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Report to the Chairman, Committee on Governmental Affairs, and the Honorable Joseph I. Lieberman, U.S. Senate

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INTERNATIONAL TRADE

U.S. Government Policy Issues Affecting U.S. Business Activities in China

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General Government Division

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May 4, 1994

The Honorable John Glenn
Chairman, Committee on Governmental Affairs
United States Senate

The Honorable Joseph I. Lieberman
United States Senate

This report responds to your request that we review major U.S. government programs and policies that either promote or hinder U.S. business activities in China. Specifically, we identified (1) factors contributing to the growing importance of the U.S.-China trade relationship, (2) U.S. government and international programs to promote bilateral trade and support the development of China's economy, and (3) U.S. government policies that may decrease U.S. business opportunities in China. In addition, at your request, we provided information on discrepancies in U.S.-China trade statistics and on prospects for increased U.S. participation in China's petroleum sector.

As arranged with you, we plan no further distribution of this report until 30 days from its issue date unless you publicly announce its contents earlier. At that time, we will send copies of this report to the Secretaries of State, the Treasury, Commerce, and Energy; and to the U.S. Trade Representative. Copies will be made available to others upon request.

Please contact me on (202) 512-4812 if you or your staff have questions concerning this report. Other major contributors to this report are listed in appendix IV.

Allan I. Mendelowitz

Allan I. Mendelowitz, Managing Director
International Trade, Finance,
and Competitiveness

Executive Summary

Purpose

With one of the world's fastest-growing economies and a population of 1.2 billion, the People's Republic of China is becoming an increasingly important player in the world trading system. In light of this development, the Chairman of the Senate Committee on Governmental Affairs, and Senator Joseph I. Lieberman, asked GAO to review major U.S. government programs and policies that either promote or hinder U.S. business activities in China. Specifically, GAO identified (1) factors contributing to the growing importance of the U.S.-China trade relationship, (2) U.S. government and international programs to promote bilateral trade and support the development of China's economy, and (3) U.S. government policies that may decrease U.S. business opportunities in China. GAO also discusses how the United States is attempting to balance its economic, human rights, security, and other interests in its relationship with China.

Background

The United States has important commercial, political, and security interests in China. China's dramatic economic growth, large population, and increasing trade and investment liberalization create challenges and opportunities for U.S. and foreign companies. If the United States is to compete successfully in the world economy, this growing market cannot be ignored. At the same time, the U.S. government continues to express serious concerns about China's human rights policies, trade practices, and exports of certain military technologies. The ability of the U.S. government to balance and integrate these sometimes conflicting interests is essential to an effective U.S. policy towards China.

In the course of its work, GAO consulted a wide range of organizations, including U.S. government agencies, major U.S. business associations, U.S. companies with business interests in China, and multilateral financial institutions. In addition, GAO met with Chinese government officials, U.S. embassy and consulate officials, human rights organizations, and U.S. business representatives in China and Hong Kong (see app. III for major sources of information).

Results in Brief

The U.S. commercial relationship with China has gained importance in recent years as China's economy has expanded and as bilateral trade has increased. China's economy experienced remarkable growth of 12.8 percent in 1992. Meanwhile, total trade between the United States and China increased by 65 percent in nominal terms from 1990 to 1992. China's efforts to liberalize its trade regime and open its economy to foreign investment have contributed to the increased interest among U.S. companies in this dynamic market.

The U.S. government has a number of programs to facilitate U.S. business activities with China. The Office of the U.S. Trade Representative is working to reduce barriers to both trade and investment in China. The Department of Commerce and the U.S. Export-Import Bank provide export promotion and financing services to U.S. companies exporting to China. In addition, multilateral agencies, such as the World Bank and the Asian Development Bank, provide loans to support the development of China's economy. U.S. companies are eligible to compete for contracts associated with these projects.

The effectiveness of the U.S. government's effort to integrate its China trade policy with other important U.S. policy objectives in China will affect the extent to which U.S. companies can realize the business opportunities associated with China's economic growth and development. For example, U.S. efforts to promote improved human rights and weapons nonproliferation practices in China are significant factors in U.S. government policies that may restrict U.S.-China business activities. U.S. government and private sector officials cited uncertainty surrounding the annual renewal of China's most-favored-nation trade status as the single most important issue affecting U.S. trade relations with China. (Most-favored-nation treatment generally refers to the practice of extending to a country the best trade privileges granted to any other nation in the form of the lowest tariff rates and other charges imposed on imported products.) Other issues of concern for U.S. companies and business associations include U.S. and multilateral export controls that restrict sales of certain technologies to China and U.S. policies that restrict government financing for U.S. business activities in China.

As the June 1994 deadline approaches for the President's decision on whether to renew China's most-favored-nation status, policymakers in Congress and in the administration will have to carefully weigh the benefits and costs of various strategies to achieve the multiple U.S. objectives in China. GAO's work underscores the view of business interests and government officials that most-favored-nation treatment is central to the U.S.-China relationship. A decision not to renew most-favored-nation status could damage U.S. foreign policy and security, as well as economic, interests in China. But what cannot be easily assessed is the potential for adverse effects on human rights conditions in China if most-favored-nation status is renewed without clear signs of overall significant progress as required by the President's May 1993 executive order. Equally unclear are the consequences of such an action for the credibility of future U.S. foreign policy initiatives.

GAO's Analysis

China's Importance as a U.S. Trading Partner Has Increased

The growing significance of the U.S. commercial relationship with China can be attributed to a number of factors, including China's economic growth and reform, increasing bilateral trade, and Chinese government investment plans. Since the late 1970s, China has made efforts to reform its economy and liberalize its trade regime (see pp. 17-24). The economic reform program has resulted in increased economic competition among domestic enterprises, price liberalization, and growing autonomy for state-owned enterprises. China has also taken steps to reduce barriers to foreign imports and investment in certain sectors. For example, in early 1993 the Chinese government announced that it would allow foreign participation in oil exploration and production projects in previously closed areas in northwest China (see app. II, pp. 69-71).

Between 1980 and 1992, two-way trade between the United States and China tripled as a percentage of total U.S. trade. U.S. exports to China totaled $7.5 billion in 1992, while imports from China were $27.4 billion. In 1992, the United States was China's third largest trading partner, and China's trade with the United States represented about 21 percent of Chinese world trade of $168 billion, according to International Monetary Fund statistics (see pp. 20-1).

China's economic development plan for the years 1991-95 indicates that the government of China planned to invest over $300 billion during this period, with high priority given to capital construction in sectors such as energy, transportation, and communications. China's development strategy, combined with its economic growth, may present opportunities for U.S. trade and investment in industries where U.S. companies are competitive. For example, the Commerce Department's U.S. and Foreign Commercial Service identified growing markets in China for U.S. sales of aircraft and aircraft parts, oil and gas field machinery and services, and telecommunications equipment, among other things (see pp. 25-6). U.S. companies GAO contacted cited China's economic growth, market potential, economic reform, and trade liberalization among the primary factors that make China an attractive market (see p. 27).

The U.S. Government Has Programs to Promote U.S. Business Activities in China

U.S. agencies such as the Office of the U.S. Trade Representative, the Department of Commerce, and the U.S. Export-Import Bank have programs to facilitate or reduce barriers to bilateral trade. In 1992, USTR negotiated two bilateral memoranda of understanding with China, under which the Chinese government pledged to reduce market barriers, such as quantitative restrictions on imports and import licensing requirements, and improve legal protection of intellectual property rights, such as copyrights and patents (see pp. 28-30). USTR is now monitoring the implementation of these agreements and is participating in international negotiations on China's application to join the General Agreement on Tariffs and Trade (see pp. 30-3).

The U.S. and Foreign Commercial Service is continuing its export promotion programs in China and leading U.S. participation in the U.S.-China Joint Commission on Commerce and Trade (see pp. 34-5). In addition, the U.S. Export-Import Bank extended about $402 million in loans and loan guarantees to support U.S. exports to China in fiscal year 1992 (see pp. 34-5). In that year, the World Bank and the Asian Development Bank provided loans of $2.5 billion and $903 million, respectively, to help develop projects in a variety of sectors of China's economy (see pp. 36-8). U.S. firms are eligible to bid for contracts for these projects.

Implications of Other U.S. Government Policies for U.S. Business Activities in China

U.S. concerns about Chinese violations of human rights and proliferation of weapons have led to the adoption of U.S. government policies that may have significant adverse implications for U.S. trade and investment activities in China. A primary concern for the 5 U.S. business associations and 15 large corporations GAO contacted was China's most-favored-nation trade status. According to these business associations and companies, the uncertainty over whether the U.S. government will withdraw or place further conditions on the renewal of China's most-favored-nation trade status affects the ability of U.S. companies to do business in China (see pp. 43-5). Some U.S. companies and business associations told GAO that uncertainty about the renewal of China's most-favored-nation status makes long-term planning difficult and contributes to tensions in U.S.-China trade relationships. In addition, they expressed concern about the potential for Chinese retaliation against U.S. exporters and investors if the U.S. government were to revoke China's most-favored-nation status.

U.S. companies and business associations that GAO contacted also raised concerns about unilateral and multilateral export controls (see pp. 48-9). Export controls related to unilateral U.S. sanctions imposed after the 1989 Tiananmen Square events continue to restrict sales of certain U.S. products, such as nuclear power generation equipment. In addition, controls instituted in conjunction with the former Coordinating Committee on Multilateral Export Controls for the export of dual-use (civilian items with military applications) and high-technology items have limited U.S. business activities in China, according to some U.S. companies. (The Coordinating Committee was established in 1949 to protect the strategic technology advantage of its 17 members.)[1] According to some U.S. business associations, liberalization of export controls failed to keep pace with the rapid development of new technologies and thus may have put U.S. companies at a disadvantage relative to countries that were not members of the Coordinating Committee.

Some of the U.S. companies GAO spoke to also expressed concern about the limited availability of U.S. government financing for trade and investment projects in China. For example, the China programs of both the Overseas Private Investment Corporation, which provides risk insurance and financing for U.S. investment in developing countries, and the Trade and Development Agency, which funds U.S. feasibility studies in developing countries, were suspended in 1989 following the Tiananmen Square events (see pp. 49-50). Although the U.S. Export-Import Bank continued its U.S. export financing operations in China during this period, some U.S. companies said they are at a disadvantage when competing with foreign companies whose governments provide (1) more extensive export credits, (2) aid tied to purchases of foreign country goods, and (3) development assistance to support business activities in China (see pp. 50-1).

Balancing U.S. Policy Objectives in China

The United States has important and wide-ranging economic, political, and security interests in China. Most-favored-nation trade status is central to

[1]In November 1993, representatives of the 17 Coordinating Committee member countries met to discuss proposals to terminate the Coordinating Committee and to establish a new organization to coordinate the export of strategic goods. These nations set an April 1994 deadline to replace the Coordinating Committee. As of April 1994, the Coordinating Committee went out of existence, but a new arrangement had yet to be formed. Thus, it was unclear how any new arrangement would affect U.S. exports of dual-use technologies to China.

the U.S.-China bilateral relationship. It is important not only to trade, but also has significant implications for the U.S. government's ability to influence China on a variety of other foreign policy and security interests. As reflected in the President's May 1993 executive order on conditions for the 1994 renewal of China's most-favored-nation status, U.S. concerns about Chinese human rights violations have become an increasingly important consideration in overall U.S. policy towards China (see pp. 39-42). As a significant export market for Chinese goods, the United States has attempted to exert leverage by conditioning China's most-favored-nation status renewal on improvements in human rights practices. Other countries that have important trade relationships with China have not joined the United States in this strategy. In addition to economic sanctions, the U.S. government has available alternative channels through which to pursue its policy objectives in China (see pp. 52-4).

China's growing role in global economic and political affairs, the broad spectrum of U.S. interests in China, and the potential economic and political costs of ending China's most-favored-nation trade status all underline the importance of the President's 1994 decision on whether to renew China's most-favored-nation status. As the decision deadline approaches, policymakers in Congress and in the administration will have to carefully weigh the benefits and costs of various strategies to achieve the multiple U.S. objectives in China.

Recommendations

GAO is making no recommendations in this report.

Agency Comments

GAO discussed applicable sections of this report with responsible program officials from the Office of the U.S. Trade Representative, the Departments of the Treasury and Commerce, the Export-Import Bank, the Overseas Private Investment Corporation, and the Trade and Development Agency. These officials suggested some technical changes and/or factual updates, which GAO made where appropriate, but generally agreed with the information presented. GAO also shared a summary of its results with the embassy of China in Washington, D.C., but did not receive any comments from Chinese government officials.

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Abbreviations

ADB	Asian Development Bank
b/d	barrels per day
BXA	Bureau of Export Administration
CCL	Commerce Control List
CIA	Central Intelligence Agency
COCOM	Coordinating Committee on Multilateral Export Controls
DOE	Department of Energy
Eximbank	Export-Import Bank of the United States
GAO	General Accounting Office
GATT	General Agreement on Tariffs and Trade
GDP	gross domestic product
GNP	gross national product
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IFC	International Finance Corporation
IMF	International Monetary Fund
JCCT	Joint Commission on Commerce and Trade
MFN	most favored nation
MOFTEC	Ministry of Foreign Trade and Economic Cooperation
MOU	Memorandum of Understanding
MTCR	Missile Technology Control Regime
OECD	Organization for Economic Cooperation and Development
OECF	Overseas Economic Cooperation Fund
OPIC	Overseas Private Investment Corporation
P.L.	Public Law
TDA	Trade and Development Agency
U.N.	United Nations
US&FCS	U.S. and Foreign Commercial Service
USTR	U.S. Trade Representative

Introduction

As the People's Republic of China has taken on an expanding role in global affairs, U.S. policymakers have had to assess the variety of U.S. interests in China. Primary among these are economic interests, human rights concerns, and security objectives. Recognizing the complexity and significance of these issues, the U.S. government continues to search for a balanced and integrated approach to its relations with China.

China's Growing Role in World Affairs

Although no longer viewed as a strategic counterweight to the former Soviet Union, China occupies an important place in U.S. foreign policy, according to administration statements. China is a growing military power, commanding nuclear as well as conventional technologies. It is one of the world's fastest-growing economies, and, based on recent estimates by the International Monetary Fund (IMF), China is the world's third largest economy.[1] It holds a permanent seat on the United Nations (U.N.) Security Council and plays a key role in regional issues. In addition, China accounts for one-fifth of the world's population. Accordingly, Chinese policies will do much to shape the future of Asia, U.S. security and trade relations in the Pacific, and other international issues. Further, China's success or failure in addressing national problems, such as environmental protection, population control, treatment of refugees, and drug trafficking, will have a global impact.

U.S. Policy Interests in China

U.S. interests in China are complex and varied. They can be broadly categorized as economic, human rights, and security interests. The challenge for the United States is to find a way to effectively balance the multiplicity of these interests and associated objectives.

Economic Interests

The ability of U.S. companies to compete successfully and take advantage of opportunities in one of the world's fastest-growing markets is a factor in the creation of jobs and economic prosperity in the United States. Most-favored-nation (MFN) trade status is the keystone of U.S.-China economic relations, allowing bilateral trade at the favorable tariff rates accorded most other U.S. trading partners.

[1]The IMF's method for measuring China's gross domestic product (GDP) is contained in an annex to the IMF's 1993 World Economic Outlook. Previous studies have compared each country's economic output by valuing its goods and services in a single currency, such as dollars, using market exchange rates. The method used in the IMF publication, known as "purchasing power parity," incorporates a more realistic valuation of nontraded output, such as housing and domestic transport.

Bilateral trade and investment ties between the United States and China have grown significantly over the last decade, making China the U.S.' seventh largest trading partner in 1992. U.S. exports to China grew by 19 percent from 1991 to 1992, and rapid growth is expected to continue. As one of China's largest foreign investors, the United States also has an enduring interest in promoting improvements in China's business environment to allow increased market access, better protection of intellectual property rights, and adherence to internationally accepted trading practices.

Human Rights Interests

The U.S.' historical commitment to promoting democracy and respect for human rights worldwide is key to its policy towards China. As defined in the President's May 1993 executive order,[2] specific areas in which the United States is encouraging improved human rights practices in China include complying with a 1992 bilateral agreement concerning exports of goods made with prison labor; ensuring freedom of emigration; taking steps to begin adhering to the Universal Declaration on Human Rights; releasing and accounting for Chinese citizens imprisoned or detained for nonviolent expression of political and religious beliefs; ensuring humane treatment of prisoners, and allowing access to prisons by international humanitarian organizations; protecting the religious and cultural heritage of Tibet; and permitting international radio and television broadcasts into China.

Security Interests

The United States also has a crucial interest in contributing to the maintenance of a stable balance of power in the Asia-Pacific region, recognizing China as one of the key players. Among its broad security objectives in China, the United States seeks to encourage Chinese participation in the peaceful resolution of regional conflicts in countries such as Cambodia; to monitor Chinese efforts to modernize and expand its conventional and nuclear military capabilities; and to facilitate Chinese cooperation in international efforts to curb the proliferation of weapons.

