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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 1979-2002, China's real annual GDP averaged 9.3%; it rose by 8.0% in 2002. Many economists speculate that China could become the world's largest economy at some point in the near future, provided that the government is able to continue and deepen economic reforms, particularly in regards to its efficient state-owned enterprises (SOEs) and state banking system. Progress in reforming these sectors in recent years has been somewhat mixed.

After many years of difficult negotiations, China became a member of World Trade Organization (WTO) on December 11, 2001. WTO accession commits China to significantly reducing a wide variety of tariff and non-tariff barriers over the next few years. Shortly afterwards, President Bush extended permanent normal trade relations (PNTR) status to China. Previously, normal trade relations status had to be extended on an annual basis.

If fully implemented, the terms of China's WTO accession will likely have a signifi-

cant impact on China's economy. The level of Chinese trade protectionism will be greatly diminished over the next few years, and nearly all sectors of China's economy (including agriculture, manufacturing, and services) will increasingly be subject to great competition. Several of China's heavily protected industries, such as autos, and certain agricultural sectors, could be negatively affected by China's WTO membership. China's labor-intensive industries, especially textiles and apparel, will likely benefit significantly with China's WTO accession. A major challenge for the government is to develop an adequate social safety net to assist laid-off workers.

China's economy remained relatively healthy in 2002, despite economic slowdowns in other parts of the world. Foreign investment continued to pour into China, and the Chinese government effectively used public spending to boost the economy. However, painful economic reforms will be necessary to keep the economy strong in 2003 and beyond. In addition, the recent outbreak of a very contagious virus called Severe Acute Respiratory Syndrome (SARS) in China appears to have had a short-term negative impact on the Chinese economy.

## **MOST RECENT DEVELOPMENTS**

On July 20, 2003, China reported that real GDP increased by 8.2% in the first half of 2003 over the same period in 2002.

On June 23, 2003, the World Health Organization dropped China and Hong Kong from a list of countries it had issued travel warning for, due to the outbreak of a contagious virus called Severe Acute Respiratory Syndrome (SARS). However, the virus caused disruptions in a number of Chinese industries, especially tourism.

## **BACKGROUND AND ANALYSIS**

### **An Overview of China's Economic Development**

#### **China's Economy Prior to Reforms**

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

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

#### **The Introduction of Economic Reforms**

Beginning in 1979, China launched several economic reforms. The central government initiated price and ownership incentives for farmers, which enabled them to sell a portion of their crops on the free market. In addition, the government established four special economic zones for the purpose of attracting foreign investment, boosting exports, and importing high technology products into China. Additional reforms followed in stages that sought to decentralize economic policymaking in several economic sectors, especially trade. Economic control of various enterprises was given to provincial and local governments, which were generally allowed to operate and compete on free market principles, rather than

under the direction and guidance of state planning. Additional coastal regions and cities were designated as open cities and development zones, which allowed them to experiment with free market reforms and to offer tax and trade incentives to attract foreign investment. In addition, state price controls on a wide range of products were gradually eliminated.

## China's Economic Growth Since Reforms: 1979-2002

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 2002 growing at an average annual rate of 9.3%, making China one of the world's fastest growing economies. The World Bank estimates that China's economic reforms have raised nearly 200 million people out of extreme poverty. The Chinese government estimates that real GDP rose by 8.0% in 2002.

**Table 1. China's Average Annual Real GDP Growth Rates: 1960-2002**

Time Period	Average Annual % Growth
1960-1978 (pre-reform)	5.3
1979-2002 (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

**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 begun in 1979, domestic savings as a percentage of GDP stood at 32%. However, most Chinese

savings during this period were generated by the profits of SOEs, which were used by the central government for domestic investment. Economic reforms, which included the decentralization of economic production, led to substantial growth in Chinese household savings (which now account for half of Chinese domestic savings). As a result, savings as a percentage of GDP has steadily risen; it was 40.1% in 2001, among the highest savings rates in the world.

