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The Global Consequences of China's Trade Expansion:
A Look at the Future

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Summary

Under the economic reform measures now in place, we estimate that by the year 2000 China is likely to double its share of world exports to become a trading power equaling Canada or Italy. The most detrimental effects of China's outward looking trade strategy will be incurred by the less developed countries as China expands its share of the developed countries' markets in products such as textiles, clothing, hand tools, toys, and sporting goods produced by the LDCs. China's trade expansion will help improve the US trade balance as it increases its purchases of capital goods and industrial supplies and will work to reinforce moderation in Beijing's political dealings with Washington. China's trade expansion will also present an important challenge for US trade policy as Beijing becomes more vehement in using its economic leverage as a bargaining chip to advance its chief economic aims of gaining greater access to US markets and technology. Only through a comprehensive agreement will the United States be able to insure that the economic gains from China's trade expansion do not accrue to China alone. In our judgment, the United States has a major stake in China's successful integration into the global trade system. The success or failure of China's market-oriented economic reforms will depend in no small measure on its ability to gain access to Western markets and technology. If it fails, the implications would be unnerving--not just for China's relations with the West, but for the promise that economic reform holds for the Third World.

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This memorandum was prepared by [redacted] Office of Global Issues. Information available as of 1 August 1986 was used in its preparation. Comments and queries are welcome and may be directed to Chief, Development Issues Branch, Economics Division, OGI, [redacted]

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THE GLOBAL CONSEQUENCES OF CHINA'S TRADE EXPANSION:
A LOOK AT THE FUTURE

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CHINA'S ECONOMIC REFORMS

In the last two years China has incurred record trade deficits resulting from a sharp increase in imports. Beijing's efforts to decentralize the foreign trade regime unleashed a vast, latent demand for foreign goods. Beijing's ensuing retrenchment--and cutbacks in purchase orders--have led many Western observers to believe that prospects for China's trade are dimmer than previously hoped. We believe this view is shortsighted; the longer historical record shows a dramatic upturn in China's economic growth and trade since 1976, which has been barely affected by these recent events [redacted]

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Origins of the "Open Door" Policy

In the 10 years since the death of Mao Zedong, China has reversed Mao's policy of "self-reliance" and moved steadily towards greater participation in the world economy. Beijing has dropped its ideological aversion to foreign debt, encouraged foreign investment in the domestic economy, established trade and diplomatic relations with the United States, joined the International Monetary Fund and World Bank, and applied for membership in the GATT [redacted]

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Beijing also has begun to institute major reforms throughout the economy that are aimed at reducing the scope of central planning and increasing the role of the market. Domestically, Beijing is now giving greater decisionmaking authority to provincial and local governments, separating government administration from enterprise management, and making enterprises responsible for their own profits and losses. In the area of foreign trade, Beijing is reducing the share of trade handled by the state-owned trade corporations, encouraging direct contacts between domestic and foreign businesses, and

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permitting enterprises to make their own foreign trade decisions and hold their own foreign exchange balances.* [redacted]

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The open door policy and market-oriented reforms have resulted in China's rapid expansion out of international isolation. During the Cultural Revolution (1966-76) China's exports never exceeded 1 percent of world trade or 3 percent of China's GNP, the smallest share for any major country. From 1977 to 1985, however, the dollar value of China's exports expanded at an average annual rate of 18 percent--three times the growth rate for world trade. Exports worth \$31.5 billion made China the second largest LDC exporter last year, after Saudi Arabia, and this year we expect China to become the largest [redacted]

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The Chinese leadership does not appear content, however, with this remarkable progress. They are genuinely displeased that a nation with nearly one-quarter of the world's population, and perhaps 7 percent of the world's resources, still accounts for less than 2 percent of the world's trade. Under the Seventh Five-Year Plan (1986-90), they plan to increase trade at least 8 percent per year, a figure that is consistent with their goal of quadrupling domestic output by the year 2000. [redacted]

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Prospects for Future Reforms

Beijing's open door policy often has clashed with its concurrent economic reform efforts. Twice in the early 1980s China has attempted to decentralize its trade apparatus and make trading companies responsible for their own profits

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and losses. Each time, however, China has had to retrench as irrational domestic prices and an overvalued exchange rate led to imports of luxury goods, exports of necessities, trade deficits, and declining foreign exchange reserves.

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Opposition to reforms has been voiced by some individuals within the Chinese leadership who favor retaining a strong element of central planning. They have been particularly critical of the detrimental side-effects of reforms such as black-marketeering, smuggling, and the importation of "bourgeois Western influences." Although xenophobia and anti-imperialist attitudes are deeprooted in the Chinese culture and Communist ideology, these factors probably are not the reason for opposition to the reforms. Many of the problems China is encountering in decentralizing trade are quite real and stem from an irrational price system. As a result of these negative experiences, Beijing probably will proceed more slowly with foreign trade reforms in the future, not letting them outstrip the pace of domestic price reforms [REDACTED]

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Given the magnitude of the task, setbacks to the reform program are almost unavoidable. Nevertheless, we believe the long-term prognosis for the open door policy are good. The Chinese have learned that there is a high price to be paid for closing off their economy and they do not want to fall further behind the modern world. They realize that they need to trade with market economies not only to obtain new technologies but also to help make their own economic system more rational. The Chinese now see their national self-interest in terms of an open door--not only for themselves but for the rest of the world as well. [REDACTED]

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EXPORT POTENTIAL

China's tremendous success in boosting exports--and its potential to continue rapid growth--are due to three underlying factors:

- o Vast untapped resources and underemployed labor.
- o Sharp improvements in economic productivity.
- o Sizeable gains through increased specialization and trade.

Ironically, because China's economy is one of the least efficient in the world at turning resources into finished goods, small improvements in efficiency can increase output dramatically. Moreover, the Chinese can continue to get large increases in exports without straining domestic consumption or production because exports still account for a only small share of output

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China's Growing Export Competitiveness

Over the last 10 years, the Chinese have made remarkable progress in expanding their exports. Since 1977 China has been able to maintain a real growth rate for exports of 14 percent per year by diverting marginal amounts of output away from domestic consumption and by breaking into established Western markets through competitive pricing policies (see figure 1). The Chinese have actually increased their share of the world market at a faster rate in the deflationary 1980s than in the inflationary period of the late 1970s. This undoubtedly reflects their competitive strength as a low-cost manufacturer.

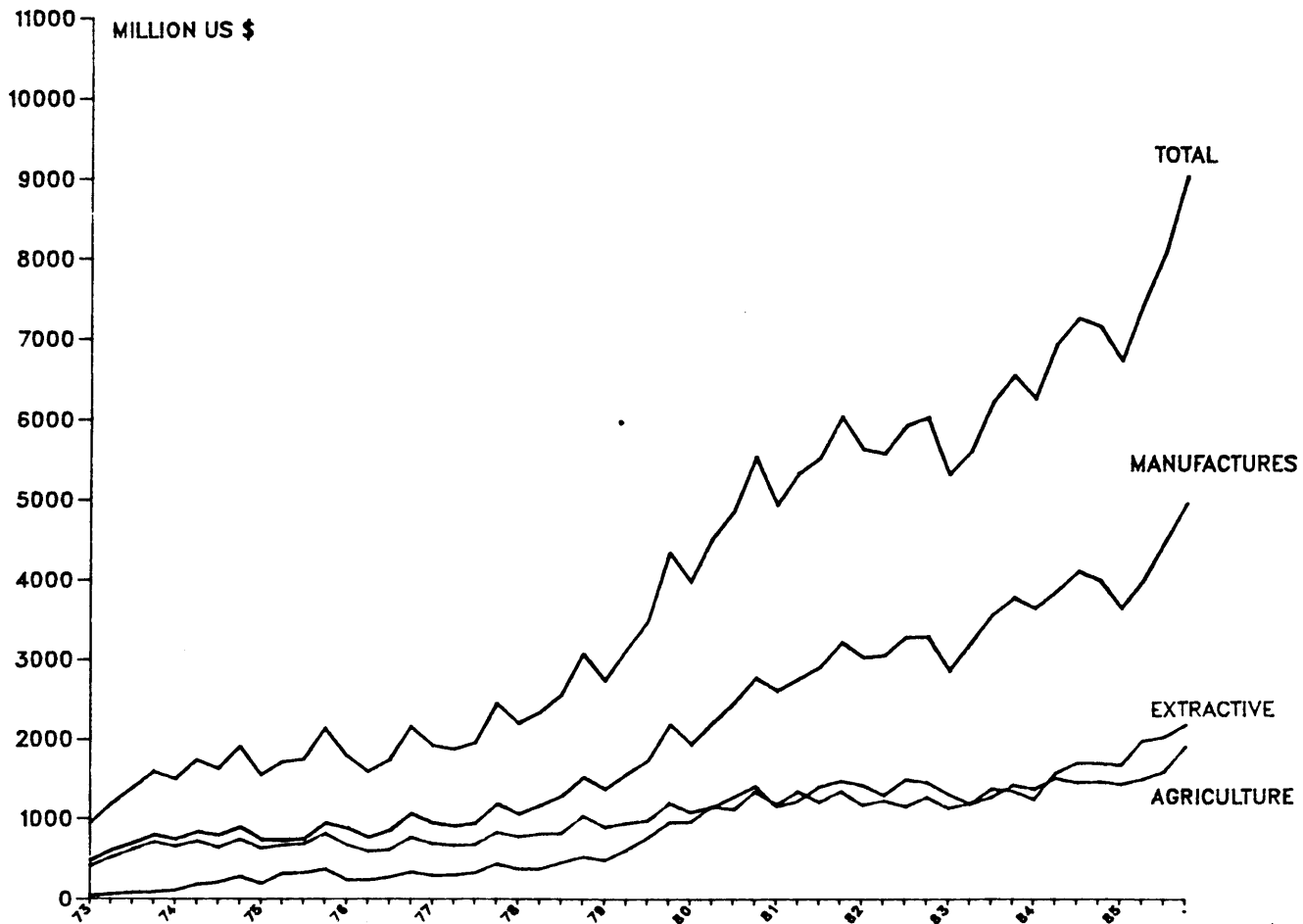
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At 20 cents per hour, China's average wage is the lowest in East Asia and one of the lowest in the world. China has more workers--urban and rural--than all the OECD and CEMA countries combined and in the next five-year plan (1986-90) China must absorb nearly 100 million new entrants into its labor force--a number