Objectives, Scope, and Methodology

In light of China's increasing importance as a player in the world trading system, the Chairman of the Senate Committee on Governmental Affairs, and Senator Joseph I. Lieberman, asked us to identify (1) factors contributing to the growing importance of the U.S.-China trade

[2]Executive Order #12850, "Conditions for Renewal of MFN Status for the People's Republic of China in 1994," May 28, 1993.

relationship, (2) U.S. government and international programs to facilitate bilateral trade and support the development of China's economy, and (3) U.S. government policies that may decrease U.S. business opportunities in China. We also discuss how the United States is attempting to balance its economic, human rights, security, and other interests in its relationship with China. In addition, our requesters asked us to provide information on discrepancies between the bilateral trade statistics recorded by the United States and China (see app. I) and on prospects for increased U.S. participation in China's petroleum sector (see app. II).

To identify factors contributing to the growing importance of the economic relationship between the United States and China, we compiled trade and investment data from several sources, including the U.S. Department of Commerce, the IMF, and the U.S.-China Business Council.[3] The IMF was our source for statistics on China's world trade and on bilateral trade between the United States and China. (However, as discussed in app. I, the U.S. and Chinese governments have different methods of interpreting bilateral trade data.)

We obtained information on China's economic and trade reforms and principal economic indicators primarily from interviews and reports provided by the World Bank, the IMF, the State Department, the U.S. intelligence community, and the Chinese government. We reviewed in translation an outline of China's 1991-1995 five-year plan for information on China's economic development and investment strategies and consulted a World Bank report that analyzed the plan. We identified the prospects for increased U.S. business with China using reports by the Commerce Department's U.S. and Foreign Commercial Service (US&FCS); interviews with U.S. Commerce, State, and U.S. Trade Representative (USTR) officials; and interviews with U.S. business associations and companies doing business in China. In addition, we traveled to China and Hong Kong in February and March 1994, where we interviewed U.S. embassy and consulate officials, Chinese government officials, U.S. business representatives, and officers of Human Rights Watch, Asia.

We gathered information on U.S. government efforts to facilitate U.S. trade and investment in China from relevant agencies including USTR, the Departments of Commerce and State, and the Export-Import Bank

[3]The U.S.-China Business Council is a private, nonprofit membership association that represents the interests of U.S. business in China. It had over 200 members in 1993.

(Eximbank).[4] In addition, we collected information from several international organizations that provide funding for economic development projects in China, including the World Bank, the International Finance Corporation (IFC), the Asian Development Bank (ADB), and the Overseas Economic Cooperation Fund (OECF).

To identify major U.S. government policy issues that may hinder U.S. business activities in China, we interviewed responsible officials from U.S. government agencies, business associations, human rights organizations, and individual companies. These individuals also provided us with relevant documents and reports. The agencies we contacted included USTR; the Departments of Commerce, State, and the Treasury; and the Eximbank. Our contacts also included major U.S. business associations such as the U.S. Chamber of Commerce, the American Chamber of Commerce in Beijing, the U.S.-China Business Council, and the National Association of Manufacturers.[5] We selected these particular associations because they represent a broad spectrum of U.S. industry sectors and companies that are active in trade with China. We also attended several seminars and conferences in the United States, where panelists discussed these issues in detail.

As part of our effort to identify U.S. government policies that affect U.S. business activities in China, we conducted a series of structured interviews with 15 large U.S. companies with current trade and/or investment interests in China. This group of companies was judgmentally selected in order to reflect a variety of industry sectors, but it is not necessarily representative of all U.S. companies doing business in China.

In our analysis of the discrepancy between U.S. and Chinese trade statistics, we utilized trade data from the IMF and the World Bank. In reviewing U.S. prospects for increased U.S. participation in China's petroleum sector, we obtained information from relevant agencies, including the Departments of State, Commerce, and Energy (DOE). We also gathered information from the World Bank, the East-West Center, the

[4]Eximbank is an independent agency that facilitates the export financing of U.S. goods and services by compensating for export credit subsidies from other governments and absorbing reasonable credit risks that are beyond the current reach of private sector lenders.

[5]The National Association of Manufacturers is a broad-based national trade association established in 1895. Its more than 12,000 member companies account for approximately 80 percent of U.S. manufacturing output and jobs, according to association statements.

Lawrence Berkeley Laboratory,[6] and the American Petroleum Institute. In order to identify factors that either encourage or discourage investment in China's petroleum sector, we conducted interviews with selected U.S. oil companies, based on a list provided by the American Petroleum Institute.

We conducted our work between August 1992 and March 1994 in accordance with generally accepted government auditing standards.

We discussed applicable sections of this report with responsible program officials from USTR, the Departments of the Treasury and Commerce, the Eximbank, the Overseas Private Investment Corporation (OPIC), and the Trade and Development Agency (TDA). These agencies suggested some technical changes and/or factual updates, which we made where appropriate, but generally agreed with the information presented. We also shared a summary of our findings with the embassy of China in Washington, D.C., but did not receive any comments from Chinese government officials.

[6]The Lawrence Berkeley Laboratory, (Berkeley, CA) is a multiprogram national research facility operated by the University of California for the Department of Energy. Its fundamental mission is to provide national scientific leadership and technological innovation to support DOE's objectives.

China's Importance as a U.S. Trading Partner

The U.S. commercial relationship with China has gained importance as China's economy has grown and as the government of China has pursued a course of sporadic but significant economic reform. Between 1985 and 1992, China's total world trade more than doubled, while trade between the United States and China more than tripled.[1] In 1993 the United States was the world's fourth leading foreign investor in China, after Hong Kong, Japan, and Taiwan.

With remarkable growth in 1992, China is now recognized as one of the world's fastest-growing economies. This fact, combined with China's efforts to liberalize trade and encourage investment, has attracted the interest of U.S. and other foreign companies. In addition, Chinese government plans to increase investment in key sectors may create opportunities for foreign companies. According to Commerce Department reports, aerospace, computers, telecommunications, and energy are among the most promising sectors for U.S. trade with and investment in China.

China's Economy

China's economy is large and growing rapidly. A 1993 IMF study concluded that China's economy is now the world's third largest, after the United States' and Japan's. China's GDP increased at a rate of 12.8 percent in 1992, while industrial output grew by over 20 percent. (By comparison, real GDP growth averaged 1.6 percent for industrial countries and 6.1 percent for developing countries in 1992.) Economic growth in China's southern provinces far exceeds the national rate, according to U.S. embassy reports. For example, Guangdong Province, with a population of 68 million, is experiencing annual industrial output growth of over 25 percent.

In addition, rapid economic growth continues to raise living standards in China, with 1992 real incomes increasing 9 percent and 6 percent for urban and rural residents, respectively. While China's consumer price inflation rate for 1992 was estimated at a moderate 6.3 percent,[2] inflation was considerably higher in urban areas and is an issue of increasing concern for the Chinese government.

China's economic expansion has been driven primarily by rapid growth in investment spending and exports. Gross domestic investment for 1992 increased by 37 percent in nominal terms over the previous year,

[1] All statistics in this chapter, including those in the tables, are reported in nominal U.S. dollars.

[2] World Market Report Update—China, DRI/McGraw-Hill (Lexington, MA: Apr. 1993).

according to a 1993 estimate,[3] while Chinese exports rose by 20 percent between 1991 and 1992. Chinese export growth has led to a significant accumulation of foreign exchange reserves, which reached almost $43 billion in February 1993.[4]

Despite these positive trends, several economic challenges confront the Chinese government. First of all, China's state enterprises are losing money, according to a 1992 Central Intelligence Agency (CIA) report.[5] In 1991, industrial output from state firms increased at less than half the national rate, and at least one-third of state-owned enterprises were operating at a loss. The state budget deficit increased by 22 percent annually between 1987 and 1991, reaching $12.2 billion in 1991. In addition, some U.S. economists anticipate that China may begin to experience escalating inflation due to an overheated economy. Finally, China's underdeveloped transportation, telecommunications, and energy infrastructures hinder economic development and foreign investment.

Economic Reform

Over the last decade, the government of China has pursued economic reform. In an uneven process, its economy has evolved from a centrally planned system to one in which market forces have become more prevalent. The initiation of China's economic transition dates back to December 1978, when the Chinese leadership introduced a policy of "reform and opening up."

Since then, China has experienced several periods of economic reform, beginning with agricultural reforms in the late 1970s and early 1980s and proceeding with industrial sector reforms in the mid-1980s. Chinese leader Deng Xiaoping introduced market initiatives in the rural areas, such as freeing prices for agricultural goods and allowing households greater freedom to market their products. As a result, China's agricultural output and productivity rose dramatically. In addition, the development of township and village enterprises set the stage for China's industrial sector growth and reform in the following years.

China's urban and industrial sector reforms were designed to increase the autonomy of state-owned enterprises in setting prices and wages. In

[3] Planned Economies in Transition Outlook, The WEFA Group (Bala Cynwyd, PA: Apr. 1993).

[4] By this measure, China's foreign exchange reserves are the world's sixth largest, after the United States', with $44 billion.

[5] The Chinese Economy in 1991 and 1992: Pressure to Revisit Reform Mounts, Central Intelligence Agency, Directorate of Intelligence (Washington, D.C.: Aug. 1992). This report may be obtained from the Library of Congress.

addition, the government introduced banking reforms, creating a new bank specifically for commercial functions. These reforms have resulted in expanded semiprivate industrial collectives, increased foreign trade and investment, and vigorous commercial rivalry among the provinces.[6] As China's private and semiprivate sector has grown, the portion of China's industrial output accounted for by state-owned firms has fallen. The CIA reported in July 1992 that state enterprises were producing less than 55 percent of China's industrial goods. Collective and family-run enterprises now produce over 33 percent of industrial output, while private enterprise and joint ventures account for the remainder, according to this report. State-owned firms' output share is expected to decrease further, to 25 percent by the year 2000. Also, the number of products allocated by the state plan has dropped sharply (from about 700 in 1978 to fewer than 20 in 1991), market pricing has become more prevalent, and competition has spread throughout the economy, according to The Economist.

The pace of economic reform has increased since 1992, although the government continues to reaffirm its commitment to socialist rule. In January 1992, Deng Xiaoping made a symbolic trip to China's reform-oriented southern coast to encourage the South to continue its progress and to further open up foreign trade and investment. Since that time, the Communist Party has issued official statements claiming that market forces are compatible with a socialist political system. For example, Chinese leaders participating in the October 1992 14th Communist Party Congress endorsed Deng Xiaoping's call for high growth, increased economic openness, and economic reform. Further, they reaffirmed the government's commitment to a "socialist market economy" and expressed support for the increased autonomy of state enterprises. U.S. embassy officials in Beijing reported that they do not anticipate any significant reversal of China's economic reform policies.

Trends in China's Trade and Investment

As shown in table 2.1, China's total trade with the world more than doubled between 1985 and 1992, according to IMF statistics. China's top trading partners in 1992 were, in rank order, Hong Kong, Japan, the United States, the former Soviet Union, and Germany. Altogether, China's total trade with these five nations accounted for 68 percent of China's reported world trade in 1992. China's world trade balance jumped from a $6 billion deficit in 1989 to a $10 billion surplus in 1990, resulting in part from efforts

[6] "When the Dragon Awakes: A Survey of China," The Economist, Vol. 325, No. 7787 (Nov. 28, 1992), pp. 1-18.

by the Chinese government to boost exports and to limit imports. The trade balance remained positive in 1991 and 1992. However, China's world trade balance shifted back to a deficit in the first half of 1993, according to Commerce Department and U.S.-China Business Council officials. This shift was attributed to China's rapid economic growth, increased domestic demand for imports, continued trade liberalization and decentralization, and relaxed credit policies.

Table 2.1: China's World Trade, 1985-92

Dollars in millions

Year	Exports	Imports	Total	Trade balance
1985	$27,329	$42,480	**$69,809**	–$15,151
1986	31,367	43,247	**74,614**	–11,880
1987	39,464	43,222	**82,686**	–3,758
1988	47,663	55,352	**103,015**	–7,689
1989	52,914	59,140	**112,054**	–6,226
1990	64,500	54,449	**118,949**	+10,051
1991	71,986	63,957	**135,943**	+8,029
1992	86,220	81,739	**167,959**	+4,481

Source: IMF, 1993.

In 1992, China's trade with the United States represented about 21 percent of its total trade of $168 billion. U.S.-China trade has grown rapidly since the two countries established MFN tariff treatment in 1980. Bilateral trade grew sevenfold, from $4.9 billion in 1980 to $34.9 billion in 1992. In 1992, China was the U.S.' seventh largest trading partner. Table 2.2 shows trends in U.S.-China trade between 1980 and 1992.

Table 2.2: U.S.-China Trade, 1980-92

Dollars in millions

Year	Chinese exports to the U.S.	U.S. exports to China	Total trade	U.S. trade balance
1980	$1,164	$3,755	**$4,919**	+$2,591
1981	2,062	3,603	**5,665**	+1,541
1982	2,502	2,912	**5,414**	+410
1983	2,477	2,173	**4,650**	–304
1984	3,381	3,004	**6,385**	–377
1985	4,224	3,856	**8,080**	–368
1986	5,241	3,106	**8,347**	–2,135
1987	6,910	3,497	**10,407**	–3,413
1988	9,261	5,017	**14,278**	–4,244
1989	12,901	5,807	**18,708**	–7,094
1990	16,296	4,807	**21,103**	–11,489
1991	20,305	6,287	**26,592**	–14,018
1992	27,413	7,470	**34,883**	–19,943

Source: IMF, 1993.

The United States was one of China's largest export markets in 1992. The principal U.S. imports from China in that year were textiles; toys, games, and sporting equipment; electrical machinery; footwear; luggage and handbags; and industrial machinery and computers. The principal U.S. exports to China in 1992 were commercial aircraft, industrial machinery and computers, fertilizers, electrical machinery, scientific and control instruments, and cereals. Between 1990 and 1992, rapidly growing Chinese exports to the United States included computers and industrial machinery, while fast-growing U.S. exports to China included commercial aircraft and scientific and control instruments.

Since 1980, Chinese exports to the United States have grown much more rapidly than U.S. exports to China. In 1980, China's exports to the United States totaled $1 billion, while U.S. exports to China were $3.8 billion. This relationship had changed dramatically by 1992, when China's exports to the United States reached $27.4 billion, while U.S. exports to China lagged far behind at $7.5 billion. Thus, the U.S. trade deficit with China reached $19.9 billion in 1992, despite a 19 percent increase in U.S. exports to China over the previous year.

The U.S. and Chinese governments disagree over how bilateral trade statistics should be calculated. The Chinese government records many goods that it ships through Hong Kong as Chinese exports to Hong Kong, while the United States records these goods as Chinese exports to the United States. Largely as a result of this recording difference, there was a $20 billion discrepancy in 1992 between Chinese statistics on exports to the United States and U.S. statistics on imports from China. Appendix I provides a detailed explanation of this issue.

As shown in table 2.3, contracted foreign investment in China shot up from $12 billion in 1991 to $57.5 billion in 1992, according to statistics provided by China's Ministry of Foreign Trade and Economic Cooperation (MOFTEC). As of February 1993, China's principal foreign investors were Hong Kong, Japan, Taiwan, and the United States, according to the Commerce Department. The majority of these investments were in small, export-oriented ventures by Hong Kong or overseas Chinese investors. In addition, foreign investors have set up a large number of medium- to high-technology ventures designed to sell in China's domestic market.

Table 2.3: Annual Foreign Investment in China, 1987-92

Dollars in billions

Year	Contracted investment	Utilized investment
1987	$3.7	$2.3
1988	5.3	3.2
1989	5.6	3.4
1990	6.6	3.5
1991	12.0	4.4
1992	57.5	11.2

Note: "Contracted investment" refers to contracts signed between foreign companies and Chinese partners, but does not represent an actual transfer of capital. "Utilized investment" refers to a transfer of capital officially recorded by MOFTEC between a foreign investor and a Chinese partner. Figures represent the annual inflow of foreign investment, not the cumulative amount.

Source: MOFTEC.

As shown in table 2.4, U.S. contracted investment in China was $3.1 billion in 1992, accounting for about 5 percent of total contracted foreign direct investment in China, according to Chinese government statistics. The Commerce Department reported that U.S. investments in China include licensing and coproduction agreements, equity and contractual joint ventures, and wholly owned foreign enterprises. According to a USTR official, most U.S. ventures have been relatively small—in the range of

$1.2 million to $3 million—and have been concentrated in the southern region. In recent years, U.S. investments in China have shifted from a concentration in resource exploitation and property development to a greater involvement in manufacturing ventures.

Table 2.4: Annual U.S. Investment in China, 1987-92

Dollars in millions

Year	Contracted investment	Utilized investment
1987	$342	$263
1988	370	236
1989	641	284
1990	358	456
1991	548	323
1992	3,120	511

Note: "Contracted investment" refers to contracts signed between foreign companies and Chinese partners, but does not represent an actual transfer of capital. "Utilized investment" refers to a transfer of capital officially recorded by MOFTEC between a foreign investor and a Chinese partner. Figures represent the annual inflow of foreign investment, not the cumulative amount.

Source: MOFTEC.

Based on data gathered from 517 American foreign investment enterprises in China, the U.S.-China Business Council reported in 1990 that the top three sectors for U.S. investment in China, based on the number of contracts, were electronics (computers and electronic components); light industrial products (textiles, leather products, and consumer goods); and agriculture and food processing. Other leading sectors for U.S. investment were services, chemicals, natural resource development (including offshore oil), transportation, and tourism. Table 2.5 shows the number of U.S. contracts in China, by sector, as of 1989.

