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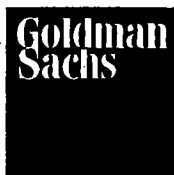
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WTO Membership *What This Means for Greater China*

- While China and the United States failed to sign an agreement on China's WTO accession this month, we continue to believe a final deal will be struck by end-1999. Sweeping tariff cuts and market opening measures will take effect in China in the next few years.
- Annual trade (exports plus imports) is projected to double to US\$600 billion by 2005, and inward FDI is likely to increase to US\$100 billion a year. Greater openness and productivity gains will likely boost the GDP growth rate 0.5 percentage points. These benefits should outweigh short-term disruptions such as rising SOE bankruptcies and unemployment.
- China's WTO entry does not imply immediate, full capital account liberalization. Its impact on the overall balance of payments is ambiguous, and it will not trigger a currency devaluation.
- Following China's accession, Taiwan will also become a WTO member, obliging Taiwanese authorities to establish direct trade relations with the mainland—a big boost to cross-Strait trade and investment flows.
- While Hong Kong may lose some of its traditional role as an entreport, China's foreign trade and economic expansion should provide significant opportunities for Hong Kong in high-value-added services.

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Investment Implications

To accede to the World Trade Organization (WTO), China has pledged a program of sweeping trade liberalization. Although President Clinton and Prime Minister Zhu Rongji failed to sign an agreement during the latter's visit to Washington this month, we believe it is almost certain China will become a WTO member by end-1999.

The tariff reductions and market opening measures China is expected to implement will transform the world's seventh-largest economy into one far more open than it has ever been, enabling China to reap large benefits from fuller global integration.

External trade is projected to nearly double to US\$600 billion annually by 2005, and foreign direct investment is likely to increase to US\$100 billion per year. Trade expansion, foreign direct investment (FDI) inflows, and associated productivity gains will enhance China's growth prospects, boosting GDP growth 0.5 percentage points. These long-term benefits should outweigh short-term disruption, including rising bankruptcies in the inefficient state industries and growing unemployment.

Contrary to a widely held view, China's WTO entry bears no relation to the timing of capital account liberalization. Its impact on the overall balance of payments is ambiguous. We do not see WTO entry as a trigger to currency devaluation. It should have a positive impact on Chinese debt.

Less known to the investment community is that Taiwan will also become a WTO member following China's accession. WTO principles would oblige Taiwan authorities to establish direct trade relations with the mainland, significantly boosting cross-strait merchandise trade and investment flows.

While Hong Kong may gradually lose its share of handling merchandise trade between China and Taiwan and the rest of the world, the expansion in China's overall trade is likely to benefit Hong Kong, providing opportunities for a range of high-value-added businesses in marketing, accounting, law, banking, and foreign exchange transaction services.

China's WTO Offer

After 13 years of marathon negotiations, the prospect of China joining the WTO is in sight. Even though Prime Minister Zhu Rongji and President Clinton failed to seal a final deal during Zhu's official visit to the United States, we believe an agreement will be completed in the coming few months. It is almost certain China will become a WTO member by end-1999.

By virtually any standards, China's WTO offer is significant for the following reasons:

1. It will lead to substantial reductions in tariffs—below 10% by 2005 from a current average of 17%. Tariffs for priority industrial products important for the United States and other developed nations will be slashed to 7%. Information technology products, such as telecom equipment, semiconductors, and computers, will receive zero tariffs (see Table 1).
2. China will dismantle most non-tariff trade barriers, such as import quotas, licensing, and other forms of trade restrictions.
3. China will lift bans on imports of key agricultural products—notably citrus fruits, meat, and wheat—as well as other agricultural goods.
4. China will open up a range of service sectors to foreign competition. For example, in the highly sensitive telecom industry, foreign multinational corporations will be able to take

Table 1: China's WTO Accession Tariff Reductions

	1999 ¹	2005
Agricultural		17% [14.5%] ²
Industrial	24.6%	9.44% [7.1%] ²
Of which:		
Hi-tech	13.30%	0
Autos	80%-100%	25%
Auto parts		10%
Wood and paper	12%-18%	5%-7%
Chemicals	35%	5.5%-6.5%
Distilled spirits	61%	10%

Note: (1) Prior to WTO accession. (2) Tariff rates applicable to US priority products.

