Case Number: 2010-1024-F

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Folder Title: China (October to November 1998) [2]
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Withdrawal/Redaction Sheet
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DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. memo	For Richard Fisher from Robert Cassidy and Christina Lund. Subject: Deputies Meeting on China and Taiwan. (6 pages)	09/1998	P1/b(1)
002. report	Results of U.S.-China WTO Summit Negotiations (1 page)	04/1998	P1/b(1)
003a. paper	Objectives. [Duplicate of vz1802.003] (7 pages)	10/16/1998	P1/b(1)
003b. list	Key Remaining Market Access Issues. (3 pages)	10/16/1998	P1/b(1)
004a. memo	For Stuart Eizenstat from Alan Larson. Subject: NEC Deputies Meeting on China. [Duplicate of vz1802.004c] (5 pages)	10/16/1998	P1/b(1)
004b. talking points	Talking Points. [Duplicate of vz1802.004d] (6 pages)	10/16/1998	P1/b(1)
004c. report	Dupicate of 002. (1 page)	10/16/1998	P1/b(1)
004d. list	Duplicate of 003b. (3 pages)	10/16/1998	P1/b(1)
005a. memo	For the President from Samuel Berger and Gene Sperling. Subject: Letter to Chinese President Jiang Zemin. Record ID: 9807412. (1 page)	10/28/1998	P1/b(1)
005b. letter	To Jiang Zemin from William Clinton. (4 pages)	10/28/1998	P1/b(1)
005c. draft	Treasury Language. (1 page)	11/04/1998	P1/b(1)

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National Economic Council
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China (October to November 1998) [2]

2010-1024-F
vz1803

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Rubin Points for 10/7

MEETING WITH FINANCE MINISTER XIANG HUAICHENG
OVERVIEW AND KEY POINTS

PURPOSE: Since Minister Xiang is your counterpart, he will want to use the meeting to advance the already-warm relations between Treasury and MoF. He will also want to reassure you about the state of the Chinese economy, and discuss concerns about the global environment. You should use the meeting to raise bilateral concerns, especially regarding fiscal policy. (See economic assessment for details).

During the meeting, Minister Xiang is likely to:

- Express concern about **regional and global economic developments**, and particularly about Japan.
- Reaffirm China's **commitment not to devalue** the renminbi.
- Review the state of the **Chinese economy** and reform program.

During the meeting, you should:

- Emphasize the **need to be realistic about growth prospects** and caution against creating overly optimistic expectations. (*State Planning and Development Commission Minister Zeng Paiyan reaffirmed the 8% target as recently as September 23*).
- Suggest that China should continue to **focus on long-term goals**, and warn against loosening fiscal policy in ways that might exacerbate long run fiscal problems. Emphasize that the **Asia crisis should energize** -- not slow -- the reform process
- Share Xiang's concerns about the **global economy** and encourage him to join with other Asian economies to press Japan to restore stability to its financial sector and restart economic growth.
- Concur with China's view that a **stable renminbi** is first and foremost in China's interest.
- Note that Treasury fulfilled its JEC and State Visit **commitment to send a technical assistance** mission to China.
- Express concern about the lack of evident progress on **SOE reform**, and about retrograde steps in the banking sector, including instructions to increase lending.
- Express satisfaction that China has supported **APEC**'s consensus for concluding a comprehensive agreement on **early voluntary sectoral liberalization** (EVSL) by November and request that the Chinese review their current offer with a view towards improving commitments in all sectors.
- Urge better compliance with bilateral agreements on **prison labor**
- Express the hope for **continued close relations** between MoF and Treasury and look forward to JEC next yr.

China -- Economic Assessment

Economic Prospects: Even if China meets its 8% GDP growth goal -- which few expect -- 1998 will be the slowest year since 1990. Most of the slowdown is due to sluggish domestic demand, as evidenced by falling prices, although the weakening external environment is playing an increasingly significant role. In view of this, much of the weight of growth is being placed on fixed investment, which rose 17.4% in the first eight months of 1998. The summer's catastrophic floods are placing an additional burden on the economy, although recovery and reconstruction efforts might ironically provide a fillip to growth.

