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China's Economic Conditions

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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 to 2004, China's real GDP grew at an average rate of 9.3%. 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 regard to its inefficient state-owned enterprises (SOEs) and the state banking system. Progress in reforming these sectors in recent years has been somewhat mixed.

Trade continues to play a major role in China's booming economy. In 2004, exports rose by 35% to \$593 billion, while imports grew by 36% to \$561 billion — making China the world's third-largest trading economy (after the United States and Germany). China's trade boom is largely the result of large flows of foreign direct investment (FDI) into China (\$64 billion in 2004). Over half of China's trade is accounted for by foreign-invested firms in China.

China experienced some inflationary pressures in 2004, fueled in part by speculation in real estate, over-investment in certain industries, and rising costs for energy and raw materials. The government responded by raising interest rates and using administrative controls to slow investment in certain sectors. Many economists contend that China's policy of pegging its currency (the yuan), which

forces the government to trade yuan for dollars (to keep the peg at 8.3 yuan to the dollar), could boost the level of inflation in China at some point in the future. They also contend that the sharp increase in the monetary supply (due to the peg) may induce Chinese banks to make bad loan decisions and thus increase the level of non-performing loans. Secretary of Treasury John Snow stated that China's currency peg poses a risk to China's economy and that of its trading partners. On July 21, 2005, China announced that it would appreciate its currency to the dollar (to 8.11) and move toward pegging the yuan to a basket of currencies.

China's economy continues to be a concern to U.S. policymakers. On the one hand, China's economic growth presents huge opportunities for U.S. exporters. On the other hand, the surge in Chinese exports to the United States has put competitive pressures on many U.S. industries. Many U.S. policymakers have argued that greater efforts should be made to pressure China to fully implement its WTO commitments and to change various economic policies deemed harmful to U.S. economic interests, such as its currency peg and its use of subsidies to support its SOEs. In addition, recent bids by Chinese state-owned firms to purchase various U.S. firms have raised concerns among Members over the impact such acquisitions could have on U.S. national and economic security.

MOST RECENT DEVELOPMENTS

On July 21, 2005, the Chinese government announced major reforms to its currency policy. It stated that China's currency (the renminbi or yuan) would now be pegged to a basket of currencies (including the dollar), and that the exchange rate of the U.S. dollar against the yuan would be adjusted to 8.11 yuan per US dollar (from 8.28), an appreciation of 2%.

On July 15, 2005, the Chinese government reported that foreign exchange reserves at the end of June 2005 had reached \$711 billion. It also reported that, during the first half of 2005, China's trade surplus totaled \$39 billion and real GDP grew by 9.5%.

On June 22, 2005, CNOOC, a Chinese company made a \$18.5 billion bid to purchase Unocal Corporation, a U.S. energy company. News of the bid raised concern among several Members, many of who contend that the deal would threaten U.S. national security. On June 30, 2005, the House passed H.Res. 344 (Pombo) by a vote of 398 to 15, expressing the sense of the House of Representatives that a Chinese state-owned energy company exercising control of critical United States energy infrastructure and energy production capacity could take action that would threaten to impair the national security of the United States. On the same day, the House passed an amendment (H.Amdt. 431) to an appropriations bill (H.R. 3058) that would prohibit the use of funds from being made available to recommend approval of the sale of Unocal Corporation to CNOOC.

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 undertook large-scale investments in physical and human capital during the 1960s and 1970s. 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 nonexistent. 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, which followed in stages, 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: 1979-2005

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 2004 growing at an average annual rate of 9.3%, making China one of the world's fastest-growing economies. Real GDP grew by 9.5% in the first half of 2005.

Table 1. China's Average Annual Real GDP Growth Rates, 1960-2005

Time Period	Average Annual % Growth
1960-1978 (pre-reform)	5.3
1979-2004 (post-reform)	9.3
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	7.3
2002	8.0
2003	9.1
2004	9.1
2005 (first quarter)	9.5

Sources: Official Chinese government data and estimates by Global Insight.

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 (these now account for half of Chinese domestic savings). As a result, savings as a percentage of GDP has steadily risen; it was around 49% in 2004, among the highest savings rates in the world. (In comparison, the U.S. savings rate is 10.7%).¹

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 caused largely by a reallocation of resources to more productive uses, especially in sectors that were formerly 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 nonstate 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, foreign direct investment (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 2004 was about \$1.6 trillion; its per capita GDP (a commonly used living-standards measurement) was \$1,230. Such data would indicate that China's economy and living standards are significantly lower than those of the United States and Japan, respectively considered to be the number-one and number-two largest economies (see **Table 2**).

