

CRS Report for Congress

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 2005 China's real GDP grew at an average annual rate of 9.7%; it grew by 10.7% in 2006. Many economists speculate that China could become the world's largest exporter within the next few years and the largest economy within a few decades, provided that the government is able to continue and deepen economic reforms, particularly in regard to its inefficient state-owned enterprises (SOEs), the state banking system, and fixed exchange rate system. In addition, China faces several other difficult challenges, such as pollution and growing income inequality, that threaten social stability.

Trade continues to play a major role in China's booming economy. In 2006, exports were estimated to have risen by 27% to \$969 billion, while imports were up by 20% to \$792 billion. This produced an estimated trade surplus of about \$177 billion. From 2003 to 2006, the value of total Chinese trade doubled. China is now the world's third largest merchandise exporter after the European Union and the United States. Well over half of China's trade is conducted by foreign firms operating in China. The combination of trade surpluses, foreign direct investment flows, and large-scale purchases of foreign currency have helped make China the world's largest holder of foreign exchange reserves at nearly \$1.1 trillion as of December 2006.

China's economy continues to be a concern to many U.S. policymakers. On the one hand, U.S. consumers, exporters, and investors have greatly benefitted from China's rapid economic and trade growth. On the other hand, the surge in Chinese exports to the United States has put competitive pressures on various U.S. industries. Many U.S. policymakers have argued that China often does not play by the rules when it comes to trade and they have called for greater efforts to pressure China to fully implement its World Trade Organization (WTO) commitments and to change various economic policies deemed harmful to U.S. economic interests (such as its currency policy and its use of subsidies to support state-owned firms). In addition, China's rising demand for energy and raw materials has raised prices for such commodities and has sharply increased pollution levels, which may have important global implications. An indicator of China's growing global economic importance was seen on February 27, 2007, when a 8.8% drop in China's main stock index contributed to a sharp decline in several foreign exchanges indexes, including in the United States (due to concerns over a possible Chinese economic slowdown).

This report provides an overview and history of China's economic development, challenges China faces to maintain growth, and the implications of China's rise as a major economic power for the United States. This report will be updated as events warrant.

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China's Economic Conditions

The rapid rise of China as a major economic power within a time span of about 28 years is often described by analysts as one of the greatest economic success stories in modern times. From 1979 (when economic reforms were first introduced) to 2006, China's real gross domestic product (GDP) grew at an average annual rate of over 9.7%; in 2006 it grew by about 10.7% (over 2005 levels). The Chinese economy in real terms was 11 times larger in 2006 than it was in 1979, and real per capita GDP was 8 times larger. By some measurements, China is now the world's second largest economy and some analysts predict China could become the largest within a decade.

China's economic rise has led to a substantial increase in U.S.-China economic relations. Total trade between the two countries has surged from \$5 billion in 1980 to an estimated \$343 billion in 2006. For the United States, China is now its 2nd largest trading partner (2006), its 4th largest export market, and its 2nd largest source of imports. Many U.S. companies have extensive manufacturing operations in China in order to sell their products in the booming Chinese market and to take advantage of low cost labor for manufacturing products for exports. These operations have helped U.S. firms remain internationally competitive and have supplied U.S. consumers with a variety of low cost goods. China's large-scale purchases of U.S. Treasury securities have enabled the Federal government to fund its budget deficits and keep U.S. interest rates relatively low.

However, the emergence of China as a major economic superpower has raised concern among many U.S. policymakers. Some express concern over the large and growing U.S. trade deficits with China, which have risen from \$10.4 billion in 1990 to \$233 billion in 2006, and are viewed by many Members as an indicator that U.S.-Chinese commercial relations are imbalanced or unfair. Others claim that China uses unfair trade practices (such as an undervalued currency and subsidies to domestic producers) to flood U.S. markets with low cost goods, and that such practices threaten American jobs, wages, and living standards. A more recent concern has been efforts by Chinese state-owned firms to acquire U.S. companies and China's accumulation of U.S. Treasury securities. Congressional concerns over perceived negative China's economic practices led to the introduction of numerous bills in the 110th Congress, some of which would impose significant tariffs on Chinese products.