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CHINA: EXPORTS BY SECTOR OF ORIGIN



equal to the present size of the total US labor force. Although wages are going up relatively rapidly in China, in absolute terms the gap between wages in China and elsewhere is widening. Thus the Chinese are particularly well suited to compete in a deflationary world trade environment. [REDACTED]

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China has been able to achieve a real growth rate for Net Material Product of 10 percent per year since 1979 in large part by overcoming its technological shortcomings, maintaining a high rate of investment in capital goods, and reforming the economic system. With a continuation of these efforts we believe that China's goal of boosting total output by an average of 7.2 percent per year is attainable. This growth will greatly increase demand for imports, but will also free up considerable capacity to export [REDACTED]

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China's plan targets for the domestic economy will generate an export growth rate of 7 to 10 percent per year until the turn of the century, according to our projections, which are presented in table 1.* This conforms with China's own export target for the Seventh Five-Year Plan (1986-90) of 8 percent annual growth. [REDACTED]

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In our judgment, the main thrust of China's export drive will continue to come from the manufacturing sector. Since 1979 exports of manufactures have grown at nearly twice the rate of agricultural and extractive commodities, rising 16 percent per year in current dollar value and more than 20 percent per year in real terms. A continuation of high industrial growth rates, combined with more emphasis on exports and a strong shift into higher valued export

* Our projections are based on past relationships between major components of output and trade and on plan targets for output in 1990 and 2000. See Appendix A for a discussion of the forecasting methods used. [REDACTED]

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Table 1
 China: Exports Generated by Beijing's
 Targets for the Domestic Economy

(Billion US Dollars)

	Actual		Projected	
	1980	1985	1990	2000
Total*	18.9	31.3	43.4	97.8
Agricultural	4.7	6.4	7.8	12.5
Extractive*	4.8	7.8	5.3	9.1
Manufacturing	9.4	17.1	30.3	76.2

* Figures assume price of crude oil remains at
 \$15 per barrel.

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lines, should enable China to maintain a growth rate of at least 12 percent per year in foreign sales. [REDACTED]

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China's exports of manufactures are spread out over a range of light industrial products--a wider range than any other developing country. China's potential appears greatest in labor-intensive areas such as textiles and clothing, metal products, hand tools, light machinery and transport equipment (shipped primarily to the LDCs), handicrafts, footwear, glassware, crude chemicals, radios, and military equipment. As with many other emerging nations, textiles and clothing are playing an important role, accounting for about one-quarter of China's total exports. Beijing has had more success than any other LDC, however, in breaking into highly protected Western markets for these products. [REDACTED]

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Based on our simulations, we believe China's agricultural exports are likely to grow at the same pace as domestic production, thus remaining at roughly 5 percent of total output. There are some crops, however, for which dramatic increases are possible--corn, cotton, soybeans, and peanuts--if China shifts crop patterns to maximize the dollar value of the yields. For example, based on China's present yields and world prices, by shifting an acre of land from wheat production to cotton China could earn enough foreign exchange from exporting the cotton to import roughly two acres worth of wheat. Nevertheless, sales of agricultural commodities to foreign countries will continue to be constrained by inadequate storage and transportation facilities. Beijing intends to establish a series of export bases in coastal areas for growing these crops, however, and probably will prove to be strongly competitive in selling them in the Asian market. [REDACTED]

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Export earnings from the extractive sector will depend primarily on China's success in boosting domestic output. Our simulations show that every 1-percent increase in output is likely to bring a 2-percent increase in exports. Normally, the Chinese do not respond quickly to changes in world prices by altering exports. Essentially, their surplus domestic production is exported at whatever price the market will bear. Over the next few years we believe that Chinese planners will attempt to hold exports of crude oil at present levels, but if the price of crude were to fall much lower, they probably would face strong internal political pressure to cut exports.

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China's Place in the World Market

By the year 2000, China will become an exporter equal in stature to Canada or Italy today if it continues to expand its share of the world market at the same rate it has since 1978. At current growth rates, China's share of the world market will reach 2.4 percent in 1990 and 4.4 percent in 2000. This is consistent with an export growth rate of 8 percent per year, the scenario we put forward above, and world trade expansion at 2 percent annually. Slower growth in world trade probably would result in China capturing an even larger share of the market, while faster growth would probably lower China's share.

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China's fastest growing exports (in terms of China's share of the world market) are shown in Table 2. These 40 commodities account for roughly two-thirds of China's total exports and one-third of the world's total imports.

Manufactures account for nearly three-fourths of the items. Five of the top seven items on the list are either textile fibers, fabrics, or clothing. At the top of the list, China has captured the largest share of the half-billion dollar market for explosives, and if trends continue

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Table 2
China: Actual and Projected Shares of World Exports,
Top 40 Growth Commodities*

(Percent, ranked on 1984)

Commodity	Actual**			Projected***	
	1975	1980	1984	1990	2000
TOTAL, ALL COMMODITIES	0.9	1.0	1.6	2.4	4.4
TOTAL, TOP 40 COMMODITIES	1.1	1.7	3.1	4.6	7.1
Explosives	10.7	22.6	28.6	36.8	50.6
Yarn of natural fibers	3.6	4.2	11.0	17.1	27.2
Textile fabrics	3.9	5.6	10.3	15.4	23.9
Fibers other than cotton	3.9	6.1	8.1	11.1	16.1
Misc. textile products	3.7	6.5	7.7	10.1	14.1
Tin manufactures	0.1	1.9	7.7	13.3	22.7
Clothing	1.4	4.0	7.6	12.2	20.0
Hand tools for farming	1.5	3.8	5.9	8.4	12.5
Vegetables	3.4	5.2	5.4	7.2	10.2
Crude vegetable material	3.6	4.5	5.1	6.1	7.7
Essential oils	2.9	4.3	5.0	6.3	8.4
Aluminum ore	1.3	4.6	4.9	7.5	11.9
Misc. consumer goods	2.0	2.7	4.8	6.9	10.4
Cotton fibers	1.5	0.3	4.4	6.6	10.2
Toys	0.9	0.9	4.0	6.4	10.4
Soybeans	2.4	1.7	3.8	5.4	8.2
Cocoa	1.5	2.3	3.6	5.0	7.2
Crude Minerals	1.2	2.3	3.4	5.1	8.0
Feedstuffs for animals	0.6	0.7	2.7	4.3	6.9
Watches	0.4	1.1	2.6	4.2	7.0
Misc. nonferrous manufactures	1.4	1.9	2.5	3.8	6.1
Hides	1.2	1.8	2.4	3.3	4.8
Pharmaceutical goods	1.1	1.5	2.4	3.2	4.6
Radios	0.1	0.4	2.3	4.0	6.7
Cutlery	1.0	1.7	2.3	3.3	5.1
Footwear	0.9	1.5	2.2	3.3	5.2
Hand & machine tools	0.4	1.1	2.1	3.2	5.1
Glass	1.6	1.5	2.1	2.6	3.5
Petroleum products	0.3	1.7	2.0	3.2	5.2
Inorganic chemicals	0.6	1.3	1.8	2.7	4.2
Yarn of synthetic fiber	0.0	0.5	1.8	3.2	5.4
Crude petroleum	0.8	0.8	1.7	2.6	4.1
Furniture	0.7	1.2	1.7	2.4	3.7
Coal	0.2	1.0	1.7	2.8	4.7
Medicinal products	0.8	1.5	1.6	2.3	3.4
Imitation jewelry	0.3	1.5	1.5	2.4	3.9
Ships	0.0	0.1	1.3	2.3	3.9
Metal manufactures, nes	0.3	0.7	1.3	2.0	3.1

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Mineral tars	0.0	2.5	1.1	1.9	3.3
Corn	0.3	0.2	1.0	1.5	2.4
Elect. equip. for home use	0.0	0.3	0.8	1.3	2.2

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- * This table lists China's 40 fastest growing export commodities in terms of China's share of world market. These commodities are not necessarily the most important in terms of China's export revenues. Commodities are defined at the three and four digit level of the SITC, Revised.
 - ** Data for 1975-84 are estimated based on China's market share in its trade with 33 trade partners. This sample represents more than 80 percent of world trade.
 - ***Projections are based either on straight line or linear regression methods.

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would account for half of world sales by 2000.*

- o Only a few basic commodities made the list, including bauxite, cotton, soybeans, cocoa, corn, coal, and crude oil.
- o Although most of China's big-ticket items are on the list, some are not because their share of the world market is either stagnant or declining. Over the last 10 years China has lost its position in the world market for only a few of its exports, including such commodities as rice, fish, tobacco, unwrought tin and zinc, leather, and textile machinery.