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,

¹ Savings defined as aggregate national savings by the public and private sector as a percentage of nominal GDP. Source: *Economist Intelligence Unit* database.

which attempts to convert foreign currencies into U.S. dollars on the basis of 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 Japan are higher), the PPP exchange rate raises the estimated size of Chinese economy to about \$7.5 trillion, significantly higher than Japan's GDP in PPPs (\$3.7 trillion), and about 64% the size of the U.S. economy. PPP data also raise China's per capita GDP to \$5,780. The PPP figures indicate that while the size of China's economy is substantial, its living standards fall far below those of the U.S. and Japan. China's per capita GDP on a PPP basis is only 14.4% of U.S. levels. Thus, even if China's GDP were to overtake that of the United States in the next decade or two, its living standards would remain substantially below those of the United States for many years to come.

Table 2. Comparisons of U.S., Japanese, and Chinese GDP and Per Capita GDP in Nominal U.S. Dollars and PPP, 2004

Country	Nominal GDP (\$ billions)	GDP in PPP (\$ billions)	Nominal Per Capita GDP	Per Capita GDP in PPP
United States	11,728	11,728	40,020	40,020
Japan	4,672	3,719	36,690	29,200
China	1,601	7,512	1,230	5,780

Sources: Economist Intelligence Unit Data Services.

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.

Foreign Direct Investment in China

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 an estimated \$64.0 billion in 2004. The cumulative level of FDI in China stood at \$563 billion at the end of 2004. Analysts predict that FDI will continue to pour into China as investment barriers are reduced under China's WTO commitments and Chinese demand for imports continue to increase. The Economist Intelligence Unit projects that FDI in China will hit \$80 billion by 2009.

Based on cumulative FDI (1979-2004), about 43% of FDI in China has come from Hong Kong. The United States is the second-largest investor in China, accounting for 8.5% (\$48.0 billion) of total FDI, followed by Japan (\$46.8 billion), Taiwan (\$39.6 billion), and the Virgin Islands (\$36.9 billion) and South Korea (\$25.9 billion) (see **Table 3**). U.S. FDI in China for 2004 was \$3.9 billion, accounting for 6.1% of FDI for that year, and ranked 5th after Hong Kong, the Virgin Islands, South Korea, and Japan.² Major U.S. investors in

² The Virgin Islands is a large source of FDI because of its status as a tax haven. Much of the FDI (continued...)

China (based on 2003 sales volumes), include Motorola (\$5,763 million in sales volume), General Motors (\$2,242 million), Dell Computer (\$2,123 million), Hewlett Packard (\$1,341 million), Kodak (\$606 million).³

Table 3. Major Foreign Investors in China: 1979-2004
(\$ billions and % of total)

Country	Cumulative Utilized FDI: 1979-2004		Utilized FDI in 2004	
	Amount (\$ billions)	% of Total	Amount (\$ billions)	% of Total
Total	563.8	100.0	64.0	100.0
Hong Kong	241.6	42.9	19.0	29.7
United States	48.0	8.5	3.9	6.1
Japan	46.8	8.3	5.5	8.6
Taiwan	39.6	7.0	3.1	4.8
Virgin Islands	36.9	6.5	6.7	10.5
South Korea	25.9	4.6	6.2	9.7

Source: Chinese government statistics. Top six investors according to cumulative FDI from 1979 to 2004.

China's Trade Patterns

Economic reforms have transferred China into a major trading power. Chinese exports rose from \$14 billion in 1979 to \$593 billion in 2004, while imports over this period grew from \$16 billion to \$561 billion (see **Table 4**). In 2004, China surpassed Japan as the world's third-largest trading economy (after the United States and Germany). China's trade continues to grow dramatically: In 2003, Chinese exports and imports rose by 35% and 40%, respectively, over 2002 levels. In 2004, exports and imports rose by 35% and 36%, respectively. Chinese exports and imports in 2004 were both more than twice as large as those in 2001. At this pace of growth, China is likely to overtake the United States as the world's largest exporter by the end of the decade.⁴ During the first half of 2005, Chinese exports and imports rose by 32.7% and 14.0%, respectively, over the same period in 2004. China's trade surplus during the first half of 2005 (\$39.3 billion) was higher than the surplus for the entire year in 2004 (\$32.0 billion).

² (...continued)

originating from Hong Kong comes from non-Hong Kong investors, such as Taiwanese.

³ Source: Chinese Ministry of Commerce.

⁴ In comparison, U.S. merchandise exports in 2004 were \$819 billion.