Source: Ministry of Foreign Trade and Economic Cooperation (MOFTEC), US Trade Representative's Office.

up to 49% equity stakes and operate fixed line, mobile, paging, satellite, and Internet services. Foreign commercial banks will be allowed to conduct retail banking in the local currency in all major Chinese cities, and the insurance sector will also be further opened. Foreign companies will be granted rights to conduct wholesale, retail sale, distribution, and export and import businesses throughout China (see Table 2).

Impact on Trade and Investment

China will become far more open an economy following WTO accession. The sweeping trade liberalization China has pledged to undertake in the coming several years will have a significant impact on the economy. China is now the tenth-largest trading economy in the world, but substantial restrictions have limited further expansion of its external trade and inward foreign investment. China's share of world trade and foreign investment has the potential to increase further once structural impediments are removed. The single most important change arising from China's accession to the WTO is that it will become a far more open economy—in some aspects more open than many of the WTO's existing members. In 1998, Greater China's total external trade amounted to US\$647 billion, placing Greater China as fourth most important in world trade (see Tables 3 and 4).

Table 3: Top Fifteen-Largest Trading Economies

	Total Trade 1997	
	US\$ billion	% of World Trade
United States	1588	14.2
Germany	958	8.6
Japan	760	6.8
United Kingdom	593	5.3
France	568	5.1
Italy	451	4.0
Canada	415	3.7
Hong Kong	397	3.5
Netherlands	373	3.3
Belgium	329	2.9
China	325	2.9
Korea, Rep.	281	2.5
Singapore	257	2.3
Taiwan	229	2.0
Switzerland	195	1.7

Source: IMF, GS estimates.

Table 4: A Glance at Greater China (1998)

(US\$ billion)	GDP	Total Trade*	Stock Market Capitalization
Mainland China	973.0	257.9	274.5
Hong Kong	167.0	205.9	304.0
Taiwan	261.0	183.5	260.4
Total	1401.0	647.4	838.8

Note: China's total market cap includes Shenzhen A+B, Shanghai A+B, H-shares, and red chip shares. * Net of China, Hong Kong and Taiwan intra-trade.

Source: Datastream, IMF, GS estimates.

Table 2: Opening Up China's Service Sectors

Telecoms Services	
Technology	Foreign suppliers can use any technology they choose to provide telecoms services (for example, GSM or CDMA in mobile communications).
Scope of services	China will phase out all geographic restrictions for: (1) paging, value-added, and closed user group: 4 years (2) mobile/cellular: 5 years; (3) domestic wireline services: 6 years. Key telecommunications hubs such as Beijing, Shanghai and Guangzhou (representing 75% of all domestic traffic) will open in all telecoms services immediately on accession.
Investment	China will allow 49% foreign investment (currently banned) in all services, and will allow 51% of foreign ownership for value-added and paging services in 4 years time.
Insurance	
Geographic limitations	China will permit foreign property and casualty firms to insure large-scale risks nationwide immediately upon accession, and will eliminate all geographic limitations for future licenses over 5 years from accession.
Scope	China will expand the scope of activities for foreign insurers to include group, health and pension lines of insurance, representing 85% of total premiums, phased in over 5 years.
Investment	China will allow majority ownership.
Banking	
Agreement reached in principle to grant full rights to foreign banks to handle local and foreign currency business transactions, and the rights to serve Chinese as well as foreign customers, and liberalize investment.	

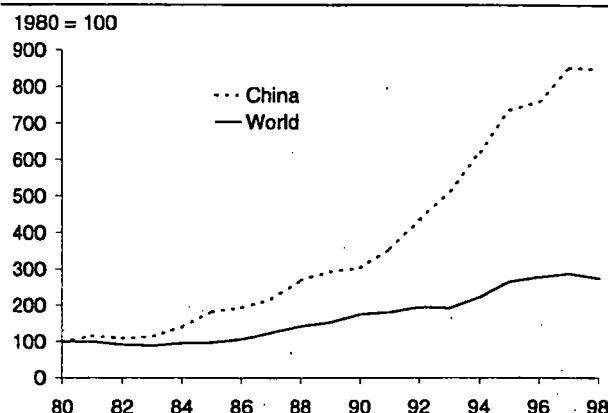
Source: MOFTEC, US Trade Representative's Office.