Key Challenges: China's most pressing policy challenge -- recognized by the leadership -- is to resolve the twin problems of the financial sector and state-owned enterprises. There are some indications, however, that the reform effort is being slowed -- and in some cases reversed -- to ameliorate short-run employment effects. Financial market restructuring is the most advanced, but the challenge is immense and recent attempts to boost lending could exacerbate the NPL problem in the future. SOE restructuring is moving slowly, if at all, while a massive housing sector reform program appears to have stalled. It also appears that the government is taking steps to discourage -- or prevent -- imports.

Fiscal Policy: While the official deficit is small -- about 1.5% of GDP -- it excludes policy lending and a large number of off-budget funds, which bring the overall deficit to an estimated 6-8% of GDP. The government is hoping to stimulate the economy through greater infrastructure investment, financed in part through a new domestic bond issue, but it is doubtful that worthwhile projects can be identified, designed, and implemented sufficiently rapidly. The tax system is weak, causing revenues to stagnate and raising concerns about the advisability of additional deficit financing, particularly given the need for additional resources to pay for reform and to ameliorate its short-run costs.

Monetary Policy: Until recently, monetary policy was kept tight as the government fought inflation and imposed increasingly binding budget constraints on SOEs. As growth began to slow, the PBOC lowered interest rates repeatedly in an attempt to boost investment, and another cut is expected soon. The rate cuts have been generally ineffectual, however, as banks chose to buy low-risk government paper instead of increasing lending. The government responded by ordering banks to increase lending, although this risks undermining the financial market reform.

Financial sector restructuring: Major aspects of bank reform announced so far center around recapitalization of the four major banks, in part through a \$32.5 billion bond issue that is being financed through a lowered reserve requirement, and which will apparently *not* bring new money into the system. Banks have been instructed to begin lending only on commercial grounds, the order that led them to prefer government bonds to lending. The order to increase lending -- both generally and for flood relief in particular -- is likely to direct more funds to SOEs-- where banks see implicit government guarantees -- rather than to the more productive and efficient non-state sector, which is generally starved for capital. Banks have also been instructed to adopt western-style accounting and classification systems by year-end.

Resolution of the sector's problems also requires addressing the bad debt overhang and -- most of all -- restructuring the banks so that future lending will be made on economically-efficient grounds. The Chinese intend to set up an RTC-type entity to handle the bad loans, although the timing for this is uncertain, and the shortage of banking expertise makes commercialization a daunting challenge. Decontrol of interest rates could allow banks to charge risk-adjusted rates, and therefore increase lending to the non-SOE sector, but it does not appear to be under consideration at this time.

Structural Reform: During the September 1997 Bank/Fund meeting Premier Zhu announced that the SOE problem would be resolved within three years. Little appears to have been done since then, and details of the proposed reforms have not been announced. Indeed, there are some indications of retrograde steps, including plans to impose domestic price and production controls in order to bolster SOE profits. The delay probably reflects a desire to keep unemployment under control and reappraise China's plans, which reportedly included the construction of *chaebol*-like conglomerates. Zhu has also pledged complete commercialization of housing and sweeping health care reform, although these too appear to have stalled.

The government is also undergoing sweeping reform, which involves reducing the number of ministries by 11 and laying-off 4 million employees. Some ministries -- including MoF and the PBOC -- have already been restructured or have restructuring underway.

External Accounts: While China does not release part-year balance of payments figures, all indications are that it continues to run a healthy surplus. While export growth has been slowing -- actually falling in August on a year-over-year basis -- the trade surplus remains healthy: in the first eight months of 1998 it reached $31.4 billion, 23% ahead of 1997's record pace. The breakdown is somewhat less encouraging: exports rose just 5.5% in the first eight months of the year, while imports edged up just 0.4%. FDI flows were $27.4 billion, down 1.5% (although contracted investment rose 6%).

