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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence

Implications of China's Current Economic Problems

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IMPLICATIONS OF CHINA'S CURRENT ECONOMIC PROBLEMS


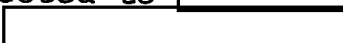
Summary

Agricultural difficulties over the past two years, along with a slowdown in industrial growth and an intensified need for foreign technology, have forced Peking to retreat from the Maoist ideal of self-reliance. China's abruptly increased dependence on the world economy -- notably on American granaries and on Japanese and Western high-technology industries -- is evidenced by:

- costly increases in imports of grain, cotton, and other agricultural products, from \$450 million in 1972 to an expected record level of \$1.2 billion in 1973; more than one-half of the 1973 total will be supplied by the United States;
- a substantial expansion in investment in agriculture and supporting industries, which requires foreign plants, equipment, and technology;
- a willingness to relax the self-imposed policy of no foreign debt by incurring medium-term obligations on foreign plants; and
- a drive to develop new sources of foreign exchange to help pay the mounting import bill.

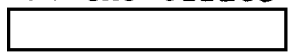
Peking's heightened reliance on foreign sources of food, machinery, and technology almost certainly will extend through the remainder of the current Fourth Five-Year Plan (1971-75). Agricultural production in the first eight months of 1973 has been hampered by drought in the north and floods in the south and may not greatly surpass the disappointing

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1972 level, which was roughly 5% below 1971. Investment in agriculture must be beefed up substantially if the long-run trend of 2% -- approximately equal to the population growth rate -- is to be maintained. The industrial, transportation, and military sectors remain dependent for their modernization on foreign technology, for example, in steel, petroleum exploration and refining, electronics, chemicals, and machine building.

The implications of China's current economic problems for the United States lie especially in agriculture. Because of worldwide food stringencies, the United States almost overnight has become the PRC's principal supplier of agricultural products and its third leading trading partner behind Japan and Hong Kong. In industry, the United States is a latecomer to a market shared by Japan and the leading industrial nations of Western Europe. So far the United States has sold communications equipment, ten Boeing 707 aircraft, and, now, three ammonia plants. As for technology, the Chinese will continue to rely on several major non-Communist industrial nations, with the United States having an advantage in high-technology branches such as civil aircraft, advanced computers, communications equipment, and oil-drilling equipment. China will not, however, enter into joint ventures with foreign firms and will seek to minimize the number of foreign technical specialists on Chinese soil. With regard to China's willingness to incur medium-term debt, Peking could readily increase its debt several fold above the present \$200 million to \$300 million. Nonetheless, it will move cautiously, and the US share in the financing of industrial purchases will be tiny in absolute amount. The United States will share the impact of the PRC's efforts to raise its foreign exchange earnings. Peking is trying to widen its market in the United States for silk textiles, specialty foods, objets d'art, and handicrafts.

Regardless of who eventually succeeds the aging Mao and Chou, China's economic problems pose constraints on political action. Any regime would be under strong pressure (a) to retain the United States as the key backup source of food and cotton merely to maintain the spartan living standards of the vast population, (b) to look to the outside

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world for modern equipment and technology in order not to lag farther behind international technical standards in industry and agriculture, and (c) to improve its military capabilities on the basis of foreign support in the fields of communication equipment, transport equipment, instruments, and metal alloys. The rhetoric of political controversy will continue to exhibit wider swings than actual economic policy, which generally will reflect these economic realities. Nonetheless, the history of political conflict in the PRC casts doubt on straight line forecasts of economic policies based simply on a calculation of economic necessity.

Discussion

Background

1. The Cultural Revolution of 1966-69, Mao's attempt to revitalize the revolutionary spirit in China and to bend the Party and government bureaucracies to his will, did little permanent damage to the economy. In particular, the Cultural Revolution was mainly an urban phenomenon and caused only small disturbances in the agricultural sector. In spite of political invective hurled at private economic activity, the peasants' small plots remained intact, and the policy of supplying the countryside with an increasing volume of fertilizers, pumps, and agricultural chemicals continued. Little damage was done to industrial plant facilities as the result of the Cultural Revolution. In 1967-68, however, industrial production dropped 10% because of sporadic strikes, street fighting, power shortages, and transportation bottlenecks.