Table 2.5: U.S. Investment in China, by Sector, as of 1989

Sector	Number of projects	Average investment (millions)
Electronics	77	$1.11
Light industry	73	0.88
Food and agriculture	70	3.40
Services	48	0.54
Chemicals	40	5.92
Resources	33	7.27
Tourism	32	12.47
Transportation	31	6.00
Medical products	27	1.90
Miscellaneous equipment	20	2.75

Note: Table includes top 10 categories in U.S.-China Business Council database, but does not include oil exploration contracts or certain other forms of investment.

Source: U.S.-China Business Council, 1990.

China's Trade and Investment Policies and Plans

Over the last decade, China has taken steps to liberalize its trade regime and encourage foreign investment in order to benefit from technology transfers and western management practices. To complement domestic economic reforms, the government of China adopted its "Open Door Policy" in the late 1970s and early 1980s. The new strategy was comprised of four elements: trade policy reforms, a new joint venture law, exchange rate and macroeconomic policies, and special economic zones. Intended to attract foreign capital, companies, and expertise, the Open Door Policy has contributed to China's increased economic efficiency and productivity over the last decade.

However, the Chinese government has continued to employ administrative controls to regulate access of foreign firms to the Chinese market. US&FCS reported that the Chinese government has designed an import policy to conserve foreign exchange and protect Chinese industries while attempting to ensure the inflow of materials in short supply and technology needed for modernization. In 1992, China pledged to reduce some of these controls when it signed bilateral agreements with the United States to improve market access and protection of intellectual property. In addition, the Chinese government has renewed its efforts to meet the requirements to join the General Agreement on Tariffs and Trade (GATT).[7] These efforts may lead to further Chinese trade liberalization.

China's Outline of the Ten-Year Program and of the Eighth Five-Year Plan for National Economic and Social Development summarizes the government's economic development strategy and investment plans for the years 1991-2000. As part of the "major tasks and important targets" of the plan, the Chinese government seeks to readjust China's industrial structure and gradually modernize the national economy. The plan focuses on six priority sectors: basic industries and infrastructure (such as energy, transport, and communications); electronics; agriculture; construction and services; defense; and processing industries.

The Eighth Five-Year Plan proposes total investment of 2,600 billion yuan—about 32 percent of gross national product (GNP) between 1991 and 1995.[8] Of this amount, state investment will constitute about 1,700 billion yuan, or 65 percent.[9] Slightly less than half of China's proposed state investment is slated for capital construction, with priority given to energy resources, transportation, communications, raw and semifinished materials, agriculture, and water conservation.

While the outline version of the plan does not contain detailed information on production and investment targets for individual subsectors, the priorities identified are reflected in China's investment allocations, according to the World Bank. For example, state investment in energy is expected to rise from 30 percent of the total in the Seventh Five-Year Plan to about 35 percent under the present plan. By developing hydropower, thermal power, and nuclear power-generating capacity, China plans to increase its total annual output of electricity by 31 percent between 1991 and 1995. The transport and telecommunications sectors are also expected to receive a larger share of state investment, with their combined share rising from 15 percent under the Seventh Five-Year Plan to about 18 percent under the current plan, according to the World Bank. Based on the Eighth Five-Year Plan, China intends to upgrade old railways using advanced technology, to build highways and airports, to increase coastal harbor construction, and to develop the telecommunications industry. In

[7]GATT is a multilateral instrument with over 100 contracting parties that establishes rules for international trade. The primary objective of GATT is to liberalize world trade, thereby contributing to global economic growth and development.

[8]At the 1992 average exchange rate of 5.5 yuan to the dollar, 2,600 billion yuan equals $471 billion. The Eighth Five-Year Plan projects an average GNP growth rate of 6 percent from 1991 to 1995.

[9]At the 1992 average exchange rate, 1,700 billion yuan equals $308 billion.

addition, China plans to advance its electronics industry by developing integrated circuits, computers, microelectronic technology, and telecommunications technology and equipment.

Opportunities for U.S. Companies in China

China's development strategy and economic growth may provide opportunities for U.S. trade and investment in industries where U.S. companies are competitive. In its 1993 Country Marketing Plan, US&FCS identified and estimated the importance of 34 industry sectors providing the best prospects for U.S. companies in China. Among the top 10 "best prospects" were aircraft and aircraft parts, agricultural and industrial chemicals, oil and gas field machinery and services, computers and peripherals, telecommunications equipment, and electric power systems. For example, US&FCS estimated that China had a fast-growing, $3 billion market for aircraft and aircraft parts in 1992 and that China was very receptive to U.S. products in this sector. China's market for computers and peripherals was estimated at $1.3 billion in 1992, with a projected growth rate of 10 percent annually between 1992 and 1994. China's market for telecommunications equipment, including digital switches, facsimile machines, and cellular equipment, was estimated at $1.8 billion in 1992 and was projected to grow by 20 percent annually between 1992 and 1994. Table 2.6 summarizes selected market indicators for 10 sectors identified by US&FCS as the best prospects for U.S. exports to China.

Table 2.6: US&FCS Assessment of 10 Best Prospects for U.S. Exports to China

Industry sector	Estimated total market size 1992 (millions)	Estimated annual market growth rate 1992-94 (percent)	Estimated annual growth of imports from U.S. (percent)	China's receptivity to U.S. products in this sector[a]
Aircraft & parts	$3,000	20	15	5
Agricultural chemicals	7,350	5	10	3
Industrial chemicals	12,000	10	6	3
Oil & gas field machinery & services	5,000	10	10	4
Computers & peripherals	1,300	10	20	4
Mining industry equipment	1,829	15	10	4
Telecommun-ications equipment	1,800	20	5	4
Electric power systems	11,000	10	7	4
Avionics & support equipment	375	25	30	5
Agricultural machinery	6,000	10	5	3

[a]US&FCS rated China's receptivity to U.S. products in these sectors on a scale of 1 to 5, with 5 as the highest rating.

Source: U.S. Department of Commerce, 1993 Country Marketing Plan.

Factors That Make China an Attractive Market for U.S. Companies

U.S. companies we interviewed identified the primary factors that make China an attractive market. The most commonly cited were China's rapid economic growth and market potential, and China's recent economic reform and trade liberalization efforts.

All of the companies we spoke to cited China's market potential as their primary reason for wanting to do business in China. As reflected in a Commerce Department report and interviews with other agency officials, opportunities abound in industries such as computers, aerospace, telecommunications, and power generation. Two U.S. electronics manufacturers told us that the market growth estimates for China's electronics and computer markets are among the highest in the world. An aerospace company official indicated that the growth of China's burgeoning economy has led to a dramatic increase in the demand for air transportation in China. Demand for air transportation has grown by over 20 percent annually for the last 5 years.

Two U.S. companies told us that China's economic expansion creates opportunities for infrastructure development projects. For example, as the fastest-growing telecommunications market in Asia, China expects its spending for telecommunications products to increase to about $2 billion per year by 1996, according to a U.S. telecommunications company official. Another U.S. company official told us that China has the world's largest new market for power generation plants and equipment, an industry in which the United States is extremely competitive. With such impressive market opportunities, some U.S. companies said that they cannot afford not to be in China.

A second factor leading some U.S. companies to do business with China is the increasing pace of economic reform and liberalization. A U.S. telecommunications company representative told us that the 1992 U.S.-China Memorandum of Understanding (MOU) on market access was critical to his firm's decision to expand operations in China. The provision to ensure open and nondiscriminatory procurement practices for digital switching systems allowed this company to conclude a joint venture to manufacture telecommunications switches in China. According to a U.S. electronics company representative, China's continued efforts to improve the business environment and meet the requirements to join GATT have encouraged his company to expand its activities in China. The 1992 U.S.-China MOU on market access offers further encouragement, as it commits China to liberalize trade restrictions, including imports of computer equipment. One U.S. company official noted that China's efforts to decentralize decision-making are an additional attraction for U.S. companies.

U.S. Government and International Efforts to Promote Trade and Investment in China

Although the U.S.-China trade relationship faces several important policy challenges, the U.S. government has continued its efforts to facilitate bilateral trade. USTR is monitoring the 1992 U.S.-China MOUs on market access and intellectual property and is participating in international negotiations on China's accession to GATT. The Department of Commerce is continuing its trade promotion programs in China. In response to a growing demand on the part of U.S. exporters, Eximbank increased its loans and guarantees for U.S. exports to China. In addition, the World Bank, the Asian Development Bank, and Japan's Overseas Economic Cooperation Fund are offering loans to support development projects in a variety of Chinese economic sectors, from agriculture to industry.

USTR Activities

USTR is monitoring China's compliance with the 1992 bilateral agreements on market access and protection of intellectual property rights and is working with the Chinese government to assist in the implementation of these agreements, according to USTR officials.[1] In addition, USTR officials said they consult regularly with U.S. business representatives to obtain their perspectives on China's trade practices. USTR also plays a key role in bilateral and multilateral negotiations to assess China's eligibility to join GATT. Further, USTR has begun negotiations with the Chinese government on opening up its service sector to greater foreign participation.

1992 Memoranda of Understanding on Market Access and Protection of Intellectual Property Rights

Among the most recent and significant steps China has taken to increase market access and improve its business climate were the two 1992 bilateral MOUs between the United States and China on market access and protection of intellectual property rights. USTR officials told us in December 1993 that China had acted to implement some of the provisions of these agreements, but that barriers to market access and infringements of intellectual property rights persist.

Market Access Agreement

In 1991, USTR identified China's four most significant trade barriers as the focus of an investigation mandated by Section 301 of the U.S. Trade Act of 1974.[2] These barriers were (1) import licensing requirements; (2) import prohibitions and quantitative restrictions; (3) technical barriers to trade

[1]An intellectual property right is the ownership of the right to possess or otherwise use or dispose of products created by human ingenuity. Patents, copyrights, and trademarks are examples of intellectual property rights.

[2]Under Section 301 of the U.S. Trade Act of 1974, as amended, the President is required to take all appropriate action, including retaliation, to obtain the removal of any act, policy, or practice of a foreign government that violates an international agreement or is unjustifiable, unreasonable, or discriminatory and burdens or restricts U.S. commerce.

such as standards, testing, and certification requirements; and (4) failure to publish laws, regulations, and administrative decisions related to imports and their sale and distribution in China.

In October 1992, after a year-long investigation, the United States and China reached an agreement resolving the Section 301 investigation. Under the terms of the agreement, the government of China committed itself to (1) progressively eliminate import barriers between 1992 and 1997, including import licensing requirements, quotas, controls, and restrictions in many key U.S. export sectors; (2) eliminate the use of import substitution policies and measures;[3] (3) increase the transparency of its trade regime by, among other things, openly publishing all laws, regulations, and decrees that govern trade, and establishing a central repository for the publication of all trade regulations; (4) remove standards and testing requirements as barriers to trade, especially in the area of agricultural standards; and (5) significantly reduce tariffs on a variety of U.S. goods by the end of 1993.

According to USTR officials, China has taken steps to implement certain provisions of the market access MOU, but has not yet opened its markets to key U.S. exports as substantially as promised in the agreement. In some areas, USTR is awaiting future deadlines to evaluate China's compliance. USTR officials have expressed their commitment to closely monitor the agreement, to continue discussions with the Chinese government, and to take decisive action if China does not fulfill its commitments.

Intellectual Property Rights Agreement

In the January 1992 U.S.-China MOU on intellectual property rights, China committed itself to providing improved protection for intellectual property. Among the most important terms of the agreement, China pledged to (1) provide strong protection for U.S. copyright holders, including computer software and sound recordings; (2) join the Berne Convention and the Geneva Phonograms Convention,[4] (3) provide full product patent protection for pharmaceutical and agricultural chemical products, and (4) adopt legislation to protect trade secrets from unauthorized disclosure or use.

[3]China's import substitution practices have involved denying approval for certain imports if an equivalent local product is produced domestically, or conditioning import approvals on the transfer of foreign technologies into local manufacturing ventures.

[4]The full titles of these conventions are the Berne Convention for the Protection of Literary and Artistic Works and the Geneva Convention for the Protection of Producers of Phonograms Against Unauthorized Duplication of Their Phonograms.

According to USTR officials, China has taken some important steps to implement its commitments under the intellectual property rights agreement, but many intellectual property rights problems remain. On the positive side, China has joined the Berne Convention and the Geneva Phonograms Convention, issued regulations implementing the Berne Convention in China, and raised the level of protection for computer software. In addition, China has acted to redress weaknesses in its patent regime, including amending its patent law to extend protection for agricultural chemical and pharmaceutical products.

However, according to USTR officials, Chinese infringement on copyrighted works and patented products is still commonplace and largely unabated by Chinese government actions. China lacks an effective intellectual property rights enforcement agency and has not established laws to prosecute offenders. According to estimates by the International Intellectual Property Alliance, U.S. industries lost more than $415 million in 1992 as a result of copyright infringement in China. USTR officials stated that the absence of effective intellectual property rights protection is one of the greatest market access barriers for foreign companies in the recording, motion picture, and computer software industries. They said in June 1993 that USTR intended to hold continued consultations with China on enforcement of intellectual property rights, with the goal of reaching agreement on a strict enforcement regime.

U.S. Participation in Negotiations on China's Application to Join GATT

International negotiations on China's application to join GATT resumed in 1992 after a 3-year hiatus. U.S. business associations and many of the companies we spoke to expressed support for China's efforts to join GATT, provided that the contracting parties[5] negotiate an acceptable protocol of accession. Such a protocol would require China to adhere to GATT obligations normally applied to market economies.

China's GATT History

The then-Republic of China was an original member of GATT in 1948, but the nationalist government of Taiwan withdrew from GATT in 1950 after the Communist revolution. The People's Republic of China secured GATT observer status in 1982, 3 years after its Open Door Policy began, and since then has attended annual meetings as a nonvoting delegate. China subsequently applied for full GATT membership in 1986. The GATT Working Group on China met for the first time in 1987 to begin negotiating the terms under which China might eventually join GATT. China's GATT negotiations stalled in the spring of 1989 as China slowed its

[5]"Contracting party" is the term used to refer to a country assuming obligations under GATT.

implementation of economic and trade reforms, recentralized its trade operations, and increased import barriers.

Status of Negotiations on China's GATT Accession

Negotiations on China's application to join GATT gained momentum in 1992, when it became apparent that China had resumed its trade and economic reform program. In addition, the successful negotiation of a bilateral MOU on market access in October 1992 gave GATT contracting parties renewed confidence in China's ability to meet GATT eligibility requirements. In this MOU, China agreed to allow greater market access for U.S. companies, and the United States agreed in turn to "staunchly support China's achievement of contracting party status to the GATT," provided that the contracting parties reach an acceptable "protocol."

The U.S. government is discussing provisions for China's protocol of accession within the context of a five-point framework, which would require China to (1) establish a single trade policy, so that GATT trading policies are applied equally in all regions, to all imports, and from all countries; (2) improve the transparency of its trade regulations and administration, including economic and trade data reporting; (3) demonstrate a commitment to eliminate nontariff barriers that conflict with GATT rules;[6] (4) commit to the establishment of a market-based price system; and (5) agree to a temporary special safeguard mechanism allowing contracting parties to protect their industries from excessive and unfair Chinese exports pending the completion of China's economic and trade reforms.

China's GATT representatives had indicated that they were prepared to negotiate on all issues of interest to the contracting parties, including a special safeguard mechanism, according to USTR officials in November 1993. In addition, China has taken steps to demonstrate its commitment to trade reforms compatible with GATT policies. For example, China reduced tariff levels on over 3,000 items, freed a number of controlled prices, and committed to unifying its multiple foreign exchange rates within 5 years.

However, USTR officials reported that several issues remain to be addressed before China's GATT accession negotiations can be concluded. Among the concerns expressed by the U.S. government and other contracting parties were (1) the continuing lack of transparency in China's trade regime, (2) the relationship between China's accession commitments

[6]Nontariff barriers are government measures or policies other than tariffs, such as import quotas or foreign exchange controls, that impede or distort the flow of international commerce.

and the implementation of Uruguay Round results,[7] and (3) the Chinese government's ability to enforce the commitments it makes when it joins GATT. According to USTR officials, China's implementation of MOUs with the United States on market access, protection of intellectual property rights, and exports of goods produced with prison labor will be a key factor in assessing the viability of similar GATT commitments.

Another factor that has complicated China's negotiations to join GATT is the conflict between the United States and China over whether GATT membership should be accompanied by permanent, unconditional U.S. MFN trade status. China has pushed for unconditional MFN status consistent with GATT provisions.[8] However, the Jackson-Vanik amendment to the U.S. Trade Act of 1974 prohibits the United States from being able to offer permanent MFN tariff treatment to nonmarket economies, and instead, requires an annual review to renew MFN status for these countries. Thus, the U.S. government has told China that it will not be able to apply GATT formally to China after accession. China's accession to GATT would oblige the U.S. government to invoke GATT article 35, which allows contracting parties to opt out of MFN tariff schedules under certain circumstances. This provision can only be applied when a party enters GATT as a new member and when the two parties have not entered into tariff negotiations with one another.