According to a projection scenario by the World Bank, China's share in world trade could more than triple to 10%, making it a major engine of growth for world trade. China would then become the second-largest trading nation in the world.

Big boost to trade flows. The first predictable effect of the WTO accession is that imports will surge owing to tariff cuts and the removal of non-tariff barriers. Average tariff rates are to be lowered by more than 60% over five years, with tariff cuts for many products taking effect immediately on accession. Assuming the price elasticity of import demand remains the same at its historical value, and simply extrapolating our current forecast on growth in domestic demand for 1999-2000 into 2001-2005 then, according to our econometric model, the expected tariff reduction would translate into new imports of US\$65 billion by 2005. We estimate the elimination of non-tariff barriers, including the lifting of bans on imports of certain agricultural products, would generate an additional US\$20-US\$30 billion in imports a year. Finally, we expect a significant jump in FDI following China's entry into the WTO (as discussed below), and FDI-induced imports (new machinery, equipment, intermediate goods, etc) could add another US\$20 billion in new imports. In total, imports will likely rise to US\$230-US\$260 billion a year by 2005.

Following China's WTO entry, exports are also likely to grow faster than historical average rates. First, a WTO deal significantly reduces uncertainty surrounding China's normal trade relations with its leading export market—the United States—and should improve access to other developed markets, including the EU and Japan (see Figure 1 and Table 5). Over the past two decades, China's trade status (formerly Most Favored Nation [MFN], and since 1998 Normal Trade Relations [NTR]) with the United States has been subject to annual review, owing to the Jackson-Vanek Act, which was originally intended to punish the former Soviet Union and other Eastern Bloc communist countries for restricting Jewish immigration to the West. The annual debate has been a highly politicized process, posing a substantial threat to Chinese exporters and US importers. Furthermore, as a non-WTO member, China is also vulnerable to a variety of unilateral trade sanctions, without the protection of a multilateral arbitration process. The United States and other countries may launch anti-dumping charges against China, treating it arbitrarily as a non-market economy.

Figure 1: China's Rapidly Growing External Trade vs. World Trade



Source: CEIC, IMF, GS estimates.

Table 5: China's Top Ten Trading Partners (1998)

Top Ten Export Markets		Top Ten Import Sources	
	Percentage of Total Exports		Percentage of Total Imports
Hong Kong	21.1	Japan	20.1
USA	20.7	USA	12.1
Japan	16.2	Taiwan	11.9
Germany	4.0	Korea	10.7
Korea	3.4	Germany	5.0
Netherlands	2.8	Hong Kong	4.8
United Kingdom	2.5	Singapore	3.0
Singapore	2.1	Russia	2.6
Taiwan	2.1	France	2.3
France	1.5	Australia	1.9

Source: CEIC, GS estimates.

Second, the WTO accession will help exports of those products in which China has a competitive advantage. Industries such as apparel, footwear, textiles, toys, consumer electronics will receive a huge boost from the expected WTO deal. As import quotas on textile and clothing imposed under the Multi-Fiber Agreement will be phased out by 2005, China is almost certain to expand its market share in this category, which currently accounts for nearly 20% of its total exports. With the elimination of import quotas, China's exports of textiles and clothing products alone would double to US\$70 billion a year. The United States, bowing to lobbyist pressure from the textile states of North and South Carolina, may attempt to impose a clause in the bilateral agreement with China on WTO accession, allowing the United States to maintain import quotas for another five years—although all other WTO members are to abolish such quotas by 2005.

We believe Washington may be willing to soften its stance on this particular, which has been criticized even by Republican leaders in Congress, such as Senator Phil Gramm, as a contradiction to free trade.

Despite this uncertainty, the post WTO market environment will be friendlier to Chinese exporters, and China's market access to major developed markets will be far more secure. While there will likely be a surge in imports of hi-tech, capital intensive goods, agricultural products and services, we expect China will thrive in exporting low- to mid-tech, labor-intensive manufacturing goods, which suits the country's comparative advantage very well.

Finally, we have observed a strong relation between FDI inflows and export growth in China. This is because: (1) some foreign investors use China as a low-cost manufacturing base for exports; (2) foreign companies have superior marketing strategies and well-established sales channels around the world; and (3) FDI usually involves substantial intra-industry and intra-company trade. Currently, firms with foreign investors, including those controlled by investors from Taiwan and Hong Kong, account for roughly half of China's total exports. With the expected increase in FDI inflows following China's WTO entry, exports should experience robust growth in the coming years.