China's trade and investment reforms and incentives led to a surge in foreign direct investment (FDI), which has been a major source of China's capital growth. Annual utilized FDI in China grew from \$636 million in 1983 to nearly \$53 billion in 2002. It is estimated that there are over 420,000 foreign-funded enterprises in China, with a cumulative level of FDI of \$448 billion. FDI in China in 2002 grew by nearly 13%, an impressive figure considering that worldwide FDI in developing countries fell by over 25%, according to the United Nations Conference on Trade and Development. 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 United Nations estimates that in 2002, China replaced the United States as the world's largest recipient of FDI. The Chinese government predicts that FDI will reach over \$100 billion by 2006.

Nearly half of FDI in China has come from Hong Kong. The United States is the second largest investor in China, accounting for 8.9% (\$39.8 billion) of total FDI in China from 1979 to 2002 (see **Table 2**). U.S. FDI in China for 2002 was \$5.4 billion, accounting for 10.2% of FDI for that year. U.S. FDI in China in 2002 was over 22% higher than 2001 levels, while Taiwan's FDI increased by over 33%.

**Table 2. Major Foreign Investors in China: 1979-2002**  
(\$ billions and % of total)

Country	Cumulative Utilized FDI: 1979-2002		Utilized FDI in 2002		
	Amount (\$billions)	% of Total	Amount (\$billions)	% of Total	% Change Over 2001 Levels
Total	448.2	100.0	52.7	100.0	12.5
Hong Kong	205.6	45.9	17.9	34.0	-6.4
United States	39.8	8.9	5.4	10.2	22.3
Japan	36.6	8.2	4.2	8.0	-3.7
Taiwan	33.2	7.4	4.0	7.6	33.2
Singapore	15.3	3.3	2.3	6.3	8.9

**Source:** Chinese government statistics. Top 5 investors according to cumulative FDI from 1979-2002.

Several economists have concluded that productivity gains (i.e., increases in efficiency in which inputs are used) were another major factor in China's rapid economic growth. The improvements to productivity were largely caused by a reallocation of resources to more productive uses, especially in sectors that were formally heavily controlled by the central government, such as agriculture, trade, and services. For example, agricultural reforms

boosted production, freeing workers to pursue employment in more productive activities in the manufacturing sector. China's decentralization of the economy led to the rise of non-state enterprises, which tended to pursue more productive activities than the centrally controlled SOEs. Additionally, a greater share of the economy (mainly the export sector) was exposed to competitive forces. Local and provincial governments were allowed to establish and operate various enterprises on market principles, without interference from the central government. In addition, FDI in China brought with it new technology and processes that boosted efficiency.

## Measuring the Size of China's Economy

The actual size of the China's economy has been a subject of extensive debate among economists. Measured in U.S. dollars using nominal exchange rates, China's GDP in 2001 was about \$1.2 trillion; its per capita GDP (a commonly used living-standards measurement) was \$875. Such data would indicate that China's economy and living standards were significantly lower than those of the United States and Japan, considered to be the number one and number two largest economies, respectively (see **Table 3**).

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

Because prices for many goods and services are significantly lower in China than in the United States and other developed countries (while prices in Japan are higher), the PPP exchange rate raises the estimated size of Chinese economy to about \$5.6 trillion, significantly higher than Japan's GDP in PPPs (\$3.5 trillion), and about half the size of the U.S. economy. PPP data also raise China's per capita GDP to \$4,300. The PPP figures indicates that, while the size of China's economy is substantial, its living standards fall far below those of the U.S. and Japan. The International Monetary Fund estimates that (using PPP measurements) China could surpass the United States as the world's largest economy as early as the year 2007. Yet, even if that were to occur, it would take China significantly longer to achieve U.S. standard of living levels.

**Table 3. Comparisons of U.S., Japanese, and Chinese GDP and Per Capita GDP In Nominal U.S. Dollars and PPP: 2001**

Country	Nominal GDP (\$Billions)	GDP in PPP (\$Billions)	Nominal Per Capita GDP	Per Capita GDP in PPP
U.S.	10,082	10,082	36,300	36,300
Japan	4,148	3,450	32,636	27,200
China	1,179	5,560	923	4,300

**Sources:** DRI-WEFA, Country Outlook, First Quarter, 2002 and CIA, World Factbook.

**Note:** PPP data for China should be interpreted with caution. China is not a fully developed market economy; the prices of many goods and services are distorted due to price controls and government subsidies.