U.S. Business Perspectives

Several U.S. business associations and individual companies we spoke to expressed support for China's efforts to join GATT. According to the National Association of Manufacturers, many of the difficulties U.S. firms face in doing business in China would be overcome if China were bound by GATT "disciplines." A spokesman for a U.S. company believes that GATT membership would increase pressure on China to "play by the rules" of international trade. An aerospace company executive commented that her company fully supports China's efforts to join GATT, provided that rules and safeguards are built into the protocol of accession to ensure that China is complying with both the letter and the spirit of GATT rules.

The U.S.-China Business Council has recommended that the U.S. government seek China's admission to GATT, as long as China's protocol of accession ensures (1) greater transparency of its trade regime, (2) elimination of the foreign exchange controls, (3) decontrol of state

[7]Launched in September 1986 in Punta del Este, Uruguay, and concluded in December 1993, the Uruguay Round of multilateral trade negotiations is the eighth negotiating round held under the auspices of GATT.

[8]Article II of GATT requires that each contracting party grant other contracting parties equal tariff treatment, or MFN status, for all traded goods.

foreign trade corporations, (4) "national treatment" for all commercial enterprises in China,[9] and (5) tariff reductions for products and services in industries in which the United States is competitive.

Department of Commerce Activities

The Department of Commerce promotes U.S. exports to China through its co-chairmanship of the U.S.-China Joint Commission on Commerce and Trade (JCCT) and through the activities of US&FCS. JCCT was established in 1983 to provide a forum for high-level consideration of bilateral trade and investment issues and to serve as a vehicle for promoting commercial relations, according to Commerce Department reports. The former Bush administration suspended annual high-level JCCT meetings from June 1989 through November 1992 in response to the Chinese military crackdown in Tiananmen Square. In addition, cooperative programs sponsored by JCCT, such as a legal exchange program, were interrupted. However, U.S. embassy-based working groups met quarterly during this period to resolve business disputes regarding U.S.-China trade, investment, and protection of intellectual property rights. Higher-level JCCT meetings were reconvened in December 1992 as part of the former Secretary of Commerce's mission to China.

According to Department of Commerce reports, new JCCT initiatives include (1) facilitating the implementation of the 1992 U.S.-China market access and intellectual property rights MOUs; (2) negotiating an agreement on end-use checks on dual-use technology; (3) exploring the resumption of talks regarding a bilateral investment treaty; (4) establishing a business development working group to enhance U.S. export opportunities in China's energy, transportation, and telecommunications sectors; (5) renewing trade promotion efforts and trade events in China, including the legal and finance seminar programs; and (6) establishing a U.S.-China Business Center in Shenzhen.

US&FCS conducts numerous programs to support U.S. trade and investment activities in China. These activities include market analysis; U.S. government support of commercial programs, business counseling, and outreach; and trade promotion. Among its market analysis efforts, US&FCS develops an annual country marketing plan and regularly reports on China's commercial and economic environment. To support other U.S. government programs in China, US&FCS is providing information and assistance to visiting delegations from USTR, Eximbank, and other agencies.

[9]National treatment affords individuals and firms of foreign countries the same competitive opportunities, including market access, as are available to domestic parties.

US&FCS' business counseling and outreach activities include (1) arranging business appointments with key government and industry leaders, (2) providing sectoral and market information to U.S. business visitors, (3) assisting U.S. companies with dispute resolution, and (4) providing other services. In addition, US&FCS supports events to promote U.S. exports to China such as sponsoring catalogue shows and trade fairs.

Eximbank Activities

Eximbank opened its programs to China in 1981 and now provides a full spectrum of loans, guarantees, and insurance to U.S. companies exporting to China. Eximbank commitments to China reached a record high in fiscal year 1992—accounting for about 5 percent of its total loans, grants, and guarantees for that year.

Since China's 1989 military crackdown in Tiananmen Square, Eximbank operating guidance has required that three special conditions be met before individual loans and guarantees to China can be authorized. These conditions include (1) an assurance by financial institutions such as the Bank of China that the transaction is imminent and carries the full faith and credit of the Chinese government, (2) a determination by Eximbank that the U.S. export would be lost either because of officially supported foreign competition or lack of available financing, and (3) a requirement that the State Department provide human rights and political clearances for China.

In fiscal year 1992, Eximbank authorized its highest level of funding for China since the program was opened in 1981. Eximbank authorized $72 million in direct loans and grants and $330 million in guarantees in that year, for a total of about $402 million. This increased funding was largely the result of growing interest in the Chinese market among U.S. companies, combined with China's positive repayment record, according to Eximbank officials. They attributed China's positive repayment record to its ample foreign exchange reserves, high economic growth, and absence of balance of payments problems. They added that Eximbank interest rates for loans, and repayment terms for loans and guarantees, for China are the most favorable permitted by the Organization for Economic Cooperation and Development (OECD) agreement on export credits.[10]

Eximbank loans and guarantees to China cover a variety of industry sectors, ranging from engineering services to chemical-processing equipment to commercial aircraft. Among its largest transactions in China, Eximbank

[10]OECD is a forum for monitoring economic trends and coordinating economic policy among its 24 member countries, which include the industrialized free-market democracies of North America, Western Europe, and the Pacific Rim.

facilitated the lease/purchase of two McDonnell Douglas MD-11 aircraft by China Eastern Airlines in 1992 with guarantees of $91.4 million and $94.5 million, respectively.

International Lenders

The most important international lenders for U.S. companies in China are the World Bank; the Asian Development Bank; and the Overseas Economic Cooperation Fund, Japan's economic assistance program. The U.S. government has important voting power in the World Bank and ADB, based in part on the size of its capital contributions to these organizations. OECF is noteworthy because of the large volume of funding it provides. These organizations generally require international competitive bidding procedures for their China project tenders, and U.S. companies have won important contracts on projects funded by these donors.

World Bank

The International Bank for Reconstruction and Development (IBRD) and its affiliate, the International Development Association (IDA), channel financial resources for development assistance projects from industrialized countries to the developing world.[11] IBRD and IDA provide loans and credits for projects in China in a variety of sectors, such as power generation, transport, health, education, infrastructure, agriculture, and the environment. IBRD and IDA lending to China doubled from 1991 to 1993. In World Bank fiscal year 1991, the IBRD and IDA boards approved $1.6 billion in loans and credits for projects in China. In World Bank fiscal years 1992 and 1993, board approvals totalled $2.5 billion and $3.2 billion, respectively, according to the Treasury's Office of Multilateral Development Banks.

Further, a Treasury official told us that after the events of Tiananmen Square in June 1989, the United States and its Group of Seven (G-7) allies sharply reduced and redirected multilateral development bank lending to China.[12] There was no new World Bank lending to China from June 1989 to February 1990. From February 1990 until July 1990, the United States and its G-7 allies supported a gradual resumption of World Bank lending to China for projects that met basic human needs. In July 1990 at the G-7 Houston Summit, participants agreed to continue World Bank lending to

[11]The World Bank Group includes IBRD and its affiliate, IDA. IBRD has two other affiliates—IFC and the Multilateral Investment Guarantee Agency.

[12]G-7 refers to the seven major economic powers (Canada, France, Germany, Great Britain, Italy, Japan, and the United States) whose finance ministers seek to promote balanced economic growth and stability among exchange rates.

support basic human needs, and to consider other loans to China that would contribute to economic reform and address environmental concerns. Since that time, other donor governments have supported the expansion of World Bank lending beyond basic human needs projects on the basis that such lending may contribute to China's development, stability, and progressive reform. In contrast, U.S. voting policy on World Bank loans to China remains unchanged, and the United States continues to oppose loans to China that do not meet the basic human needs of the Chinese people. U.S. companies, however, are eligible to compete for all contracts financed by the World Bank Group in China.

Despite U.S. voting policy on World Bank lending to China, Treasury officials believe U.S. companies have been successful in the competition for procurement in IBRD- and IDA-financed contracts in China. The administration has analyzed World Bank data on procurement disbursement in fiscal years 1988-92 for IBRD and IDA China projects. During this 5-year period, procurement disbursements on projects in China totalled $5.3 billion, of which $3 billion (or 57 percent) were paid to foreign addressees/suppliers, and $2.3 billion (or 43 percent) were paid to local addressees/suppliers within China. Of these foreign disbursements (averaged over the 5-year period), two-thirds were to companies from six industrialized countries including France, Germany, Italy, Japan, the United Kingdom, and the United States. Of the disbursements to addressees in these six countries, payments to U.S. addressees ranked first (27 percent), followed by Japan (25 percent), and Germany (21 percent).[13] For U.S. companies, the key sectors were power, education, primary energy development, agricultural and rural development, and industry.

The mission of IFC is to promote private sector growth in developing countries by providing loans and capital for this purpose. According to IFC officials, the rapid growth in China's nonstate sector has led IFC to actively seek China projects for which it can provide financial resources. IFC has invested approximately $50 million in China since 1985, including $29.4 million in a joint venture to produce bicycles and $18.2 million in a joint venture to produce automobiles. IFC is also establishing a joint venture consulting firm to assist Chinese state-owned enterprises in the process of privatization. In addition, it is considering new projects in a variety of sectors, including glass, chemicals, electronics, automobiles, and power generation. The IFC program in China is growing quickly. IFC

[13]These data must be interpreted very cautiously. The data represent IBRD and IDA procurement disbursements according to addressees where payment was made. For example, payments made to a U.S.-owned company address in France would be recorded as disbursements to France rather than to the United States.

officials reported that IFC expects to increase its exposure to $150 million in 1993, and to $450 million in 1994.

Asian Development Bank

ADB, comprised of 52 member countries, is engaged in promoting the economic and social progress of its developing member countries in the Asian and Pacific region. The U.S. government is the second largest holder of capital stock in ADB after Japan, and U.S. firms are eligible to bid on ADB contracts. ADB supports the Chinese government's strategy for economic growth as stated in its Eighth Five-Year Plan (1991-95). ADB projects in China have emphasized efficiency improvement, environmental protection, natural resource conservation, and poverty reduction. In 1992, ADB financed projects in several key sectors, including transportation, communications, and industry. In recent years, ADB loan commitments for projects in China have grown substantially. For example, in 1992, ADB approved $903 million in loans to China, up from $496 million in 1991—an increase of 82 percent. The loan approvals for 1991 represented an almost tenfold increase from the 1990 level of $50 million.

Japan's Overseas Economic Cooperation Fund

In addition to the multilateral development banks, OECF is a further source of development funding worth noting because of its large size and openness to foreign bidders. OECF, a development finance institution of the Japanese government, assists the governments of developing countries in building social and economic infrastructure by providing low-interest, long-term loans. In 1990 and 1991, OECF loan commitments to China were mainly for economic infrastructure projects, such as transportation, electric power, telecommunications, and agriculture. Loan commitments to China (including loans to the private sector) in fiscal year 1991 were about $968 million.

OECF also provides financial assistance in the form of concessional (below-market interest rate) loans and/or equity investments to private sector companies for projects that contribute, for example, to economic development and increased employment. OECF reported that in 1991, 90 percent of OECF loans were open to any foreign company under international competitive bidding procedures. According to the China Business Review, OECF projects could present significant opportunities for U.S. companies in sectors where they are competitive, if U.S. companies pursue them more actively.

U.S. Government Policies That May Decrease U.S. Business Opportunities in China

U.S. companies, eager to participate in China's growing market, have been expanding their sales efforts and operations in China. However, certain U.S. government policies designed to address concerns about China's human rights, trade, and weapons proliferation practices may prevent U.S. companies from being able to more fully realize the business opportunities associated with China's economic growth and development. For example, the confidence of U.S. companies in their ability to do business in China is affected by their uncertainty over whether the U.S. government will renew China's MFN trade status, according to U.S. business associations and companies. In addition, some U.S. business associations and companies have expressed concern about export control regulations for products sold to China and about insufficient U.S. government financing for trade and investment activities in China. U.S. government policymakers continue to grapple with the challenge of balancing the U.S.' political, security, and economic interests in China.

Debate Over Renewal of China's MFN Trade Status

Since 1990, congressional decision-making on whether to disapprove the President's annual recommendation to extend China's MFN benefits has provoked intense debate among U.S. policymakers and affected interest groups. Those who favor revoking or placing conditions on China's MFN status generally argue that the United States should use its economic leverage to pressure China to improve its behavior in such areas as human rights, trade, and nonproliferation of weapons. Those who favor maintaining China's MFN status contend that economic engagement with China is not only in the commercial interest of the United States, but also offers the best prospects for political liberalization in China and for Chinese cooperation in global security, environmental, and other issues. In May 1993, the President issued an executive order extending China's MFN status for 1 year (July 3, 1993-July 2, 1994) with renewal thereafter subject to certain conditions relating to China's human rights practices.

China's MFN History

In 1979, the United States and China signed a bilateral trade agreement providing mutual MFN benefits. The agreement took effect in 1980. Because China is a non-market-economy country, MFN status was granted to China subject to the conditions of the Jackson-Vanik amendment to the U.S. Trade Act of 1974. The Jackson-Vanik amendment allows an affected country to receive MFN status only if the President determines that the country permits free and unrestricted emigration. The President may recommend renewal of the waiver for successive 12-month periods if he determines that further extensions will substantially promote the objectives of the Jackson-Vanik amendment. Any recommendations for further waiver by the President must be made at least 30 calendar days before the previous year's waiver authority expires (i.e., by no later than June 3).

Congress has up to 60 calendar days following the expiration on July 3 of that waiver authority (i.e., by no later than September 3) to pass a joint resolution disapproving a Jackson-Vanik waiver. In effect, then, Congress has 90 calendar days from the President's June 3 notification to consider the extension. Congress has an additional 15 legislative days to override any presidential veto of a resolution disapproving a waiver extension, beginning the date that the veto message is received.

Since the Chinese government's suppression of the Tiananmen Square demonstrations, Members of Congress have annually introduced, but not enacted, numerous bills that would either terminate or place conditions on China's MFN status.[1] These conditions have related primarily to China's human rights policies, trade practices, and adherence to international weapons nonproliferation guidelines.

The President issued an executive order in May 1993 providing for extension of China's MFN status until July 1994, with renewal thereafter subject to certain conditions relating to China's human rights practices. According to the executive order, the Secretary of State shall not recommend extension unless he or she determines that (1) extension will substantially promote the freedom of emigration objectives of the Jackson-Vanik amendment and (2) China is complying with the 1992 bilateral agreement between the United States and China concerning exports of goods made with prison labor. In making this recommendation, the Secretary of State is also required to determine whether China has demonstrated overall, significant progress in respecting human rights. Criteria by which such progress will be measured include, among other things, (1) adherence to the Universal Declaration of Human Rights, (2) release of and accounting for Chinese political and religious prisoners, and (3) protection for the religious and cultural heritage of Tibet. The executive order also commits the administration to pursue all legislative and executive actions to ensure that China abides by its agreements to follow fair trade practices and that China adheres to its weapons nonproliferation commitments.

[1]In 1992, two bills placing conditions of renewal of China's MFN status were passed by both the House and the Senate and subsequently vetoed by former President Bush. These vetoes were overridden by the House and upheld by the Senate.

Key Issues in the China MFN Debate

During the 12-month period following the issuance of the President's executive order, it is likely that arguments for renewing China's MFN status, placing conditions upon it, or revoking MFN status outright will continue to be debated among Members of Congress, the administration, the business community, and other interest groups. While various U.S. interest groups have expressed support for improving China's human rights and trade practices and increasing China's cooperation with international weapons nonproliferation efforts, policymakers disagree over how best to pursue these goals and to what extent they should be linked to China's MFN status.

Arguments for Placing Conditions on China's MFN Status

Those who favor revoking or placing conditions on China's MFN status argue that the United States should use its considerable economic leverage to promote improvements in China's policies in areas such as human rights, trade, and weapons nonproliferation. As one of China's largest export markets, the United States purchased 32 percent of China's exports in 1992. Losing U.S. MFN status would raise duties on Chinese products substantially, diminishing China's ability to provide certain products to the U.S. market at competitive prices. While it does not take a policy position, the Congressional Research Service reported that, based on 1991 trade and tariff data, the termination of China's MFN status would result in duty increases on 93 percent of all U.S. imports from China.[2] Proponents of linking China's MFN status to progress in human rights or other issues believe that China's stake in the U.S. market gives the Chinese government an incentive to improve its policies in order to preserve MFN tariff treatment.

Human Rights Concerns

Widespread congressional concern about China's human rights practices, especially since the military crackdown in Tiananmen Square, has prompted legislative proposals to link U.S. MFN treatment for China with progress in this area. Several prominent human rights organizations take issue with the notion held by some China policymakers that China's economic reform and modernization will naturally lead to political liberalization. Human Rights Watch, Asia, a division of Human Rights Watch,[3] cites evidence to suggest that even as China's economic reform efforts have picked up momentum in recent years, political repression has continued unabated. According to the Clinton administration and private

[2]Vladimir N. Pregelj, Most-Favored-Nation Status of the People's Republic of China, Congressional Research Service, The Library of Congress (Washington, D.C.: Oct. 1992), pp. 5-6.

[3]Human Rights Watch is the largest U.S.-based international human rights organization, composed of five regional organizations, including Human Rights Watch, Asia. It monitors the human rights practices of about 60 governments around the world and works to stop human rights abuses by generating political pressure on these governments.

human rights organizations, China's human rights policies remain repressive and fall far short of internationally accepted norms. In 1993 testimony before Congress, Human Rights Watch, Asia, stated that the Chinese government continues to suppress freedom of assembly, expression, and religion, and to deny international human rights groups access to labor camps, prisons, and other places of detention.