This report provides background on China's economic rise and current economic structure (such as GDP, trade, and foreign investment) and challenges, and describes Chinese economic policies that are of concern U.S. policymakers.

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 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 along the coast 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 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: 1979-2006

Since the introduction of economic reforms, China's economy has grown substantially faster than during the pre-reform period (see **Table 1**).¹ From 1960 to 1978, real annual GDP growth was estimated at 5.3% (a figure many analysts claim is overestimated, based on several economic disasters that befell the country during this time, such as the Great Leap Forward and the Cultural Revolution). During the reform period (1979-the present), China's average annual real GDP grew by 9.7%; it grew by an estimated 10.7% in 2006 over the previous year. Since economic reforms were begun, the size of the economy in real terms has increased eleven-fold, and real per capita GDP (a common measurement of living standards) has gone up eight-fold.

Table 1. China's Average Annual Real GDP Growth: 1960-2006

Time period	Average annual % growth
1960-1978 (pre-reform)	5.3
1979-2006 (post-reform)	9.7
1990	3.8
1991	9.3
1992	14.2
1993	14.0
1994	13.1
1995	10.9
1996	10.0
1997	9.3
1998	7.8
1999	7.6
2000	8.4
2001	8.3
2002	9.1
2003	10.0
2004	10.1
2005	9.9
2006	10.7

Source: Official Chinese government data and Economist Intelligence Unit.

¹ In January 2006, China made major revisions to its GDP data for 1993-2004. The revisions indicated that, based on new estimates of growth in the service sector, the size of China's economy and its GDP growth were significantly higher than previously estimated. For example, real GDP growth in 2004 had been originally measured at 9.5%, but the revised figure puts this rate at 10.1%, and the overall size of the economy in 2004 was estimated to be nearly 17% bigger.

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 initiated 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 state-owned enterprises (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 reached nearly 50% in 2005, among the highest savings rates in the world.²

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 the more productive 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 2006 is estimated at about \$2.3 trillion; its per capita GDP (a commonly used living-standards measurement) was \$1,700. 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**).

² In comparison, the U.S. savings rate was about 10% in 2005. Savings defined as aggregate national savings by the public and private sector as a percentage of nominal GDP. (*Economist Intelligence Unit* database.)

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 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 from \$2.7 trillion (nominal dollars) to \$9.9 trillion (PPP dollars), significantly larger than Japan's GDP in PPPs (\$4.1 trillion), and nearly three-fourths the size of the U.S. economy. PPP data also raise China's per capita GDP from \$2,040 (nominal) to \$7,500. 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 17% of U.S. levels. Thus, even if China's GDP were to overtake that of the United States in the next few decades, its living standards would remain substantially below those of the United States for many years to come.

Table 2. Comparisons of United States, Japanese, and Chinese GDP and Per Capita GDP in Nominal U.S. Dollars and PPP, 2006

Country	Nominal GDP (\$ billions)	GDP in PPP (\$ billions)	Nominal Per Capita GDP	Per Capita GDP in PPP
United States	13,226	13,226	44,140	44,140
Japan	4,371	4,088	34,290	32,070
China	2,677	9,862	2,040	7,500

Source: Economist Intelligence Unit.

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 \$63.0 billion in

2005.³ The cumulative level of FDI in China at the end of 2006 stood at nearly \$698 billion. Chinese data for 2006 indicates that actual FDI rose by about 5% over the previous year.

Based on cumulative FDI for 1979-2006 about 40% of FDI in China has come from Hong Kong, 8.3% from Japan, 8.2% from the British Virgin Islands,⁴ and 7.7% from the United States (see **Table 3**). As of 2006, the United States was the 4th largest overall (cumulative) investor in China (at \$54 billion).⁵ It was the 5th largest investor for the year 2006 and accounted for 4.6% (\$2.9 billion) of total. U.S. FDI flows to China peaked at \$5.4 billion in 2002, but have declined each year since.