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Impact on Western Markets

China has yet to tap its full potential in the world's largest markets for these commodities. In the past China's exports have been skewed heavily towards Japan and Hong Kong, the world's fifth and eighth biggest markets, respectively. The Chinese are just beginning to mount a significant sales effort in the United States and West Germany, the top two markets. The United States is not only the largest, but also the fastest growing market in the world for these 40 commodities, having expanded from 7 percent of the world market in 1975 to about 13 percent last year. The Chinese have only captured 3 percent of the US market, however, compared with nearly 10 percent of the Japanese market.

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Table 3 presents projections for China's share of its 10 leading Western markets for 1990 and 2000. China will remain Hong Kong's leading supplier as

* Although pyrotechnical articles account for the lion's share of this category, China is rapidly invading the market for dynamite, detonators, and ammunition. China is one of the most advanced countries in the field; recently it even signed a joint venture agreement to transfer technology to Sweden's Nobel Corporation, whose founder invented dynamite.

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Table 3
China: Actual and Projected Shares of
Ten Leading Markets*

(Percent)

Market	Actual			Projected**	
	1975	1980	1984	1990	2000
ALL COMMODITIES:					
WORLD	0.9	1.0	1.6	2.4	4.4
Hong Kong	20.3	20.0	25.0	29.8	37.9
Japan	2.6	3.1	4.4	5.7	7.7
United States	0.2	0.5	1.0	1.4	2.2
Singapore	3.5	2.6	4.7	5.7	7.3
West Germany	0.3	0.4	0.6	0.8	1.2
Brazil	0.0	1.1	3.9	4.3	7.1
Australia	0.9	1.2	1.4	1.4	1.8
Italy	0.3	0.4	0.5	0.5	0.7
France	0.3	0.3	0.4	0.6	0.8
United Kingdom	0.2	0.3	0.4	0.6	0.7
TOP 40 COMMODITIES***					
WORLD	1.3	2.3	3.8	5.4	8.1
Hong Kong	20.5	28.4	40.1	53.2	74.9
Japan	4.2	6.2	9.5	13.0	18.9
United States	0.4	1.9	3.3	5.2	8.5
Singapore	8.9	7.5	9.2	9.4	9.7
West Germany	0.5	1.1	1.5	2.2	3.3
Brazil	0.1	0.1	0.1	0.1	0.1
Australia	2.6	3.5	4.2	5.3	7.0
Italy	1.1	1.6	2.0	2.6	3.6
France	0.7	1.0	1.2	1.5	2.1
United Kingdom	0.7	0.9	1.0	1.2	1.5

* The markets listed in this table were China's ten leading markets in terms of total export revenues. Several other LDC trading partners were larger in terms of China's share of the market.

** Projections use linear extrapolation methods on disaggregated commodity data.

*** Unlike the previous table this group of China's fastest growing exports excludes crude oil.

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the 1997 date for China's resumption of sovereignty over the Territory approaches. By that date China and Hong Kong will be highly integrated economically. In the interim their economic interests are gradually beginning to coincide. Beijing and Hong Kong, for example, have agreed to take the same positions on multilateral trade issues in such fora as the Multi-Fiber Arrangement [redacted]

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China already has become a concern for economic policymakers in Japan. Last year China ranked sixth on Japan's list of foreign suppliers. China has exerted immense pressure on Tokyo to open up its markets to Chinese exports of manufactures, especially since the price of crude oil has declined. Beijing is particularly disturbed that Tokyo tends to use it as a natural resource base, buying up most of its oil, coal, nonferrous minerals and metals, while greatly restraining imports of clothing, textiles, and other light manufactures. The Chinese have some leverage in the matter by virtue of the direct controls Beijing can place on imports from Japan, which totaled \$12 billion in 1985-- nearly twice the level of China's exports. The United States has a major stake in the outcome of Sino-Japanese trade negotiations, because Tokyo's unwillingness to open its doors to China will put even greater pressure on Beijing to expand into the US market and because we are allies in our efforts to open up the Japanese market. [redacted]

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China's share of the US market has not risen as quickly as its share in some other markets, in part because the US market itself was expanding so rapidly. A rise in protectionist demands in the United States could reverse this tendency, however, and create even greater competition between China and other suppliers of labor-intensive manufactures. US quantitative restraints on imports tend to

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favor more established suppliers over newcomers to the market, and this could become a source of great friction in bilateral relations, should Washington take more restrictive measures. The recent slide in the dollar against the major currencies should restrict US imports from most countries. The Chinese themselves, however, have been devaluing against the dollar in order to be in a better position to compete. China's share of the US market also could do better than past trends suggest if the Chinese join the GATT and become eligible for US GSP tariff treatment. About 60 percent of China's exports would be covered by GSP and the average tariff on them would be lowered by 14 percentage points

Western Europe is one area China has targeted for a vast expansion in sales, a factor not accounted for in our projections. The EC constitutes nearly half of the world market for the products China will be exporting but accounts for only 15 percent of China's current exports of them. Likewise, the share of China's exports to the LDCs will gradually diminish as China concentrates its marketing efforts on the biggest and fastest growing markets.

Impact on China's Competitors

The strongest competition for China will come from the Newly Industrializing Countries (NICs), in particular Taiwan, Hong Kong, South Korea, Brazil, and Mexico. The 10 largest LDC competitors for China and changes in their shares of the world market over the last 10 years are shown in Table 4. Overall, only India and Argentina are badly losing ground, while South Korea and Taiwan are keeping pace with China. Shares of the world market for the other six countries have increased marginally

China's competitiveness varies by commodity, but in textiles and clothing

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Table 4

China and Its Competition: Changes in Shares of World Market
From 1976 to 1984 for China's Fastest Growing Exports

Commodity	China	Taiwan	Hong Kong	South Korea	Brazil	Mexico	India	Thailand	Singapore	Argentina	Malaysia
Total, Top 40 Commodity	2.6	2.5	0.5	2.1	0.6	0.2	-0.1	0.2	1.0	0.2	0.3
Explosives	11.0	-1.9	0.6	-0.1	-0.1	0.1	0.1		0.1		0.1
Yarn of natural fibers	8.2	0.2	-1.2	-0.8	0.7	-0.6	-0.6	0.3	-0.6	-0.1	-0.1
Textile fabrics	6.8	1.3	-0.7	3.1	0.5	-0.4	-1.2	0.2	-0.1		0.1
Clothing	6.2	2.4	-0.7	1.1		-0.4	0.2	0.6	0.2	-0.1	0.6
Fibers other than cotton	4.1	1.1	0.3		0.1	0.4		-0.1		-0.7	-0.1
Aluminum ore	3.4		0.1		8.1						0.1
Hand tools for farming	3.3	10.2	0.2	1.3	1.5	0.7	-0.1	0.1			
Toys, Sporting Goods	3.3	11.5	1.8	4.4		0.6	-0.2	0.1	0.6		0.4
Misc. textile products	3.2	2.1		-2.3	0.7		0.9	0.2	-0.1		
Cotton fibers	3.0	0.1			-0.1	-0.3	-1.1	0.1		-1.2	
Misc. consumer goods	2.8	6.6		-0.6	0.1		0.2	0.3	0.2		
Crude Minerals	2.4	0.1			0.8	1.1	0.6		0.1		0.2
Vegetables	2.4	0.4	0.3								0.2
Soybeans	2.4				-4.4	0.2	-1.9	-0.3		-0.3	-0.1
Watches & Clocks	2.2	0.3	8.6	0.7		-0.5		-0.3	-1.5	0.7	0.2
Radios	2.2	3.2	-1.7	3.9	1.4	3.9					-1.2
Feedstuffs	2.2	0.2			6.0		-2.3	0.3			1.3
Cocoa	1.9	-0.3	0.1		-0.2	-0.3	-0.2	0.2	0.8	1.9	0.3
Yarn of synthetic fiber	1.8	3.2	-0.4	1.5	0.7	0.2	0.1	0.3		0.4	0.9
Misc. nonferrous metals	1.8	0.2		-0.3	0.1	-0.5	-0.1	-0.1			
Petroleum Products	1.7	0.1		0.2	1.2	1.1	0.2			0.6	0.2
Coal	1.6										
Hand & machine tools	1.5	5.7	0.3	0.3	0.4	0.2	-0.3		0.3		
Footwear	1.5	7.4	-0.1	3.3	4.8		-0.1	0.3			
Cutlery	1.4	6.8	1.3	3.7	0.2	-0.2	0.9			-0.1	-0.3
Ships(non-war)	1.3	1.9	4.1	3.1	0.1	0.2	3.3		0.1		
Crude vegetable materials	1.3	0.2	0.1	-0.5	-0.2	-0.5	-1.2	0.1	1.3		0.2
Crude Petroleum	1.3					0.0	0.8			-0.2	-0.1
Inorganic Chemicals	1.3	0.2			0.5	0.7					1.5
Imitation Jewelry	1.2	13.1	-3.7	3.6	-0.1	0.1	1.4	0.1			0.1
Crude Chemicals	1.1	0.8		5.0	1.5	0.6					
Pharmaceutical Goods	1.1	-0.4	0.3	0.1					1.7	0.8	
Hides	1.0		0.1		-0.1	-0.1	-0.2	0.1	0.2		0.1
Furniture	1.0	6.8	-0.3	0.2				0.1		-1.9	-0.1
Metal manufactures, nes	1.0	3.4	0.3	1.6	0.5	0.2		0.5	0.4		-0.1
Medicinal Products	0.9	-0.1		-0.1							
Glass	0.8	3.9	0.5	1.1	0.4	0.6	0.1	-0.5	-0.1		
Elect. equip. for home use	0.7	2.8	3.8	3.3	0.4	0.6	0.1	0.1	0.1		0.1
Corn	0.7	0.1			-0.2				1.9		0.1
								-2.5	0.2	-2.6	

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China has no peer. Its share of the world market for natural yarn, fabrics, and clothing has increased by 8,7, and 6 percentage points, respectively, the largest gains for any country. Hong Kong, Mexico, India, and Singapore have all felt China's onslaught, each having lost shares in these products.

