	8.0	2.6	5.5	-2.9

Source: Official Chinese trade data.
Note: Chinese data on its bilateral trade often differ substantially from the official trade data of other countries on their trade with China.
*China and Taiwan do not maintain direct trade links. Most trade takes place via Hong Kong.

U.S. trade data indicate that the importance of the U.S. market to China's export sector is likely much higher than is reflected in Chinese trade data. Based on U.S. data on Chinese exports to the United States (which, as noted, do not agree with Chinese data), and Chinese data on total Chinese exports, it is estimated that Chinese exports to the United States as a share of total Chinese exports grew from 15.3% in 1986 to an estimated 40.2.% in 2000.

A growing level of Chinese exports are from foreign funded enterprises (FFEs) in China. According to Chinese data, the share of total Chinese exports produced by FFEs rose from 0.1% in 1980 to 47.9% in 2000. FFEs also accounted for 52.1% of total Chinese imports. A large share of these FFEs are owned by Hong Kong and Taiwan investors, many of whom have shifted their labor-intensive, export-oriented, firms to China to take advantage of low-cost labor. A significant share of the products made by such firms are exported to the United States.

Major Chinese Trade Commodities

China's abundance of cheap labor has made it internationally competitive in many low cost, labor-intensive, manufactures. As a result, manufactured products comprise an increasingly larger share of China's trade. The share of Chinese manufactured exports to total exports rose from 50% in 1980 to 90% in 1999, while manufactured imports as a share of total imports rose from 65% to 84%. A large share of China's manufactured imports are comprised of intermediates (e.g., chemicals, electronic components, and textile machinery) used in manufacturing products in China.

Major Chinese imports in 2000 included machinery and mechanical appliances, electrical equipment, and sound recorders and reproducers; minerals; and metal products (see **Table 6**). China's major 2000 exports included machinery and mechanical appliances, electrical equipment, and sound recorders and reproducers; textiles and textile articles; and miscellaneous manufactured products (see **Table 7**).

Table 6. Major Chinese Imports: 2000

Commodity	Total ($Billions)	% of Total Imports
Machinery and mechanical appliances, electrical equipment, and sound recorders and reproducers	85.2	37.8
Mineral products	24.5	10.9
Base metals and articles of metal	20.6	9.2
Chemicals and allied products	18.1	8.0
Textiles and textile articles	16.6	7.4
Iron and steel	7.2	4.3
Total top 5	172.2	77.6

Source: Official Chinese trade statistics

Table 7. Major Chinese Exports: 2000

Commodity	Total ($Billions)	% of Total Exports
Machinery and mechanical appliances, electrical equipment, and sound recorders and reproducers	72.9	29.3
Textiles and textile articles	49.3	19.8
Miscellaneous manufactured products, such as toys, games, etc.	17.8	7.1
Base metals and articles of metal	16.6	6.7
Footwear, headgear, umbrellas, and feather products	12.0	4.8
Total top 5	168.6	67.7

Source: Official Chinese trade data.

Major Challenges Facing the Chinese Economy

China's economy has shown remarkable economic growth over the past several years, and many economists project that it will enjoy fairly healthy growth in the near future. Standards and Poor's DRI, a private international forecasting firm, projects China's GDP will grow at an average annual rate of about 6.7 over the next 15 years. Economists caution, however, that these projections are likely to occur only if China continues to make major reforms to its economy. Failure to implement such reforms could endanger future growth.

- **State-owned enterprises (SOEs)**, which account for about one-quarter of Chinese industrial production and employ nearly two-thirds of urban workers, put an increasingly heavy strain on China's economy. Over half are believed to lose money and must be supported by subsidies, mainly through state banks. Government support of unprofitable SOEs diverts resources away from potentially more efficient and profitable enterprises. In addition, the poor financial state of many SOEs makes it difficult for the government to reduce trade barriers out of fear that doing so would lead to wide-spread bankruptcies of many SOEs.