The government has taken vigorous steps to bolster the balance of payments. These include greatly strengthened enforcement of foreign exchange regulations, apparently designed to choke import growth, as well as a crackdown on black market currency trading, rule changes designed to discourage hedging the *renminbi*, and improved incentives for exporters and investors. Chinese leaders at several levels continue to reiterate their determination not to devalue the currency.

Despite the balance of payments surplus, reserves have been virtually flat throughout 1998. Part of this can be explained by relaxed surrender requirements, which have allowed exporters to retain foreign exchange that would earlier have found its way into reserves and by counting of exports that have been shipped but not paid for. Part of the discrepancy will probably be reflected through higher errors and omissions, some of which reflects capital flight, however. China's external debt is modest, at an estimated $131 billion (14.5% of GDP) at the end of 1997, with a debt service ratio below 7.5%. The debt numbers contain a $38 billion discrepancy from those provided by BIS, however.

Bilateral Issues and Relations:

- U.S. Bank Exposure to China: Total U.S. bank outstanding exposure stood at $2.5 billion as of end-1997.

- Trade Balance: The U.S. trade deficit with China has grown rapidly, and was the second largest U.S. deficit in 1997, at $49.7 billion (the deficit with Japan was $55.7 billion). In the first six months of 1998, the deficit was $25.1 billion, up from $21.2 billion in the corresponding period last year. Year-to-date imports from China rose 17.1%, while exports rose 11.9%.

- U.S. FDI in China: At the end of 1997, U.S. direct investment in China totaled $5 billion.

- Financial Services Presence: Six U.S. banks have a total of 13 branches in China. Only one -- Citibank's branch in Pudong -- is permitted to conduct business in *renminbi*, although this privilege is soon to be extended to Shenzhen as well.

- Tax Treaty: The U.S. and China have a tax treaty in force.

CHINA
Summary Statistics

Population: 1.24 billion (1997)
Per Capita Income: $ 727 (1997)

Population Growth Rate: 1.5%
Fiscal Year: Calendar

GROSS DOMESTIC PRODUCT	1994	1995	1996	1997	1998p
GDP ($ bn)*	540.5	704.6	817.0	900.0	950
Real GDP Growth	12.6%	10.5%	9.7%	8.8%	5.5%
Gross Domestic Investment (% of GDP)	41.2%	40.8%	39.6%	38.2%	38.5%
Gross National Savings (% of GDP)	42.6%	41.1%	40.5%	42.1%	41.9%
GOVERNMENT BUDGET (% of GDP)					
Expenditure (incl. net lending)	13.6%	12.9%	12.9%	13.6%	13.7%
Overall Balance (official)	-1.6%	-1.7%	-1.5%	-1.5%	-1.4%
INFLATION/MONEY					
Retail Price Inflation	21.7%	14.8%	6.1%	0.8%	-2.0%
Money Supply Growth (M3)	34.5%	29.5%	25.3%	17.3%	15.0%
One Year Time Deposit Rate	11.0%	11.0%	7.5%	5.7%	5.2%
EXCHANGE RATE					
Nominal (RMB/US$)	8.5	8.3	8.3	8.3	8.3
Real Effective (Index 1990=100)	78.6	82.8	86.9	92.0	n.a.
BALANCE OF PAYMENTS ($ bn)					
Exports	102.6	128.1	151.2	182.7	190
(% Change)	33.1%	24.9%	18.0%	20.8%	4.2%
Imports	95.3	110.1	131.5	136.5	143.3
(% Change)	12.2%	15.5%	19.4%	3.8%	5.0%
Trade Balance	7.3	18.0	19.7	46.2	46.7
Current Account Balance	7.7	1.6	7.3	35.5	27.2
(% of GDP)	1.4%	0.2%	0.9%	3.9%	2.9%
Overall Balance of Payments	30.5	22.5	31.7	35.7	22.5
INTERNATIONAL RESERVES					
Gross Reserves ($ bn)	51.6	73.6	105.0	139.9	140.6
Months of Imports (G&NFS)	5.6	6.5	8.2	10.0	10
EXTERNAL DEBT					
Total Debt ($ bn)	95.0	106.6	116.2	121.2	141.3
(% of GDP)	17.6%	15.1%	14.2%	13.5%	14.9%
of which: short-term ($ bn)	10.4	11.9	14.1	n.a.	n.a.
Debt Service Ratio (%X G&NFS)	11.6%	10.6%	10.9%	9.8%	6.9%