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Hong Kong's situation presents a major dilemma for Beijing. In many cases China's gain has come at Hong Kong's expense. As China expands its presence in the world market, Beijing will have to take account of the negative impact of its actions on the Territory. This will circumscribe Beijing's options, probably leading to greater moderation in its trade policies. South Korea and Taiwan have held their shares better than Hong Kong. Both of these economies have had greater success in moving rapidly into new product lines--hand and machine tools, toys and sporting goods, radios, household electrical equipment, etc, as well as many new technologies.

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Several developed countries have been the largest "losers" over the last 10 years in the product lines where China has done the best. West Germany, France, the United Kingdom, Italy and the United States, combined, have lost 10 percent of the world market in these goods. These countries probably did not have a comparative advantage in most of these products, however, and their shift into higher-technology areas may have produced a net gain in world output. Many LDC producers, however, have not come away unscathed. Iran--largely for its own reasons--and Pakistan, as well as Jamaica, Trinidad and Tobago, Ghana, Nigeria, Sudan, and Peru, have seen their market shares slip sharply.

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For many countries, the export lines China has targeted for fastest growth account for a significant share of export earnings. These include some of the poorest countries of Asia, Africa, and Latin America. On average, China's 40

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fastest-growing exports account for an estimated 40 percent of the non-oil exporting LDC's foreign exchange earnings. They account for nearly 70 percent of the exports of South Asia, the region most likely to be hurt by China's advances.

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Alternative Export Scenarios

Until recently the Chinese were counting on oil exports to help support their ambitious drive for modernization. Disappointing results of offshore oil development and declining world prices, however, have forced Chinese leaders to reexamine their trade policies. China now appears to be adopting an even more aggressive export strategy, which will create more competition and conflicts with other developing countries.

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Our analysis suggests that even though China's exports now amount to 7 percent of GNP*, China still is severely undertrading. We believe a "normal" export share of GNP for China might be on the order of 14 percent, nearly double the current share. A number of factors determine what share of a country's output is likely to be traded, including the size of the domestic market, the per capita income of the populace, the domestic availability of resources, the physical accessibility of the country to international shipping lanes, population density, and the nature of the economic system. Our estimate of a "normal share" for China is based on multiple regression analysis of export to

* Western estimates of China's GNP in terms of dollars are subject to a large degree of error because of the lack of an appropriate exchange rate for converting national accounts data, the lack of good statistics on the services sector in China, and the irrationality of domestic prices used to value output. Comparisons of output and GNP figures between China and other countries suggest that China's GNP may be much larger than even the highest Western estimates now available.

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GNP ratios on these eight factors for 44 countries.**

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Although we have no evidence to show that the Chinese have made any precise calculations on how much they ought to trade, intuitively Beijing must realize that China is still not trading up to its potential. Each time Beijing has pushed the "open door" wider--both exports and imports have risen dramatically.

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We believe that China's potential to expand exports is vast, but that in the near term a range of factors will restrain export growth:

- o China's international marketing network is skewed towards Asia-- developing a presence in the United States, Europe, and in the rapidly advancing LDCs will take time.
- o China has yet to develop adequate concern for the needs of the buyer, the result of operating for so long in a supplier's market in which consumers had no choice but to take what was offered.
- o Chinese managers still have little incentive to take risks in developing new products or markets.
- o Perhaps the largest constraint, however, is China's antiquated transportation system. The cost of moving goods between the hinterland and the coastal cities of China often exceeds the cost of shipping goods overseas.

**These countries include eight developed countries (the United States, Canada, Japan, France, Italy, the Netherlands, United Kingdom, and West Germany), eight communist countries (the USSR, Bulgaria, Czechoslovakia, East Germany, Hungary, Poland, Romania, and Yugoslavia), and 28 less developed countries (Indonesia, Malaysia, Philippines, Thailand, Bangladesh, India, Pakistan, Iran, Iraq, Syria, Saudi Arabia, United Arab Emirates, Kuwait, Qatar, Egypt, Algeria, Libya, Morocco, Ivory Coast, Gabon, Nigeria, Zaire, Zimbabwe, Chile, Columbia, Ecuador, Peru, and Venezuela)

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Thus, while China ultimately might benefit from doubling the share of trade in GNP it is highly unlikely to do so in the near term. Nevertheless, our analysis suggests that China's trade will continue to expand at a faster rate than the domestic economy, for at least the next 15 years.

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IMPORT PROSPECTS

The Future For Imports

According to our projections, China's targets for domestic output would generate import growth of 7.3 percent per year between 1985 and 1990, a figure which coincides roughly with the Chinese target for imports of 8 percent (see Table 5).^{*} Our projections also imply an import growth rate of 9.6 percent over the entire period 1980-2000, a rate only slightly faster than the 7.2 percent targeted by Chinese planners for the growth of Net Material Product

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Industrial supplies will continue to account for the largest chunk of China's import budget. Demand for industrial supplies will increase at a faster pace than the domestic economy can supply them. Our simulations show that every 1-percent increase in the Gross Value of Industrial Output (GVIO) has resulted in a 1.1- to 1.3-percent rise in imports for the industrial sector. If GVIO rises 7 percent per year according to plan, imports are likely to increase 7.4 to 8.9 percent per year.

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Foodstuffs are likely to remain a small portion of China's total import bill. Agricultural reforms, begun in 1979, have been so successful in boosting production and raising living standards that many of China's recent policies have centered on controlling, rather than increasing production, in order to reduce surpluses and reduce storage costs and waste. Over the long term we have no reason to believe that shortfalls in agricultural production would lead to a significant upturn in imports. In the past China's imports of grain have been

^{*} See Appendix B for a discussion of the methods used in estimating China's imports.

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Table 5
China: Import Requirements Generated By Beijing's
Targets for the Domestic Economy

(Billion Current US Dollars)

	Actual		Projected	
	1980	1985	1990	2000
Total	19.2	39.5	56.1	119.6
Foodstuffs	2.9	1.9	2.6	2.6
Consumer Durables	0.5	2.2	2.9	5.5
Industrial Supplies	10.0	17.9	25.6	54.4
Capital Goods	5.8	17.5	25.0	57.1

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primarily related to shipping constraints within China. The Chinese found it more economical to import grain into coastal areas than to ship it from the interior on an already overburdened transport system. Although the Chinese could gain substantially by shifting production out of wheat and into higher-yielding crops, we believe that over the next five to 10 years these transport costs will remain the major constraint on trade. Hence, we feel imports of foodstuffs probably will not increase substantially from current levels. [REDACTED]

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Consumer durables have always been a small share of total imports, even in recent years, when China's planners made a conscious attempt to boost standards of living and soak up excess currency by selling these goods in the domestic market. Wasteful expenditures on TVs, VCRs, cameras and the like were much ballyhooed in the Chinese press last year in conjunction with the anti-corruption campaign; however, these clearly were not the reason for the significant jump in imports (see figure 2). Future increases in consumer durable imports will come only gradually. [REDACTED]

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Capital goods have always been the most variable component of China's total imports, declining (from their previous peak) in the first half of a five-year plan and rising sharply to a new peak late in the second half (see figure 2). In 1985, imports of capital goods skyrocketed to more than \$17 billion, as Chinese enterprises rushed to complete projects scheduled under the last five-year plan and began gearing up for production in the next. We estimate that capital goods imports will tail off during 1987 and 1988 but then begin to rise in 1989, before peaking again in 1990. [REDACTED]

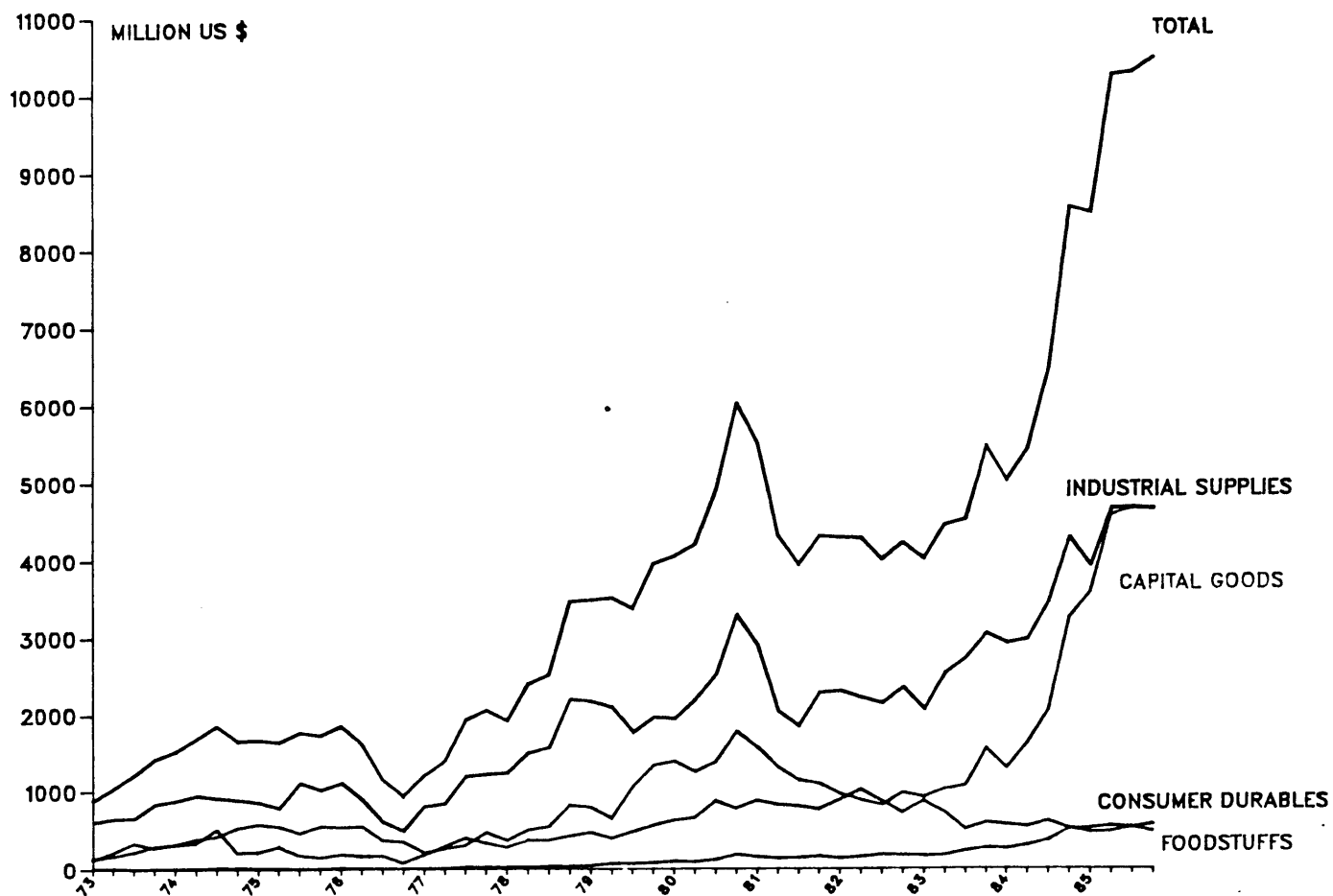
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Our projections of China's imports of capital goods are based on their past relationship to Chinese investment in fixed capital. According to a recently