Table 3. Major Foreign Investors in China: 1979-2006
(\$billions and % of total)

Country	Cumulative Utilized FDI: 1979-2006		Utilized FDI in 2006	
	Amount (\$ billions)	% of Total	Amount (\$ billions)	% of Total
Total	697.5	100.0	63.0	100.0
Hong Kong	279.7	40.1	20.2	32.1
Japan	57.9	8.3	4.6	7.3
British Virgin Islands	57.2	8.2	11.3	17.9
United States	54.0	7.7	2.9	4.6
Taiwan	44.0	6.3	2.2	2.1
South Korea	36.3	5.2	5.2	3.9

Source: Chinese government statistics. Top six investors according to cumulative FDI from 1979 to 2006. Data for 2006 do not reflect FDI in the financial sector (these were included for 2005 data only and are reflected in cumulative totals).

Note: Chinese data on FDI differ significantly from that of investor countries.

³ The Chinese government recently revised its 2005 FDI total from \$60.3 billion to 72.4 billion, claiming previous estimates excluded FDI in the banking, insurance, and securities sectors. However, 2006 FDI does not include the financial sector.

⁴ The British Virgin Islands is a large source of FDI because of its status as a tax haven. Much of the FDI originating from Hong Kong comes from non-Hong Kong investors, such as Taiwanese.

⁵ According to the Chinese Ministry of Commerce, major U.S. investors in China (based on 2003 sales volumes) include Motorola (\$5.8 billion in sales volume), General Motors (\$2.2 billion), Dell Computer (\$2.1 billion), Hewlett Packard (\$1.3 billion), and Kodak (\$0.6 billion).

China's Trade Patterns

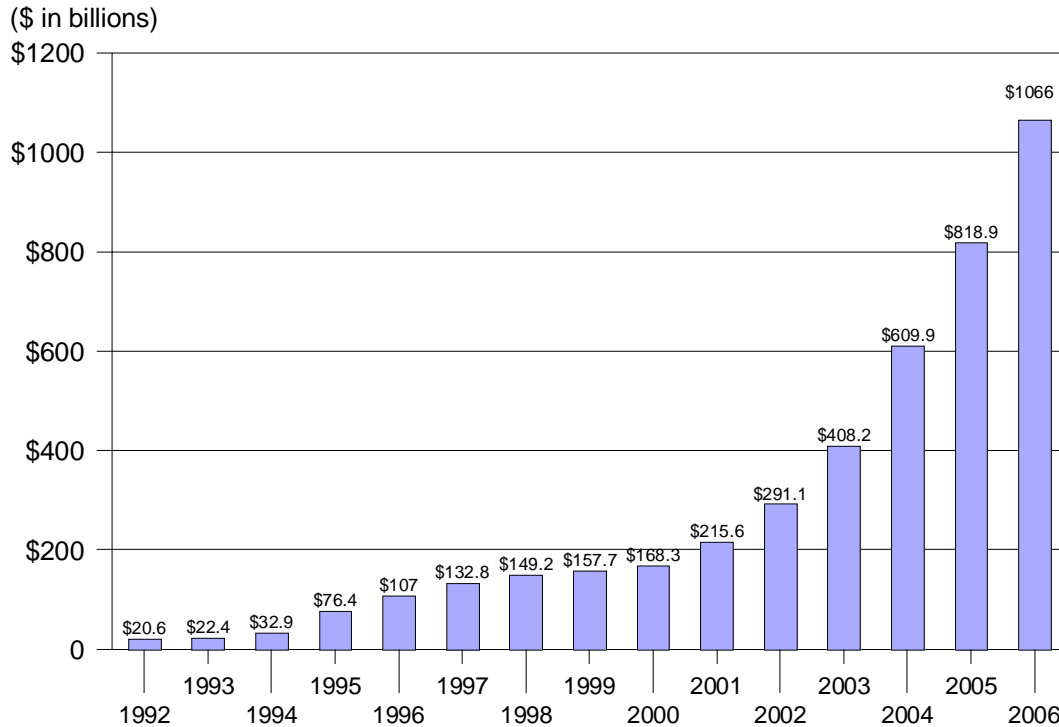
Economic reforms have transferred China into a major trading power. Chinese exports rose from \$14 billion in 1979 to \$969.2 billion, while imports over this period grew from \$16 billion to \$791.5 billion (see **Table 4**). In 2004, China surpassed Japan as the world's third-largest trading economy (after the European Union and the United States). China's trade has grown dramatically in recent years, doubling in size from 2003 to 2006. China's trade surplus, which totaled \$32 billion in 2004, surged to an estimated \$178 billion in 2006.