Under our projection scenario, China's annual total trade (the sum of exports and imports) would increase to US\$600 billion by 2005 from US\$324 billion in 1998. The trade to GDP ratio, a measure of economic openness, is expected to rise to 36% by 2005 from 32% in 1998, reaching levels achieved previously in 1990-1994.

Positive impact on FDI inflows. During the 1990s, China has emerged as a major destination of FDI. Since 1996 China has attracted more FDI than any other country, except the United States. Even in 1998, when private capital flows to developing countries reversed following the emerging markets turmoil in Asia, Russia and Latin America, China still managed to pull in US\$45 billion in FDI (see Appendix 1).

As the most populous nation, China is endowed with a huge pool of inexpensive, skilled or semi-skilled labor. Some multinational corporations (MNCs) are attracted by China's abundant labor

supply and the opportunity to use the country as a low-cost manufacturing base. This type of FDI sees China as an export platform. China's Unit Labour Cost remains favourable compared with other emerging markets.

There are other MNCs, which are primarily attracted by China's potential as one of the biggest and fastest-growing markets. These MNCs are interested in building up plants in China to serve local customers. Regardless of their investment objective or strategy, MNCs have faced a substantial barrier—government laws and regulations in China often prevent them from entering the market.

WTO membership would oblige China to phase out most of the restrictions limiting FDI. For instance, China has offered to open up to foreign competition in a variety of sectors closed until now—such as agriculture, telecoms, retail and distribution, and financial services. Such significant market opening measures, and an increasingly rule-based, transparent, and non-discriminatory system, would attract more FDI into China. Our intensive discussions with Chinese ministerial officials, and a survey of a number of prominent MNCs, suggest if China implements the pre-committed opening, annual FDI inflows could easily reach US\$100 billion by 2005. The number may sound incredibly large, but it is not out of proportion. China's share in world FDI will remain relatively small as FDI is concentrated within developed nations. It implies FDI will rise to 6.3% of GDP by 2005, from 4.5% of GDP in 1998. The higher FDI/GDP ratio would still be below the corresponding ratio for Chile or Malaysia in past years.

Beneficial effect for economic growth. If China completes liberalization in external trade and investment, the economy will become far more open than ever before. Ample empirical evidence suggests increased openness brings about large benefits through specialization based on comparative advantage, knowledge spillover, and transfer of technology and managerial know-how, therefore improving a country's long-term growth prospects.

The direct benefits of trade expansion and foreign investment inflows, plus the resulting efficiency gains, are expected to translate into higher GDP growth for China. A number of academic studies employing both macro- and firm-level data show that China achieved significant historical growth in

total factor productivity—averaging 2 percentage points a year between 1979-1996. This could be attributed to three sources: (1) external trade, (2) FDI inflows, and (3) organizational/institutional changes, such as the introduction of family farming in place of communal farming, increased managerial autonomy and profit-linked incentive schemes at industrial firms, and the removal of controls on prices. While different studies assign different relative contributions from the above three factors to productivity, researchers tend to agree the efficiency gain associated with China's increasing openness—in terms of foreign trade and investment—plays an important role in the country's growth process, accounting for at least one-third of the observed productivity growth rate. If we ignore the growth attributable to increases in inputs (e.g., capital investment undertaken by foreign investors), and focus on the productivity part, then the liberalization package associated with China's WTO entry would add roughly 0.5 percentage points to China's potential GDP growth rate by 2005.

Short-term disruptions will likely be large. China is likely to face greater industry dislocation, rising bankruptcies, and increased unemployment following entry into the WTO. Intensifying foreign competition will further add to the woes of China's ailing state industry and banking system, complicating an already difficult transition from central planning to a market economy. The biggest losers will be inefficient state-owned enterprises (SOEs) in heavy industries such as steel and machinery—redundant capacity that needs to be eliminated. Entrenched special interest groups in sectors threatened by the WTO deal, and millions of laid-off workers, could create powerful resistance to China's ongoing reforms and trade liberalization.