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CHINA: IMPORTS BY END USE



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completed Rand Corporation Study,* China's goal of quadrupling output by the year 2000 will require investment growth of 7.5 percent per year, a figure that we have used for our simulation. Overall our projections show a net trade deficit of roughly \$50 billion from 1986 to 1990, and equal amounts for the following two five-year plans. This is in line with statements made by Chinese leaders concerning China's financing needs, as well as with the results of the Rand Study. Assuming an average maturity of five years on this debt, China's debt service ratio would only rise to 20 percent, an amount that is certainly tolerable [REDACTED]

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China's Take From the World Market

By the year 2000 China will become one of the world's 10 largest markets if it continues to expand imports at the same rate it has since 1978. At current growth rates, China's share of the world market will reach 2.8 percent in 1990 and 4.8 percent in 2000. This would be consistent with import growth of 7.7 percent per year, the scenario we put forward above, provided world trade expands at 2 percent annually. [REDACTED]

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China's fastest growing imports (in terms of its share of the world market) are shown in Table 6. During the Sixth Five-Year Plan (1981-85) these 40 products accounted for roughly 70 percent of China's total imports and one-quarter of the world's total exports.

o Capital goods and industrial supplies are clearly Beijing's top priority.

They are the fastest growing imports and account for four out of five

* K. C. Yeh, "Estimating Capital Needs For China's Economic Development," A Rand Note, N-2439, March 1986 [REDACTED] 25X1

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Table 6
China: Actual and Projected Shares of World Imports,
Top 40 Growth Commodities*

(Percent, ranked on 1984)

Commodity	Actual**			Projected***	
	1975	1980	1984	1990	2000
TOTAL, all commodities	0.8	1.0	1.4	2.8	4.8
TOTAL, top 40 commodities	1.6	2.5	4.1	7.2	11.0
Zinc unwrought	0.0	0.0	11.1	15.0	27.6
Steel bars	2.5	4.4	9.0	13.8	21.8
Fertilizer	6.7	8.0	9.0	9.1	12.7
Televisions	0.0	3.8	8.6	10.8	18.9
Wheat	4.8	12.4	8.4	12.4	19.2
Steel sheets	4.1	3.4	7.5	10.1	14.5
Electron accelerator equip.	1.0	0.2	7.5	12.4	20.5
Railway vehicles and equip.	0.5	0.1	7.4	12.8	21.8
Fibers other than cotton	2.1	6.9	6.8	10.3	16.2
Steel pipe	4.0	3.4	6.7	8.0	10.3
Yarn of natural textile fiber	0.6	3.3	5.9	9.9	16.5
Copper ore	0.0	2.0	5.8	10.2	17.4
Yarn of synthetic fibers	0.9	3.8	5.6	9.0	14.8
Electric medical apparatus	0.4	1.0	4.6	7.7	12.8
Copper unwrought	1.1	0.8	4.4	7.4	12.4
Textile machinery	0.4	2.8	4.4	7.5	12.6
Steel ingots	2.7	0.6	4.3	6.3	9.7
Insecticides	0.3	1.0	4.1	7.0	11.9
Electric measuring equip.	0.8	1.8	3.8	6.3	10.4
Crude rubber	2.4	3.4	3.7	5.6	8.7
Wood, lumber & cork	0.0	0.4	3.7	6.4	10.9
Plastic materials	0.6	1.3	3.4	5.5	9.0
Textile fabrics	0.3	1.7	3.4	5.6	9.2
Glassmaking machinery	0.8	2.7	3.3	5.8	9.9
Motorcycles	0.0	0.1	3.3	5.8	9.9
Silver, platinum, & lead	0.6	0.2	3.1	5.1	8.5
Mining machinery	0.5	1.7	3.0	5.1	8.6
Trucks	1.1	0.7	2.8	4.6	7.6
Misc. industrial machinery	0.7	1.9	2.6	4.1	6.6
Leather & dressed furskins	0.0	2.5	2.4	4.2	7.2
Telecommunications equip.	0.2	0.5	2.4	4.1	7.0
Watches & clocks	0.5	1.5	2.1	3.4	5.7
Sound recorders	0.0	0.4	2.1	3.6	6.1
Phonograph records & tapes	0.0	0.5	2.1	3.6	6.1
Paper and pulp mill machinery	0.2	0.3	2.0	3.4	5.8
Cameras	0.2	0.5	2.0	3.4	5.8
Ships	2.1	3.5	1.8	2.9	4.8
Tobacco	0.0	0.4	1.8	3.2	5.4

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Food processing machinery	0.1	0.2	1.8	3.2	5.4
Electric equip. for home use	0.0	0.2	1.7	3.0	5.1
Computers	0.1	0.6	1.4	2.4	4.2

-
- * This table lists China's fastest growing import commodities in terms of share of the world market. These commodities are not necessarily the most important in terms of China's total import expenditures. Commodities are defined at the three and four digit level of the SITC, Revised.
 - ** Data for 1975-84 are estimated from China's market share in its trade with 33 trade partners. This sample represents more than 80 percent of world trade.
 - ***Projections are based either on straight line or linear regression methods.

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items on the list. Imports such as steel, zinc, copper, and lumber, suggest Beijing's emphasis on capital construction projects; purchase of railway equipment, trucks, ships, and road-building machinery are indicative of China's efforts to overcome transport bottlenecks; and imports of fertilizers, insecticides, textile fibers and yarn, tobacco, and machinery for the textile, glassmaking, papermaking, and food processing industries demonstrate China's commitment to relieving constraints on light industry.

- o On the other hand, the increase in Chinese purchases of televisions, motorcycles, watches, sound recorders and recordings, cameras and household electrical equipment, from virtually a zero share of the world market, suggests that a huge repressed demand for consumer durables exists in China. We believe this will be a continuing problem Beijing will have to grapple with, at least through the turn of the century. Beijing's solution probably will be to continue restricting imports while forging ahead to boost domestic production. This is probably consistent with China's comparative advantage in these areas.
- o A number of China's high-value imports are not on the list--as China's own production increased its share of the world market dropped for such products as organic chemicals, paper, cotton, vegetable oils, aluminum, metalworking machinery, boilers and turbines, and ball bearings

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Beneficiaries of China's Import Surge

Presently, the geographic distribution of China's imports of these commodities differs substantially from the geographic distribution of the rest of the world's imports. This leads us to believe that as China's economy

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approaches a more "normal" market-orientation, the direction of China's imports may change significantly. China's imports have been skewed heavily towards Japan, perhaps more a reflection of Japan's geographic proximity and historical trade relationship than of Japan's innate competitive abilities in these areas. In the last two years Japan accounted for more than 30 percent of China's imports, compared with its share of only 15 percent of the world market. In contrast, the US share of China's market for these 40 commodities is slightly below its 13-percent share of the world market; West Germany, the world's largest exporter of these 40 products with a 14-percent share of the world market, accounts for only 4 percent of China's imports

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Table 7 presents projections for China's share of the exports of its 10 leading Western suppliers for 1990 and 2000, based on the assumption that current trends continue. Japan would remain China's leading supplier, with Hong Kong--acting in many cases as an entrepot for other countries--fast approaching Japan's share

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In 1985 China became the second largest market for Japan, accounting for 7.1 percent of Japan's total exports. Last year was undoubtedly a peak year, however, and we expect China's share of Japan's total exports will grow only marginally hereafter, to perhaps 8.8 percent by 1990. From 1980 to 1984 Japan's exchange rate depreciated 24 percent against the dollar, but then jumped back to the 1980 level at the end of 1985. This has led the Chinese to request renegotiation of major capital equipment contracts already signed, a request to which some Japanese firms have reluctantly agreed. The Chinese tend to be more sensitive to import price hikes than most countries; hence, the yen appreciation could lead to slower growth in China's share of Japan's sales than past trends