- **The banking system** faces several major difficulties due to its financial support of SOEs and failure to operate solely on market-based principles. China's banking system is regulated and controlled by the central government, which sets interest rates and attempts to allocate credit to certain Chinese firms. The central government has used the banking system to keep afloat money-losing SOEs by pressuring state banks to provide low interest loans, without which a large share of the SOEs would likely go bankrupt. Currently, about 70% of state-owned bank loans now go to the SOEs, even though a large share of loans are not likely to be repaid. The high volume of bad loans now held by Chinese banks (estimated to total $250 billion) poses a serious threat to China's banking system. Three out of the four state commercial banks are believed to be insolvent. The precarious financial state of the Chinese banking system has made Chinese reformers reluctant to open its banking sector to foreign competition Corruption poses another problem for China's banking system because loans are often made on the basis of political connections. This system promotes widespread inefficiency in the economy because savings are generally not allocated on the basis of obtaining the highest possible returns.

- **China's agricultural system** is highly inefficient due to government policies that seek to maintain a 95% self-sufficiency rate in grains, mainly through the extensive use of subsidies and restrictive trade barrier. These policies divert resources from more productive economic sectors and keep domestic prices for many agricultural products above world prices.

- **Infrastructure bottlenecks**, such as inadequate transportation and energy systems, pose serious challenges to China's ability to maintain rapid economic growth. China's investment in infrastructure development has failed to keep pace with its economic growth The World Bank estimates that transportation bottlenecks reduce China's GDP growth by 1% annually. Chronic power shortages are blamed for holding China's industrial growth to 80% of its potential. Transportation bottlenecks and energy shortages also add inflationary strains to the economy because supply cannot keep up with demand.

- **The lack of the rule of law** in China has led to widespread government corruption, financial speculation, and mis-allocation of investment funds. In many cases, government "connections," not market forces, are the main determinant of successful firms in China. Many U.S. firms find it difficult to

do business in China because rules and regulations are generally not consistent or transparent, contracts are not easily enforced, and intellectual property rights are not protected (due to the lack of an independent judicial system). The lack of rule of law in China limits competition and undermines the efficient allocation of goods and services in the economy. In addition, the Chinese government does not accept the concept of private ownership of land and assets in China

- **High trade barriers** are maintained by the government in large part to protect domestic firms from foreign competition. Such policies have several negative effects. They prevent the most efficient utilization of resources in the economy, give domestic firms less incentive to improve efficiency, and raise prices for Chinese consumers.

- **A wide variety of social problems** have arisen from China's rapid economic growth and extensive reforms, including pollution, a widening of income disparities between the coastal and inner regions of China, and a growing number of bankruptcies and worker layoffs. This poses several challenges to the government, such as enacting regulations to control pollution, focusing resources on economic development in the hinterland, and developing modern fiscal and tax systems to address various social concerns (such as poverty alleviation, health care, education, worker retraining, pensions, and social security).

Recent Chinese Initiatives to Reform the Economy

At a news conference in March 1998, newly appointed Chinese Premier Zhu Rongji outlined a number of major new economic initiatives and goals for reforming China's economy and maintaining healthy economic growth, including:

- Respond to the effects of the Asian financial crisis by not devaluing China's currency, expanding domestic demand (especially through increased spending on infrastructure), and maintaining the pace of previously planned economic reforms.

- Reform and restructure loss-making medium-and-large-sized state-owned enterprises (SOEs) to make them profitable. Reorganize the banking system to increase the regulatory and supervisory power of the central bank and make commercial banks operate independently. Substantially reduce the size of the government and reorganize the remaining government institutions. All three goals to be obtained within three years.

- Commercialize government housing, reform the health insurance system, improve the system the for circulating grain, rationalize the system for approving investment and finance projects, and improve tax collection.

Zhu Rongji's economic plan was viewed at the time by many analysts as representing the most significant restructuring of the economy to date, since it called for a significant reduction

in the size of the government and diminished control over various sectors of the economy, dismantling of much of the remaining "iron rice bowl" of cradle-to grave benefits for government and SOE workers, the commercialization of bank loans, and significant restructuring of the SOEs. Implementation of such policies would take China significantly closer towards a functioning market economy. Progress of these reforms is discussed below.