## China's Trade Patterns

Economic reforms have transferred China into a major trading power. Chinese exports rose from \$14 billion in 1979 to \$326 billion in 2002, while imports over this period grew from \$16 billion to \$295 billion (see **Table 4**). China is currently the world's 6<sup>th</sup> largest trading nation (based on 2001 data). Despite the worldwide economic slowdown, China's exports in 2002 rose by 22.3%, while imports grew by 21.2%.

Historically, China has run trade deficits in some years and surpluses in others. However, over the past 9 years, China has run trade surpluses; in 2002 that surplus was \$30.5 billion. Merchandise trade surpluses and large-scale foreign investment have enabled China to accumulate the world's second largest foreign exchange reserves, estimated to have reached \$243 billion in June 2002.

**Table 4. China's Merchandise World Trade: 1979-2002**  
(\$ billions)

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



	Exports	Imports	Trade Balance
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

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

## 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 2002 were Japan, the United States, Hong Kong, Taiwan, and South Korea (see **Table 5**). Chinese data show the United States as China's largest destination for its exports and the fourth largest source of its imports.

**Table 5. China's Top 5 Trading Partners: 2002**  
(\$ billions)

Country	Total Trade	Chinese Exports	Chinese Imports	China's Trade Balance
Japan	102.0	48.5	53.5	-5.0
U.S.	97.2	70.0	27.2	42.8
Hong Kong	69.3	58.5	10.8	44.7
Taiwan	44.7	6.6	38.1	-31.5
S. Korea	34.1	15.5	28.6	-13.1

**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.

U.S. trade data indicate that the importance of the U.S. market to China's export sector is likely much higher than is reflected in Chinese trade data. Based on U.S. data on Chinese exports to the United States (which, as noted, do not agree with Chinese data), and Chinese data on total Chinese exports, it is estimated that Chinese exports to the United States as a share of total Chinese exports grew from 15.3% in 1986 to an estimated 38.5% in 2002.

A growing level of Chinese exports are 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 are exported to the United States.

## Major Chinese Trade Commodities

China's abundance of cheap labor has made it internationally competitive in many low cost, labor-intensive, manufactures. As a result, manufactured products comprise an increasingly larger share of China's trade. The share of Chinese manufactured exports to total exports rose from 50% in 1980 to 90% in 2000, while manufactured imports as a share of total imports rose from 65% to 84%. A large share of China's manufactured imports are comprised of intermediates (e.g., chemicals, electronic components, and textile machinery) used in manufacturing products in China.

Major Chinese imports in 2001 included mechanical and electrical equipment, high tech products, electronic integrated circuits and components, crude oil, plastics (see **Table 6**). China's major 2002 exports included mechanical and electrical products, high tech products, clothing, textiles, and computers (see **Table 7**).

**Table 6. Major Chinese Imports: 2002**

Commodity	Total (\$Billions)	% of Total Imports	% Change Over 2002 Levels
Mechanical & electrical products	120.5	40.8	29.1
High-tech products	64.1	21.7	29.2
Integrated circuit & electronic components	16.6	5.6	54.6
Crude oil	11.7	4.0	9.4
Primary plastics	11.7	4.0	13.7
<b>Total top 5</b>	<b>224.6</b>	<b>76.1</b>	<b>— .</b>

**Source:** Official Chinese trade data.

**Table 7. Major Chinese Exports: 2002**

Commodity	Total (\$Billions)	% of Total Exports	% Change over 2001 Levels
Mechanical & electrical products	118.8	36.5	32.3
High tech products	46.5	14.3	46.1
Clothing and accessories	36.6	11.1	12.7
Textile yarn, fabrics, and their products	16.8	5.2	22.2
Automatic data processing machines (computers)	8.0	2.5	64.4
Total top 5	226.7	69.6	—

Source: Official Chinese trade statistics.