Concerns About China's Trade Practices

Proponents of placing conditions on China's MFN status have also raised China's trade practices as a key issue. Some observers link the growing U.S. trade deficit with China in part to Chinese trade practices that unfairly limit market access for U.S. and other foreign products. They have expressed concern that the government of China continues to engage in unfair trade practices against the United States such as raising tariffs, charging discriminatory customs rates, failing to enforce intellectual property rights, and setting import quotas. In addition, they have complained about China's alleged illegal transshipment of textiles and other items to the United States through third countries, as well as exports of goods made with prison labor. China began to address these concerns in 1992 when it signed the U.S.-China MOUs on market access, intellectual property rights, and exports of goods made with prison labor. However, some congressional and administration officials have expressed skepticism about how well these agreements are being implemented and enforced.

Weapons Proliferation Concerns

Concerns about China's proliferation of weapons have been raised in the debate over China's MFN trade status. For example, some Members of Congress have suggested that, to receive MFN treatment, China should be required to demonstrate significant progress in adhering to the guidelines of the Missile Technology Control Regime (MTCR)[4] and complying with international agreements on sales of nuclear and chemical weapons technology. China increased its support for global nonproliferation initiatives in 1992 and 1993 with its accession to the Nuclear Nonproliferation Treaty,[5] its commitment to the guidelines of MTCR, and its signing of the Chemical Weapons Convention, according to the President's

[4]MTCR, established in 1987, is a set of export controls on certain types of equipment, software, and related technical data that could be used in the development and production of missiles capable of delivering nuclear weapons. These controls are intended to limit the global proliferation of such missiles. Adherents to MTCR are Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Spain, the United Kingdom, and the United States.

[5]This treaty became effective in 1970 and was intended to limit the number of states with nuclear weapons to the United States, the Soviet Union, Great Britain, France, and China. Over 140 states have pledged not to acquire nuclear weapons and to accept the safeguards of the International Atomic Energy Agency over all their nuclear materials.

May 1993 report to Congress on China. However, reports of certain sensitive Chinese exports raise questions about China's compliance with these commitments. For example, the U.S. government determined in August 1993 that certain Chinese and Pakistani entities had engaged in transfers of missile technology from China to Pakistan. These actions put China in violation of its commitments under MTCR and led the U.S. government to impose sanctions requiring denial of new export licenses and U.S. government contracts related to certain munitions and dual-use items.[6]

Arguments for Renewing China's MFN Status Without Conditions

MFN Debate Creates Instability in Business Relationships

The great majority of the U.S. business associations and companies we contacted told us that the annual uncertainty surrounding China's MFN status potentially hinders their business activities in China. In a May 1993 letter to the President, 316 U.S. corporations and trade associations represented by the Business Coalition for U.S.-China Trade jointly expressed their view that "the persistent threat of MFN withdrawal does little more than create an unstable and excessively risky environment for U.S. companies considering trade and investment in China, and leaves China's booming economy to our competitors." According to one U.S. company executive we spoke with, this uncertainty precludes long-term business deals and makes strategic planning difficult. The annual MFN review process may also be a negative factor for U.S. companies in securing financing for business transactions in China from the international lending community, according to a recent report prepared by over 20 leading U.S. firms in the electric power and fossil fuel industry.[7] The U.S.-China Business Council and the National Association of Manufacturers affirmed the importance of a stable commercial environment for business planning and stressed that the need to make a

[6]According to the State Department, U.S. law calls for the imposition of sanctions on foreign persons who knowingly transfer to a non-MTCR country MTCR items that contribute to development of missiles capable of carrying a payload of 500 kilograms a distance of 300 kilometers, or about 1,100 pounds over 190 miles. U.S. sanctions were imposed in August 1993 for a 2-year period, and affect items designated in an MTCR Annex such as certain avionics equipment, space launch equipment, and advanced computer technologies.

[7]U.S. Electric Power Mission to China (Washington, D.C.: Aug. 1993). This report was based on a June 1993 mission to China to promote the use of U.S. electric power technology and services. The mission included 24 U.S. companies and was sponsored by the U.S. Departments of Energy and Commerce.

politically charged decision about China's MFN status every spring creates an annual crisis for business people and diplomats alike.

Possible Chinese Retaliation If China Does Not Meet Conditions and MFN Status Is Revoked

U.S. business representatives have also highlighted the potential economic losses for U.S. companies were China to retaliate against a U.S. withdrawal of MFN trade benefits by raising its own tariffs or taking other measures to limit U.S. access to the Chinese market.[8] The Emergency Committee for American Trade[9] stated that China would be almost certain to retaliate against a U.S. withdrawal of MFN tariff treatment by raising Chinese tariffs and diverting its purchases to non-U.S. firms. Companies represented by the Business Coalition for U.S.-China Trade have expressed concern that placing administrative or legislative conditions on China's MFN status would put at risk the $7.5 billion worth of products they exported to China in 1992. Chinese retaliation could hurt U.S. companies' ability to compete not only in China but also in other markets, according to some U.S. business associations. For example, the National Association of Manufacturers fears that, in certain industries, such as aerospace, electronics, and machine tools, it would be nearly impossible for U.S. firms to be globally competitive if they were excluded from the Chinese market, because China is such an important and rapidly growing new market.

Potential Costs to the U.S. Economy If MFN Status Is Revoked

Advocates of maintaining unconditional MFN status for China also point out that U.S. consumers and workers would suffer if tariffs on Chinese imports were to increase dramatically. The International Business and Economic Research Corporation estimated that loss of China's MFN status could cost U.S. consumers $10 billion-$14 billion per year as a result of price increases for Chinese imports or their alternatives. The highest duty increases would be on consumer goods, such as shoes, clothing, electronic products, and toys, of which China is a significant U.S. supplier. For example, if China's MFN benefits were revoked, tariffs on silk apparel would rise from 6.9 percent to 65 percent, and tariffs on audio tape players would rise from 3.7 percent to 35 percent. U.S. importers and retailers relying on Chinese imports for their livelihood could be hurt, and employees of these enterprises would stand to lose their jobs.

[8]Some U.S. companies and business associations we contacted believe that Chinese retaliation against U.S. companies would be very likely.

[9]The Emergency Committee for American Trade is an organization of the heads of 65 large U.S. international business enterprises, with combined annual worldwide sales of about $1 trillion.

Effectiveness of Unilateral MFN Trade Sanctions Questioned

Some U.S. business, government, and academic observers have also questioned the effectiveness of U.S. trade sanctions against China if imposed in isolation. According to a State Department official, none of China's other trading partners intend to follow the United States in imposing higher tariffs on Chinese products. Although these countries may share the concerns of the United States regarding China's human rights, trade, and weapons proliferation practices, none of them link MFN treatment to progress in these areas. Thus, some observers express skepticism that a unilateral U.S. decision to revoke MFN tariff treatment for China would motivate any significant change in Chinese government policies. The fear expressed by two major U.S. business associations is that rather than change its internal policies, China might transfer its business to U.S. foreign competitors, at the expense of U.S. exporters and their employees.

Controls on Exports of Dual-Use Technology Restrict U.S. Sales to China in Some Sectors

The U.S. Department of Commerce controls and licenses exports and reexports of dual-use commodities (civilian items with military applications) and technical data. Under the legislative authority of the Export Administration Act of 1979 (P.L. 96-72), as amended, controls on these items are maintained for reasons of national security, foreign policy, or short supply. Within Commerce, the Bureau of Export Administration (BXA) oversees the regulation and enforcement of the Export Administration Act and is responsible for a wide range of policy matters relating to maintaining the vitality of the U.S. defense industrial base. Some export controls have been imposed in coordination with multilateral arrangements, such as the former Coordinating Committee on Multilateral Export Controls (COCOM);[10] others are imposed unilaterally; and some have aspects of each.

COCOM was established in 1949 to protect the strategic technology advantage of the United States and its allies. National security controls, developed and implemented in coordination with COCOM members, were designed to prevent the transfer of strategic items and technical data to "proscribed" destinations, such as China, Romania, Poland, and all of the former Soviet republics. In November 1993, representatives of the 17 COCOM member countries met to discuss proposals to terminate COCOM and to establish a new organization to coordinate the export of strategic goods. These nations set an April 1994 deadline to replace COCOM and agreed to invite Russia, China, and other former Communist Bloc

[10]COCOM membership included Australia, Belgium, Canada, Denmark, France, Germany, Greece, Italy, Japan, Luxembourg, the Netherlands, Norway, Portugal, Spain, Turkey, the United Kingdom, and the United States.

countries to join the new arrangement. As of April 1994, COCOM was dismantled but no agreement was reached on a successor organization. Thus, it was unclear how any new arrangement would affect U.S. exports of dual-use technologies to China.

BXA maintains the Commerce Control List (CCL), which includes all items subject to Commerce Department export controls.[11] The number of commodities, technical data, and software listed on CCL was reduced by 50 percent in September 1991 as a result of COCOM liberalization efforts, according to BXA officials. The United States supported this liberalization in view of the changing Soviet strategic threat and the democratization of Eastern Europe. Further liberalization was announced in 1993 and 1994.

As of January 1994, the licensing policy toward China remained consistent with the policy set forth by President Bush and the Department of Commerce following the Tiananmen Square crisis, according to BXA officials. BXA reviews export license applications for China on a case-by-case basis for those items subject to controls as listed on CCL. While China benefits from the decontrols and relaxations adopted by COCOM for all proscribed destinations, COCOM did not adopt, and the United States did not support, any additional favorable treatment for exports to China after 1989.

Export license requests for China receive additional administrative review focused on possible contributions to nuclear, military, or police activities. The 1992 Export Administration Act regulations stipulate that certain commodities, data, and end-uses may require extended review or denial. Of particular concern, according to these regulations, are exports that would make a direct and significant contribution to nuclear weapons and their delivery systems, electronic and antisubmarine warfare, air superiority, power projection, or intelligence gathering.

The United States imposed certain unilateral sanctions after the 1989 military crackdown in Tiananmen Square. Presidential and legislatively mandated sanctions affecting export licenses included (1) suspension of all government-to-government military sales and commercial exports of

[11]Published annually and continually updated, CCL is based primarily on COCOM controls, but also includes items controlled for foreign policy and short-supply reasons. CCL includes technologies in 10 general categories, but does not include those items exclusively controlled for export by other agencies of the U.S. government, such as arms, ammunition, and implements of war.

weapons,[12] (2) suspension of activities involving nuclear energy cooperation, (3) suspension of export licenses for crime control and detection equipment, (4) opposition to talks within COCOM on liberalizing controls on high-technology exports to China,[13] and (5) continuation of suspension of any defense article on the U.S. munitions list.

In August 1993, the Clinton administration announced additional sanctions after concluding that China had violated its MTCR commitments by shipping sensitive missile technology to Pakistan. The sanctions, detailed on page 43, affect an estimated $400 million to $500 million in sales of U.S.-built satellites and satellite components to China each year, according to a State Department spokesman.

U.S. Business Concerns

By their nature, export controls place restrictions on the ability of U.S. companies to ship certain goods and technologies abroad. Thus, it was not surprising that some of the U.S. government and private sector officials we contacted expressed concerns about the negative impact of export controls on U.S. sales to China. While they recognized the strategic necessity of export controls, some of the companies we contacted perceived the export control system as a key factor in limiting or discouraging their trade and investment activities in the China market. According to some U.S. government and private sector officials, U.S. manufacturers of high-technology products, such as computers, telecommunications equipment, and power generation equipment, were among those most affected by either COCOM controls or controls on exports to China mandated by unilateral sanctions.

A computer company official told us that COCOM controls limited her company's ability to sell mainframe computers and workstations in China. Another U.S. computer company estimated in 1993 that export controls could cost the company between $60 million and $70 million in sales over the next 2 years.

Some U.S. companies and business associations we contacted also complained that COCOM liberalization had failed to keep pace with the rapid development of new technologies, thus giving an advantage to

[12]On two occasions, the Bush administration granted waivers to this sanction, allowing the sale of four Boeing commercial jets to China, and granting export licenses for three U.S. communications satellites to be launched on Chinese launch vehicles.

[13]Under the terms of the 1992 U.S.-China MOU on market access, the U.S. government pledged to pursue liberalization of some COCOM restrictions, including those for China. According to the MOU, the U.S. government, in concert with COCOM, is considering liberalized treatment of computers and has agreed to liberalize controls on telecommunications exports.

non-COCOM members. For example, a telecommunications company official told us that COCOM still restricted exports of certain telecommunications products that were 10 years old and ready to go out of production. Such products, he said, could now be easily obtained from non-COCOM members like India and Israel. Another official from this same company reported in June 1993 that COCOM continued to ban the export of high-speed telecommunications switching equipment to China, despite evidence to suggest that China is now able to manufacture this equipment locally. The official stated that by the end of 1993, his company would have lost $110 million in potential sales due to outdated export controls on telecommunications equipment. A computer company official told us that it was difficult for her company to design a workstation that stayed within COCOM export control limits for the Chinese market because the technology is continually advancing. Meanwhile, computer producers in India, Taiwan, and South Korea who are not bound by COCOM restrictions—or companies that continue to produce lower-technology workstations—could gain an advantage in this market. In response to complaints of this nature, the U.S.-China Business Council advocated that the U.S. government press its COCOM allies to support removal or relaxation of unnecessary export controls.

Export controls mandated by unilateral U.S. sanctions also limit U.S. exports to China. According to an energy products manufacturer, sanctions-related export controls on components used to build and operate nuclear power plants prevent U.S. companies from being able to take advantage of China's huge market for nuclear power generation equipment. The U.S.-China Business Council estimated that U.S. sanctions could cost U.S. companies roughly $16 billion in lost nuclear power plant equipment sales over the next 16 years, while competitors from France, Russia, Japan, and Switzerland are unencumbered by these sanctions. In their recent report, the members of the 1993 U.S. Electric Power Mission to China recommended that the U.S. government review current policy on the export of nuclear technologies associated with the production of electric power.

Commerce Department officials told us that U.S. industry has generally expressed more concern about unilateral restrictions on exports to China than about multilateral controls mandated by COCOM. Unilateral controls tend to have a more negative impact on U.S. competitiveness, since other countries that are major competitors may not impose the same restrictions. For example, the 1991 U.S. government prohibition against satellite sales to China allowed a French company to gain an advantage in this market.

In August 1993 testimony before Congress, the Secretary of Commerce said that while export controls serve legitimate security and foreign policy objectives, the current system is so unwieldy and bureaucratic that it is a major impediment to doing business. He said that based on ongoing interagency and private sector studies, he expected to receive recommendations to (1) streamline the administrative processing of licenses to be more timely, transparent, and consistent; (2) minimize duplication and delay; (3) provide for prompt resolution of disputes; and (4) liberalize controls on goods widely available.

Restrictions on U.S. Government Financing for Business Activities in China Put U.S. Companies at a Disadvantage Relative to Their Competitors

According to some U.S. government and private sector officials, restrictions on U.S. government financing for trade with and investment in China put U.S. companies at a disadvantage relative to companies whose governments provide greater financial support. While the Eximbank continued its lending programs to China after the Tiananmen Square events of 1989, both OPIC and TDA programs have been legislatively suspended since that time. In addition, some of the governments of major U.S. trade competitors have had active assistance and tied aid loan programs in China,[14] while the U.S. government provides no assistance funding for programs in China and generally discourages the use of tied aid financing.

OPIC and TDA Programs for China Have Been Suspended Since 1989

OPIC and TDA suspended their programs for China by administrative action within a few days of the June 1989 Tiananmen Square events. These suspensions were codified in February 1990 by section 902 of the Foreign Relations Authorization Act (P.L. 101-246) for fiscal years 1990-1991. According to the law, these programs shall not be reactivated unless the President reports to Congress either that (1) the government of China has made progress on a program of political reform throughout the country, including Tibet; or that (2) it is in the national interest of the United States to terminate these suspensions. An OPIC official said that his agency continues to receive periodic requests for its insurance, guarantees, and loan programs to support business activities in China. A TDA official told us that there is great demand in China for the types of infrastructure project planning activities that TDA normally funds. Several U.S. companies stated that the absence of U.S. government financing, risk insurance, and other

[14]"Tied aid" refers to foreign assistance that is linked to the purchase of exports from the country extending the assistance.

support from OPIC and TDA limits their ability to win contracts in China when competing with other foreign companies whose governments provide greater support of this kind.

Tied Aid Offered by Some Foreign Countries Has Put U.S. Companies at a Disadvantage When Competing for Projects in China

China is one of the world's major recipients of tied aid credit. In 1991, China received an estimated $2.3 billion in government-supported loans from Japan, Canada, West European countries, and other countries. Most of these funds were tied to the purchase of exports from the donor country, according to U.S. embassy reports from Beijing. These reports suggest that Japan, France, and Italy have been among the most active lenders to China in recent years. China has relied heavily on tied aid to finance its infrastructure and industrial development, according to a May 1993 U.S.-China Business Council publication.