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Table 7
Leading Suppliers of China's Imports:
Share of Exports Going To China*

Exporter	(Percent)				
	Actual			Projected**	
	1975	1980	1984	1990	2000
ALL COMMODITIES					
WORLD	0.8	1.0	1.4	2.8	4.8
Japan	4.0	3.9	4.2	8.8	12.0
Hong Kong	0.6	6.4	17.8	29.3	48.4
United States	0.3	1.7	1.4	2.4	3.7
Canada	1.1	1.2	1.1	1.2	1.2
West Germany	0.6	0.6	0.6	1.5	2.1
France	0.7	0.3	0.3	0.9	1.7
Australia	2.7	3.5	3.3	4.2	5.2
Italy	0.4	0.3	0.6	0.7	1.0
Brazil	0.8	0.4	1.8	2.5	3.6
United Kingdom	0.4	0.3	0.5	0.5	0.8
TOP 40 COMMODITIES					
WORLD	1.6	2.5	4.1	7.2	11.0
Japan	5.0	5.0	6.8	15.4	22.2
Hong Kong	0.6	15.4	39.0	64.6	100.0
United States	0.1	3.5	4.3	7.1	11.8
Canada	3.9	3.3	3.7	3.6	3.3
West Germany	1.1	1.0	1.5	1.8	2.2
France	0.8	0.7	1.0	2.2	3.0
Australia	6.0	7.4	9.1	11.2	14.6
Italy	0.9	1.0	1.8	2.4	3.4
Brazil	0.0	1.3	0.0	12.5	20.8
United Kingdom	0.4	0.9	1.4	2.1	3.2

* This table shows China's top 10 suppliers based on China's total import expenditures, not on China's share of the exporter's market. Several LDCs had higher export shares going to China.

** Projections use linear regression techniques on disaggregated commodity data.

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China's purchases from Hong Kong --as well as its sales to the Colony--are growing at such a pace that by 1997 the colony will be economically integrated into the mainland. Projections of current trends show that for China's top 40 imports, China would account for all of the colony's sales by 2000, a feat which of course is virtually impossible. What our projections clearly suggest, however, is that Hong Kong's economic fate will depend in great part on China's continued economic growth. Major shifts in Beijing's economic policies could have a devastating impact on the colony. [REDACTED]

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US prospects for sales to China probably are better than indicated by a projection of past trends. US exports have been held in check since 1980 by several factors, including the appreciation of the US dollar, declining Chinese demand for grain, and perhaps even Chinese retaliation for US attempts to restrict textile imports. In 1980, with the dollar at a low, the United States occupied 20 percent of the Chinese import market, a figure which fell to 11 percent in 1984, when the dollar reached its peak. Roughly half of the decline was due to Chinese cutbacks in grain purchases, however. If the dollar stabilizes at current levels, the United States probably could take a 15 percent share of the Chinese market, equal to the present US share of the world market for the commodities China is buying. [REDACTED]

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Overall the developed countries account for more than 80 percent of the world's supplies of China's 40 fastest growing imports, and we expect them to gain the most through China's emergence. Western Europe's share of the China market is far below its share of the world market for the same commodities. China simply has been too far away to attract much attention from businessmen in

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these countries. Only the biggest European firms have put much effort into exploiting this rapidly growing market. Nevertheless, we expect China's imports from Western Europe to continue making sizeable gains because of the nature of the products China will be buying. [REDACTED]

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Among grain exporters, Canada and Argentina probably will be hurt the most from China's shift away from importing wheat. China has not yet tapped Canada's potential as an exporter of trucks, mining equipment, and telecommunications gear, nor of various commodities such as fertilizer, copper, and zinc. On the other hand, China's importance as a market has continued to rise for Australia, because Australia has been able to find other commodities such as iron ore, steel, zinc, and plastics to sell in place of wheat. [REDACTED]

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We estimate that sales to China will not grow nearly as fast for the developing countries as for the developed. A number of developing countries, however, are major exporters of some commodities that China will be buying, and therefore, stand a good chance to benefit from China's import surge. These include exporters of copper ore and unwrought copper and zinc: Zambia, Zaire, Chile, Papua New Guinea, and Peru; wood exporters: Burma, the Philippines, and several other equatorial countries; tobacco exporters: Malawi and Zimbabwe; and rubber exporters: Malaysia, Sri Lanka, and Liberia. [REDACTED]

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For many products the NICs also are in an excellent position to reap the benefits of China's expansion. South Korea and Taiwan are becoming major exporters of synthetic textiles, fabrics, steel, plastics, televisions and telecommunications equipment. Their sales to China, through Hong Kong, have jumped dramatically, a factor that could lead to increased pressures to deal directly with Beijing. Of all the developing countries, however, Brazil clearly

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has the most to gain from China's emergence. By 1990 China will be one of the top three buyers for several of Brazil's exports: plastics, pig iron, steel, and fertilizer. Brasilia and Beijing have agreed to technological exchanges in a variety of fields, including nuclear power development. [redacted]

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The Communist countries' share of China's trade probably will not increase dramatically, with one exception, the USSR. The Soviets have many of the goods that China needs most: steel, lumber, nonferrous metals, trucks, aircraft, and other capital goods. Soviet technology in areas such as hydropower, long-distance power transmission, and metallurgy generally is equal to what China could get from the West. The Chinese realize, however, that for development purposes the latest in Western technology is not always the most appropriate for their needs--Western technology often is geared to saving on high-cost labor, while the appropriate technology for China would be capital saving and labor using. In some fields, the Soviets offer technology that may be more appropriate for China's stage of development. For example, the Chinese will be able to use Soviet assistance in revitalizing many of the factories built by the Soviets back in the 1950s. The Sino-Soviet five-year trade agreement agreement signed last year calls for a tripling of bilateral trade by 1990--as a result the USSR's share of China's trade probably will increase from 3 percent last year to over 6 percent by 1990. This share could increase even further if China contracts with the Soviets to construct major development projects outside the barter agreement [redacted]

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IMPLICATIONS FOR THE GLOBAL TRADING SYSTEM

Converging Interests: China and the Developed Countries

China's entry into the global trade system--after years of economic isolation--offers the rest of the world the possibility of major economic gains through specialization of production and trade. The gains will undoubtedly be greater for the developed than for the developing countries, due to the greater complementarity of the economies and the lower risk of destructive competition. In our judgment, China will be a major buyer of Western technology and industrial goods, at a time when other markets may be in decline. China will also be a significant new borrower of Western capital, at a time when other developing countries have reached their limits. Because China used great caution in borrowing when interests rates were high, China is one of the few developing countries that still has a large capacity to expand borrowing and repay its loans. [REDACTED]

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The surge in China's demand for capital goods and technology has opened significant opportunities for sales by the developed West, but it has created new challenges as well. In some sectors--textiles and apparel in particular--the Chinese will outcompete local producers, causing a contraction of domestic industries. China's entrance into the world economy thus will entail some major adjustment costs on the part of the developed countries. [REDACTED]

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China's growing power as a major buyer has also given Beijing a new source of influence with Western policymakers. Beijing often has used the lure of increased sales as a bargaining point in its negotiations both with foreign suppliers and with their governments. Beijing also has threatened to cut

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imports from countries that have restricted Chinese exports

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We believe the Chinese will use their economic leverage primarily to achieve their overriding economic goals, not in the pursuit of political or military ends. Chinese negotiators frequently insinuate that increased trade depends on an improvement in political relations, but Beijing does not normally use explicit trade threats or promises for political objectives. There is no hard evidence, for example, that Beijing has ever promised to increase trade with a country in return for its switching diplomatic recognition from Taipei.

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Diverging Economic Interests: China and the LDCs

Over the last 35 years Beijing has consistently supported the views of the developing countries in international organizations. China's own economic interests, however, do not always match those of the Third World. In practice, China behaves more as a competitor than as a compatriot. In the future, we expect that China's practical objectives in the international economy will begin to clash strongly with those of many other developing countries.

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The most detrimental effects of China's outward looking trade strategy will be incurred by the developing countries. As an exporter, China will compete fiercely in developed country markets for light industrial goods, particularly with the Newly Industrializing Countries. This export thrust will squeeze the foreign exchange earnings of labor-intensive, low-cost, LDC manufactures by making it more difficult for them to compete in developed country markets. Although the Chinese have consistently urged the developed countries to grant trade preferences to "emerging" nations, they have used their leverage as a major buyer to obtain favorable treatment for their own exports, to the

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exclusion of other low-cost producers. This behavior conceivably could force many developing countries to accept market sharing arrangements with the developed countries, just so that they can hold onto their present shares [] 25X1

As an importer, too, China's interests probably differ substantially from those of most LDCs. China's competitive strength comes from exporting finished products. For most commodities China will be mainly a buyer rather than a seller. As a buyer China will benefit most by declining commodity prices, in contrast to many LDCs, which would rather see commodity prices increase.* For this reason, China has consistently refused to participate in any of the major commodity cartels. [] 25X1

So far most LDCs have not felt the brunt of China's expansion, and appear to be oblivious to China's potential negative impact on them. Most see China as a champion of third world causes, a source of development aid, and as a potentially large market for their own exports--an image Beijing has carefully cultivated.** They fail to see China as a first rate competitor, an alternative

* Crude oil may be an exception to this. At this point the Chinese are not sure whether their advantage lies in higher or lower prices. The sharp drop in price earlier this year cut China's expected foreign exchange earnings from oil in half, to about \$3 billion. In the long run, however, energy is one of the chief constraints on China's economic growth, and if prices stay low, China might be able to shift some of its planned oil exports back to domestic consumption [] 25X1