Reform of State Owned Enterprises

The Chinese leadership has been talking about undertaking major reforms of unprofitable SOEs for the past several years, but has been hesitant to act due to concerns that reforms would lead to widespread bankruptcies and cause political instability. However, the Chinese government has acknowledged that support of SOEs has put a heavy drain on the economy and cannot be maintained indefinitely. As a result, reform of SOEs has been made a top priority. In September 1997, Chinese President Jiang Zemin stated that China would take steps which, if implemented, would essentially privatize (although referred to by the Chinese as "public ownership") all but 1,000 out of an estimated 308,000 SOEs by cutting off most government aid and forcing them to compete on their own. This policy was re-affirmed and expanded upon by Premier Zhu Rongji in March 1998. Under this plan, some unprofitable SOEs would be closed, while others would be merged with more profitable enterprises. Many firms would be allowed to issue stock in order to raise funds. SOEs would also be released from the responsibility of providing subsidized housing. Finally, the government announced that SOEs would no longer receive preferential treatment by state banks for loans.

Reform of the SOEs over the past few years has been relatively uneven. On the one hand, the government has sought to improve SOE efficiency by significantly reducing the number of redundant workers and cutting back on the level of free services (such as education, housing, and health care) given to remaining workers. As a result of these policies, employment by SOEs has fallen sharply in recent years, from its peak of 112.6 million in 1996 to 90.6 million in 1998, to an estimated 81.2 million 1999. Workers who have been laid off from SOEs have been encouraged by the government to find jobs in the private sector or to start their own businesses. On the other hand, the economic slowdown experienced by China in 1998 and early 1999 (due to the Asian financial crisis) caused the government to put additional pressure on state banks to extend loans to SOEs in order to keep production from falling and to boost their competitiveness. In preparation for WTO accession, the Chinese government has announced plans to move ahead with further SOE reform to make them even less reliant on government support. Several large and medium-sized SOEs are being encouraged to raise funds on their own through the issuance of stock. In addition, several sectors of the economy, traditionally dominated by SOEs, reportedly will be opened up to the private sector and foreign firms.

Reform of the Banking System

Chinese officials have indicated a desire to strengthen and reform its banking system. In January 1998, the central government announced it would implement new reforms to enhance the power of the central bank over the provincial and state banks and to improve the management systems of all Chinese banks. Such reforms would attempt to lessen the power of local officials to pressure banks into making "bad loans." In addition, the government has indicated that banks will be allowed to make bank loan decisions based on commercial, rather than political, considerations. Finally, on March 2, 1998, the government announced plans

to issue bonds to recapitalize the state banks to enable them to write off bad loans. Chinese officials claim their long-term goal is to develop a modern banking system similar to that of the U.S. Federal Reserve system. However, the slowdown in the economy caused the central government to resume pressure on the state banks to continue to lend money to money-losing enterprises. In preparation for WTO entry, the government has reaffirmed its commitment to making its banking system more responsive to market forces. It has continued re-capitalizing the banks to enable them to write off bad loans.

Infrastructure Development

The Chinese government's concerns over the disruptive effects of economic reforms and sluggish domestic demand have led the government to significantly boost spending on infrastructure spending. Chinese officials announced in February 1998 their intentions to spend $750 billion on infrastructure development over the next 3 years; in September 1998, Chinese officials indicated that $1.2 trillion would be spent. Many analysts, however, have questioned China's ability obtain funding for such a massive financial undertaking in such a short period of time. The issuance of government bonds has become a major source of finance for infrastructure, which has increased government budget deficits. It appears, however, that infrastructure spending by the government has been a major contributor to China's economic growth over the past few years. However, the government is concerned over the potentially destabilizing effects of increased debt. Efforts have been made in recent years to improve tax collection with mixed success.

Major Issues in China-U.S. Economic Relations

China's growth as a major economic and trading power has expanded U.S.-China commercial ties, although disputes have arisen over a number of issues, such as trade investment barriers, China's most-favored-nation (MFN), or normal trade relations (NTR), status, and the terms for China's accession to the World Trade Organization (WTO). The World Bank projects that by the year 2020, China will be the world's second largest trading economy after the United States. China's continued rapid growth has increased concerns among U.S. policymakers that China's trade regime must be brought in compliance with multilateral rules to ensure that U.S. firms are given access to China's growing markets.