Table 4. China's Merchandise World Trade, 1979-2006
(\$ billions)

Year	Exports	Imports	Trade balance
1979	13.7	15.7	-2.0
1980	18.1	19.5	-1.4
1985	27.3	42.5	-15.3
1990	62.9	53.9	9.0
1995	148.8	132.1	16.7
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
2005	762.0	660.1	101.9
2006	969.1	791.5	177.6

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

Merchandise trade surpluses, large-scale foreign investment, and its peg to the U.S. dollar have enabled China to accumulate the world's largest foreign exchange reserves. As seen in **Figure 1**, China's accumulation of foreign exchange reserves has been particularly acute over the past few years. China's total reserves reached \$1,066 billion at the end of December 2006.

Figure 1. China's Foreign Exchange Reserves

Source: Official Chinese government data.

China's Major Trading Partners

China's trade data often differ significantly from those of its major trading partners, especially with the United States. This is largely due to the large share of China's trade (both exports and imports) passing 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 2006 were the European Union (EU), Hong Kong, the United States, Japan, 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, the EU, and Hong Kong, while its top sources for imports were Japan, Hong Kong, and the EU (the United States ranked 7th). China maintained substantial trade surpluses with the United States, the EU, and Hong Kong, but had large deficits with Taiwan, South Korea and Japan. China reported that it had a \$144 billion trade surplus with the United States (but U.S. data show that surplus at about \$233 billion).

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 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 nearly 30.0% in 2006.

A growing level of Chinese exports is from foreign-funded enterprises (FFE) in China. According to Chinese data, FFEs were responsible for 58% of Chinese exports in 2006 compared with 41% in 1996. 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 large share of the products made by such firms is likely exported to the United States.

Table 5. China's Major Trading Partners: 2006
(\$ billions)

Country	Total trade	Chinese exports	Chinese imports	China's trade balance
European Union	272.3	182.0	90.3	91.7
Hong Kong	262.8	155.4	107.4	48.0
United States	262.7	203.5	59.2	144.3
Japan	207.6	91.8	115.8	-24.0
ASEAN*	160.8	71.3	89.5	-18.2
South Korea	134.5	44.5	89.8	-45.3
Taiwan	107.8	20.7	87.1	-66.4

Source: China Monthly Statistics.

Note: Chinese data on its bilateral trade often differ substantially from the official trade data of many of its trading partners.

* Association of Southeast Asian Nations (ASEAN) member countries are Indonesia, Malaysia, the Philippines, Singapore, Thailand, Brunei, Cambodia, Laos, Myanmar (Burma), 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 substantial amount of China's imports is comprised of parts and components that are assembled in Chinese factories (major products include consumer electronic products and computers), then exported. China's top 10 exports and imports in 2006 are listed in **Tables 6 and 7**, respectively.⁶

⁶ Based on the Harmonized Tariff Schedule, 4 digit level.