We believe short-term costs will be outweighed by long-term gains arising from the WTO agreement. Reformist leaders may succeed in mobilizing political support for the sweeping liberalization program. In turn, a secured WTO membership will firmly help anchor China in the global economy and neutralize domestic opposition to the wrenching market-oriented economic reforms.

WTO Accession and Renminbi Capital Account Convertibility

Contrary to market perceptions, WTO membership has no bearing on capital account liberalization. Capital account convertibility falls within the IMF's jurisdiction. Member countries of the IMF are not obligated to make the currency fully convertible on capital account transactions, although they are encouraged to do so. A more open trade regime in China could therefore co-exist with some form of continued capital control, especially over short-term portfolio flows. It is unlikely WTO membership would force China to open up the capital account prematurely, leading to massive capital outflows and a large balance of payments deficit.

Impact on balance of payments and currency ambiguous. While WTO membership has a significant impact on China's current and capital accounts, the precise direction of the effect is difficult to pin down. As discussed earlier, while imports are to surge due to tariff cuts and the market opening, exports are also likely to increase with improved access to overseas markets. Entry to the WTO will also induce larger capital inflows. In general, the balance of payments should reflect the overall stance of China's macroeconomic policies, inflation, interest rates, and productivity changes. The precise impact of China's entry to the WTO remains an open empirical question. We believe WTO membership *per se* will have a neutral impact on the renminbi exchange rate. As far as the near-term currency outlook is concerned, our view remains unchanged—we do not believe there will be a devaluation on, or shortly after, China's WTO accession.

Positive impact on Chinese credits. With WTO accession, China is expected to foster a far more open trade and investment regime. WTO membership requires that China adopt global standards and that it must play by global rules. The greater consistency, transparency, and predictability of government policy would mitigate some important risks for investing in Chinese debt securities, such as poor disclosure, information asymmetry, and regulatory uncertainty. Unhappy sagas, such as the collapse of the Guangdong International Trust and Investment Company, may be greatly reduced. Therefore, we believe China's WTO accession is positive for its credit outlook—for the quality names of institutional debt, as well as the sovereign bond.

Impact on Taiwan and Hong Kong

Taiwan—the forgotten trading power. Less known to the investment community is that with China's WTO accession, Taiwan, the world's fourteenth-largest trading economy, will also become a WTO member as a separate customs territory (similar to the current status of Hong Kong within the WTO). This will oblige Taiwanese authorities to lift most, if not all, bans on direct trade with Mainland China. Taiwanese authorities have already started revisiting the possibility of establishing the so-called 'three links' with Mainland China, which are:

1. direct transportation (cross-Strait air and ocean cargo and passenger traffic);
2. direct communication links (telecom and postal services); and,
3. direct trade.

Until now, the three direct links remain a political 'taboo' in Taiwan, forcing Taiwanese businesses to conduct trade with the mainland via Hong Kong or other countries, substantially increasing transaction and transportation costs, constraining the volume of merchandise trade between the two.

In 1997 and 1998, cross-Strait trade amounted to US\$31.4 billion and US\$30.6 billion, respectively (including re-exports through Hong Kong). Mainland China/Hong Kong has already become Taiwan's second-largest export market, accounting for 22.4% of the island's total exports in 1998 (see Table 6). Taiwan's total foreign direct investment in Mainland China amounts to US\$16.2 billion since 1994. Taiwan's technology, capital, and management, combined with mainland land, labor, and markets, offer substantial opportunities for enhanced returns for both sides. The establishment of direct trade would provide a significant boost to the already robust cross-Strait investment flows and the volume of merchandise trade.

What will be the downside risks to Taiwan? We believe the adjustment costs to the post-WTO environment are rather small. Taiwanese industries, dominated by small- and medium-sized enterprises, are well positioned to withstand the shock. As successful niche players, most Taiwanese firms are already part of the complex web of cooperation and division of labor with firms around the world. They are actively participating in the global value-added

Table 6: Taiwan's Top Five Trading Partners (1998)

	Exports	
	US\$ billion	% share
USA	29.38	26.57
China/Hong Kong	24.82	22.44
Japan	9.32	8.43
Germany	4.08	3.69
Singapore	3.26	2.94
	Imports	
	US\$ billion	% share
Japan	27.00	25.80
USA	19.68	18.80
South Korea	5.67	5.42
France	5.33	5.09
Germany	5.15	4.92

Source: CEIC, GS estimates.