** In the last year, the Chinese have made a major effort to court the LDCs of South Asia, the Middle East, Africa, and Latin America, with lengthy trips to those areas by Premier Zhao Ziyang, Party Chairman Hu Yaobang, President Li Xiannian and other ranking leaders. They have voiced strong support for debt relief for the developing nations, economic sovereignty over the multinationals, and a New International Economic Order, issues in which they have only marginal interest. In large part, this effort to portray China at the forefront of the fight for Third World issues is designed to garner support among the LDCs for the issue most critical to China--the elimination of protectionism and reduction of the barriers to China's trade [] 25X1

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outlet for Western investment, or as a importing country with many interests in common with the industrialized nations. [redacted]

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Only a handful of LDCs have voiced any concern about the implications of China's emergence for themselves. India was the first LDC to have any misgivings, having lost nearly half of its World Bank allocations to China, following China's admission to that organization. Even though Brazil probably has much to gain through trade with China it is becoming more reluctant to support China's participation in activities of the Group of 77, GSTP meetings, and in the GATT. Pakistan, too, is beginning to adjust its views on China, a likely result of changes in the structure of bilateral trade in the last few years. Pakistan now sees China as a major competitor for cotton fiber exports, rather than as a major buyer, the situation just three years ago. Indonesia's trade relations with China have been on-again and off-again, but Jakarta's reluctance is not out of concern for China's economic potential, but out of fear that Chinese traders will act as insurgents. [redacted]

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As China has offered generous terms in its trade with the developing countries, most of them will be unwilling to erect barriers to China's exports in order to fence off China's thrusts into third-country markets. Their best hope is to negotiate carefully on China's accession agreement to the GATT. [redacted]

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China and the GATT

The case for China's admission to the GATT is substantially different from that of other centrally planned economies because of its huge export potential. Although China is moving to reform the economy, whenever problems arise with the

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economic reform effort China's natural inclination will be to return to previous modes of operation. In the process, the Chinese will create institutions that may be rather onerous to the market oriented trading system. The Chinese have made every effort to insure that they gain the maximum benefits of the open door policy and of economic reforms, often at the expense of their trade partners:

- o China has a strong penchant for the use of barter and bilateralism in its foreign economic relations. The Chinese will link their import decisions to the willingness of foreign markets to open up to China's exports.
- o The Chinese have developed and will maintain an extensive system of subsidies to exporters. These include favorable "internal" exchange rates, direct rebates, foreign exchange retention and allocation schemes, favorable tax and tariff treatment, and priority access to raw materials, energy, and transportation. If the GATT contracting parties are to protect themselves against unfair trade by China, they will need to devise procedures for judging whether the Chinese are engaged in dumping their products.
- o The Chinese system is replete with devices for protecting the domestic market. In addition to the standard methods of tariffs, quotas, and licensing procedures, there are a host of other channels for government interference in import decisionmaking, including direct and indirect administrative controls, credit controls, and restrictions on foreign exchange allocations and disbursements.
- o In order to cope with what the Chinese perceive as a persistent foreign exchange shortage, the Chinese have adopted a series of trade-related investment measures that will distort trade patterns. These include

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such measures as export performance requirements, technology import requirements, and requirements that investors maintain foreign currency balances with the Bank of China.

- o Government-run trade corporations will remain a part of the landscape, even though their direct role in trade decisionmaking diminishes. Industrial targeting and trade discrimination are second nature to these corporations. Although the Foreign Trade Corporations (FTCs) under the Ministry of Foreign Economic Relations and Trade (MFERT) presently are directly responsible only for about 40 percent of trade, probably more than 80 percent of all trade transactions involve the FTCs in some way--marketing, negotiations, shipping, etc.

As a result of these problems we believe that the West must negotiate carefully China's admission to the GATT to insure that their economies are not unfairly hurt by China's trade expansion. [redacted]

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Are the Chinese Dumping?

Because wages, prices, and interest rates do not reflect their true costs in China, the Chinese have difficulty determining in what product lines they have a comparative advantage. In their annual trade plans, the Chinese establish foreign exchange targets for individual exports. As a result of these foreign exchange targets, China's trade behavior has been economically perverse. In the short-run, declining world prices often meant the Chinese would try to expand exports in order to reach a specific foreign exchange target, while increasing world prices allowed them to cut the volume of exports after fulfilling their foreign exchange quotas. Over the longer run, volumes generally were adjusted to changing world prices but without much regard for real domestic costs

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Once foreign exchange quotas have been established in the plan China's pricing strategy in essence has been to sell at whatever price the market would bear. The Chinese have already encountered complaints from US manufactures that they are dumping products as diverse as manhole covers, menthol, mushrooms, wax candles, clothespins, chloropicrin, ammonium paratungstate, greige goods, and printcloth. In some of these commodities the Chinese probably have a comparative advantage--based on low real labor costs--and are relatively efficient producers. In other cases, the Chinese may be exporting, despite a comparative disadvantage, simply because they do not know what their real costs are. Although we do not have any evidence that China is pursuing a policy of predatory pricing in order to drive competitors out of the market, in effect it sometimes--wittingly or unwittingly--engages in a form of dumping to expand its market share. Perhaps the biggest challenge for GATT will be to find a solution to this problem

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IMPLICATIONS FOR US POLICY

We believe the United States has a major stake in China's successful integration into the Western trade system. China's geopolitical course and growing economic and political power will offer numerous opportunities for the advancement of US interests. As with any change of such global proportions, however, there are bound to be conflicts as well as common interests. The Chinese are tough-minded and hard bargainers. Still mindful of the exploitation of China by other countries when it was disunited in earlier times, the Chinese today are sensitive to what they regard as their sovereign prerogatives when negotiating with either governments or private business firms. Their constant use of the term "equality and mutual benefits" in laying down the preconditions for any dealings demonstrates their continued prickliness on this issue. But they often pursue their interests in a way to ensure that the benefits accrue more equally to China than to its partners.

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Economic Costs and Benefits

China's program of economic modernization will benefit many US economic and commercial interests. Prospects for US sales are very good in areas such as coal-mining and oil-extraction equipment; hydroelectric and electric power generation; locomotives, aircraft, and trucks; telephones, computers, and air traffic control systems; defensive weapons and military avionics; and plastics, synthetic fibers, lumber and fertilizer. We estimate that US sales to China over the period 1986 to 2000 will total \$130-160 billion. This will be partially offset by losses of \$8-10 billion in US exports from Chinese encroachment on traditional US markets, particularly in the Far East and primarily for commodities such as corn, cotton, soybeans, and crude chemicals.

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How much the US economy gains or loses from China's huge financing efforts will depend primarily on whether the United States itself is a net borrower or lender. The \$150 billion in financing that we project China will need over the next 15 years pales in comparison with net US borrowings of \$125 billion last year alone. Although US banks would clearly benefit from fees earned through servicing Chinese loans, these fees may not be sufficient to offset the economic losses caused by upward pressure on interest rates if both the United States and China are competing for funds. [REDACTED]

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In a similar vein, the economic benefits of US direct investment in China may be diluted if the investment would otherwise have been made in the United States. This danger would be compounded if the technology transferred to China through the investment created competition for industry in the United States. US investment in China may carry less risk than investment elsewhere, however. Because China's investment demand will be largely for infrastructural and resource development projects, we believe China is not likely to be a significant alternative to US investment at home. [REDACTED]

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We estimate that US investment in China--already worth about \$1.4 billion--could reach \$10-15 billion by 2000. As investment increases US businessmen will intensify pressure on Washington to obtain concessions from China for fair and equal treatment of investments, compensation against expropriations, and guarantees of foreign exchange convertibility and remittances. Unless China's economic system changes dramatically, however, Beijing will continue to have difficulty offering such concessions, a factor that will be a source of irritation in bilateral relations. [REDACTED]

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We estimate that Chinese sales to the United States will total \$75-100 billion over the next 15 years. US industries such as textiles, clothing, and processed foodstuffs will be hurt the most. Actual economic losses, however, will not be as large as they appear on paper. Many of China's exports will simply displace those of other higher-cost exporters in US markets that have long been dominated by foreign goods. Moreover, the negative impact on some industries probably will be greatly outweighed by the benefits to other US industries from greatly increased sales to China and to US consumers through lower prices. [REDACTED]

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Accommodating a new entrant into the US market will not be easy. China is following its new path at a time when protectionism is being advocated with increasing regularity throughout the world. With stagnant or declining world trade, China's expansion can come only at the expense of some other countries' trade shares. Difficult choices will have to be made between several deserving trade partners. Although these decisions will have a significant economic impact on some of the United States' trade partners, we believe they will depend primarily on political rather than economic considerations. [REDACTED]

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Political Costs and Benefits

The potential political benefits of increased US-China trade and economic cooperation could be as great or greater than the economic ones. Expanding economic relations should help strengthen political ties. Even though closer economic links cannot guarantee friendly political relations, on balance they will enhance the prospects for good overall relations. To the extent that US cooperation, both private and governmental, helps Beijing achieve its developmental goals, this should contribute to political stability in China, increase the chance that Beijing will continue to pursue pragmatic, growth-oriented policies at home, and reinforce the trend towards more moderate, cooperative Chinese foreign policies. [REDACTED]

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A China that sees its future modernization dependent on improvements in economic relations with the West will be less likely to lean back towards the Soviets. Economics and trade are potent weapons for drawing China closer to the United States and away from the Soviet Union. Moscow recognizes this, too, however. The Soviets have offered a range of technology that would help the Chinese in developing their economy. China's economic needs thus could lead to a reduction in Chinese vituperance against the Soviets, and perhaps even to some improvement in relations on the political front. Because the Chinese have sufficient commercial options through their trade with Japan, Western Europe, and the USSR to obtain most of the most of the technologies that they need for development, US economic leverage on Beijing through restrictions on sales will be very limited. [REDACTED]

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China's increasing desire for markets, technology, and industrial supplies probably will make China less belligerent regionally, as well as globally. We

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believe, for example, that China will be less likely to jeopardize its economic ties to Washington by becoming involved in a major confrontation over US links with Taiwan. Although an economically stronger China could appear more menacing, both militarily and economically, to some South East Asian countries, we suspect these countries would turn to the United States for support, not to the Soviet Union. South Korea, Taiwan, Indonesia, Singapore and Malaysia, in particular, would find that capitulation with the Soviets is intolerable. Many of these countries will thus seek redress from Washington for damages wrought by competition from China, whether they are justified or not.