CREDIT RATING	Sept.
Standard & Poor's	BBB+
Moody's	A3

OASIA/INA/A. Marcus
Sept. 23, 1998

Sources: IMF and Treasury Department Data; Consensus Forecasts

USTR POINT

POINT TO MAKE TO CHINESE CENTRAL BANK PRESIDENT AND MINISTER OF TRADE RE: Economic growth, deregulation and trade:

- China can increase economic growth at home *and* promote recovery in other Asian economies by focusing its reform efforts on deregulation. In particular, eliminating restrictions on private distribution and trading would help create jobs for Chinese citizens, lead to greater efficiency in the Chinese economy, and assist Asian neighbors trying to find markets. China has already agreed to these reforms in its WTO talks.

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FROM: Hank Levine
Deputy Director for Economic Affairs
Office of Chinese and Mongolian Affairs
U.S. Department of State, Washington, DC

TEL: 202-647-6796
FAX: 202-647-6820

TO:

Malcolm Lee

URGENT

☒ **PER DISCUSSION** ☐ **FOR CLEARANCE** ☐ **FYI**

① Not cleared by EB.
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Deputies Meeting
China Economic Issues
October 16, 1998

Agenda

1. Economic Outlook and Status of Reforms (Treasury)

2. China WTO (USTR)
   - -- State of Play
   - -- Strategy and Next Steps

3. Taiwan WTO (USTR)

4. Alternative Approaches to China Market Access Issues (USTR/Commerce)

5. Status Updates
   - -- JCCT (Commerce)
   - -- Maritime and Civair (State)
   - --. Asian Longhorned Beetle (Agriculuture/State)
   - -- Labor Dialogue (Labor)
   - -- TDA/OPIC

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Malcolm Lee
OA/Box Number: CF 1177

FOLDER TITLE:

China (October to November 1998) [2]

2010-1024-F
vz1803

RESTRICTION CODES

Presidential Records Act - [44 U.S.C. 2204(a)]

P1 National Security Classified Information [(a)(1) of the PRA]
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RR. Document will be reviewed upon request.

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DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
004c. report	Dupicate of 002. (1 page)	10/16/1998	P1/b(1)

COLLECTION:

Clinton Presidential Records
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004d. list	Duplicate of 003b. (3 pages)	10/16/1998	P1/b(1)

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U.S. DEPARTMENT OF TREASURY
OFFICE OF EAST ASIAN NATIONS

Date: November 3, 1998

To: Lael Brainard
395-6853
From: Chris McCoy
Phone: 202 622-0337
Fax: 202 622-0349

Todd Crawford asked me to fax you the following.

CHINA

- China has been affected less by the crisis than other countries in the region, although export growth has suffered -- especially exports to Japan.

  [FYI: In the first nine months of 1998, China's exports rose 3.9% over 1997's record pace, while its trade surplus rose 15% to $35.2 billion.]

Exchange Rate

- We agree with the Chinese government that maintenance of a stable *renminbi* is in China's interest -- as well as beneficial to the rest of the region.

  -- A devaluation could be a blow to confidence in China and might thereby suppress investment flows.

  -- It would also likely have serious effects on the currencies of Hong Kong and other countries in the region.

  -- China's export success does not suggest that a devaluation is needed, nor that one would be particularly effective in promoting exports. Over 50% of China's exports involve some degree of import processing.

  -- In addition, as exports account for only about 20% of China's GDP, measures centered on the domestic economy could have a bigger effect on GDP growth than would a devaluation.