## Economic Aspects of the SARS Epidemic in China

SARS, a new and deadly disease, is believed to have originated in Guangdong Province in China around November 2002. It soon spread to other regions and subsequently to 17 countries (by mid-April 2003). Initially, the Chinese government claimed that it had SARS under control, but later admitted (on April 5, 2003) that the outbreak of the disease was far more serious than it had previously admitted. Chinese officials subsequently pledged closer cooperation with international health agencies, such as the World Health Organization (WHO), to fight the disease. The WHO estimated that by May 14, 2003, there were 5,124 SARS cases in China and 267 SARS-related deaths.

The economic effects of the spread of the SARS epidemic appears to have begun to occur in March 2003 and intensified after the WHO issued warnings on April 7, 2003, against nonessential travel to Guangdong Province and on April 16, 2003 against nonessential travel to Beijing and Shanxi Province. Another blow came when the Chinese government admitted on April 20, 2003, that the spread of the SARS virus was far more extensive than it had previously admitted. The immediate effect of these events was a sharp drop in air travel to and from China followed by widespread cancellations by foreigners of tours and hotel reservations. Next, many foreign business representatives postponed trips to China. A number of international meetings, exhibitions, conferences and sporting events were, and have been, cancelled. Fears over the disease began affecting consumer spending in many cities, as individuals sought to avoid crowded areas, such as shops and restaurants. In Beijing, recreational facilities, such as movie houses and health clubs, were ordered shut down in several cities by the government in order to contain the virus.

The cumulative or long-term economic effects of SARS on the Chinese economy are difficult to predict since there are no clear indicators when the virus will be effectively eradicated or controlled (as new outbreaks could still occur) and because fear of the disease has had a much bigger impact on economic activity than has the cost of responding to the virus. It will also take time before the effects of the virus will be reflected in economic data. Restoring normal economic activity in China will thus depend, not only on the ability of the Chinese government to check the virus, but also its ability to convince its population as well as foreign businesspeople that it has in fact contained the virus. Projections of the economic

effects of SARS on China's real GDP in 2003 range from -0.2% by the International Monetary Fund (assuming SARS lasts one quarter) to -1.2% by China's State Council (if SARS lasts the entire year).

**The Service Sector.** Tourism appears to have been one of the hardest hit economic sectors in China. Foreign tourism accounted for 1.5% of GDP in 2001, while domestic travel accounted for 3.7% of GDP. The SARS virus led to a sharp drop in foreign travel to China in April-May, while domestic travel during the May Day holidays was significantly curtailed. This in turn has impacted service industries catering to foreign tourists, foreign business travelers, and domestic travelers, such as hotels, restaurants, caterers, tour companies, and local vendors. Chinese statistics indicate that the number of stay-over tourists fell by 42% in April 2003 over April 2002 levels. In Beijing, the number of tourists dropped by nearly 94% in May 2003 over May 2002 levels; hotel occupancy rates of 5-star hotels reportedly fell to 20% and some were at zero. A group of scholars from the Peking University predicted that SARS would cost China's tourism industry about \$16.9 billion. China Southern Airlines reported that its passenger traffic in May fell 83% year on year. According to the Official Airline Guide (OAG), a leading source of information on international flight schedules, the number of planned flights to and from China in June 2003, has fallen by 45% compared with June 2002, and the number of planned flights within China has fallen by 15%. The Chinese government reported that national retail sales in May rose by 4.3% year on year, the lowest growth in 5 years; in Beijing retail sales for the month fell by 9.6%.