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Finally, China's economic expansion may also have a profound psychological impact on the Third World. If market-oriented reforms succeed in China, many developing countries will be tempted to follow in China's path. China's economic success already has led North Korea to take a more neutral position between Beijing and Moscow, and thus is partly responsible for the reduction in tensions on the Korean Peninsula. China has gone further than any other communist country in breaking away from Soviet-style planning. Western attempts to contain China's economic expansion probably would cause Beijing to reexamine the open door policy and could lead to a retrogression in its efforts. A reversal in China's course could lead many Third World countries to believe that free trade and market-oriented reforms would not work for them either.

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Recommendations

The Chinese view full participation in the world economy as a right that is naturally due them. They believe the current level of their trade falls far below their present capabilities and they are working feverishly to raise trade to a level that is commensurate with their national economic stature. Any overt

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attempt by the United States to hamper Chinese efforts to reach this goal--for example by denying China access to markets, supplies, or technologies--is likely to be considered an unfriendly act by Beijing. Yet, we believe several steps could be taken to insure that the benefits of China's participation in the global economy are shared more equally [REDACTED]

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In our judgment, China's desire to join the GATT probably will provide Washington with the best opportunity it has of influencing China's trade behavior. In the past the United States has been at a disadvantage in dealing with China. Unlike China, the United States lacks a mechanism for directly linking import and export decisions. We believe that through comprehensive bilateral negotiations the United States will be able to insure that all of its interests are served. [REDACTED]

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As a condition for China's entry into the GATT, we believe it is more important to get a commitment from Beijing to gradually move its internal prices to external levels than to negotiate reductions in China's tariffs, which in the Chinese system do not have a major role in influencing trade. Many of the trade problems that the United States has with China can be attributed to China's lack of a rational pricing system. The Chinese use tariffs and quotas largely to overcome the distortionary effects of their domestic pricing system--quite a different purpose than for market economies. The Chinese would have less need to subsidize exports or to protect their own industries from imports if they were to allow internal prices to rise or fall to external levels. A more rational pricing system would also help to eliminate the boom-bust cycles in China's imports that have had such a destabilizing influence on Western trade partners. Nothing has been more discouraging to Western businessmen than to

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have their deals go sour after years of negotiation because the Chinese authorities arbitrarily clamp down on foreign exchange usage at the first sight of a drop in their reserves.* [REDACTED]

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Japan's experiences in dealing with China probably contain some useful lessons for the United States. Japanese trading companies have established a much larger presence in China than US firms have. These companies are able to offer China "one-stop" shopping, in which not only financing, but barter and compensation trade deals can be arranged. This became a major advantage to the Japanese as China decentralized. Chinese enterprises had to search for their own source of funds; no longer could they depend on direct allocations from the state. Japanese firms were ready to supply them with the funds and any other help they needed. Now that anti-trust restraints on US firms have been removed under the Export Trading Act of 1982, we believe US firms could be encouraged to join forces to participate in the China market. [REDACTED]

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The Sino-Japanese Long Term Trade Agreement has increased Tokyo's leverage on Beijing and has provided a focal point for discussions on major trade disagreements. Although bilateral trade agreements tend to distort the efficient allocation of resources, as a second best solution, we believe a concrete arrangement such as Tokyo has with Beijing would more firmly establish the benefits to be gained by both sides from expanded trade. An agreement of

* We believe the GATT negotiating process might also be used to extract concessions from Beijing that would improve conditions for US investors in China. There is no guarantee that American businessmen will continue to regard China with favor unless there is a perception that they can eventually be profitable in China's market. China's desire to gain the benefits of GATT membership will provide the United States with leverage that was lacking in the Sino-US Bilateral Investment Treaty negotiations. [REDACTED]

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this sort could be negotiated as side document to the GATT process. [redacted] 25X1

Japan has been able to gain more from trade with China because it has taken a much more active position in ferreting out what China has to offer. The Japanese, for example, have actively participated in financing several railroads that are dedicated to bringing Chinese coal to port cities for export to Japan. The Japanese are helping to build infrastructure in Yunnan Province in southwestern China in order to make extraction and processing of several minerals and metals commercially viable. Because of Japan's coordinated efforts to obtain those goods that are most useful to it, the Japanese have taken the bulk of China's resources, while other countries have gotten what is left. In contrast, the United States has tended to focus on sales to China as the only benefit of the trade relationship while viewing imports as a necessary evil--losing sight of the fact that the only reason for exporting is to get something else in return. [redacted] 25X1

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APPENDIX A

Estimation Methods for Exports

We used a supply-side approach to estimate China's future exports because China's export growth has been driven primarily by China's own competitiveness rather than by increasing world demand. The supply side approach, ignoring world demand, is justified based on China's past export record. Over the past 10 years, about 55 percent of China's export growth has been due to China's increasing competitiveness in the world.* Of the remainder, about 35 percent was due to the general increase in world imports (the demand side), and 15 percent was due to the geographic destination of exports, while the particular commodities China exported created a drag on export growth of minus 5 percent. In the period since 1979, China's competitiveness has increased to account for nearly 70 percent of export growth. Most impressively, China has been competing in product lines that have been subject to decreasing world demand, but has managed to garner an increase in market share by undercutting the prices of its competitors.

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Our estimates of export availabilities generated by the plan were derived by first, examining relationships between exports and domestic output of agricultural goods, extractive commodities, and manufactures for the period 1978

* This estimate was made using the Constant-Market-Share Analysis of export growth, developed by Edward Leamer. According to this technique, changes in a country's exports can be broken down into four categories according to the following causative factors: a general change in world imports (the engine of growth concept); a change in particular markets and how it relates to the geographic dispersion of the country's exports; a similar structural change in respect of product composition; and changes in price or quality that can be called competitiveness

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to 1985, then, applying China's plan targets for each of these variables to the estimating equations to derive export availabilities. Our estimates, with t-Statistics in parenthesis, are as follows:

$$X_{ag} = 1920.7 + 0.0346 Q_{ag} \quad \text{Adjusted } r^2 = 0.88$$

(3.50) (5.97)

where:

X_{ag} = Dollar value of agricultural exports.

Q_{ag} = Gross value of agricultural output at constant 1980 prices, converted to US dollars at 3.0 Yuan/\$.

$$\ln X_{ext} = -8.443 + 2.0377 \ln Q_{eng} + 1.099 \ln P_{oil}$$

(6.85) (11.27) (11.19) Adjusted $r^2 = 0.95$

where:

X_{ext} = Dollar value of exports from the extractive sector.

Q_{eng} = Total energy production (in standard fuel equivalents).

P_{oil} = World price of crude oil.

$$\ln X_{man} = -7.283 + 1.3621 \ln Q_{ind} \quad \text{Adjusted } r^2 = 0.80$$

(2.19) (5.01)

where:

X_{man} = Dollar value of exports from the manufacturing sector.

Q_{ind} = Gross value of industrial output in constant 1980 prices, converted to US dollars at 3.0 Yuan/\$.

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[Redacted]

Our estimates for China's share of the world market for individual commodities in tables 2 and 3 were derived by linear regression or by linear projection of end-year trends, whichever procedure appeared to produce the best fit, given the existence of outlying data. This same procedure was also used to estimate China's import share of the world market, in tables 6 and 7. [Redacted] 25X1

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APPENDIX B

Estimation Methods For Imports

Linear regression methods were used to estimate China's import requirements generated by the plan. Our model assumes a totally elastic supply of world exports, so that only China's demand is taken into account. We analyzed past relationships between the growth of domestic demand for investment goods, intermediate inputs, and final consumer goods and imports of those goods in order to project the effects of China's long-term targets for the domestic economy on trade. Our projections for China's imports are subject to more error than projections for exports, in part because China's imports will ultimately depend on export growth and in part because China's imports have behaved more erratically than exports.

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Our estimating equations, with t-Statistics in parenthesis, are as follows:

$$\text{Ln Mind} = -6.293 + 1.273 \text{ Ln Qind}$$

(2.78) (6.88)

$$\text{Adjusted } r^2 = 0.89$$

where:

Mind= Dollar value of imports of industrial supplies.

Qind= Gross value of industrial output in constant 1980 prices, converted to US dollars at 3.0 Yuan/\$.

$$\text{Mcap} = -5276.3 + 0.3828 \text{ Ifix}$$

(2.20) (5.42)

$$\text{Adjusted } r^2 = 0.83$$

where:

Mcap= Dollar value of imports of capital goods.

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Ifix= Investment in fixed assets, converted into US dollars.

Our estimate for imports of consumer goods is a linear regression on time trend, since no other regression yielded satisfactory results. Likewise, we could find no significant correlation between imports of foodstuffs and agricultural output and therefore assume, for reasons stated in the text, assumed that they will remain constant.

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