

Central Intelligence Agency



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DIRECTORATE OF INTELLIGENCE

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China's Uncertain Economic Climate: Impact on US Interests [redacted]

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Summary

Differences in Beijing over the direction of economic policy, more public and intense since the fall of Hu Yaobang, will probably complicate existing problems in Sino-US economic relations, rather than create new ones. Specifically, China may find it more difficult to respond positively to the complaints of foreign investors or to meet US needs on a bilateral investment treaty. Trade frictions, especially textile issues and China's deficit, may be exacerbated and GATT negotiations will probably be more difficult. Coming visits by US officials will provide important indications of the magnitude of the effect of internal political struggles on the Sino-US economic relationship. [redacted]

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This typescript was written by [redacted], Office of East Asian Analysis, based on contributions from [redacted] [redacted] China Division, OEA. Information available as of 18 February was used in its preparation. Comments and queries are welcome and may be directed to the Chief, Economic Assessments Branch, China Division, OEA [redacted]

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Conservative Influence on Foreign Economic Ties

Chinese economic policy statements show a resurgence of more conservative, planning-oriented themes since the fall of Hu Yaobang, reflecting what we believe could be a revived and protracted struggle between reformers and conservatives over the pace and direction of economic reform. We expect controversy to surround many of the reform policies that support China's open door to the West and specifically its relationship with the United States, including encouragement of foreign investment, membership in GATT, interest in foreign technology, and even promotion of study abroad. Many of these were already issues in Sino-US relations, but the atmosphere of uncertainty in Beijing will probably make progress in resolving them more difficult. [redacted]

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Attracting Foreign Investment

Even before Hu's fall and the economic debates, Beijing was having difficulty answering foreign complaints about China's investment climate. China has been slow to address such issues as labor costs, required use of Chinese materials, local-level obstruction of central regulations, and most important, the ability to repatriate profits. But last year, a 50-percent drop in the value of new investment agreements to only \$3.3 billion probably alarmed Beijing into action. New direct foreign investment regulations issued in October, however, made only minor concessions and sidestepped investors' key concerns; in particular, Beijing did virtually nothing to increase foreign firms' ability to bring profits out of China in foreign currency. [redacted]

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Reformers are concerned that recent political events will lead investors to conclude that China's investment climate is unstable [redacted]

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[redacted] We believe, however, that the current debates will, at least in the short term, make it difficult to offer new incentives to foreign investors. Moreover, a conservative shift would harden China's opposition to demands of the United States in the proposed bilateral investment treaty--certain international law standards and the precedence of international law over domestic law--which would further complicate the already stalled negotiations. Without improvements in the investment climate, US firms--whose investment so far has been largely limited to offshore oil exploration and coal mining--will, we believe, remain cautious. [redacted]

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Bilateral Trade Tensions

In our opinion, pressure from conservatives to correct bilateral trade deficits may aggravate existing friction with the United States over protectionism and other issues relating to China's balance of trade. Ministry of Foreign Economic Relations and Trade (MOFERT) calculations of trade accounts--which differ from Western methods--show a continuing trade deficit with the United States, though it was down to \$800 million last

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[redacted]

year from \$2 billion in 1985; according to US customs statistics, which factor in Chinese-origin re-exports through Hong Kong, China enjoyed a \$2.2 billion surplus, up from \$368 million in 1985. We expect Beijing to take a hard line in the textile negotiations because last year textiles became China's primary source--26 percent--of foreign exchange. This increased dependence on textiles adds impetus to Beijing's invigorated promotion of its textile industry and will stiffen resistance to international pressure to limit textile exports. Consequently, Beijing will be less amenable to limiting sales to the United States and may threaten retaliation against US exports if protectionist measures are implemented. [redacted]

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Foreign Loans Policy

The internal debate has also touched on China's efforts to secure international credits, aid, and concessionary financing, including US Eximbank loans. The effect will depend on the focus of conservative attacks in coming months. An attack on China's use of foreign loans could reduce Chinese pressure on the United States and Japan for concessionary financing, while increasing pressure for countertrade, compensation trade, or even restructured loans. If the conservatives, instead, highlight the need to reduce imports and improve foreign exchange holdings, Beijing may press even more for low-cost financing on what the Chinese do buy. According to press accounts, Eximbank is involved in transactions with China worth \$120 million, and is considering another \$1 billion in projects which may be affected by the debate over loan policy. [redacted]

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The Future of Special Economic Zones