**Foreign Trade and Investment.** China's most recent data on foreign trade show little signs that SARS has begun to slow China's rapid trade growth. In 2002, exports and imports grew by 22.3% and 21.2%, respectively. China reported that exports in May 2003 were up 37.3% over 2002 levels, while imports were up 40.9%. For January-May 2003 exports and imports up 34.3% and 45.5%, respectively. However, analysts warn that the effects of SARS will likely show up in later data due to a decline in export orders that has occurred, largely because buyers have put off visiting China to place their orders. For example, one of China's largest bi-annual trade fair in Guangzhou (Guangdong Province) was closed down after four days (on April 19<sup>th</sup>) due to SARS. The dollar level of purchase contracts signed (\$3.3 billion) reportedly was equal to less than one-fifth of last year's total (\$18.5 billion). Guangdong (which was one of the most affected provinces from SARS) is China's largest provincial exporter, accounted for 37% of China's exports in 2002. Credit Suisse First Boston estimates that SARS has reduced orders for Chinese exporters by 10-15%. Because it generally takes three to six months lag time between export orders and their production and delivery, the negative effects of SARS on China's exports is likely to be reflected in third and fourth quarter 2003 trade data.

FDI continues to show rapid growth in 2003. From January to May 2003, actual FDI in China rose by 48.2%, while contractual investment grew by 42.2%, over January-May 2002 levels. However, contractual investment in May 2003 increased by only 17.6% year on year. This could be an indication that the sharp reduction in foreign business representatives visiting China due to SARS may have begun to affect the number of new contracts being signed, which could result in a slowdown in the level of actual FDI going to China in 2003. *Credit Suisse First Boston* estimates that SARS will reduce FDI in China by \$3 billion in 2003 and \$4-6 billion in 2004. The longer term outlook for FDI in China is unclear. Some analysts argue that the lack of transparency and poor health care system may

undermine investor confidence in China, while others contend that China's large, low cost, labor supply will continue to attract large amounts of FDI.

**Production and Employment.** Little information has surfaced about the employment and effects of SARS. Press reports indicate that only a few foreign firms in China have experienced production disruptions due to SARS. Analysts warn, however, that precautions taken to avoid spread of the virus and delays in visits to China by foreign business representatives will interfere with work and deliveries. In addition, several foreign companies are delaying the launching of new products, opening new plants, or starting new joint ventures. *Export Development Canada* contends that SARS has had a serious impact on millions of small-and medium-sized enterprises. One possible indicator of a possible production slowdown is the latest figure on industrial output, which grew by 13.7% in May 2003 over May 2002 — this was the lowest monthly year on year increase since August 2002. One major group that has been acknowledged by Chinese officials to have likely been significantly affected by SARS is China's large migrant worker population, estimated to number over 80 million people. According to Chinese government estimates, 5.5 million migrant workers fled urban areas because of SARS. The exodus has led to labor shortages in some cities, but the main impact is expected to be on rural incomes (as many migrant workers transmit part of their incomes back home). China's *Xinhua News Agency* reported that migrant workers could lose \$4.8 billion by the end of the year, and that rural incomes would fall by 1.5 to 2.0 percentage points, due to SARS.

**Public Finance.** The SARS virus will likely have a significant effect on China's public finance system. First, tax revenues have likely fallen from the effects of SARS on economic activities. A Chinese government tax official estimates that SARS will cost the government \$2.4 to \$3.6 billion in lost revenues. Secondly, the government has pledged to provide extensive tax incentives, tax cuts and fee reductions (estimated at costing the government \$1.2 to \$2.4 billion) for sectors most affected by SARS. Thirdly, the Chinese government has pledged to spend \$725 million to fight SARS (including providing free medical services to needy farmers and urban workers) and an additional \$423 million to improve nationwide health care coverage. Finally, many analysts predict that China will attempt to boost government spending, such as on infrastructure development, in order to offset the negative affects of SARS. These factors will likely put new strains on central and provincial budgets. According to the World Bank, China's growing public debt, which as a share of GDP has risen from 11.4% in 1997 to 25.3% in 2002, is hampering the ability of the government to devote resources to social sectors.