Table 6. Top 10 Chinese Exports: 2006

HS #	Description	Exports (\$billions)	As a % of Total Exports	2006-2006 Percent Change (%)
	Total Exports	969.3	100.0	27.2
8471	Automatic data processing machines and units thereof; magnetic or optical readers, machines for transcribing and processing coded data, NESOI	93.1	9.6	21.8
8525	Transmission apparatus for radiotelephony, radiotelegraphy, radio broadcasting or tv; tv cameras; still image video cameras and recorders	44.2	4.6	42.8
8473	Parts etc for typewriters & other office machines	33.0	3.4	15.5
8529	Parts for television, radio and radar apparatus	25.2	2.6	38.8
8542	Electronic integrated circuits and micro-assemblies; parts thereof	21.6	2.2	47.6
9013	Liquid crystal devices nesoi; lasers; opt appl; pt	13.8	1.4	20.8
8528	Television receivers, including video monitors and video projectors	13.0	1.3	54.2
6110	Sweaters, pullovers, vests etc, knit or crocheted	12.9	1.3	36.7
6204	Women's or girls' suits, ensembles, suit-type jackets, dresses, skirts, divided skirts, trousers, etc.	12.5	1.3	18.0
8517	Electric apparatus for line telephony etc, parts	11.8	1.2	25.1

Source: World Trade Atlas.

Notes: Harmonized Tariff, four-digit level. NESOI means not elsewhere specified or included.

Table 7. Top 10 Chinese Imports: 2006

HS #	Description	Value (\$billions)	Percent of Total (%)	2005-2006 Percent Change (%)
	Total	791,793.9	100.0	19.9
8542	Electronic integrated circuits and micro-assemblies; parts thereof	107,181.8	13.5	30.4
2709	Crude oil from petroleum and bituminous minerals	66,398.1	8.4	38.7
9013	Liquid crystal devices NESOI; lasers; optical appliances and instruments NESOI; parts and accessories thereof	35,903.1	4.5	17.3
2601	Iron ores & concentrates	20,813.3	2.6	13.6
8471	Automatic data processing machines and units thereof; magnetic or optical readers, machines for transcribing and processing coded data, NESOI	19,926.9	2.5	10.6
8529	Parts for television, radio and radar apparatus	19,685.0	2.5	18.8
8473	Parts etc for typewriters & other office machines	19,148.4	2.4	16.3
2710	Oil (not crude) from petrol & bituminous mineral etc.	15,557.4	2.0	49.0
8541	Diodes, transistors and similar devices; photosensitive semiconductor devices; light-emitting diodes; mounted piezoelectric crystals; parts thereof	13,172.4	1.7	17.1
8479	Machines and mechanical appliances having individual functions, NESOI, and parts	9,998.1	1.3	16.4

Source: World Trade Atlas.

Notes: Harmonized Tariff, four-digit level. NESOI means not elsewhere specified or included.

China's Trade with North Korea

North Korea's nuclear test on October 9, 2006, has led many U.S. policymakers to call on China to impose economic sanctions against its neighbor in response to its nuclear activities. China is North Korea's largest trading partner and a major supplier of foreign aid (largely in the form of food and fuel).⁷ In 2005, Chinese exports to, and imports from, North Korea totaled \$1.1 billion and \$497 million, respectively. China accounted for 37.3% of North Korea's exports and 39.8% of its imports. However, North Korea was China's 57th largest export market (0.14% of total) and its 59th largest source of its imports (0.08% of total).

Preliminary Chinese data for 2006 indicate that its imports from North Korea fell by 5.8%, to \$468 million, over the same period in 2005, while its exports rose by 13.6%, to \$1.2 billion. North Korea's ranking for Chinese imports and exports in 2006 fell to 64th and 65th, respectively. According to Chinese data, its top five exports to North Korea (2006) were oil, meat, electrical machinery (such as TVs), machinery, and plastics (see **Table 8**), while its top imports from North Korea were ores, coal, woven apparel, fish, and iron and steel (see **Table 9**).