In contrast to many of its trade competitors, the U.S. government has generally discouraged the use of tied aid.[15] The basis for this policy, according to a Treasury official, is that tied aid can distort funds allocation in developing countries towards capital-intensive projects and shift supply from more efficient producers to less efficient producers with access to subsidized financing. Therefore, the United States has authorized the use of tied aid to China in only one instance, when the Eximbank made a $10 million loan in 1990 from its "war chest" to support U.S. bids against tied aid competition for a Chinese subway system project.[16]

U.S. government and private sector officials have suggested that tied aid packages offered by some OECD member countries made it difficult for companies whose governments do not offer such loan programs, including U.S. companies, to compete for capital projects in China. According to the U.S.-China Business Council publication, the influx of tied aid into China during the late 1980s sharply reduced the U.S. market share in some Chinese sectors in which U.S. companies had previously been very competitive, such as power generation.

Over the last decade, the U.S. government has attempted to restrict the use of trade-distorting tied aid through a series of international agreements with other OECD member governments. Most recently, in an effort to more

[15]In February 1994, the Eximbank released a draft of its tied aid policies and procedures, signaling a more proactive approach to tied aid. As part of this effort, the Eximbank is administering a new tied aid capital projects fund.

[16]Congress authorized the Eximbank's "war chest" in 1986 to provide concessional loans for U.S. firms when there is "reasonable proof that concessional foreign financing is being offered to a foreign competitor for a U.S. export sale."

effectively limit the trade distortions associated with the use of tied aid, 22 of the 24 OECD member governments developed new guidelines on the extension of tied aid, which came into effect in February 1992.[17] The new guidelines generally prohibit (1) the use of tied aid for projects in countries known as "better-off developing countries," whose annual per capita income exceeded $2,465 in 1990; and (2) the use of tied aid and mixed credits for commercially viable projects, meaning that tied aid may only be extended to projects that are either unable to generate cash flow sufficient to cover the project's operating costs or cannot be financed by the private market or official export credits.[18] In addition, the new guidelines strengthened OECD notification and consultation procedures. An Eximbank official stressed that the goal of the 1992 agreement is not necessarily to reduce the use of tied aid, but to channel tied aid toward developmental needs such as rural telecommunications or bridge construction projects that are not commercially viable.

It is still too early to be able to fully assess the impact of the new guidelines on U.S. business endeavors in China. However, U.S. embassy officials in Beijing gave optimistic reports about the agreement, noting that competition for projects is now conducted more clearly on the basis of price and quality, with financing offered at OECD-approved export credit rates. They reported that U.S. companies in industries such as petrochemicals and telecommunications appear to face less tied aid competition than in the past. The U.S.-China Business Council publication concluded that if the commercial viability provisions of the new guidelines are implemented faithfully, U.S. companies stand to gain in sectors such as power generation and telecommunications.

[17]The agreement, formally known as the "Arrangement on Guidelines for Officially Supported Export Credits," was signed by Australia, Austria, Canada, Finland, Japan, New Zealand, Norway, Sweden, Switzerland, the United States, and the 12 members of the European Union.

[18]These limitations do not apply to projects in least-developed countries, such as Afghanistan and Bangladesh.

Balancing U.S. Policy Objectives in China

China's growing role in global economic and political affairs, the wide range of U.S. economic, human rights, and security interests in China, and the high potential economic and political costs of ending China's MFN trade status have prompted calls for a reexamination of current U.S. MFN renewal policies. In light of these concerns, some U.S. policymakers are questioning whether an instrument as central to the U.S.-China relationship as MFN status is appropriate for pursuing any individual objective.

Because China's role in world affairs is expanding, China's policies will profoundly affect economic, military, and political events in the future. As discussed in this report, China is one of the world's fastest-growing major economies, offering opportunities for foreign trade and investment. It is an active participant in the U.N. Security Council and has a growing military force in the Asia-Pacific region. In addition, since China accounts for one-fifth of the world's population, its cooperation is crucial in addressing international problems such as environmental protection, population control, management of large-scale migration, public health, and drug trafficking.

At the same time, China's authoritarian political system and reported human rights abuses make a close U.S.-China relationship problematic. In recent months, the most visible U.S.-China bilateral issue has been China's human rights record. The United States has conditioned renewal of China's MFN privileges on China's progress in meeting human rights conditions specified in the President's May 1993 executive order, as discussed in chapter 4 (see p. 40).

In addition to MFN status, the U.S. government has a variety of bilateral and multilateral tools available to promote its policy goals in China. With regard to promoting U.S. democratic values and respect for internationally recognized human rights principles in China, for example, government, academic, and private sector experts who participated in a recent Atlantic Council study on U.S.-China relations[1] have suggested such bilateral measures as (1) making greater use of channels at senior levels of the U.S. and Chinese governments through which the U.S. government can raise specific human rights concerns, (2) increasing program resources for Voice of America broadcasts in China and encouraging the Chinese government to end its efforts to jam these broadcasts, and (3) expanding educational and cultural exchanges with China.

[1] U.S.-China Relations at a Crossroads, Atlantic Council of the United States (Washington, D.C.: Feb. 1993).

Alternatively, an official of a major human rights organization monitoring conditions in China has proposed a graduated approach to linking MFN status with human rights progress. This official said that rather than facing the choice of either granting or revoking full MFN benefits for China, the U.S. government could recognize partial progress on human rights with the extension of partial MFN benefits.

To encourage improved Chinese human rights practices within a multilateral context, the Atlantic Council report and other observers have suggested that the U.S. government (1) reinforce its diplomatic efforts through international organizations such as the U.N. Human Rights Commission, (2) actively seek cooperation from U.S. allies for multilateral action, and (3) support ongoing activities of the International Committee of the Red Cross to monitor treatment of Chinese prisoners.

The U.S. government continues to employ bilateral and multilateral mechanisms to encourage Chinese cooperation with international nonproliferation and security efforts. The U.S. government lifted the suspension of high-level military contacts with China imposed after the Tiananmen Square events by sending the Assistant Secretary of Defense for Regional Security to meet with China's Defense Minister in November 1993. In addition, China has agreed in recent years to adhere to several conventions to control weapons proliferation, including the Nuclear Nonproliferation Treaty, MTCR, and the Chemical Weapons Convention. Where China has not lived up to its agreements, the United States has taken unilateral action on several occasions—most recently in imposing targeted sanctions related to China's violation of its MTCR commitments, as explained in chapter 4 (see pp. 42-3).

In the area of economic relations and trade, the U.S. government has achieved some success with bilateral programs and trade agreements. Among the more prominent examples of these activities, as discussed in chapter 3, are USTR investigations mandated by U.S. trade law that resulted in bilateral MOUs on market access and on protection of intellectual property rights in China (see pp. 28-30); active participation in international negotiations on China's application to join GATT (see pp. 31-3); and the establishment of bilateral commissions such as the Joint Commission on Commerce and Trade (see p. 34).

While the United States has on occasion successfully used the threat of targeted economic sanctions to pursue its economic agenda with China, the overall U.S. experience with economic sanctions has been mixed. In the past, sanctions have been most effective when applied multilaterally, while unilateral measures have been less successful in achieving policy goals.[2] While other countries have expressed concern about China's human rights practices, no other country has actively supported the United States in linking China's MFN benefits to progress in human rights. As discussed in chapter 4, some observers express skepticism that a unilateral U.S. decision to revoke MFN tariff treatment for China would motivate any significant change in Chinese government policies (see p. 45).

In addition, unilateral sanctions may carry high economic costs for the sanctioning country. For example, as noted in chapter 4, the possible withdrawal of China's MFN trade status could result in higher prices for U.S. consumers and jeopardize U.S. exports to and investments in China (see p. 44). In addition, the uncertainty created by the annual MFN renewal process for China causes great concern for U.S. companies that are attempting to forge long-term business relationships in China (see pp. 43-5).

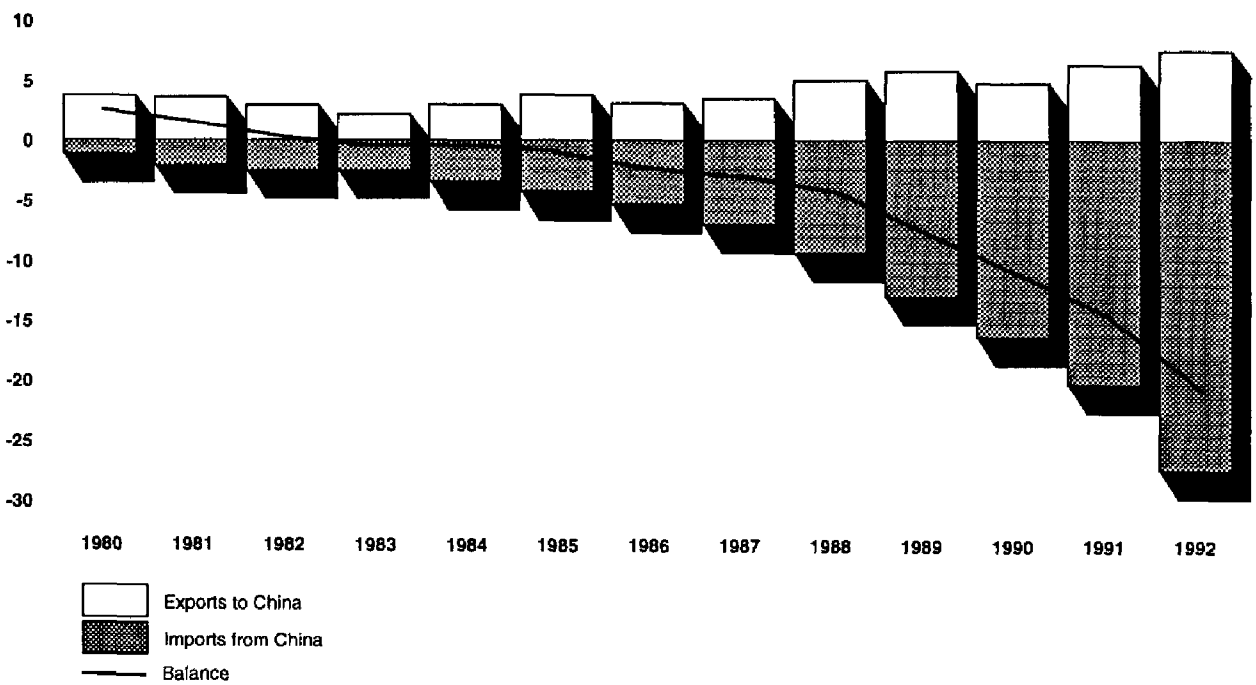
As is recognized in public debate, the United States has a wide range of complex interests and objectives with regard to China. Chapter 1 highlighted some of the significant economic, human rights, and security interests and objectives that the U.S. government must attempt to balance as its policy towards China evolves (see pp. 12-13). In the last few years, U.S. concerns about human rights abuses in China have become an increasingly important factor in U.S. government decision-making on renewal of China's MFN privileges. MFN trade status is central to the U.S.-China relationship. A decision not to renew China's most-favored-nation status could damage U.S. foreign policy and security, as well as economic, interests in China. But what cannot be easily assessed is the potential for adverse effects on human rights conditions in China if most-favored-nation status is renewed without clear signs of overall significant progress as required by the President's May 1993 executive order. Equally unclear are the consequences of such an action for the credibility of future U.S. foreign policy initiatives. In leading up to the President's 1994 MFN renewal decision for China, policymakers in Congress and in the administration will have to carefully weigh the benefits and costs of various strategies to achieve the multiple U.S. objectives in China.

[2]See Economic Sanctions: Effectiveness as Tools of Foreign Policy (GAO/NSIAD-92-186, Feb. 19, 1992).

Discrepancies Between U.S. and Chinese Trade Statistics

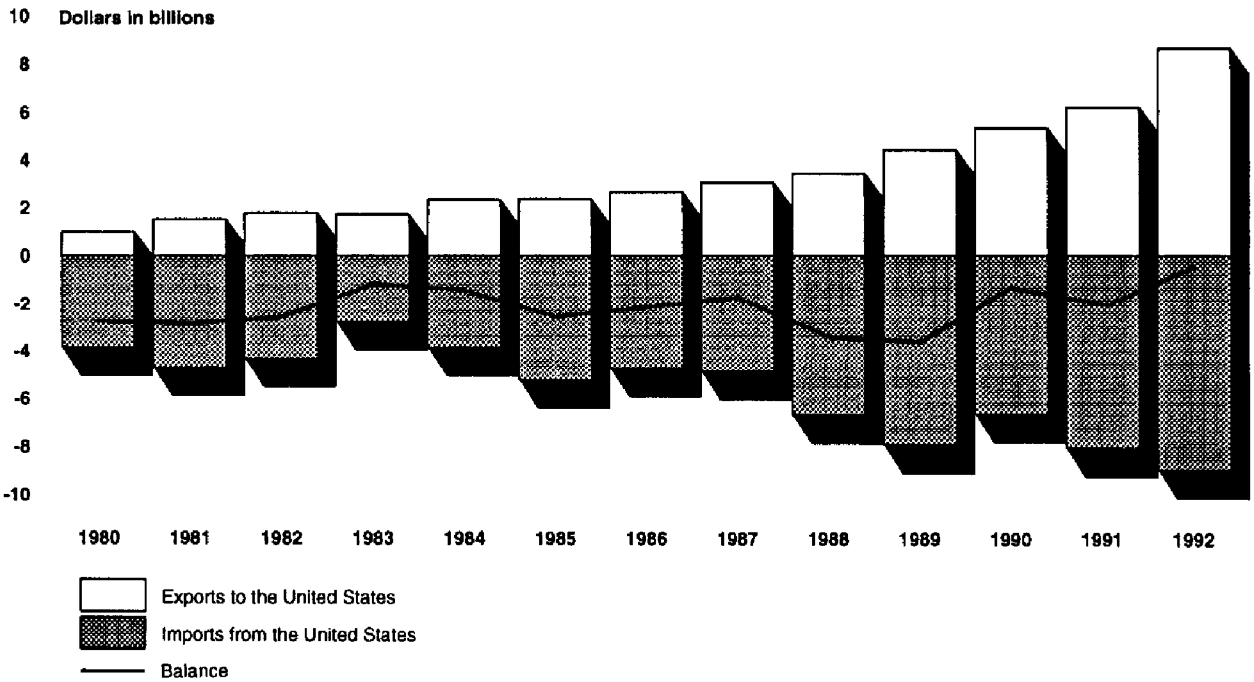
During the last decade, the merchandise trade statistics produced by the United States and China have begun to show a large discrepancy. U.S. reported statistics indicate that the trade deficit with China increased sharply after 1985 when U.S. trade with China was roughly in balance (see fig. I.1). However, Chinese statistics show that U.S. exports to China exceeded U.S. imports from China during this period. Instead of showing a corresponding Chinese trade surplus, their reported statistics show they have had a deficit with the United States (see fig. I.2). The discrepancy between U.S. and Chinese statistics exceeded $20 billion in 1992.

Figure I.1: Bilateral Trade Based on U.S. Statistics, 1980-92



Source: IMF, Direction of Trade Statistics Yearbook, 1987 and 1993.

Figure I.2: Bilateral Trade Based on Chinese Statistics, 1980-92

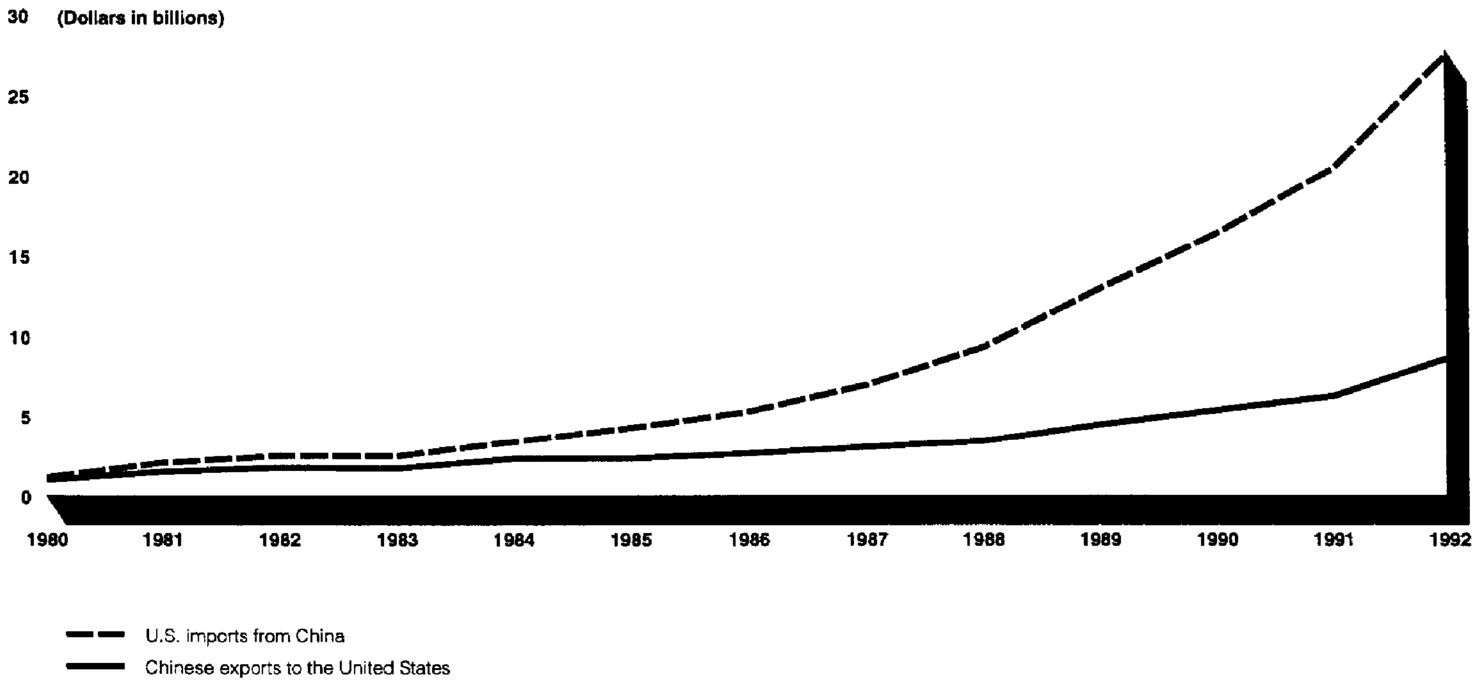


Source: IMF, Direction of Trade Statistics Yearbook, 1987 and 1993.