**China's Health Care System.** The SARS contagion has focused new attention on China's public health system for a variety of reasons. First has been concern that the lack of a comprehensive health care system could allow contagious diseases, such as SARS, to spread throughout the country unchecked. This was especially of concern when millions of migrant workers returned home due to the SARS outbreak who, if left unchecked, might have spread the virus throughout China, resulting in a social and economic disaster. Secondly, the spread of SARS has raised new concern over the growing disparity in health care insurance and services available to urban and rural workers. The lack of health care for many workers has also raised concerns that it could undermine China's attraction as a destination for FDI (i.e., if foreign investors perceive that China cannot effectively deal with contagious epidemics, and that their operations in China could be easily disrupted as workers get sick, they may be more reluctant to invest in China). Finally, a number of Chinese and

foreign analysts contend that the poor state of China's health care system poses a long-term threat to China's future economic development.

## 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. DRI-WEFA, a private international forecasting firm, projects China's GDP will grow at an average annual rate of over 7.0% over the next several years. At this rate, China would be able to double its GDP every 10 years. 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-quarter of Chinese industrial production and employ nearly two-thirds of urban workers, put an increasingly heavy strain on China's economy. Over half are believed to lose money and must be supported by subsidies, mainly through state banks. Government support of unprofitable SOEs diverts resources away from potentially more efficient and profitable enterprises. In addition, the poor financial state of many SOEs makes it difficult for the government to reduce trade barriers out of fear that doing so would lead to wide-spread bankruptcies of many SOEs.
- **The banking system** faces several major difficulties due to its financial support of SOEs and failure to operate solely on market-based principles. China's banking system is regulated and controlled by the central government, which sets interest rates and attempts to allocate credit to certain Chinese firms. The central government has used the banking system to keep afloat money-losing SOEs by pressuring state banks to provide low interest loans, without which a large share of the SOEs would likely go bankrupt. Currently, 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 high volume of bad loans now held by Chinese banks (estimated to total \$250 billion) poses a serious threat to China's banking system. Three out of the four state commercial banks are believed to be insolvent. The precarious financial state of the Chinese banking system has made Chinese reformers reluctant to open its banking sector to foreign competition. Corruption poses another problem for China's banking system because loans are often made on the basis of political connections. This system promotes widespread inefficiency in the economy because savings are generally not allocated on the basis of obtaining the highest possible returns.
- **China's agricultural system** is highly inefficient due to government policies that seek to maintain a 95% self-sufficiency rate in grains, mainly through the extensive use of subsidies and restrictive trade barrier. These

policies divert resources from more productive economic sectors and keep domestic prices for many agricultural products above world prices.

- **Infrastructure bottlenecks**, such as inadequate transportation and energy systems, pose serious challenges to China's ability to maintain rapid economic growth. China's investment in infrastructure development has failed to keep pace with its economic growth. The World Bank estimates that transportation bottlenecks reduce China's GDP growth by 1% annually. Chronic power shortages are blamed for holding China's industrial growth to 80% of its potential. Transportation bottlenecks and energy shortages also add inflationary strains to the economy because supply cannot keep up with demand.
- **The lack of the rule of law** in China has led to widespread government corruption, financial speculation, and mis-allocation of investment funds. In many cases, government "connections," not market forces, are the main determinant of successful firms in China. Many U.S. firms find it difficult to do business in China because rules and regulations are generally not consistent or transparent, contracts are not easily enforced, and intellectual property rights are not protected (due to the lack of an independent judicial system). The lack of rule of law in China limits competition and undermines the efficient allocation of goods and services in the economy. In addition, the Chinese government does not accept the concept of private ownership of land and assets in China
- **A wide variety of social problems** have arisen from China's rapid economic growth and extensive reforms, including pollution, a widening of income disparities between the coastal and inner regions of China, and a growing number of bankruptcies and worker layoffs. This poses several challenges to the government, such as enacting regulations to control pollution, focusing resources on economic development in the hinterland, and developing modern fiscal and tax systems to address various social concerns (such as poverty alleviation, education, worker retraining, pensions, and social security). In addition to SARS, China faces a series 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.