2. The years since the Cultural Revolution have been marked by pragmatic economic policies and a return to regularized central economic planning. The restoration of order in the economy has been accompanied by the reappearance of a number of planners and economic ministers dismissed in the purges, the gradual resumption of high-level technical education under Maoist guidelines, and the partial restoration of scientific publications and ties with scientists of other nations.

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3. In late 1970, Premier Chou En-lai announced a new Fourth Five-Year Plan for 1971-75. We have almost no details on the targets in this plan. On the basis of fragmentary information, we estimate that the annual rates of increase projected in the plan are a step higher than the long-term growth rates of the PRC under the Communists -- 2% in agriculture (or approximately the same as population growth), 8% in industry, and 4% in overall output.

4. In 1971-72, the first two years of the new plan, agricultural difficulties, along with a slowdown in industrial growth and an intensified need for foreign technology, brought about new efforts by the Chinese leadership to "speed up the pace of socialist construction."* The need for reconsideration of economic policies had strong political connotations and rekindled longstanding arguments over (a) the primacy of agriculture versus industry, (b) the authority of the ideological leader versus the technically oriented specialist, the "red versus expert" controversy, and (c) the importance of self-reliance in economic and technical affairs as opposed to the gains to be had from drawing on the advanced technology of the non-Communist world.

5. The unexpectedly rapid re-establishment of communication between China and the United States, beginning in 1971, was a major political development for both nations. Within the PRC, this development quickly became linked with the issue of self-reliance when China had to turn to the United States for sizable quantities of grain. The present discussion summarizes China's current economic problems and some of the implications of these problems for the United States. A table of general economic data is included as an appendix.

Agriculture: Renewed Priority

6. In the first decade of Communist rule over China, agriculture was conducted essentially as a holding operation. The restoration of peace and order in rural areas and the supposed advantages of collectivist organization would, it was argued,



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enable the agricultural sector to feed the growing population and provide materials for industry and export. This policy collapsed in the disaster period of 1959-61, when China's population suffered a 20%-25% cut in already meagre rations and when discontent spread even to the ranks of the People's Liberation Army. In an important turn-about in policy in 1962, the agricultural sector was accorded substantial and increasing support from the modern industrial sector in the form of chemical fertilizers, agricultural machinery, irrigation equipment, and pesticides. This new policy was modified in the Cultural Revolution, when much of the burden of supporting agriculture was passed down to the farming units themselves. Locally financed small-scale factories producing low-grade chemical fertilizer, simple agricultural implements, and irrigation pumps sprang up by the thousands. Bumper harvests in 1967 and 1970 appeared to convince the Chinese leadership that (a) the flow of resources from the modern industrial sector to agriculture could be safely leveled off, and (b) the imports of grain from Canada, Australia, and France -- which had amounted to 5 million to 6 million tons annually beginning in 1961 -- could be safely cut and ultimately eliminated. The leadership wished to concentrate on spurring the industrial modernization program.

7. But farming weather turned unfavorable in 1971 and was worse still in 1972. Grain production failed to grow in 1971 and then fell by 4% in 1972. A reduction of grain imports from 4.6 million to 3 million tons in 1971 proved decidedly premature. Imports bounced back to 4.8 million tons in 1972 and will reach a record 7 million tons in 1973. Cotton output was hit even harder, dropping by perhaps 6% in 1971 and as much as 25% in 1972. Imports of cotton jumped from 94,000 tons in 1971 to 160,000 tons in 1972, to an expected 500,000 tons in 1973. Production of key oilseeds also declined in both years.*

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8. Two disappointing harvests in a row spotlighted problems that had gone unnoticed because of the generally good crops of previous years:

- gains in Chinese agricultural production still depend vitally on good weather coupled with competent management of rural resources;
- makeshift products such as low-grade fertilizer from small rural factories are poor substitutes for high-quality, modern inputs;
- without large and systematic increases in the application of modern techniques and modern inputs, China's limited farmland cannot yield the grain, cotton, and oilseeds needed for China's growing consumption and industrial needs; and
- no matter what corrective measures are initiated now, the country must continue to import sizable quantities of farm-support products for the next several years.