- China's leaders have reiterated to us that they have no plans to devalue. We accept those assurances.

Growth

- China will probably have the fastest growth of any major economy this year -- a formidable achievement in the difficult current environment.

- It is important in this context that China avoid the temptation to sacrifice hard-won credibility through short-term expediency.

- To provide a sound basis for sustainable growth in the long run, China needs to continue reform. Key areas include the financial sector, state-owned enterprises, and opening to the world.

- Chinese leaders have a firm understanding of these issues, and we are optimistic that they will move decisively and rapidly in continuing reforms.

GITIC Failure

- The closure of GITIC is both discouraging and encouraging.

- It is always discouraging when a major financial firm fails. In this case it is particularly disconcerting that such a firm should fail in Guangdong -- one of the wealthiest and most economically-successful parts of China.

- The closure is encouraging in that it indicates that the Government of China is willing to take strong action against failed financial firms. The lesson from all over the world is that delaying only raises the eventual costs of resolving such problems.

- At the moment there is great uncertainty about how GITIC will be wound up, and about the status of other "itics." As a result, lenders are very nervous about the itics and about China in general.

- It is therefore essential that the resolution be transparent, even-handed, and expeditious.

OASIA/INA/A. Marcus November 2, 1998

China – Economic Assessment

Economic Prospects: Even if China meets its 8% GDP growth goal – which few expect -- 1998 will be the slowest year since 1990. Most of the slowdown is due to sluggish domestic demand, as evidenced by falling prices, although the weakening external environment is playing an increasingly significant role. In view of this, much of the weight of growth is being placed on fixed investment, which rose by 20% at state-owned enterprises in the first nine months of 1998. The summer's catastrophic floods are placing an additional burden on the economy, although recovery and reconstruction efforts might ironically provide a fillip to growth.

Key Challenges: China's most pressing policy challenge – recognized by the leadership – is to resolve the twin problems of the financial sector and state-owned enterprises. It appears, however, that the reform effort is being slowed – and even reversed -- to ameliorate short-run effects on growth and employment. Banking reform, which had been the most advanced, is being partially undermined by directives for banks to increase lending, which will likely exacerbate the long-term NPL problem. SOE restructuring is moving slowly, if at all, while a massive housing sector reform program appears to have stalled. It also appears that the government is taking steps to discourage – or prevent – imports.

Fiscal Policy: While the official deficit is small -- about 1.5% of GDP – it excludes policy lending and a large number of off-budget funds, which bring the overall deficit to an estimated 6-8% of GDP. The government is hoping to stimulate the economy through greater infrastructure investment, financed in part through a new $12 billion domestic bond issue, but it is doubtful that worthwhile projects can be identified, designed, and implemented sufficiently rapidly. The tax system is weak, causing revenues to stagnate and raising concerns about the advisability of additional deficit financing, particularly given the need for additional resources to pay for reform and to ameliorate its short-run costs.

Monetary Policy: Until recently, monetary policy was kept tight as the government fought inflation and imposed increasingly binding budget constraints on SOEs. As growth began to slow, the PBOC lowered interest rates repeatedly in an attempt to boost investment, and another cut is expected soon. The rate cuts have been generally ineffectual, however, as banks chose to buy low-risk government paper instead of increasing lending. The government responded by ordering banks to increase lending, although this risks undermining the financial market reform.

Financial sector restructuring: Major aspects of bank reform announced so far center around recapitalization of the four major banks, in part through a $32.5 billion bond issue that is being financed through a lowered reserve requirement, and which will apparently *not* bring new money into the system. Earlier this year, banks were instructed to begin lending only on commercial grounds, the order that led them to prefer government bonds to lending. The recent order to increase lending is likely to direct more funds to SOEs, where banks see implicit government guarantees, rather than to the productive but capital-starved non-state. Banks have also been instructed to adopt western-style accounting and classification systems by year-end. Resolution of the sector's problems also requires addressing the bad debt overhang and -- most of all -- restructuring the banks so that future lending will be made on economically-efficient grounds. The Chinese intend to set up an RTC-type entity to handle the bad loans, although the timing for this is uncertain, and the shortage of banking expertise makes commercialization a daunting challenge. Decontrol of interest rates could allow banks to charge risk-adjusted rates, and therefore increase lending to the non-SOE sector, but it does not appear to be under consideration at this time.