Table 8. Major Chinese Exports to North Korea: 2003-2006

(\$ millions and % change)

	2003	2004	2005	2006	2005-/2006 % change
Total Exports	628.0	794.5	1,084.7	1,231.9	13.6
Mineral fuel, oil, etc. (mainly oil)	180.7	204.4	285.7	347.5	21.6
Meat (mainly pork)	63.6	140.6	104.2	118.9	7.3
Electrical machinery (such as TVs)	39.6	45.8	56.6	97.6	72.5
Machinery	27.0	39.6	77.1	83.0	7.8
Plastics	24.6	32.0	52.2	52.0	-0.4

Source: *World Trade Atlas*.

⁷ See CRS Report RL31785, *Foreign Assistance to North Korea*, by Mark E. Manyin; and CRS Report RL32493, *The North Korean Economy: Background and Policy Analysis*, by Dick K. Nanto and Emma Chanlett-Avery.

Table 9. Major Chinese Imports From North Korea: 2003-2006
(\$ millions and % change)

	2003	2004	2005	2006	2005-2006 % change
Total Imports	395.5	582.2	496.5	467.7	-5.8
Ores, slag, and ash	15.0	58.9	92.3	118.4	28.3
Mineral fuel, oil, etc. (mainly coal)	17.2	53.0	112.2	102.3	-8.8
Woven apparel	52.2	49.1	58.3	63.3	8.6
Fish and seafood	206.9	261.2	92.4	43.2	-53.2
Iron and steel	46.8	75.0	72.2	35.2	-51.2

Source: *World 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.

- **An inflexible currency policy.** China does not allow its currency to float and therefore must make large-scale purchases of dollars to keep the exchange rate within certain target levels. Although the yuan has appreciated somewhat since reforms were introduced in July 2005, analysts contend that it remains highly undervalued against the dollar. Economists warn that China's currency policy has made the economy overly dependent on exports and fixed investment for growth and has promoted easy credit policies by the banks. These policies may undermine long-term economic stability by causing overproduction in various sectors and could increase the level of non-performing loans held by the banks (see below).⁸
- **State-owned enterprises (SOEs),** which account for about one-third of Chinese industrial production, put a 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

⁸ For further information on the economic consequences of China's currency policy, see CRS Report RL32165, *China's Currency: Economic Issues and Options for U.S. Trade Policy*, by Wayne M. Morrison and Marc Labonte.

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. 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.
- **Growing public unrest.** The Chinese government reported that there were over 87,000 protests (many of which became violent) in 2005 (compared with 53,000 protests in 2003) over such issues as pollution, government corruption, and land seizures.⁹ A number of protests in China have stemmed in part from frustrations among many Chinese (especially peasants) that they are not benefitting from China's economic reforms and rapid growth, and perceptions that those who are getting rich are doing so because they have connections with government officials. Protests have broken out over government land seizures and plant shutdowns in large part due to perceptions that these actions benefitted a select group with connections. A 2005 United Nations report stated that the income gap between the urban and rural areas was among the highest in the world and warned that this gap threatens social stability. The report urged China to take greater steps to improve conditions for the rural poor, and bolster education, health care, and the social security system.¹⁰
- **Growing pollution.** The level of pollution in China continues to worsen, posing serious health risks to the population. The Chinese government often disregards its own environmental laws in order to promote rapid economic growth. According to the World Bank, 16 out of 20 of the world's most polluted cities are in China, with direct

⁹ See CRS Report RL33416, *Social Unrest in China*, by Thomas Lum.

¹⁰ *China's Human Development Report 2005*.

costs to the economy (such as health problems, crop failures and water shortages). According to one government estimate, environmental damage costs the country \$226 billion, or 10% of the country's GDP, each year. The Chinese government estimates that there are over 300 million people living in rural areas that drink unsafe water (caused by chemicals and other contaminants). Toxic spills in China in recent months have threatened the water supply of millions of people. Rising income inequality, particularly between people living in the urban coastal and those living in the inner rural regions of China, has become another source of tension.