9. Prospects for grain currently indicate a moderate increase over 1972 but no bumper harvest. Only the summer grain harvest (wheat, barley, and lentils), which accounts for almost 20% of China's grain, is completed. The yields of these crops were not as high as expected. Peking's reference to this year's summer harvest as equivalent to the record summer harvest of 1972 should be interpreted in light of the substantial expansion of acreage. Preliminary reports on the early rice crop, which also accounts for almost 20% of total output, do not suggest an unusually good harvest. Furthermore, the hasty readjustments of crop rotations have left crops more vulnerable to unfavorable weather, especially in north China where the fall harvest of coarse grains will be unusually late. The shift of sizable acreages of farmland from cotton and oilseeds to grains will limit the output of these important crops in 1973.

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10. In addition to changes in crop patterns, Peking has taken the following actions:

- tightened individual rations of food-stuffs and textiles;
- decreed that no more than 5% of a commune's labor can be devoted to commune industries;
- assigned additional middle-school graduates to the countryside and stepped up programs for agricultural research and the training of agricultural specialists;
- purchased from abroad a record \$1.2 billion in grain, cotton, and oilseeds for delivery in 1973, compared with purchases of \$450 million in 1972;
- arranged for the import of more than \$200 million in chemical fertilizers in 1973; and
- contracted for the import of four huge fertilizer manufacturing complexes and six man-made fiber facilities costing about \$450 million.

11. More than half, or about \$650 million, of China's imports of agricultural products in 1973 will come from the United States, compared with \$75 million in 1972. By value, 60% of the grain, 35% of the cotton, and almost all of the vegetable oil and soybeans purchased by the PRC in 1973 will be of US origin. As a result of these sales, the United States suddenly has become China's principal supplier of farm products and its third ranking trading partner. American firms also are supplying China with a small volume of fertilizer and synthetic fibers, as well as three complete plants for the big fertilizer complexes.

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12. China's overall growth in industrial production has slipped from an estimated 13% in 1971 to 8% in 1972. Provincial reports of industrial gains in the first half of 1973, when compared to parallel reports for 1972, suggest that industrial production for the entire year will fall below 8%. The slowing down of industrial growth is attributable to a number of factors which have affected the Chinese economy and whose impact will be felt for some time to come:

- The stimulative effects of the large injection of Soviet plant, equipment, and technical know-how in the 1950s have worn off;
- capacity idled during the worse disorders of the Cultural Revolution of 1966-69 has been fully re-employed;
- reserves of easily assimilated techniques and easily available natural and human resources have been largely exploited; and
- the dependence on labor-intensive methods in extractive industries, construction, and transportation has led to imbalances in the output mix of machinery and equipment.

13. The Soviet assistance program provided China with the nucleus of a major industrial base -- metallurgical plants, power stations, machine tool plants, etc. The Soviet pullout in mid-1960 left the Chinese with unfinished construction projects and in many cases only partially equipped shops. Nonetheless, the groundwork, in the form of initial training, plans, and prototypes, had been laid for a substantial capital goods industry. During the 1960s the Chinese gradually completed and put into operation most of the unfinished Soviet-aid plants. The PRC turned to Japan and Western Europe, not for across-the-board support of the Soviet kind, but

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for several dozen key plants in the electronics, chemical, and other modern industries.

14. In the aftermath of the Cultural Revolution, production from established factories and mines was restored to normal, and investment projects whose construction had been delayed were completed. Thus, a large element of catch-up, non-recurring gains was contained in the high industrial growth rates of 1970-71.

15. Increases in output henceforth often will require larger increases in capital investment. For example, because most of the easily mined coal and iron ore deposits now are being fully exploited, large investment in capital equipment will be needed to overcome the shortages of coking coal and iron ore confronting China's metallurgical industry. Large new industrial complexes being built in the hinterland entail unusually large construction and transportation costs. The exploitation of offshore oil deposits -- first in shallow, then in deep water -- will require costly specialized equipment. With the nearly complete participation of the population in economic activity, those industries that have been prominent users of labor-intensive methods need larger amounts of capital goods to maintain satisfactory growth rates. In order to produce more mining, construction, and transportation equipment, plants for building new types of machinery need to be built and old plants must be re-equipped to alter their product mix. Under these conditions, rates of growth in the output of machinery and equipment for manufacturing and other industries are likely to decline.