The recent closing of GITIC -- a large non-bank financial entity controlled by the province of Guangdong -- was a landmark in bank regulation. It may reflect a new willingness to deal forcefully with financial sector problems, although the failure of the company -- in one of China's wealthiest provinces -- underlines the depths of the sector's problems. At least two other "itics" have defaulted on loans, and many others are believed to be in difficulty.

Structural Reform: During the September 1997 Bank/Fund meeting Premier Zhu announced that the SOE problem would be resolved within three years. Little appears to have been done since then, and details of the proposed reforms have not been announced. Indeed, there are increasing indications of retrograde steps, including plans to impose domestic price and production controls in order to bolster SOE profits. The delay probably reflects a desire to keep unemployment under control and a reappraisal of plans which had centered on the construction of *chaebol*-like conglomerates. Zhu has also pledged complete commercialization of housing and sweeping health care reform, although these too appear to have stalled.

The government is also undergoing sweeping reform, which involves reducing the number of ministries by 11 and laying-off 4 million employees. Some ministries -- including MoF and the PBOC -- have already been restructured or have restructuring underway.

External Accounts: While China does not release part-year balance of payments figures, all indications are that it continues to run a healthy surplus. While export growth has been slowing -- actually falling in September on a year-over-year basis -- the trade surplus remains healthy: in the first nine months of 1998 it reached $35.2 billion, 15% ahead of 1997's record pace. The breakdown is somewhat less encouraging: exports rose just 3.9% in the first nine months of the year, while imports edged up just 0.4%. FDI flows were $31.4 billion, down 1% from 1997's record pace. The slowdowns in exports and investment are both attributable for the most part to other Asian countries, especially Japan.

The government has taken vigorous steps to bolster the balance of payments. These include greatly strengthened enforcement of foreign exchange regulations, apparently designed to choke import growth, as well as a crackdown on black market currency trading, rule changes designed to discourage hedging the *renminbi*, and improved incentives for exporters and investors. Chinese leaders at several levels continue to reiterate their determination not to devalue the currency.

Despite the balance of payments surplus, reserves have been virtually flat throughout 1998. Part of this can be explained by relaxed surrender requirements, which have allowed exporters to retain foreign exchange that would earlier have found its way into reserves and by counting of exports that have been shipped but not paid for. Part might also be explained by the depreciation of yen-denominated assets. Some of the discrepancy will probably be reflected through higher errors and omissions, however, some of which reflects capital flight. China's external debt is modest, at an estimated $131 billion (14.5% of GDP) at the end of 1997, with a debt service ratio below 7.5%. The short-term debt numbers are $38 billion below those provided by BIS, however.

Bilateral Issues and Relations:

- U.S. Bank Exposure to China: Total U.S. bank outstanding exposure stood at $2.5 billion as of end-1997.

- Trade Balance: The U.S. trade deficit with China has grown rapidly, and was the second largest U.S. deficit in 1997, at $49.7 billion (the deficit with Japan was $55.7 billion). In the first eight months of 1998, the deficit was $36.4 billion, up from $31 billion in the corresponding period last year. Year-to-date imports from China were just under $45 billion, up 15.7.

- U.S. FDI in China: At the end of 1997, U.S. direct investment in China totaled $5 billion.

- Financial Services Presence: Six U.S. banks have a total of 13 branches in China. Only one -- Citibank's branch in Pudong -- is permitted to conduct business in *renminbi*, although this privilege is soon to be extended to Shenzhen as well.

- Tax Treaty: The U.S. and China have a tax treaty in force.