Table 7: Hong Kong's Top Five Trading Partners (1998)

	Exports	
	US\$ billion	% share
China	59.85	34.39
USA	40.65	23.36
Japan	9.12	5.24
UK	6.76	3.88
Germany	6.71	3.86
	Imports	
	US\$ billion	% share
China	74.99	40.63
Japan	23.26	12.60
USA	13.77	7.46
Taiwan	13.45	7.29
South Korea	8.91	4.83

Source: CEIC, GS estimates.

chain, and well integrated with the production process of the world's leading MNCs. This is particularly true in the electronics industry, but also for a range of traditional manufacturing sectors. Low-tech and labor-intensive operations have been largely relocated to Mainland China and Southeast Asia, providing a competitive cost advantage for Taiwanese firms to withstand the MNC's assault in their home market, as well as overseas markets. WTO membership is expected to benefit large Taiwanese firms such as President Enterprises, the Far Eastern Group, Acer, and Evergreen, as well as many smaller firms with strong ties to the mainland.

Hong Kong poised to gain from China's WTO entry. Hong Kong is the eighth-largest trading economy in the world, thanks to its role as an entrepot. While the increasing likelihood of direct trade between Taiwan and the mainland could erode Hong Kong's traditional role as the middleman, reduced re-exports (originated from Taiwan and destined for the mainland, and vice versa) may be more than compensated for by the expansion of the mainland's overall external trade. Suppose that Hong Kong loses the entire re-export business originating from Taiwan, which amounts to US\$10 billion annually, the loss can be recovered fairly easily by the increase in re-exports from Mainland China, which amounts to US\$90 billion annually. The trade diversion resulting from China's entry to the WTO is likely to be outweighed by the trade creation that will be generated by China's trade liberalization. Hong Kong is well positioned to benefit from increasing opportunities to provide high-value-added services, including marketing, accounting, law, shipping and freight, insurance, trade financing, foreign exchange transactions (see Tables 7, 8, and 9).

With the expected entry into the WTO, MNCs would likely directly set up shop in the mainland, bypassing Hong Kong. However, while the mainland is an attractive location for manufacturing, economic expansion there will translate into greater demand for sophisticated financial and commercial services, which Hong Kong is uniquely positioned to provide. Shanghai may eventually emerge as an important financial center, but Hong Kong's competitive advantage as the preeminent service center is unlikely to be eroded in the medium term.

Table 8: Hong Kong's Total Trade and Re-Exports From China and Taiwan

	Total Trade	China		Taiwan	
	US\$ billion	US\$ billion	% share ¹	US\$ billion	% share ¹
1980	42.18	1.69	4.00	0.43	1.02
1981	46.61	2.30	4.93	0.61	1.30
1982	44.53	2.42	5.44	0.41	0.93
1983	46.27	2.71	5.86	0.35	0.77
1984	56.90	3.60	6.32	0.65	1.15
1985	59.89	4.44	7.42	1.23	2.05
1986	70.80	6.61	9.34	1.11	1.57
1987	96.94	10.81	11.15	1.63	1.68
1988	127.06	16.85	13.26	2.72	2.14
1989	145.32	24.14	16.61	3.46	2.38
1990	164.65	30.87	18.75	3.89	2.36
1991	198.81	40.63	20.43	5.37	2.70
1992	242.90	52.16	21.47	7.03	2.90
1993	273.92	61.28	22.37	8.36	3.05
1994	313.23	70.63	22.55	9.32	2.98
1995	366.51	82.27	22.45	10.77	2.94
1996	379.30	88.38	23.30	10.62	2.80
1997	396.63	93.43	23.56	10.76	2.71
1998	358.58	89.27	24.90	9.27	2.59

Note: (1) Percentage share of total trade.

Source: CEIC, GS estimates.

External trade, hotel, and financial services industries currently account for 34.4% of Hong Kong's economy. If expanded trade and service flows associated with China's entry to the WTO generate a 1% additional increase in value-added services in these sectors by 2005, this would translate roughly into a 0.2-0.3-percentage-point increase in new growth for Hong Kong's GDP. Companies likely to gain from China's WTO entry include Li & Fung, Hutchison Whampoa, Citic Pacific, HSBC Holdings, Bank of East Asia, and to a lesser degree, infrastructure-related developers.