16. Confronted by these problems, the Chinese are looking to imports as a stimulant to growth and modernization. The list of requirements for complete plants and equipment in basic as well as high-technology industries is a long one, however, and Peking is moving cautiously and selectively in concluding purchase contracts. Thus far in 1973 the Chinese have contracted for a record \$450 million in whole plants, nearly all of which will be expended on fertilizer and fiber facilities. They also have just signed a \$43 million deal for the purchase of British mining equipment, apparently

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intended for the coal industry. In addition, firms in West Germany, Japan, and the United States are now competing for a contract to sell China some \$300 million worth of whole plant equipment which could raise the PRC's finished steel capacity from 17 million to 20 million tons annually. In electric power, the Chinese have been negotiating with several suppliers for nuclear and conventional steam power station equipment which could total \$500 million. Numerous other negotiations entail smaller outlays designed to upgrade China's industry, transportation, and communication systems.

17. In view of the pressing need for agricultural imports, Peking may have to postpone some of these negotiations over the next two or three years. If so, the burden of supplying needed machinery and equipment will fall even more heavily on China's own domestic machine building industries. China has a fairly large capacity for producing general-purpose equipment for small and medium-sized plants in basic industries. This equipment is generally obsolescent, however, compared with equipment available abroad. Mining equipment appears to be in especially short supply, although Peking claims to be rapidly increasing production from a small base.

18. Even if the Chinese should quickly conclude several pending deals for metallurgical, mining, and construction equipment, deliveries of this equipment will be spread out over the next three years at least, and new facilities thus could not become operational until the latter half of the 1970s. In the meantime, Peking is exhorting managers of factories and mines to exploit the "latent capacity" of existing facilities -- that is, to step up production without adding either capital equipment or labor. But fewer reserves of this type remain to be discovered in China's industry today than in earlier periods.

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Foreign Trade: Financing Imports

19. The question arises as to how China -- with an economy so dependent on agriculture and the weather -- can simultaneously finance continued costly imports of agricultural products, chemical fertilizer, whole plants for making fertilizer and man-made fibers, and whole plants and equipment for basic industries. Indeed, Vice Premier Li Hsien-nien raised this issue late last year when he told visiting industrialists that he would rather import more metallurgical and mining equipment than grain because the former helps expand China's industrial base whereas the latter "can only be eaten."

20. One answer is that China has relaxed its strictures on the acceptance of foreign credits. Of the \$450 million in complete industrial plants contracted for thus far in 1973, at least \$230 million will be financed by medium-term loans repayable in installments over five years following delivery of the facilities. Peking also has obtained short-term credits for purchases of US grain and possibly cotton as well. The Chinese -- were they willing to do so -- undoubtedly could obtain sizable additional credits.

21. At the same time, Peking has taken other steps aimed at increasing China's earnings of foreign exchange. These include price increases of exports in strong demand, measures to enlarge remittances and bank deposits of overseas Chinese, and plans to develop new markets both in new areas such as the United States and in new products such as petroleum.* Nevertheless, in 1973 China probably will run a hard currency deficit of as much as \$300 million in its trade with non-Communist countries. As a result, China probably will draw down its foreign reserve holdings this year and -- if it follows past practices -- will cut back on imports of less crucial capital goods next year in order to redress the deficit.

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22. Faced with dim prospects for an expansion of agricultural exports, Peking in the long run must find additional new sources of export earnings. An eye toward export potential may be indicated by China's continuing expansion and modernization of its oilfields and refineries and recent interest in developing its offshore drilling capabilities. China is likely to have considerable interest in the United States as a supplier of advanced petroleum equipment and technology. Japan presumably will stand ready to buy all the petroleum that China can produce above domestic requirements.

The Political Dimension

23. Periods of agricultural difficulty generate powerful pressures within the Chinese bureaucracy to treat economic problems in purely technical terms. Such pressures are obviously operating today, as they were even more obviously in the early 1960s after the Leap Forward debacle. At the same time, such difficulties also stimulate countervailing pressures to seek political solutions to economic problems.