## Major Issues in China-U.S. Economic Relations

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

## **China's Accession to the World Trade Organization**

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

## **China's Normal Trade Relations Status**

On July 22, 1998, President Clinton signed into law P.L. 105-206 (a bill to reform the Internal Revenue Service), which contained a provision replacing the term "most-favored nation (MFN) status" with the term "normal trade relations" (NTR) in U.S. trade law. This change was made to help dispel the belief of some that the term "MFN status" indicates a preferential trade status, when in fact it indicates the trade status afforded by the United States to all but a handful of countries. Prior to January 2002, U.S. law (Title IV of the 1974 Trade Act, as amended) required China's NTR status to be renewed on an annual basis (based on freedom-of-emigration requirements of the Jackson-Vanik amendment).

From 1980 (when NTR status was restored to China after being suspended in 1951) to 1989, the renewal of China's NTR status was relatively noncontroversial and was relatively unopposed by Congress. However, congressional concern over the Tiananmen Square incident in 1989 and subsequent crackdown on human rights led many Members to support legislation terminating the extension of China's NTR status or to condition that status on additional requirements, mainly dealing with human rights. While none of these measures were enacted, many Members sought to use the annual renewal of China's NTR status as a focal point to express concerns, as well as to pressure the executive branch, over a wide range of Chinese trade (e.g., trade barriers and failure to protect intellectual property rights) and non-trade (e.g., human rights, prison labor, Taiwan security, and weapons proliferation) issues. Several members opposed such linkage, arguing that it had little effect on Chinese policies, and that the often rancorous congressional debate over China's trade status undermined long-term U.S.-Chinese relations and added uncertainty to the trade relationship.

In order to ensure that the WTO agreements would apply between the United States and China once China gained admittance to the WTO, Congress passed legislation (H.R. 4444, P.L. 106-286) granting authority to the President to extend permanent normal trade relations (PNTR) status to China upon its entry to the WTO. (Additionally, the law contains a number of provisions dealing with such issues as human rights, Chinese prison labor exports, and Chinese compliance with WTO rules.) On December 27, 2001, President Bush issued a proclamation extending PNTR status to China, effective January 1, 2002.



## Outlook for China's Economy

The short term outlook for the Chinese economy is difficult to predict, due largely to uncertainties over the current state of the global economy, as well as the uncertainties over the cumulative or long-term economic effects of SARS on the Chinese economy. Restoring normal economic activity in China will depend, not only on the ability of the Chinese government to keep the virus in check, but also the government's ability to convince its population as well as foreign businesspeople that it has in fact contained the virus. Some medical experts warn that SARS could flare up again during the winter time.

China's economy has held up remarkably well in the face of economic slowdowns in the United States and its other major trading partners. Foreign investment has continued to pour into China, which has helped boost Chinese exports. In addition, the Chinese government has continued a policy of boosting the economy through public spending. As a result, China's real GDP is projected to rise by around 7.8% in 2003. Long term growth will be largely determined by the government's ability to reform the SOEs to make them profitable, and to reform the banking system to make it more responsive to market forces.

China's efforts to join the WTO appear to represent a major commitment on the part of the Chinese government to significantly reform its economy and provide greater access to its markets. Some China observers believe that the Chinese government considers accession to the WTO as an important, though painful, step towards making Chinese firms more efficient and able to compete in world markets. In addition, the government hopes that liberalized trade rules will boost foreign investment in China, which has declined in recent years. Economists argue that, over the long-run, greater market openness in China will boost competition, improve productivity, and lower costs for consumers, as well as for firms using imported goods as inputs for production. Economic resources will more likely be redirected away from money-losing activities (such as SOEs) to more profitable ventures, especially those in China's growing private sector. As a result, China is likely experience more rapid economic growth (than would occur under current economic policies). A study performed by the Chinese government estimates that WTO membership would boost China's GDP by 1.5% annually by 2005 and thereafter. On the other hand, however, the Chinese government is deeply concerned with maintaining social stability. Many analysts warn that, if trade liberalization were followed by a severe economic slowdown, leading to widespread bankruptcies and layoffs, the Chinese government might choose to halt or delay certain economic reforms, rather than risk possible political upheaval. An additional problem posed by China's WTO accession will be to get Chinese local and provincial governments to adhere to WTO rules, since many of them impose a variety of protectionist policies to protect firms under their jurisdiction.