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~~Todd Crawford asked me to fax you the following~~

~~Addi~~ Additional material
Two pages to follow.

CHINA

1. GROWTH RATE. No one believes they will meet the 8% target, although they will probably announce something close to it. (Zhu stated that they grew 7.6% in the third quarter -- before it was over -- and Xiang mentioned the goal 3 times in a speech during Bank/Fund). We have no way of determining what the real number is (proxies like energy use are used by some, but are fatally flawed). Without knowing, it is difficult to take a position on whether additional stimulus is warranted.

They might reasonably take prudent steps to stimulate the economy, but they need to retain their focus on reform and maintain credibility. Stimulatory options are limited, however. Fiscal position is already very weak (true deficit is about 6-8% of GDP and revenue buoyancy poor), although they are proceeding with a RMB100 billion SDB bond issue for infrastructure. Monetary policy is also risky since it will likely translate into more bad loans.

Even if they fall short of 8% by a few percent they are likely to have the world's highest growth rate this year (or second after India).

2. REFORM PROCESS. The process is always a few steps forward, a few steps back, but ***lately many steps seem to be backwards.***

Backward steps include:

(1) Orders for the banks to accelerate lending and to lend for specific purposes, including flood relief. Much of the lending will inevitably go to SOEs, which banks see as carrying implicit guarantees.

(2) Reported plans to introduce price and production controls to support SOE profits/viability. Despite Zhu's pledges at 1997 Bank/fund, there are no signs of SOE reforms.

(3) Balance of payments -- they are taking a number of steps to crack down on imports/encourage exports. Most significant is a major crackdown on currency licences, creating an insurmountable paperwork burden while claiming to be in compliance with Article VIII. There are also additional export tax rebates, a crackdown on black market trading and rule changes designed to discourage hedging the renminbi. Also various specific trade/investment restrictions, which USTR is excited about. An interesting wrinkle: today's cancellation/postponement of MOFTEC Minister's visit/JCCT -- supposedly due to illness.

It is unclear whether these are precautionary or a response to developments, perhaps hidden in false or unreported statistics.

Steps forward:

(1) Banking: recapitalization is underway, with the bonds having been issued -- although we haven't received a straight answer as to whether they will be tradable. If not, no new money

comes into system. PBOC reorganization apparently on track, as are new accounting/loan classification rules. Closing of GITIC is welcome recognition of need to act -- but also possibly a sign that things in the sector are even worse than expected.

(2) Government reorg. apparently on track.

3. BALANCE OF PAYMENTS

Indications are that current account remains heavily in surplus: trade surplus is up 23% through August and FDI only slightly down. Exports are up 5.5% -- certainly not great, but respectable in this environment. Imports are about flat due to weak demand and crackdown.

But reserves are flat. Why? Possibilities include:

(1) Surrender requirements. They eased these to allow 15% retention of earnings, and there has been growth in bank holdings of forex.

(2) Trade figures are misleading. They count exports that have been shipped but not paid for. We don't know how many $ are involved.

(3) Currency losses on yen-denominated assets -- reportedly 1/3 of total at beginning of 1998.

(4) Increased capital flight. Errors and Omissions are very high and keep growing. Anxiety about RMB and the crackdown are likely to be driving additional black market activity, although there's no real data. Reported black market premia (about 8%) seem quite low in view of the criminal penalties (which include death).

Most likely all of these contribute.

4. EXCHANGE RATE

They continue to insist that they won't devalue -- although they don't provide any dates. In view of current account, reserves, controls, low debt levels and new protectionism ***we believe them***. They derive a lot of political satisfaction from maintaining rate, and would lose lots of face if they changed it now. Xiang made strong statement at Bank/Fund on why devaluation wouldn't help them, making the same points we've been making to them (scare investors, heavy dependence on imported inputs, foreign debt burden...).

5. XIANG/RER MEETING. Short and friendly. Mostly about regional/global situation with ***little new or interesting*** about China.