Trade

Total trade between China and the United States rose from $4.8 billion in 1980 to 116.4 billion in 2000, making China the 4th largest U.S. trading partner. China has become a major supplier to the U.S. market of a variety of low-cost U.S. consumer goods, such as toys and games, textiles and apparel, shoes, and consumer electronics and computers, while China has been a major buyer of U.S. aircraft, computers, and machinery. In recent years, U.S. imports from China have far exceeded U.S. exports to China (in 2000, U.S. imports from China totaled $100.1 billion while U.S. exports to China were $16.3 billion). As a result, the U.S. trade deficit with China has surged, reaching nearly $84 billion in 2000. U.S. officials claim that China's pervasive use of trade and investment barriers and restrictions for the relatively lackluster growth of U.S. exports to China, while Chinese officials argue that U.S. export

controls substantially diminish U.S. export sales to China. (see CRS Issue Brief IB91121, *China-U.S. Trade Issues*).

China's Normal Trade Relations Status

On July 22, 1998, President Clinton signed into law P.L. 105-206 (a bill to reform the Internal Revenue Service), which contained a provision replacing the term "most-favored nation (MFN) status" with the term "normal trade relations" (NTR) in U.S. trade law. This change was made to help dispel the belief of some that the term "MFN status" indicates a preferential trade status, when in fact it indicates the trade status afforded by the United States to all but a handful of countries. Under current U.S. law, (Title IV of the 1974 Trade Act, as amended) China's NTR) status must be renewed on an annual basis (based on freedom-of-emigration requirements of the Jackson-Vanik amendment).

From 1980 (when NTR status was restored to China after being suspended in 1951) to 1989, the renewal of China's NTR status was relatively noncontroversial and was relatively unopposed by Congress. However, congressional concern over the Tiananmen Square incident in 1989 and subsequent crackdown on human rights led many Members to support legislation terminating the extension of China's NTR status or to condition that status on additional requirements, mainly dealing with human rights. While none of these measures were enacted, many Members sought to use the annual renewal of China's NTR status as a focal point to express concerns, as well as to pressure the executive branch, over a wide range of Chinese trade (e.g., trade barriers and failure to protect intellectual property rights) and non-trade (e.g., human rights, prison labor, Taiwan security, and weapons proliferation) issues. Several members opposed such linkage, arguing that it had little effect on Chinese policies, and that the often rancourous congressional debate over China's trade status undermined long-term U.S.-Chinese relations and added uncertainty to the trade relationship. Legislation was passed in the 106th Congress (H.R. 4444, P.L. 106-286, see below) to extend permanent normal trade relations (PNTR) status to China upon its entry to the WTO. However, because China did not gain WTO membership by June 3, 2001, President Bush was required to issue a waiver to extend NTR status to China for an additional year. In the House, Representative Rohrabacher has introduced H.J.Res. 50, a measure that would disapprove the President's waiver to extend China's NTR status. On July 12, 2001, the House Ways and Means Committee voted to adversely report out the measure, and on July 19, 2001, the House voted to reject the measure.

China's Accession to the World Trade Organization and PNTR

China has made its accession to the World Trade Organization (WTO) a major priority. On November 15, 1999, U.S. and Chinese officials reached a bilateral agreement on China's WTO bid. China completed its bilateral WTO negotiations when it signed an agreement with Mexico on September 13, 2001, the last of the 37 WTO members that had requested such an accord. On September 17, 2001, China completed negotiations with the WTO Working Party handling its WTO application. China's WTO membership was formally approved by the WTO on November 10, 2001, and on November 11, China informed the WTO that it had ratified the WTO agreements. As a result, China will officially join the WTO on December 11, 2001.