24. Two political issues are immediately apparent in the approach the Chinese seem to have adopted in the past year or so. The first revolves about the issue of autarky -- whether China in the long run will allow itself to be dependent on purchases from abroad. In the past there have been powerful voices in China demanding something close to complete autarky; such a position can be buttressed by pointing to the troubles to which China was subjected following the abrupt withdrawal of Soviet aid and technicians in 1960. There is, however, no good indication that the argument for complete autarky is being pressed with any vigor in China at this time. To some extent, critics of current policies probably are being mollified by the careful attention paid to the division of China's foreign purchases among a number of states, which keeps Peking from being truly dependent on any one of them. Furthermore, Premier Chou En-lai has been careful to disavow an intention of joint economic ventures, such as the proposed Soviet-Japanese ventures for exploiting Soviet oil and gas, and only a handful of foreign technicians have been permitted to enter China to help with the installation of imported equipment.

25. The second political issue involves an argument over the appropriate pace of planned economic development and the extent to which economic and technical considerations should govern development policy. There have been a number of recent indications that the developing technical elite has drawn fire from fundamentalists wedded to "Leap" style reliance on mass action. A prominent outcropping of this internal doctrinal struggle is the present uproar in the press over a hard-working youth in the countryside who was so busy at farm tasks he had no time to study for the university entrance examinations. Under the revived policy of entrance examinations, the ranks of the universities will be filled by bookworms, it is argued, instead of by dedicated young workers. As a result of this criticism, the university entrance examination system has been revised to make political suitability the major prerequisite for admittance. The historical precedents since 1949 suggest that each swing of the pendulum builds increasingly strong countervailing pressures that eventually cause it to swing in the opposite direction. This historical experience makes it extremely difficult to adopt with confidence a straight line forecast of Chinese economic policies based simply on a calculation of economic necessities.

26. But the swings in the Party line on economic questions are wider than the swings in economic reality. There are lags and foot-dragging in implementation; the directives become diluted and misinterpreted as they pass through administrative channels; the directives prove impractical; or the whole change in policy is overtaken by events. As mentioned above, political invective against the private plots during the Cultural Revolution was not followed by their dismantlement; indeed, word was quietly passed to rural cadres not to let their political zeal override the practical necessity of retaining the plots. Similarly, in spite of all the talk about autarky, the PRC has made much of its economic progress, first, on the basis of Soviet industrial plants, and, later, on the basis of technology embodied in Japanese and West European plants and equipment.

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27. The continuation of China's present economic policy depends heavily on Chou En-lai, inasmuch as his demise could pave the way for a strong radical resurgence. Thus Chou's ability to get his followers appointed to key policy positions at the forthcoming Tenth Party Congress may well be a key factor in shaping future Chinese economic policy.

Implications for the United States

28. Regardless of who eventually succeeds the aging Mao and Chou, China's present economic problems will pose constraints on political action. In order to get back on the agricultural trend line, the normal annual growth rate of 2% must more than double during 1973-75. The situation is worse than it looks if grain alone is considered, because grain output has been propped up by the transfer of acreage from other crops. Moreover, the austere grain and clothing rations are already so low that they cannot be substantially cut without internal repercussions. Indeed, genuine revolutionary ardor is an increasingly scarce commodity among the rank-and-file, who have had to be content with small gradual increases in living standards. The implication seems clear -- China will have to continue large-scale imports of grain to feed the large cities of northern and central China. Some erosion of the US position as the principal supplier of agricultural products to China would accompany a return to normal international supply conditions, particularly in Canada and Australia. Even so, Chinese actions suggest that the United States -- with its unrivaled supplies of a wide variety of grains, cotton, and oilseeds -- will remain an important factor in the PRC's agricultural trade.

29. A second implication for the United States concerns China's need to refurbish and expand its industrial plant. At China's present stage of technology, most of its requirements were being readily met by Japan, France, the United Kingdom, West Germany, and other West European nations before the rapprochement with the United States. In various high-technology items -- the Boeing 707s are a case in point -- the United States will have

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an advantage over other industrial nations. The devaluations of the US dollar over the past two years will improve the competitive position of US exporters of industrial equipment. But the Chinese policies against joint ventures and large numbers of foreign technicians will apply doubly to the United States, which is still billed in the Chinese press as the leading capitalist-imperialist power. These political considerations could favor Japanese or West European suppliers in deals where technicians need to be stationed in the PRC and where other considerations are roughly equal.