Most of this discrepancy can be attributed to the differences between exports to the United States reported by the Chinese government and imports to the United States as reported by the U.S. government. The figures from these two sources should be roughly similar since both sets of statistics represent the value of the same set of goods.[1] However, a large discrepancy developed in 1986 and increased in each subsequent year (see fig. I.3). In 1992, the discrepancy between U.S. imports from China and Chinese exports to the United States exceeded $18 billion.

[1]These figures normally differ due to transportation costs, timing, and other statistical factors. For example, export prices are normally collected at the port of export and, unlike import prices, do not include the cost of insurance and freight to the foreign port.

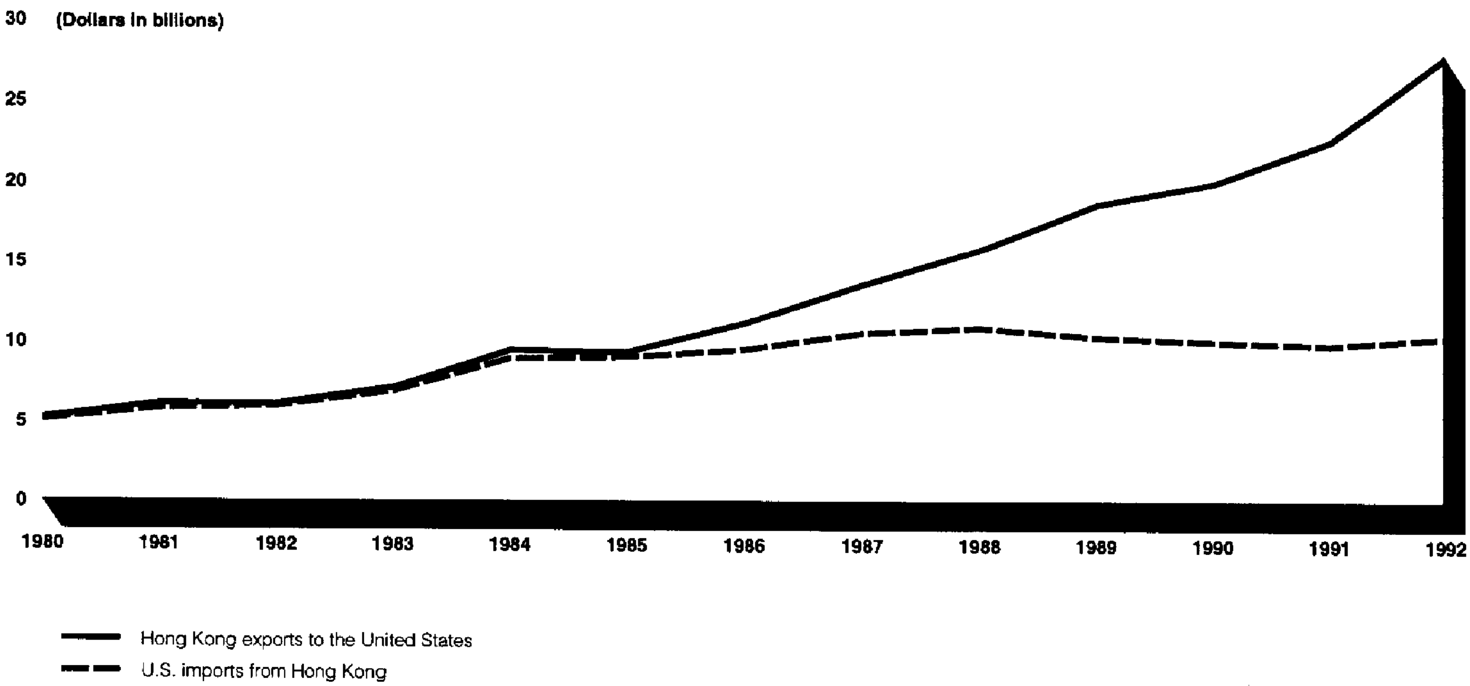
Figure I.3: U.S. Imports From China Compared to Chinese Exports to the United States, 1980-92



Source: IMF, Direction of Trade Statistics Yearbook, 1987 and 1993.

The opposite trend is occurring in U.S. trade with Hong Kong. Beginning in 1986, U.S. imports from Hong Kong appear increasingly smaller than the amount of exports to the United States reported by Hong Kong (see fig. I.4).

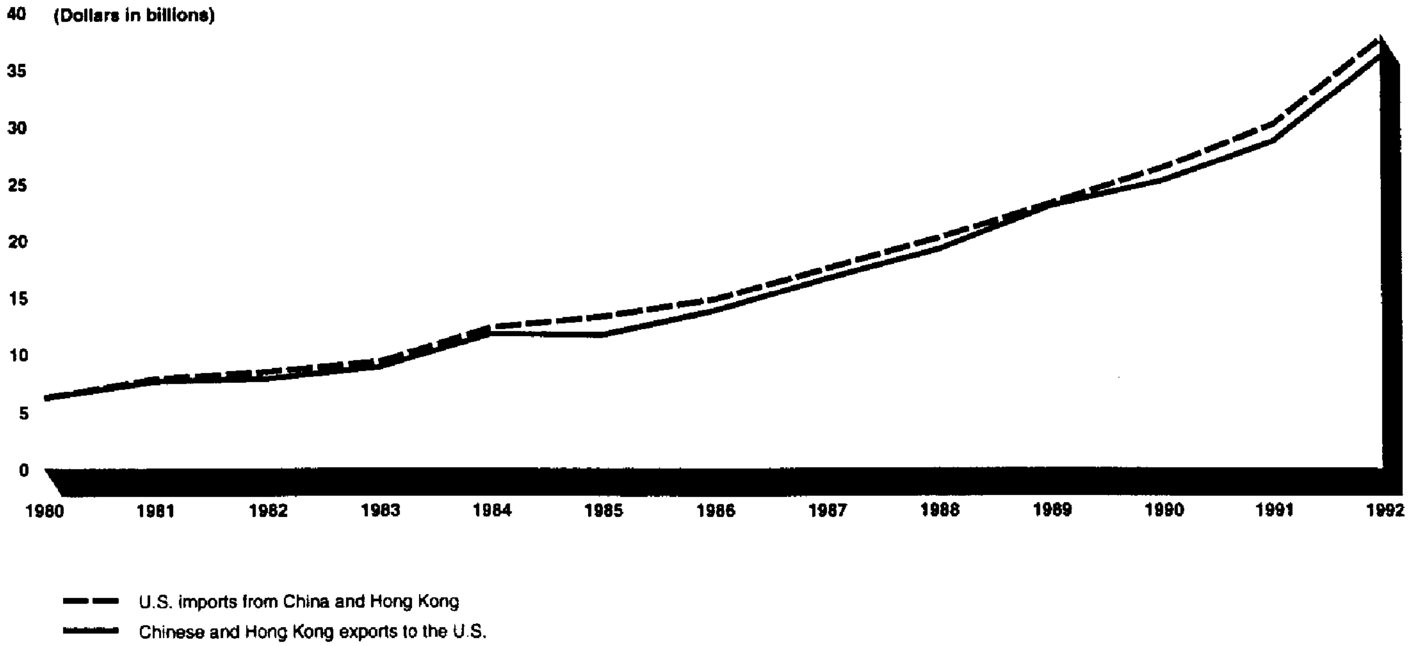
Figure I.4: Hong Kong Exports to the United States Compared to U.S. Imports From Hong Kong, 1980-92



Source: IMF, Direction of Trade Statistics Yearbook, 1987 and 1993.

However, if Chinese and Hong Kong exports to the United States as reported by the Chinese and Hong Kong governments are added together, they appear quite close to the level of U.S. imports from those two countries reported by the U.S. government (see fig. I.5).

Figure I.5: U.S. Imports From China and Hong Kong Compared to Exports From Those Two Nations, 1980-92



Source: IMF, Direction of Trade Statistics Yearbook, 1987 and 1993.

As figure I.5 indicates, the statistical discrepancy is due primarily to differences in U.S. and Chinese treatment of trade through Hong Kong. For statistical purposes, China considers Hong Kong the destination for much of its exported merchandise, even if the ultimate destination of the goods is the United States or some other nation. Goods shipped from China to Hong Kong are often classified as "reexports" by Hong Kong when shipped to their final destination.[2] Hong Kong defines reexports as products that have previously been imported into Hong Kong and that are reexported without having undergone a manufacturing process that has permanently changed the shape, nature, form, or utility of the product.[3] The United

[2]Hong Kong reported reexports originating from China of over $40 billion in 1991.

[3]Hong Kong distinguishes between reexports and transshipped goods. It defines transshipped goods as those that pass through the port on a through bill of lading or a through airway bill and does not include these in its official export or import statistics.

States considers these products to be Chinese exports unless some substantial transformation has occurred in Hong Kong.[4]

Many of these exports, while produced in China, are based on a contractual arrangement with a Hong Kong company. An example provided by the Hong Kong Government Information Services of a reexport illustrates the role of both countries in a typical export process. A Hong Kong company would design and market a toy doll and prepare molds for the manufacturing. These molds would be transferred to a factory in China, where the production, painting, and finishing of the dolls would take place. The whole assembly would then be sent back to Hong Kong for final inspection, packaging, and shipment to the ultimate destination.

China considers these items as exports to Hong Kong since services such as packaging, banking, shipping, and insurance are often carried out in Hong Kong. Upon completion of those additional services, Hong Kong classifies these products as reexports rather than "domestic" exports, but includes them in its export statistics. On the other hand, U.S. Customs and their counterparts in other nations who oversee imports would consider China as the origin of the products.

[4]Reexports are not included in the official U.S. export statistics.

China's Crude Oil Industry

While China has the world's tenth largest deposits of oil, its oil production has leveled off in recent years. China's oil production has not kept pace with growth in internal demand, resulting in a reduction in oil exports and an increase in imported oil. To meet the need for additional oil, China is encouraging foreign investment in the exploration and production of new oilfields located in the Tarim Basin (see fig. II.1). Further, China is using enhanced recovery technology to increase production in its older fields. Some U.S. oil companies have indicated that China's abundant oil reserves and China's history of conducting business with U.S. companies make investing there attractive. However, some of these same companies pointed out that the geological undesirability of the tracts offered for foreign exploration and production discourage investment in China's petroleum sector. U.S. oil company officials also pointed out that China's State Council, which has overall responsibility for the oil industry, offers less favorable terms to foreign investors than to government-owned corporations. Subordinate government corporations administer the varied functions of the Council.

China Has Large Oil Reserves

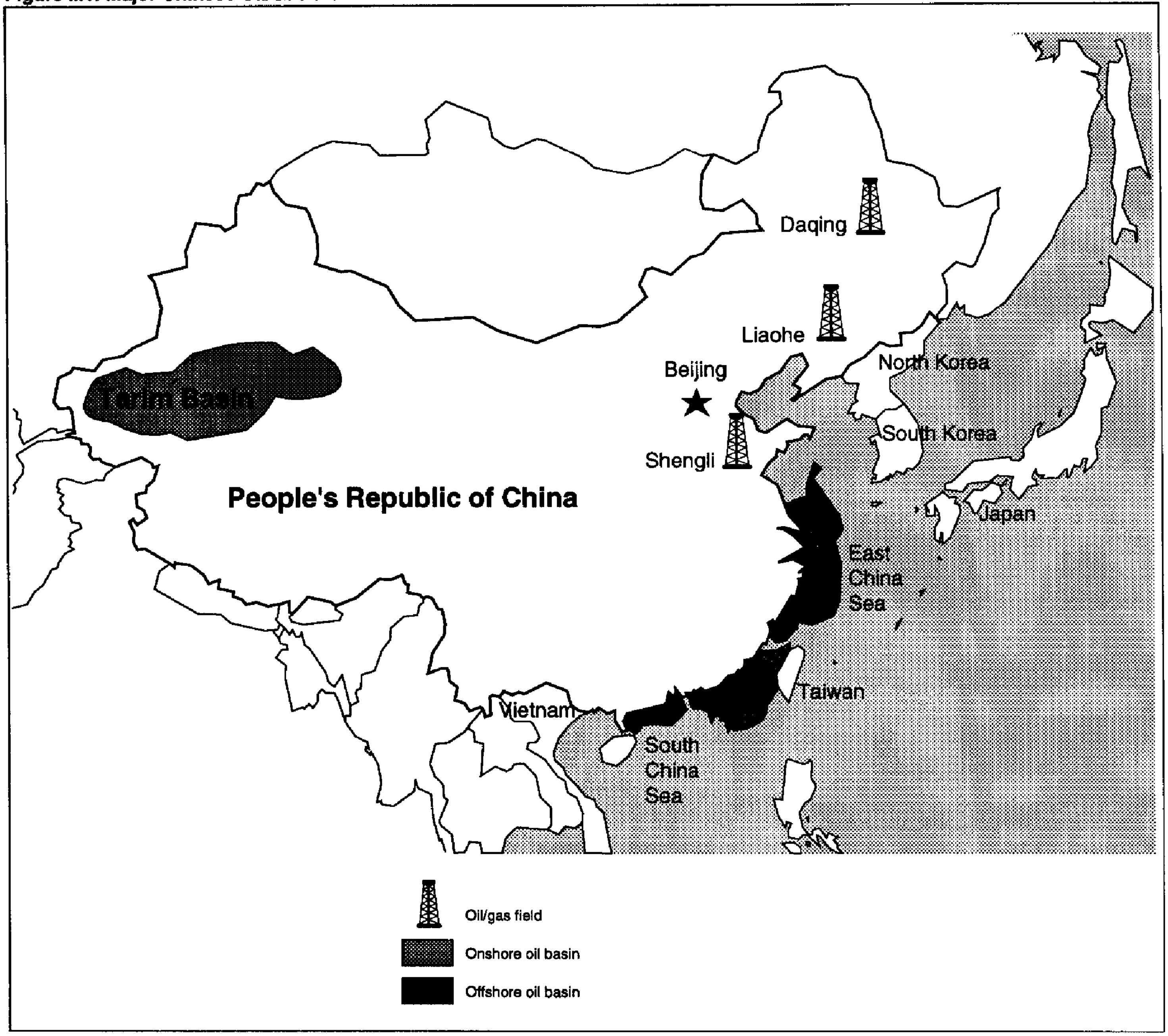
China ranks tenth in the world in proven reserves.[1] These deposits, located both offshore and onshore, are estimated to be about 24 billion barrels of oil. As shown in figure II.1, the offshore oil deposits are located in the East and South China Seas. The onshore oil deposits include China's oldest producing oilfields and are located in the northeast region.

In addition, China has large, untapped, onshore oil deposits in the Tarim Basin, which is located in the uppermost western corner of the country. Estimates of the amount of oil in this region vary. However, a conservative estimate made by the East-West Center puts the amount of oil deposits at about 70 billion barrels.[2] Although the government has known about the potential oil deposits in the Tarim Basin for several decades, to date it has not had the financial resources to develop the region.

[1]International Energy Outlook 1992, U.S. Department of Energy, Energy Information Administration (Washington, D.C.: U.S. Government Printing Office, Apr. 1992).

[2]The East-West Center is located in Honolulu, Hawaii. It is a center for cultural and technical interchange between the East and the West. The center is a national educational institution established by the U.S. Congress and incorporated by the State of Hawaii. Its energy program conducts research on China.

Figure II.1: Major Chinese Oil/Gas Fields and Tarim Basin



Current Production Trends

Since 1988, China's crude oil production has remained level at about 2.8 million barrels per day (b/d). Between 1980 and 1988, oil production increased from 2.1 million b/d to 2.8 million b/d. According to officials at the

U.S. Department of Energy (DOE) and the East-West Center, China has been unable to increase its oil production beyond 2.8 million b/d because of its aging oilfields and the absence of adequate capital financing.

Aging Oilfields and Inadequate Capital Financing Hinder Production

Accounting for 75 percent of total 1990 production, Daqing, Shengli, and Liaohe are China's major producing oilfields and are located in the northeastern region of the country. Although the Chinese have made efforts to increase oil production, this production has leveled off in these fields. Crude oil production began at Daqing in 1960. In 1962, Shengli began production and was followed by Liaohe, which began operation in 1970. In 1970, these fields produced a combined 446,000 b/d. Between 1980 and 1990, production in these fields increased by about 40 percent, from 1.5 million b/d to 2.1 million b/d. However, since 1990, production at these fields has been steady at about 2.1 million b/d. According to an official at the East-West Center, these oilfields are China's largest and are projected to produce between 1.8 million b/d to 2 million b/d in 1995.