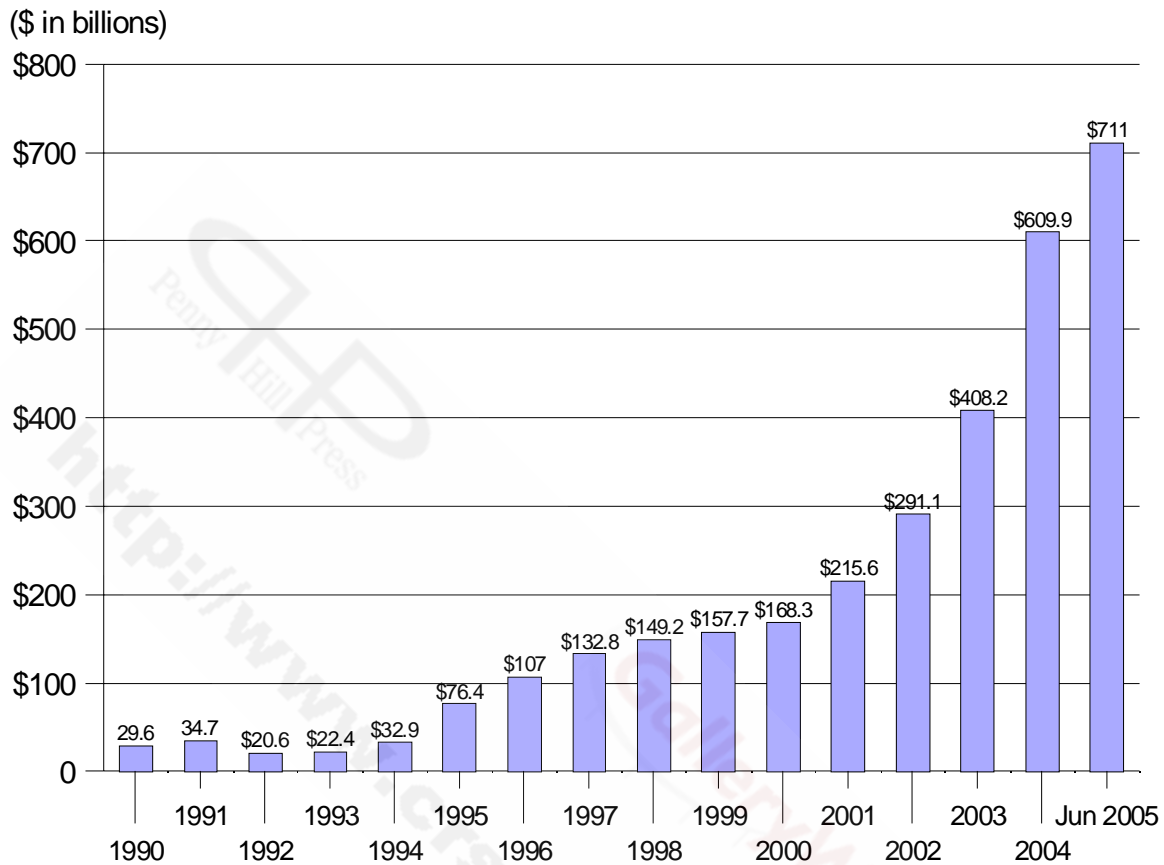
Table 4. China's Merchandise World Trade, 1979-2005
(\$ billions)

Year	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
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	266.2	243.6	22.6
2002	325.6	295.2	30.4
2003	438.4	412.8	25.6
2004	593.4	561.4	32.0
Jan-June 2005	342.3	302.7	39.3

Source: International Monetary Fund, *Direction of Trade Statistics*, and official Chinese statistics.

Merchandise trade surpluses and large-scale foreign investment have enabled China to accumulate the world's second-largest foreign exchange (after Japan), which reached \$711 billion at the end of June 2005. As seen in **Figure 1**, China's accumulation of foreign exchange reserves has been particularly acute over the past few years

**Figure 1. China's Foreign Exchange Reserves,
1990-June 30, 2005**



Source: Official Chinese government data.

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 2004 were the European Union (EU), the United States, Japan, Hong Kong, and the 10 nations that constitute the Association of Southeast Asian Nations (ASEAN) (see **Table 5**). China's largest export markets were the United States, Hong Kong, and the EU, while its top sources for imports were Japan, the EU, and Taiwan (the United States ranked sixth).

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 33.1% in 2004.

A growing level of Chinese exports is from foreign-funded enterprises (FFEs) in China. According to Chinese data, about half of its trade in 2002 was conducted by FFEs. 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 is exported to the United States. Chinese data indicate that the share of China's exports produced by foreign-invested enterprises in China rose from 2% in 1986, to 41% in 1996, to 57% in 2004.

