Order Code IB98014

China's Economic Conditions

Updated January 12, 2006

Wayne M. Morrison
Foreign Affairs, Defense, and Trade Division

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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 9.6%. 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. 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 2005, exports rose by 28.4% to $762 billion, while imports grew by 17.6% to $660 billion, producing a $102 billion trade surplus. China is now the world's third-largest trading economy after the United States and Germany. China's trade boom is largely the result of large inflows of foreign direct investment (FDI) into China, which totaled $61 billion in 2004 and an estimated $58 billion in 2005. 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 about 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 posed a risk to its economy and that of its trading partners. On July 21, 2005, China announced that it would appreciate its currency to the dollar from 8.28 to 8.11 and replace its dollar peg with "a managed float exchange rate regime" with reference 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 change various economic policies deemed harmful to U.S. economic interests, such as its currency policy and its use of subsidies to support its state-owned firms. 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 January 9, 2005, the Chinese National Bureau of Statistics made major revisions to its estimates of China's GDP from 1993-2004. The new revisions indicate that China's economy grew significantly faster than previously recorded.

On November 21, 2005, the International Monetary Fund urged China to adopt greater flexibility in its currency policy in order to obtain balanced growth and development and to help reduce global trade imbalances.

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 no longer be pegged to the dollar but instead would be a managed float regime with reference to a basket of currencies (including the dollar), and that the exchange rate of the U.S. dollar against the yuan would be adjusted from 8.28 to 8.11 yuan per U.S. dollar, an appreciation of 2.1%.

On June 22, 2005, CNOOC, a Chinese company, made a $18.5 billion bid to purchase Unocal, a U.S. energy company. News of the bid raised concern among several Members, many of who contended that the deal threatened U.S. national security. On August 2, 2005, CNOOC withdrew its bid, citing strong political opposition in the United States. On January 10, 2006, CNOOC announced it had reached $2.3 billion deal to purchase a 45% stake in a block of offshore Nigerian oil fields.

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 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: 1979-2005

Since the introduction of economic reforms, China's economy has grown substantially faster than during the pre-reform period (see **Table 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%. Overall, the size of the economy in 2004 was estimated to be nearly 17% higher than previously thought. Based on these revisions, China's average annual real GDP is estimated to have grown by 9.6% between 1979 and 2005; it grew at by estimated 9.8% in 2005.

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

Time period	Average annual % growth
1960-1978 (pre-reform)	5.3
1979-2005 (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 (estimate)	9.8

Source: Official Chinese government data.

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 49% in 2004, among the highest savings rates in the world.[1]

[1] In comparison, the U.S. savings rate was 10.7% in 2004. Savings defined as aggregate national savings by the public and private sector as a percentage of nominal GDP. (*Economist Intelligence Unit* database.)

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 2005 is estimated at about $1.9 trillion; its per capita GDP (a commonly used living-standards measurement) was $1,460. 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, 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 $1.9 trillion (nominal dollars) to $8.1 trillion (PPP dollars), significantly larger than Japan's GDP in PPPs ($4.0 trillion), and about 65% the size of the U.S. economy. PPP data also raise China's per capita GDP to $6,210.[2] 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 14.7% 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.

[2] These data are estimates from the Economist Intelligence Unit and were made before China's January 2006 revisions to its GDP data (discussed on page 2).

Table 2. Comparisons of United States, Japanese, and Chinese GDP and Per Capita GDP in Nominal U.S. Dollars and PPP, 2005

Country	Nominal GDP ($ billions)	GDP in PPP ($ billions)	Nominal Per Capita GDP	Per Capita GDP in PPP
United States	12,473	12,473	42,180	42,180
Japan	4,605	4,021	36,150	31,560
China	1,912	8,116	1,460	6,210

Source: Economist Intelligence Unit Data Services. 2005 data are estimates.

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 $61 billion in 2004 (it was estimated at $58 billion in 2005). The cumulative level of FDI in China stood at about $618 billion at the end of 2005. 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 continues to increase.

Based on cumulative FDI for 1979-2004, about 43% of FDI in China has come from Hong Kong. The United States is the second-largest overall 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 British Virgin Islands ($36.9 billion) and South Korea ($25.9 billion) (see **Table 3**).[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 British Virgin Islands, South Korea, and Japan.[4] During the first 10 months of 2005, the top foreign investors in China (in terms of realized FDI) were Hong Kong, the British Virgin Islands, Japan, South Korea, and the United States. Actual U.S. FDI in China was down by 24% over the same period in 2004, although contractual FDI was up by 10.5%.

[3] 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).

[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.

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
British 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 $762 billion in 2005, while imports over this period grew from $16 billion to $660 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: From 2002 to 2005, the size of China's exports and imports more than doubled. In 2005, exports and imports rose by 28.4% and 17.6%, respectively. China's trade surplus, which totaled $32 billion in 2004, tripled to $102 billion.