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DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
005a. memo	For the President from Samuel Berger and Gene Sperling. Subject: Letter to Chinese President Jiang Zemin. Record ID: 9807412. (1 page)	10/28/1998	P1/b(1)

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DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
005b. letter	To Jiang Zemin from William Clinton. (4 pages)	10/28/1998	P1/b(1)

COLLECTION:

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National Economic Council
Malcolm Lee
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005c. draft	Treasury Language. (1 page)	11/04/1998	P1/b(1)

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BUREAU OF EAST ASIAN & PACIFIC AFFAIRS (EAP)

OFFICE OF CHINESE & MONGOLIAN AFFAIRS (CM)

FAX COVER SHEET

DATE: Tuesday, November 03, 1998

TO: NEC - Malcolm Lee

FAX: 202-456-9290 **PHONE:**

FROM: EAP/CM - Benjamin Weber

FAX: 202-647-6820 **PHONE:** 202-647-6819

NUMBER OF PAGES INCLUDING COVER SHEET: 5

REMARKS:

Mr. Lee:

Attached please find Mr. Li Tieying's itinerary and curriculum vitae. Hank Levine will call with further details.

Best regards. BW

United States Department of State

Washington, D.C. 20520

DRAFT
-pending Susan Shirk/ Stanley Roth clearance

INFORMATION MEMORANDUM
S/S

SENSITIVE BUT UNCLASSIFIED

TO: The Secretary

FROM: EAP - Stanley O. Roth

SUBJECT: Potential Disruption of Trade with China

The Department of Agriculture (USDA) has traced six U.S. infestations of the Asian long-horned beetle to solid wood packing material (SWPM) from China. The beetles, which bore into trees and kill them, have no natural predators in the United States. In New York and Chicago, millions of dollars have been spent and thousands of trees destroyed to combat the pest. Because the beetle threatens billions of dollars in U.S. forest-based industry, on September 18 USDA proposed a regulation that China certify that SWPM has been treated against the beetle. The rule takes effect December 17.

Initial Chinese reaction was defensive, although subsequent feedback has been more constructive. Some Chinese officials hold the mistaken belief that the rule is a trade sanction or that we might negotiate a compromise. Since before the rule was announced we have stressed to the Chinese the rule's scientific basis and the importance of swift implementation. Technical delegations and Embassy officers -- including Ambassador Sasser to Vice Foreign Minister Yang last week -- have repeatedly urged Beijing to accelerate implementation.

Achieving Chinese compliance will be complex. Thousands of wooden shipping crates carry China's huge volume of exports to the United States (US $62.5 billion in 1997). China has few facilities to fumigate or heat-treat the SWPM. Our consulates in China tell us that many local officials and exporters are aware of the rule but await instructions from ministries in Beijing. Despite USDA's and our best efforts, a serious disruption to trade is a growing possibility, given the short time remaining. We are increasingly concerned about shipments being delayed or returned to China. The cost to U.S. importers and consumers could be great as would the damage to China's already troubled economy. We are urging USDA to develop a strategy for the inevitable arrivals of untreated SWPM. We will strive for an approach that causes the least disruption to trade while protecting America's forests.

One aspect of the rule has yet to be definitively addressed: the applicability of the rule to Hong Kong, with its separate customs territory. While half of China's exports to the United States are shipped via Hong Kong, the beetle is native to northern China and most exports from the south (e.g., toys and apparel) are lightweight and are packed in cardboard, not wood. USDA is deliberating whether and how the rule should apply to Hong Kong. Our position has been to defer to USDA on the scientific basis for the decision, but where possible to narrow the focus of the rule to minimize trade disruptions.

DRAFT

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11/02/98 7-6798
Drafted: EAP/CM:MRKoumans
Cleared: EAP/CM:HALevine ok
EAP/CM:SASchlaikjer ok
EAP/FO:SLShirk PENDING
EB/ATT:MJBruno ok
USDA/FAS:LIAlfalla ok
E:DXNorland (info)
P:DXStraub ok
S/P:TLDelare ok