Chinese policymakers such as State Councillor Gu Mu have been quick to reassure the Japanese and others that Beijing's policy toward Special Economic Zones (SEZs) will not change, but conservative attacks on such "nonproductive" investments as hotels and restaurants may lead to additional changes in regulations governing the types of investment allowed. Beijing had already sought to discourage these projects; last October's foreign investment regulations excluded nonproductive investments from the new incentives offered to foreigners. Conservatives may seek to impose greater central control over all aspects of SEZ economic activity, including taxes and wages, which in our view would reduce their already limited attractiveness to foreign investors. US firms have little invested in the SEZs and will probably not be affected much by any changes in SEZ policy. [redacted]

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GATT Negotiations

Obstacles already working against China's efforts to join GATT are now compounded by fallout from Hu's demise; the negotiations will probably be even longer. In working toward accession, Beijing has encountered recurring difficulties in reassuring GATT members that China's large nonmarket economy and bureaucratic trade management structure would allow Chinese participation in GATT consistent with organizational guidelines. Most important, Beijing had indicated to the GATT organization that reforms would show some progress in 1987 on the key obstacle, China's distorted and arbitrary system of state-set prices. In the wake of student protests and Beijing's fears of worker unrest, however, price reform--plans for which had already been scaled back in November--is on hold. Indeed, the State Council announced in January that there would be no price increases this year. Because a delay in price reform will throw China's already tentative policy timetable off, US negotiators--among the key discussants in talks leading up to China's GATT application this month--will probably find accession talks even more complicated than expected. [redacted]

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Technology Transfer

Because of the debates over economic policy, we expect a low-key reaction to the US announcement--scheduled for the Secretary of State's March visit--of a more liberal export control policy for China. Reformers will be anxious to forestall charges from conservative critics that they are making China dependent on the West. Moreover, widely published reports indicate that China is having difficulty absorbing the "high-tech" items it is already receiving. Consequently, we expect Beijing to mitigate its public demands for even greater access to sophisticated technologies, though private expressions of discontent with remaining restrictions will probably continue. [redacted]

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We also believe that, in the short term, the United States may see a levelling off, perhaps even a falloff, in the dollar value of all technology exports--high-tech as well as more mundane equipment, know-how, and training--to China. Indeed, Chinese statistics published in late January show a declining US share of China's technology imports in 1986, partly because of large, probably one-time, contracts with other countries. But last year, China had already begun to reassess the role of foreign technology in its modernization effort and had taken steps to revamp the import process, centralize decisionmaking on big-ticket items, eliminate redundant acquisitions, and link equipment purchases to transfers of production know-how.¹ The present Chinese political climate, in our view, will reinforce steps in this direction. [redacted]

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¹ Under the five-year plan covering 1986-90, technology imports will increase, and we expect the US share to stabilize or even rise as 1990 approaches. [redacted]

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Study Abroad

Beijing moved last year to tighten regulations governing study abroad in order to increase the number of students returning to China after completing their studies. Although the demonstrations in December have not been blamed on foreign-trained students, concerns about the appeal of Western ideas and values will increase the pressures for tighter controls.

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The new measures, disclosed in January, will further reduce the number of students sent to the United States and other Western countries, with more preconditions and shorter stays allowed--policies more in line with what conservatives had sought last year.

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Signposts

Although we expect to see the current political uncertainties in Beijing reflected in each of the areas noted above, the effect on US interests may vary greatly. In our judgment, bilateral trade issues and additional concessions to investors will probably be affected most. In any case, a key party statement and a series of visits by US officials in coming weeks should provide important clues:

- Zhao's Address to the National People's Congress. Premier Zhao Ziyang's annual work report to the National People's Congress in March should discuss economic policy and lay out reform plans for 1987. It will be an important indication of the impact the present economic debate will have on US interests.
- The Secretary of State's Visit. The Secretary's March visit does not have an economic focus, but it will provide an opportunity for senior leaders to offer reassurances and clarifications of policy. The tone of Chinese statements should also indicate whether relations with Washington have become an issue in Beijing.
- The Secretary of Commerce's Visit. Planning efforts for the Joint Committee for Commerce and Trade (JCCT) meetings in Beijing this April should provide indications of changes in Chinese perceptions of the Sino-US economic relationship. Working groups will discuss trade and investment, market access issues, and US antidumping import investigations.
- Other bilateral negotiations. In coming weeks, US and Chinese officials will meet to discuss textile trade and will continue a series of informal bilateral meetings on GATT. These sessions should provide the best indication of how recent events will affect Sino-US economic relations.

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SUBJECT: CHINA'S UNCERTAIN ECONOMIC CLIMATE: IMPACT ON THE UNITED STATES

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