China hopes to increase production with the use of enhanced oil recovery technology and the exploitation of new oilfields. According to officials at the East-West Center and DOE, China's total oil production is expected to increase to 2.9 million b/d by 1995 and to 3.1 million b/d by the year 2000. Crude oil production rates for 1980 through 1992 are shown in table II.1.

Table II.1: Chinese Crude Oil Production, 1980-92

Barrels in millions per day

Year	Crude oil production	Annual percent change
1980	2.1	NA
1981	2.0	-4.76
1982	2.0	0
1983	2.1	5.00
1984	2.3	9.52
1985	2.4	4.35
1986	2.6	8.33
1987	2.7	3.85
1988	2.8	3.70
1989	2.8	0
1990	2.8	0
1991	2.8	0
1992	2.8	0

Legend

NA = Not applicable

Sources: China Energy Databook, 1992; Lawrence Berkeley Laboratory, Berkeley, California; and 1991 and 1992 production data provided by the East-West Center, Honolulu, Hawaii.

China's Oil Exports Have Declined Overall

Between 1985 and 1992, exports of crude oil accounted for a significant but declining share of Chinese production—from 24 to 15 percent overall. China's crude oil exports reached a high in 1985 of about 610,000 b/d and steadily declined to about 430,000 b/d in 1992, a decrease of about 30 percent. According to DOE, in 1990, the most recent year for which the following data are available, China ranked about seventeenth as a world oil exporter (500,000 b/d). The top three world oil exporters were Saudi Arabia, Iran, and the former Soviet Union. Daily exports from these countries were about 4.8 million b/d, 2.2 million b/d, and 2.2 million b/d, respectively.

The three largest export markets for Chinese crude oil are the United States, Japan, and Singapore. According to the East-West Center, exports to the United States in 1985, for example, totalled about 90,000 b/d, but by 1992 had declined by 20 percent, to about 72,000 b/d. China's exports to Singapore also declined by 74 percent, from about 170,000 b/d in 1985 to 45,000 b/d by 1992. On the other hand, exports to Japan between 1985 and 1992 increased by 14 percent, from 221,000 b/d to 252,000 b/d.

Petroleum exports are a major part of China's total foreign exchange earnings but have fallen in importance relative to other exports since 1985, when 26 percent of gross foreign exchange earnings came from petroleum. In 1992, oil exports accounted for only about 4 percent of China's total foreign exchange earnings, amounting to about $3.8 billion in foreign exchange revenues.

China's Increased Oil Consumption Pushes Demand for Oil Imports

China's rapid economic growth has caused an increase in internal demand for crude oil. Table II.2 shows China's crude oil consumption and imports for the period 1980 to 1992.

The major contributing factor to the increase in imports is the demand for oil by China's transportation sector. According to officials at DOE, there is a great demand for oil to operate motor vehicles (taxis, trucks, and buses). This sector's need for oil is projected to grow at about 7 percent annually between 1985 and the year 2000, according to the Petroleum Industry Research Foundation. Oil consumption for purposes other than transportation will also continue to increase. For example, the East-West Center estimates that as China's overall economy continues its robust growth, the demand for oil will increase, reaching 4.8 million b/d by the year 2000. Although more conservative in its estimate, DOE also projects an increase in China's oil consumption. It estimates demand will rise to 3.2 million b/d by the year 2000 and to 4 million b/d by 2010.

Energy experts at DOE and the East-West Center project that China's oil consumption will continue to increase and that by 1995 China will become a net importer of oil. Between 1980 and 1992, China's imports of crude oil increased from about 8,000 b/d to 227,000 b/d, while consumption of oil increased from 1.8 million b/d to 2.7 million b/d. Between 1991 and 1992, crude oil imports increased by 91 percent. Imports of crude oil are expected to reach about 400,000 b/d by 1995 and 1.2 million b/d by the year 2000. China imports crude oil mostly from neighboring countries such as Indonesia and Malaysia, but also from the Middle East. In 1991, for example, it imported about 53,000 b/d of crude oil from Oman and about 1,000 b/d from Iran.

Table II.2: Chinese Crude Oil Consumption and Imports, 1980-92

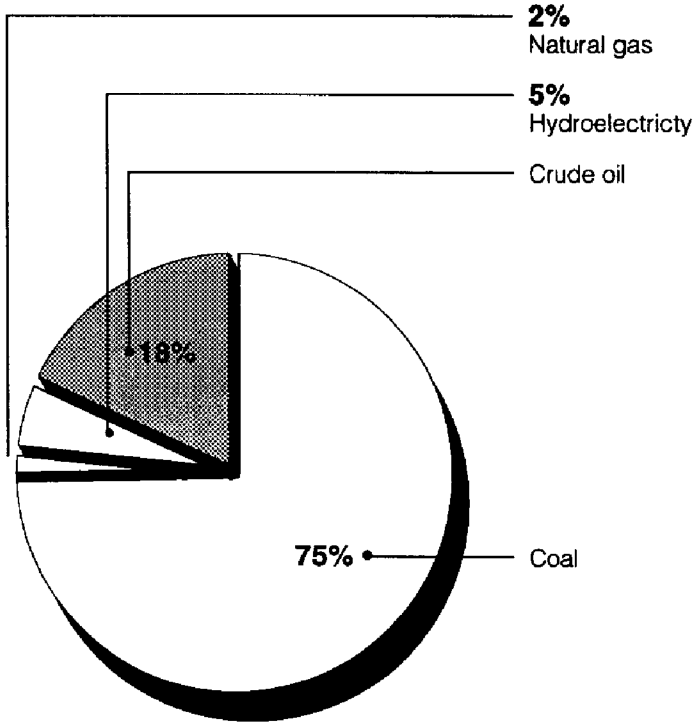
Barrels in millions per day

Year	Crude oil consumption	Crude oil imports
1980	1.8	0.008
1981	1.7	0.001
1982	1.7	0.013
1983	1.7	0.008
1984	1.7	0.005
1985	1.8	0.015
1986	2.0	0.022
1987	2.1	0.035
1988	2.2	0.017
1989	2.3	0.066
1990	2.3	0.059
1991	2.5	0.119
1992	2.7	0.227

Sources: China Energy Databook, 1992; 1991 and 1992 data were provided by the East-West Center.

Oil represented about 18 percent of China's 1992 overall energy consumption. Coal remains the primary source of energy. As depicted in figure II.2, coal represented about 75 percent of total energy consumption in 1992. Coal will continue to be China's primary source of energy into the next century. By 2010, for example, China will still rely on coal to meet about 75 percent of its energy needs, according to DOE. Notwithstanding the central importance of coal, oil is an important energy source and will remain so for some time into the future.

Figure II.2: China's Overall Energy Consumption, 1992



Source: Lawrence Berkeley Laboratory.

China Encourages Foreign Investments in the Petroleum Sector, but Impediments Remain

As China's rapid economic growth has increased its demand for oil, China has encouraged foreign investment in order to obtain the capital and technology needed to expand exploration and production. While exact information is not available on China's domestic investment in its oil industry, U.S. energy experts told us that China lacks the financial resources to increase investment in oil exploration and production activities. U.S. oil companies, however, have invested more than $1 billion in China's petroleum sector since 1978.

To encourage foreign investment in its oil industry, in early 1993 the Chinese government announced that it would allow foreign oil companies to bid competitively for exploration and production contracts in previously closed areas in northwest China and other onshore areas. Several U.S. oil companies have signed agreements with Chinese officials, and some are discussing potential exploration and production activities. In addition, China has made other reforms to encourage foreign investment. For example, it reduced the amount of oilfield royalties that foreign firms must pay from 12.5 percent for all oilfields to an adjustable rate for various production levels of the fields.[3]

We contacted 10 U.S.-owned oil companies based on a list provided by the American Petroleum Institute to obtain their perspectives on China's petroleum industry. All of the U.S. oil companies we interviewed are either currently investing or considering investing in China either in onshore or offshore oilfields within the next 5 years. Eight of the companies we interviewed said they had invested in China's oil industry beginning as early as 1978. As of December 1992, these oil companies had investments ranging from $10 million to $200 million or more each. Five of the companies individually had $200 million or more invested in China. Most of the oil companies we interviewed said they were primarily involved in exploration.

Factors That Promote U.S. Investment in China's Petroleum Sector

Officials of the 10 U.S. companies we contacted cited the following factors that make China's oil industry an attractive investment opportunity:

- China has abundant crude oil reserves (roughly equal to those of the United States).
- China's relatively unexplored Tarim Basin is believed to contain large potential reserves of crude oil.
- China's population and rapidly growing economy create a large and growing demand for energy, including oil.
- China has had about 15 years of experience in conducting business with U.S. oil companies.

Impediments to U.S. Investment in China's Petroleum Sector

U.S. oil companies we contacted, both those presently investing in China and those considering doing so, told us that the following factors discourage investment in China's oil sector:

- The companies' earlier onshore and offshore oil exploration and production efforts in China were not fully successful. China had opened several onshore tracts to foreign investors in 1985. Those companies

[3]For example, an oilfield with marginal production potential would pay a royalty rate lower than 12.5 percent to make production feasible. These changes do not apply to the Tarim Basin.

investing in these tracts did not recover sufficient oil to make their investments profitable.

- China's proposed oil tracts in the Tarim Basin offered for bid are not considered the best geologically, and the basin's remote location makes exploration and transportation costly.
- China continues to control oil prices. Although China has paid international prices for oil to foreign companies producing offshore, some companies are not sure whether China will be willing to pay international market prices for oil produced by foreign companies onshore. If China does not pay international market prices, oil production and transportation may be too costly for foreign companies.
- China's past contract terms have not been adequate for continued foreign investment. Some oil company officials said that China needs to improve its contract terms in order to continue to attract foreign investment for the Tarim Basin.
- China's government gives preferential treatment to its government-owned corporations over foreign companies. Several oil company officials said they found it difficult to do business in China because foreign companies are not treated equally. For example, some U.S. oil companies consider the tracts offered for foreign investment in the Tarim Basin to be less geologically desirable than other tracts in that region.

Structure and Organization of China's Oil Industry

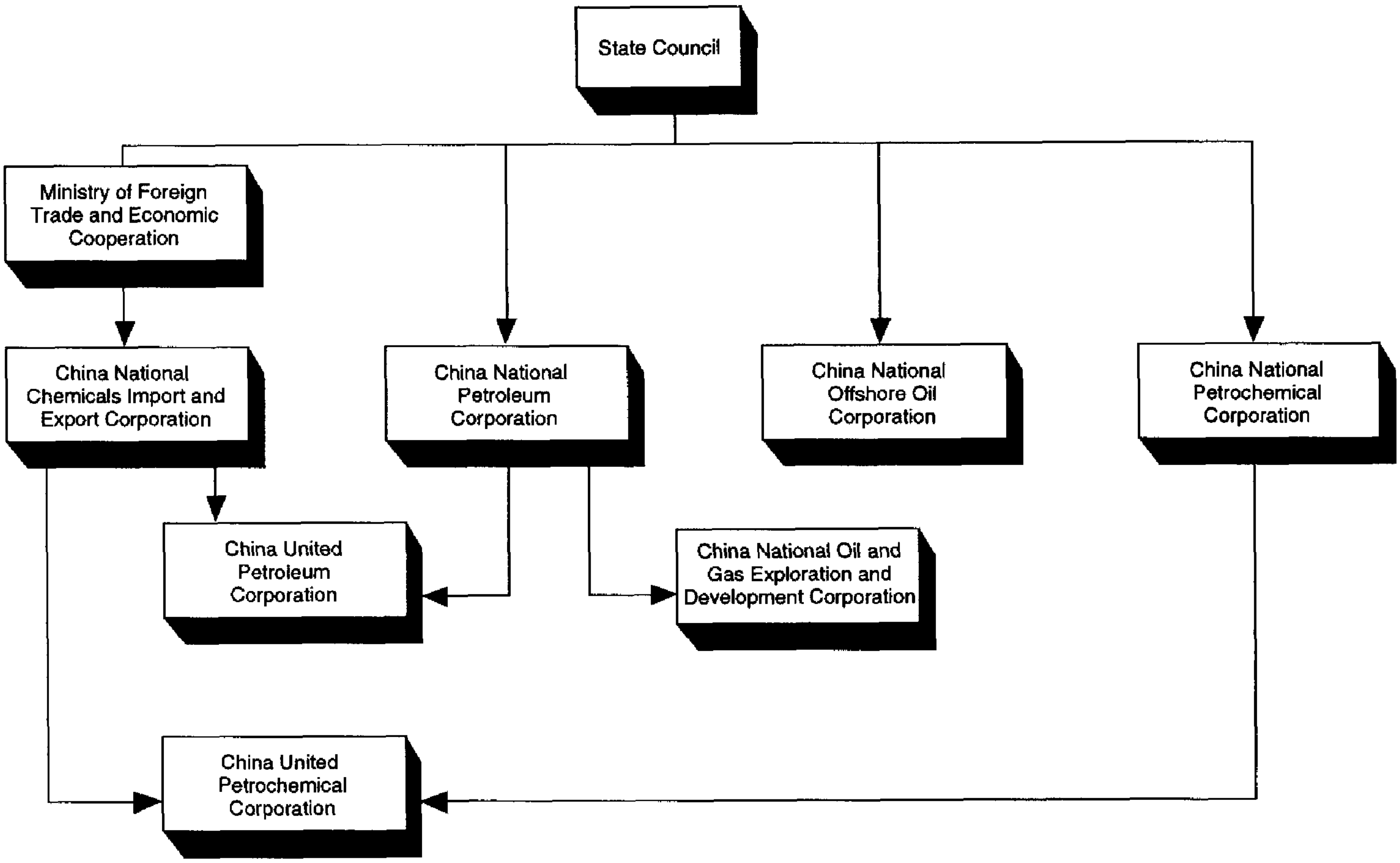
China's State Council has the overall responsibility for the Chinese oil industry, while subordinate government corporations under the Council administer its functions. In early 1993, these administering corporations' functions were as follows:

- The Ministry of Foreign Trade and Economic Cooperation is responsible for establishing and implementing foreign trade policy.
- The China National Petroleum Corporation is responsible for exploration and development of onshore and shallow water offshore oilfield areas, and natural gas fields. When China opened 11 southern provinces to foreign investors in 1985, China National Petroleum Corporation established the China National Oil and Gas Exploration and Development Corporation to negotiate and sign oil exploration contracts in the Tarim Basin and other oilfield areas.
- The China National Offshore Oil Corporation controls all deep offshore operations and manages foreign oil company investment in Chinese deep waters.
- The China National Petrochemical Corporation manages oil refining and marketing of refined products.

- The China National Chemicals Import and Export Corporation manages oil exporting and importing.

The Chinese government has also established two joint venture companies: (1) China United Petroleum Corporation (China Oil)—a joint venture between China National Chemicals Import and Export Corporation and China National Petroleum—and (2) China United Petrochemical Corporation—a joint venture oil trading company between China National Petrochemical Corporation and China National Chemicals Import and Export Corporation (see fig. II.3). Both China Oil and United Petrochemical Corporation handle oil trading, overseas investments, foreign investment in China's exploration and development sector, and Chinese investment abroad.

Figure II.3: Structure of Chinese Oil Industry



Sources: Petroleum Argus and East-West Center.

GAO Sources

Federal Government

Congressional Research Service
Council of Economic Advisers
Department of Commerce
Department of Energy
Department of State
Department of the Treasury
Office of the U.S. Trade Representative
Overseas Private Investment Corporation
Trade and Development Agency
U.S. Export-Import Bank
U.S. International Trade Commission

Private Sector

American Chamber of Commerce, Beijing
American Cyanamid Company
American Association of Exporters and Importers
AT&T
The Babcock & Wilcox Company
Battelle
The Boeing Company
Caterpillar, Inc.
Corning, Inc.
EG&G, Inc.
Eli Lilly & Co.
Emergency Committee for American Trade
General Electric Company
International Business and Economic Research Corp.
International Business Machines Corp.
McDonnell Douglas Corp.
Motorola, Inc.
National Association of Manufacturers
S.C. Johnson & Son, Inc.
SmithKline Beecham
The U.S.-China Business Council
U.S. Chamber of Commerce
Xerox Corp.

Multilateral Financial Institutions

Asian Development Bank
International Monetary Fund
The World Bank

Other Organizations

Asia Pacific Policy Center
Asia Foundation
The Brookings Institution
The East-West Center
The Heritage Foundation
Human Rights Watch, Asia
National Committee on United States-China Relations, Inc.
National Council on Chinese Affairs
The Atlantic Council of the United States
The Overseas Economic Cooperation Fund
The Puebla Institute
The Rand Corporation
University of Washington

Major Contributors to This Report

General Government Division, Washington, D.C.	Virginia C. Hughes, Assistant Director Anthony L. Hill, Assignment Manager Sara B. Denman, Evaluator-in-Charge Mary M. Park, Evaluator Susan S. Westin, Senior Economist
Resources, Community and Economic Development, Washington, D.C.	Linda Chu, Evaluator
Office of the General Counsel, Washington, D.C.	Herbert I. Dunn, Senior Attorney
Office of the Chief Economist, Washington, D.C.	Loren Yager, Senior Economist
Los Angeles Regional Office	Larry S. Thomas, Evaluator

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