Table 9: Composition of Hong Kong GDP by Sector

(% of GDP)	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
Agriculture and fishing	0.34	0.31	0.26	0.24	0.22	0.19	0.18	0.16	0.14	0.12	0.11
Mining and quarrying	0.07	0.05	0.04	0.04	0.03	0.03	0.02	0.02	0.03	0.03	0.02
Manufacturing	20.84	19.59	18.34	16.70	14.56	12.78	10.48	8.68	7.93	6.94	6.13
Electricity, gas and water	2.50	2.22	2.07	2.14	2.02	2.00	1.99	2.20	2.21	2.26	2.18
Construction	4.40	4.49	4.91	5.13	5.19	4.78	4.88	4.60	5.12	5.45	5.45
Transport, storage, communications	8.18	8.70	8.52	8.98	9.07	9.12	8.94	9.15	9.56	9.31	8.69
Community, social, pers. services	13.69	13.27	13.37	13.81	14.12	14.18	14.76	15.03	16.46	16.68	16.29
Ownership of premises	9.26	9.44	9.83	10.06	10.31	10.37	10.17	11.49	12.62	12.37	12.19
Wh. sale, retail, imp., exp., restaurants, hotels (WR)	23.05	23.88	23.79	23.89	24.45	24.43	25.41	24.76	25.30	25.26	24.48
Financing, insurance, real est., business serv. (FI)	16.97	18.01	18.56	19.20	21.46	22.91	24.29	25.27	23.20	23.82	24.85

Source: CEIC.

Appendix 1: China Capital Inflows

Foreign direct investment, net inflows (US\$bn)

	China	Argentina	Brazil	Chile	Indonesia	Malaysia	Mexico	Philippines	Thailand
1990	3.49	1.84	0.99	0.59	1.09	2.33	2.63	0.53	2.44
1991	4.37	2.44	1.10	0.52	1.48	4.00	4.76	0.54	2.01
1992	11.16	4.05	2.06	0.70	1.78	5.18	4.39	0.23	2.11
1993	27.52	2.56	1.29	0.81	2.00	5.01	4.39	1.24	1.80
1994	33.79	3.07	3.07	1.77	2.11	4.34	10.97	1.59	1.37
1995	35.85	4.18	4.86	1.67	4.35	4.13	9.53	1.48	2.07
1996	40.18	4.29	9.89	4.09	7.96	4.50	7.62	1.41	2.34

Foreign direct investment, net inflows (% of GDP)

	China	Argentina	Brazil	Chile	Indonesia	Malaysia	Mexico	Philippines	Thailand
1990	0.98	1.30	0.21	1.94	0.96	5.45	1.00	1.20	2.85
1991	1.16	1.29	0.29	1.52	1.16	8.50	1.51	1.20	2.05
1992	2.67	1.77	0.55	1.64	1.28	9.00	1.21	0.43	1.90
1993	6.37	0.99	0.30	1.77	1.27	7.97	1.09	2.28	1.44
1994	6.25	1.09	0.55	3.40	1.19	6.14	2.61	2.48	0.96
1995	5.14	1.49	0.71	2.48	2.16	4.84	3.33	1.99	1.23
1996	4.93	1.45	1.32	5.51	3.53	4.54	2.28	1.68	1.26

Portfolio investment (US\$ bn)

	China	Argentina	Brazil	Chile	Indonesia	Malaysia	Mexico	Philippines	Thailand
1990	(0.05)	(0.84)	0.13	0.31	0.34	(0.95)	1.22	0.40	0.36
1991	0.68	0.84	1.99	0.16	0.38	0.15	6.20	0.12	(0.04)
1992	1.19	1.81	4.68	0.44	0.27	0.02	4.55	0.28	0.55
1993	6.06	10.30	10.88	0.37	2.46	3.74	23.23	2.18	4.95
1994	6.79	5.26	6.89	0.96	4.17	2.57	11.40	2.38	3.27
1995	3.12	4.12	7.05	0.76	7.12	4.74	4.37	3.02	4.28
1996	4.66	9.81	8.62	1.96	6.84	6.42	15.27	3.65	5.33

Portfolio investment (% of GDP)