Table 5. China's Top Five Trading Partners: 2004
(\$ billions)

Country	Total Trade	Chinese Exports	Chinese Imports	China's Trade Balance
European Union	177.3	95.9	63.4	32.5
United States	169.7	125.0	44.7	80.3
Japan	167.9	73.5	94.4	-20.9
Hong Kong	112.7	100.9	11.8	89.1
ASEAN*	105.9	42.9	63.0	-20.1

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.

*Association of Southeast Asian Nations (ASEAN) member countries are Indonesia, Malaysia, the Philippines, Singapore, Thailand, Brunei, Cambodia, Laos, Myanmar, and Vietnam.

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 constitute an increasingly larger share of China's trade. A large share of China's imports, such as raw materials, components and parts, and production machinery is used to manufacture products for export. For example, China imports cotton and textile-production machinery to produce textile and apparel items. A substantial amount of China's imports comprises parts and components that are assembled in Chinese factories (major products include consumer electronic products and computers), then exported.

China's top five imports in 2004 were electrical machinery and parts; boilers, machinery, mechanical appliances, and parts; crude oil; plastics; and organic chemicals (see **Table 6**). China's top five exports in 2004 were boilers, machinery, mechanical appliances and parts; electrical machinery and parts; apparel; furniture, bedding, and lamps, and optical, photo, and medical equipment and parts (see **Table 7**).

Table 6. Major Chinese Imports, 2002-2004
(\$ billions)

Commodity	2002	2003	2004	2004/2003 % change
Electrical machinery and equipment and parts; sound recorders and reproducers, television recorders and reproducers, parts and accessories. ^a	26.4	41.9	61.4	46.8
Boilers, machinery, mechanical appliances, and parts. ^b	21.2	29.8	38.6	29.5
Crude oil	12.8	19.8	33.9	71.1
Plastics	17.4	21.0	28.1	33.4
Organic chemicals	11.2	16.0	23.8	48.8

Source: Global Trade Atlas

a. Electronic integrated circuits and micro-assemblies and parts constitute a large share of these imports.

b. Office machines and automatic data-processing machines (such as computers) and parts constitute a large share of these imports.

Table 7. Major Chinese Exports, 2002-2004
(\$billions)

Commodity	2002	2003	2004	2004/2003 % change
Boilers, machinery, mechanical appliances, and parts	50.9	83.4	118.3	41.8
Electrical machinery and equipment and parts; sound recorders and reproducers, television recorders and reproducers, parts and accessories	65.2	89.0	129.7	45.7
Apparel	36.6	45.8	54.8	19.7
Furniture, bedding, and lamps	9.9	12.9	17.3	34.3
Optical, photo, and medical equipment and parts	7.4	10.6	16.3	53.9

Source: Global Trade Atlas.

Major Long-Term 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. However, economists caution 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-third 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 condition of many SOEs makes it difficult for the government to reduce trade barriers out of fear that doing so would lead to widespread bankruptcies among many SOEs.
- **The banking system** faces several major difficulties due to its financial support of SOEs and its 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 number of the SOEs would likely go bankrupt. Currently, over 50% of state-owned bank loans now go to the SOEs, even though a large share of loans are not likely to be repaid. Ernst & Young estimates that the level of nonperforming loans by Chinese banks in 2002 was \$480 billion (equal to about 43% of China's GDP).⁵ The high volume of bad loans now held by Chinese banks 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 the 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.

⁵ Ernst & Young Asia Pacific Financial Solutions, *Nonperforming Loan Report, Asia, 2002*.

- **The lack of the rule of law** in China has led to widespread government corruption, financial speculation, and misallocation 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 the 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.
- **A wide variety of social problems** has 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, education, worker retraining, and pensions). In addition, China faces a serious HIV/AIDS crisis. A 2002 report by the United Nations stated that China was on the verge of “catastrophe that could result in unimaginable suffering, economic loss and social devastation,” due to the rapid rise of HIV/AIDS in China.

Outlook for China’s Economy and Implications for the United States

The short-term outlook for the Chinese economy appears to be positive, but it will likely be strongly influenced by the government’s ability to reform the SOEs and banking system to make them more responsive to market forces, to fully implement its WTO commitments, and to assist workers who lose their jobs due to economic reforms (in order to maintain social stability). Global Insight, an economic forecasting firm, projects that China’s real GDP will grow by 8.4% in 2005 and at an average annual rate of 7.0% from 2006 to 2010.⁶ A 7% GDP growth rate would enable China to double its GDP in 10 years.