- **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 October 2006, the Chinese government formally outlined its goal of building a "harmonious socialist society" by taking steps (by 2020) to lessen income inequality, improve the rule of law, beef up environmental protection, reduce corruption, and improve the country's social safety net (such as expanding health care coverage to rural areas).

Outlook for China's Economy and Implications for the United States¹¹

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, increase the flexibility of its exchange rate policy, 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 average 7.8% over the next 10 years, indicating that China could double the size of its economy in less than 10 years. Real GDP is projected to rise by 9.7% in 2007.¹² China's merchandise exports will likely exceed those of the United States in 2007.

¹¹ For further discussion of this issue, see CRS Report RL33604, *Is China a Threat to the U.S. Economy?*, by Craig K. Elwell, Marc Labonte, and Wayne Morrison.

¹² Global Insight, *China: Interim Forecast Analysis: Economic Growth*, January 10, 2007.

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 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, despite reforms undertaken in July 2005, 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. They have urged China to move toward a floating exchange rate regime as soon as possible, contending that such a move would benefit China's economy and those of its trading partners.¹³ For example, China's accumulation of large foreign exchange reserves has forced it to increase the money supply, which may eventually lead to inflationary pressures on the economy. In addition, many analysts contend that easy money policies have led to over-investment in certain economic sectors. However, Chinese officials have expressed concern that further currency reforms, if implemented too quickly, could prove disruptive to the economy. A number of bills were introduced in the 109th Congress to address Chinese currency policy, including some that would have imposed an additional tariff of 27.5% tariff on Chinese goods unless China appreciated its currency to market levels. Failure by China to implement further reforms to its currency regime could prompt Congress to take up currency-related legislation in the 110th Congress. On the other hand, some analysts have raised concerns that currency reforms may induce China to diminish its purchases 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. In some cases, China has attempted to purchase large foreign companies. For example, in December 2004, Lenovo Group Limited, a computer company primarily owned by the Chinese government, purchased IBM's personal computer division. In June 2005, the China National Offshore Oil Corporation (CNOOC) made a bid to buy a U.S. energy company, UNOCAL, for \$18.5 billion, although strong opposition in Congress forced CNOOC to withdraw its bid. 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

¹³ For a discussion of this issue, see CRS Report RS21625, *China's Currency: A Summary of the Economic Issues*, by Wayne M. Morrison and Marc Labonte.

major international corporations. Many Members charge that China's use of extensive subsidies to support state-owned firms, especially to fund takeover bids, threatens U.S. economic interests and may violate its WTO commitments.

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 2025.¹⁴ 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 factor in world oil markets."¹⁵ China has also reportedly become the largest consumer of steel, cement, and copper.

Some U.S. policymakers have expressed concern over China's rising ownership of U.S. government debt, due to fears that China might attempt to use its holdings as leverage in its dealings with the United States on economic and/or political matters. China is the second largest foreign holder of Treasury securities (after Japan), and both the level of those holdings and China's share of total foreign holdings have increased sharply over the past few years. These went from \$51.8 billion in 1999 to \$350 billion at end of December 2006. China's U.S. Treasury securities holdings as a share of total foreign holdings over this period have grown from 4.1% to 15.8%. Some have raised concerns that threats by China to halt future purchases, or to sell existing holdings, could cause the value of the dollar to depreciate in world markets (raising import prices), increase U.S. interest rates, lead to a decline in U.S. stock and bond markets, and possibly cause the U.S. economy to slow. However, any such disruption to the U.S. economy would also hurt China's economy since about a third of China's exports go to the United States.

¹⁴ Global Insight, Global Petroleum Outlook Forecast Tables (Long-Term), January 2005.

¹⁵ U.S. Energy Information Administration website at [<http://www.eia.doe.gov/>].