Many analysts contend that, in order to ensure that the United States and China have a relationship in the WTO, the United States must extend PNTR status to China before it

accedes. This is based on the belief that the annual renewal of China's NTR status is inconsistent with WTO rules, which require members to afford each other "unconditional" MFN treatment. Without a change in law, the United States would have to invoke Article XIII in the WTO, the non-applicability clause, prior to China's WTO accession. Invoking Article XIII would technically prevent the United States and China from applying the WTO agreements to one another. If this were to occur, it is uncertain whether U.S. exporters and investors in China would receive the full benefits of the trade concessions China will make to get into the WTO. Due to the uncertainty that would likely govern U.S.-China trade relations if Article XIII was invoked, the Clinton Administration, following the completion of the November 1999 U.S.-China bilateral trade agreement, urged Congress to pass legislation granting PNTR status to China as soon as possible. The House approved PNTR legislation (H.R. 4444) on May 24, 2000, the Senate approved the bill on September 19, 2000, and President Clinton signed the bill on October 10, 2000 (P.L. 106-286). The measure authorizes the President to extend PNTR status to China upon its accession to the WTO as long as the President certifies that the final WTO agreement on the terms of China accession is no less favorable than the November 1999 U.S.-China trade agreement. Additionally, the law contains a number of provisions dealing with such issues as human rights, Chinese prison labor exports, and Chinese compliance with WTO rules.

Outlook for China's Economy

The short term outlook for the Chinese economy remains mixed. China was able to weather the effects of the Asian financial crisis (which first occurred in mid-1997), although this was done at the cost of delaying needed economic reforms to the SOEs and the banking system. Continued support of money-losing SOEs draws resources away from more potentially productive enterprises, and thus undermines future growth. In addition, much of the economic growth that has occurred in recent years has resulted from extensive government spending (mainly on infrastructure projects). Still, China has been able to maintain healthy economic growth in 2001, while much of the world's economy has slowed. China's real GDP is projected to rise by 7.2% in 2001.

The year 2002 will likely pose great challenges for the Chinese economy as trade and investment barriers are lowered, subjecting Chinese firms to more competition. The Chinese government has been hoping that workers who are displaced by economic reforms and increased foreign competition will quickly be able to find jobs in other sectors of the economy, especially China's export industries. However, the September 11, 2001 terrorist attacks against the United States have worsened an already slowing world economy, which will likely significantly reduce foreign demand for Chinese products. As a result, the Chinese government will likely have to take measures (such as increased public spending) to stimulate the domestic economy until the economies of its major trading partners begin to recover.

China's efforts to join the WTO appear to represent a major commitment on the part of the Chinese government to significantly reform its economy and provide greater access to its markets. Some China observers believe that the Chinese government considers accession to the WTO as an important, though painful, step towards making Chinese firms more efficient and able to compete in world markets. In addition, the government hopes that liberalized trade rules will boost foreign investment in China, which has declined in recent years. Economists argue that, over the long-run, greater market openness in China will boost

competition, improve productivity, and lower costs for consumers, as well as for firms using imported goods as inputs for production. Economic resources will more likely be redirected away from money-losing activities (such as SOEs) to more profitable ventures, especially those in China's growing private sector. As a result, China is likely experience more rapid economic growth (than would occur under current economic policies). A study performed by the Chinese government estimates that WTO membership would boost China's GDP by 1.5% annually by 2005 and thereafter.

The Chinese government is deeply concerned with maintaining social stability. Many analysts warn that, if trade liberalization were followed by a severe economic slowdown, leading to widespread bankruptcies and layoffs, the Chinese government might choose to halt or delay certain economic reforms, rather than risk possible political upheaval. An additional problem posed by China's WTO accession will be to get Chinese local and provincial governments to adhere to WTO rules, since many of them impose a variety of protectionist policies to protect firms under their jurisdiction.

Chinese President Jiang Zemin's July 2001 speech urging the inclusion of private sector entrepreneurs as members of the Communist Party reflects the growing importance of the private sector to China's economy. That importance is likely to grow after China joins the WTO when Chinese trade and investment barriers are significantly reduced. This may pose an additional challenge for the Chinese government, which wants to maintain a mixed economy, where the state continues to account for a significant share of industrial production, especially in sectors deemed important to national development (e.g., autos). Increased competition from foreign firms, as well as from China's domestic private sector, may force the Chinese government to eventually choose between privatization and bankruptcy to keep many unprofitable SOEs afloat.