China’s rise as an economic superpower is likely to pose both opportunities and challenges for the United States and the world trading system. China’s rapid economic growth has boosted incomes and is making China a huge market for a variety of goods and services. In addition, China’s abundant low-cost labor has led multinational corporations to shift their export-oriented, labor-intensive manufacturing facilities to China. This process has lowered prices for consumers, boosting their purchasing power. It has also lowered costs for firms that import and use Chinese-made components and parts to produce manufactured goods, boosting their competitiveness. Conversely, China’s role as a major international

⁶ Global Insight, *China: Interim Forecast Analysis: Economic Growth*, May 5, 2005.

manufacturer has raised a number of concerns. Many developing countries worry that growing FDI in China is coming at the expense of FDI in their country. Policymakers in both developing and developed countries have expressed concern over the loss of domestic manufacturing jobs that have shifted to China (as well as the downward pressures on domestic wages and prices that may occur from competing against low-cost Chinese-made goods).

Many analysts contend that China's currency policy of pegging its currency (the renminbi or yuan) to the U.S. dollar is having a negative impact on the economies of many of its trading partners by artificially making its exports cheaper, and imports more expensive, than they would be under a floating system. U.S. Secretary of Treasury John Snow has stated that China's currency peg poses a risk to both China's economy and that of its trading partners. As a result, China has come under increasing pressure to reform and/or appreciate its currency. A number of bills have been introduced in Congress, including some that would impose a 27.5% tariff on Chinese goods, and others that would apply U.S. countervailing laws to non-market economies (dealing with government subsidies). However, on July 21, 2005, China announced that the yuan would now be pegged to a basket of currencies (including the dollar), and that the exchange rate of the U.S. dollar against the yuan would be adjusted to 8.11. China announced the currency peg would be allowed to operate within a band of 0.3% daily. Some analysts have speculated the move was meant to stall legislative action in Congress against China, while others contend the move represents the beginning of China's gradual move toward a floating currency. What is still not clear is whether China will allow the yuan to gradually appreciate beyond what it has already done or will intervene in currency markets to maintain the new peg at a relatively constant level. Also, the economic effects of the appreciation are unclear. Some speculate the move will boost U.S. exports to China, and reduce imports from China, but few predict a significant fall in the U.S. trade deficit with China. In addition, some analysts have raised concerns that China's move toward pegging to a basket of currencies may diminish China's purchase of U.S. Treasury securities, which could affect U.S. interest rates.

China is attempting to establish and promote companies that can compete globally, especially in advanced technologies. For example, on December 7, 2004, Lenovo Group Limited, a computer company primarily owned by the Chinese government, purchased IBM's personal computer division. Chinese auto companies have indicated plans begin exporting cars to the United States by 2007. U.S. firms are likely to face increasing competitive pressures from China in a variety of goods and services industries — and not just those that are labor-intensive.

China's rapid economic growth and continued expansion of its manufacturing base are fueling a sharp demand for energy and raw materials, which is becoming an increasingly important factor in determining world prices for such commodities. China is now the world's second largest consumer of oil products (after the United States) at 6.7 million barrels per day, and that level is projected to double to 13.4 million barrels per day by 2025.⁷ According to the U.S. Energy Information Administration, around 40% of world oil demand growth over the past four years came from China and this demand is "a very significant

⁷ Global Insight, Global Petroleum Outlook Forecast Tables (Long-Term), January 2005.

factor in world oil markets.”⁸ China has also reportedly become the largest consumer of steel, cement, and copper.

On June 23, the China National Offshore Oil Corporation (CNOOC), through its Hong Kong subsidiary (CNOOC Ltd.), made a bid to buy a U.S. energy company, UNOCAL, for \$18.5 billion. The bid has raised concern in Congress over the national and economic security implications of such a purchase, especially since CNOOC is largely state-owned and may be receiving extensive subsidies from the government; and many Members have announced opposition to the bid.⁹ China’s possession of large currency reserves, and desire to become a world leader in the production of a variety of goods and strategic commodities will likely lead the Chinese government to expand efforts to take over major international corporations. Many Members charge that China’s use of extensive subsidies to support state-owned firms, especially to fund their takeover bids, threatens U.S. economic interests and may violate China’s WTO commitments. Legislation has been introduced to block the sale.

⁸ U.S. Energy Information Administration website: [<http://www.eia.doe.gov/>].

⁹ For more information, See CRS Report IB91121, *China-U.S. Trade Issues*, by Wayne M. Morrison.