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

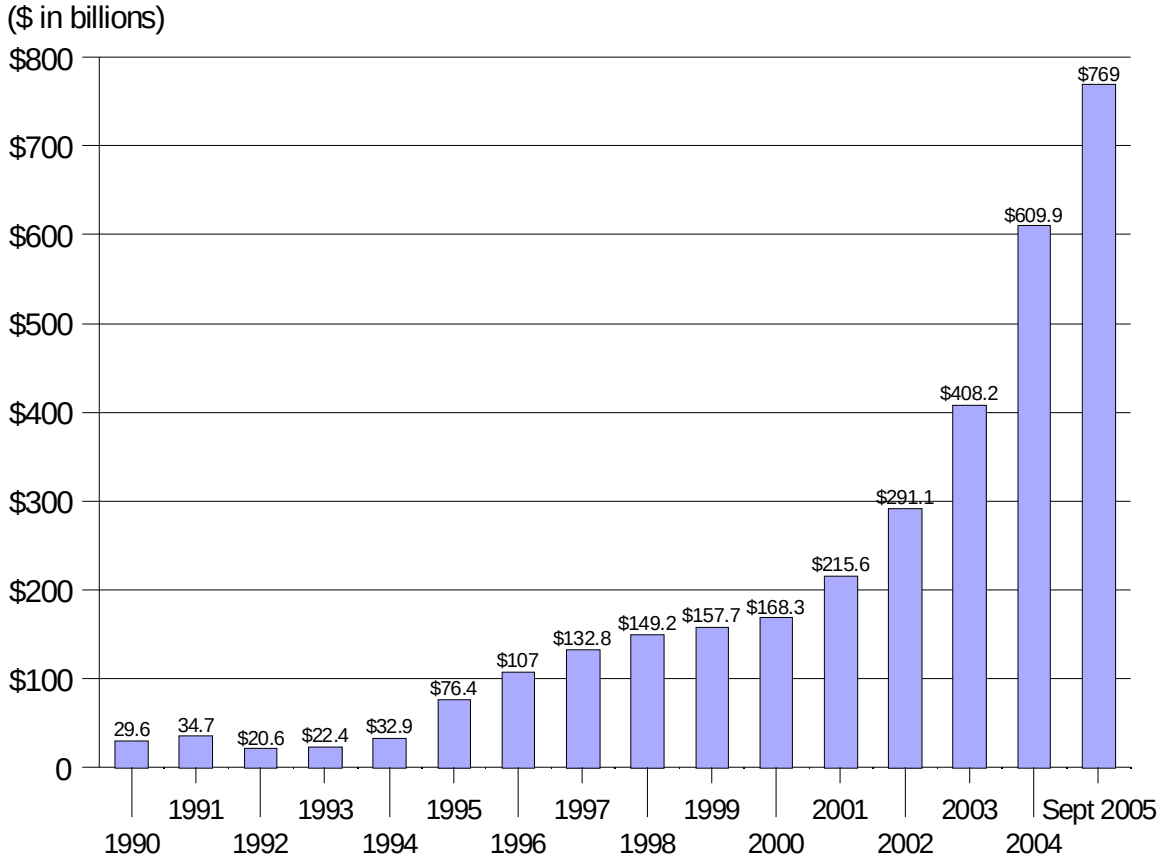
Year	Exports	Imports	Trade balance
1979	13.7	15.7	-2.0
1980	18.1	19.5	-1.4
1981	21.5	21.6	-0.1
1982	21.9	18.9	2.9
1983	22.1	21.3	0.8
1984	24.8	26.0	-1.1
1985	27.3	42.5	-15.3
1986	31.4	43.2	-11.9
1987	39.4	43.2	-3.8
1988	47.6	55.3	-7.7

Year	Exports	Imports	Trade balance
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
2005	762.0	660.1	101.9

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

Merchandise trade surpluses, large-scale foreign investment, and its peg to the U.S. dollar have enabled China to accumulate the world's second largest foreign exchange (after Japan). 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 $769 billion at the end of September 2005, up nearly 50% over the same period in 2004.

Figure 1. China's Foreign Exchange Reserves, 1990-September, 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, FFEs were responsible for 57% of Chinese exports in 2004, 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 significant share of the products made by such firms is likely exported to the United States.

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

Country	Total trade	Chinese exports	Chinese imports	China's trade balance	Trade Balance as Reported by Partner
European Union	177.3	95.9	63.4	32.5	-90.7
United States	169.7	125.0	44.7	80.3	-162.0
Japan	167.9	73.5	94.4	-20.9	-20.5
Hong Kong	112.7	100.9	11.8	89.1	-3.9
ASEAN*	105.9	42.9	63.0	-20.1	N/A

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 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 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, 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 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.

- **Public unrest over pollution, government corruption, and growing income inequality poses threats to social stability.** The Chinese government reported that there were over 74,000 protests (many of which became violent) involving 3.8 million people in 2004 (up from 53,000 protests in 2003) over such issues as pollution, government corruption, and land seizures. Pollution in China continues to worsen, posing series 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, and the direct costs to the economy (such as health problems, crop failures and water shortages) is estimated to be hundreds of billions of dollars yearly. 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

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

living in the inner rural regions of China, has become another source of tension. 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.

- **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.

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 average 8.0% over the next five years, indicating that China could double the size of its economy in less than 10 years.[6] The Economist Intelligence Unit projects that China will become the world's largest exporter by 2010 and the world's largest economy by 2020.

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

[6] Global Insight, *China: Interim Forecast Analysis: Economic Growth*, December 15, 2005.

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.[7] Chinese officials have expressed concern that further currency reforms, if implemented too quickly, could prove disruptive to the economy. A number of bills have been introduced in Congress to address Chinese currency policy, including some that would impose a 27.5% tariff on Chinese goods unless China appreciated its currency to market levels.[8] Failure by China to implement further reforms to its currency regime could prompt Congress to take up currency-related legislation. On the other hand, some analysts have raised concerns that China's move toward a managed float tied 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. 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 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.[9] 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

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

[8] For a listing of these bills, See CRS Issue Brief IB91121,*China-U.S. Trade Issues*, by Wayne M. Morrison.

[9] Global Insight, Global Petroleum Outlook Forecast Tables (Long-Term), January 2005.

factor in world oil markets."[10] 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 $252.2 billion as of September 2005. China's U.S. Treasury securities holdings as a share of total foreign holdings over this period have grown from 4.1% to 12.1%. China's Treasury securities holdings as a percent of total privately held U.S. Treasury securities rose from 1.6% to 6.4%. 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.

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