30. In the matter of China's military efforts, the PRC seems to have been able to import practically all the machine tools, instrumentation, and other equipment needed to support defense production, provided that the item was not blatantly and exclusively military in nature. China now produces a variety of modern weapons, including jet military aircraft, submarines, guided-missile patrol boats, tanks, and armored personnel carriers.

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APPENDIX
 PRC: Economic Indicators

	1952	1957	1958	1959	1960	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970	1971	1972
GDP (billion 1971 US \$)	42	86	99	96	94	75	83	86	94	102	110	106	105	117	132	139	139
Population, mid-year (million persons)	570	641	657	672	685	695	704	716	731	747	763	780	798	817	837	857	878
Per capita GDP (1971 US \$)	109	134	151	144	137	107	118	120	129	136	144	136	132	143	158	163	158
Grain (million metric tons)	154	185	200	165	160	162	175-180	175-180	180-185	180-195	195-200	210-215	195-200	200-205	220-225	220-225	210-215
Cotton (million metric tons)	1.3	1.6	1.7	1.5	1.3	0.9	0.9	0.9	1.3	1.5	1.6	1.8	1.6	1.7	1.7	1.6	1.2
Industrial production index (1957 = 100)	51	100	131	166	161-161	107-110	108-113	119-125	133-142	148-160	166-182	136-151	147-168	178-203	208-241	233-273	249-295
Crude steel (million metric tons)	1.35	5.35	8.0	10	13	8	8	9	16	11	13	10	32	35	38	21	23
Coal (million metric tons)	66.5	130.7	210	100	280	170	180	190	200	220	240	190	200	150	100	125	140
Electric power (billion kilowatt hours)	7.3	19.3	28	42	47	31	30	33	36	42	50	45	50	60	72	86	95
Crude oil (million metric tons)	0.44	1.48	2.3	3.7	4.6	4.5	5.0	5.5	6.9	8	10	10	11	14	20	26	30
Cement ¹ (million metric tons)	2.86	6.88	9.3	11.0	9.0	6.0	5.5	7.1	8.5	11	12	10	10	12	13	14.5	15.5
Chemical fertilizers (million metric tons)																	
Supply	0.4	1.9	3.0	3.1	3.5	2.4	3.1	4.9	4.7	6.8	8.0	8.7	10.3	12.3	14.3	16.6	18.9
Production	0.2	0.8	1.4	1.9	2.5	1.4	2.1	2.9	3.5	4.5	5.5	4.4	6.3	8.2	10.0	12.3	14.7
Imports	0.2	1.1	1.6	1.2	1.0	1.0	1.0	2.0	1.2	2.3	2.5	4.3	4.0	4.1	4.3	4.3	4.2
Machine tools (thousand units)	13.7	28.3	30	33	38	30	25	35	38	44	48	40	40	45	50	55	60
Trucks (thousand units)	0	7.5	16.0	19.4	15	1	14	16	26	34	47	34	31	60	70	86	100
Locomotives (units)	20	167	350	500	600	100	25	25	25	50	140	200	240	260	280	200	220
Freight cars (thousand units)	5.8	7.3	11	17	23	3	4.0	5.9	5.7	6.6	7.5	6.9	8.7	11	12	14	15
Cotton cloth (billion linear meters)	3.83	5.05	5.7	7.5	5.8	4.0	4.2	4.5	4.9	5.4	6.0	4.8	4.8	6.5	7.5	7.5	7.5
Foreign trade (billion current US \$)																	
Total	1.89	3.06	3.76	4.29	3.99	3.02	2.68	2.77	3.22	3.88	4.24	3.90	3.76	3.86	4.29	4.70	5.80
Exports	0.88	1.62	1.94	2.23	1.96	1.53	1.53	1.57	1.75	2.04	2.21	1.95	1.94	2.03	2.05	2.42	3.06
Imports	1.01	1.44	1.82	2.06	2.03	1.49	1.15	1.20	1.47	1.84	2.03	1.95	1.82	1.83	2.24	2.28	2.74

¹ Modern plants only.

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