	China	Argentina	Brazil	Chile	Indonesia	Malaysia	Mexico	Philippines	Thailand
1990	(0.01)	(0.60)	0.03	1.03	0.30	(2.21)	0.47	0.89	0.42
1991	0.18	0.44	0.52	0.47	0.30	0.31	1.97	0.27	(0.04)
1992	0.28	0.79	1.24	1.04	0.20	0.03	1.25	0.53	0.50
1993	1.40	3.99	2.49	0.81	1.56	5.96	5.76	4.00	3.96
1994	1.26	1.87	1.24	1.84	2.36	3.63	2.71	3.71	2.28
1995	0.45	1.47	1.02	1.13	3.54	5.56	1.53	4.07	2.54
1996	0.57	3.33	1.15	2.64	3.03	6.47	4.56	4.36	2.88

Bank and trade-related lending (US\$bn)

	China	Argentina	Brazil	Chile	Indonesia	Malaysia	Mexico	Philippines	Thailand
1990	4.67	(1.20)	(0.56)	1.19	1.79	(0.62)	4.38	(0.29)	1.69
1991	2.47	(0.38)	0.51	0.49	1.50	0.01	1.04	(0.27)	3.06
1992	8.95	(0.20)	2.96	0.41	2.51	0.87	0.25	(1.29)	1.64
1993	5.98	0.04	4.04	0.95	(3.39)	2.51	(6.46)	(0.15)	0.77
1994	3.81	1.77	2.37	1.54	1.48	1.45	(1.66)	0.77	(0.21)
1995	4.70	0.77	8.11	1.77	0.07	1.22	2.15	0.08	3.67
1996	5.26	0.32	9.88	0.75	3.23	1.18	0.76	(0.46)	5.86

Source: World Bank.

EXECUTIVE SUMMARY

Assessment of the Economic Effects on the United States of China's Accession to the WTO

On December 18, 1998, the U.S. Trade Representative (USTR) asked the U.S. International Trade Commission (USITC) to prepare a report assessing the probable economic effect on the United States of China's accession to the World Trade Organization (WTO). The USTR requested that the USITC use formal economic analysis to provide, to the extent possible, a quantitative assessment of the effects on the U.S. economy of China's WTO membership, specifically in reference to possible reductions in China's tariff and non-tariff measures and to China's participation in the WTO Agreement on Textiles and Clothing. In supplemental requests from the USTR on May 5, 1999 and June 16, 1999, the Commission was also asked to analyze the specific tariff and market access offers respectively, made by China in April 1999 in the context of its WTO accession negotiations.

In responding to this request, the USITC has used a combination of analytical techniques. Because the necessary data were available, the USITC was able to conduct a quantitative analysis of the effect of various tariff reductions, including China's April 1999 tariff offer, on both the U.S. and Chinese economies. This analysis was developed using a multi-country economic model with economy-wide coverage of merchandise and service sectors, *i.e.*, a global computable general equilibrium model, described in this study as the China-WTO model. The model attempts to isolate and measure the effects of the tariff reductions on the U.S. and Chinese economies by comparing the actual state of the economy with what it would have looked like if the tariff reductions had been in place. The China-WTO model was also used to estimate the impact of removing import quotas on textiles and apparel from China in the context of the WTO Agreement on Textiles and Clothing.

Because the data were not available in the time provided for this study, the USITC was, for the most

part, unable to quantify through formal economic analysis the effect of reductions in China's non-tariff barriers (NTBs). Instead, a qualitative analysis of such reductions is provided. In these cases, input from other sources is used to assess the likely economic impact.

Through this combination of analytical techniques, the report attempts to provide a more complete and balanced picture of the effect of China's WTO accession than would be offered by either approach in isolation. A global CGE model, such as the China-WTO model, which estimates not only the static effects of the proposed tariff cuts but also accounts for the growth effects of such trade reductions is the best economic tool available for estimating the impact of the tariff aspects of China's WTO accession. However, given the significance of NTBs in China's trade policy regime, the inability to fully quantify the impact of their removal imposed limitations on the quantitative results offered by this study. The effects resulting from NTB changes are found primarily through the qualitative approach.

Many sources of information were consulted for this analysis. Data were obtained from an economic literature review, from USITC contacts with the U.S. private sector, the U.S. Department of Commerce, the United Nations, the International Monetary Fund, the Institute for International Economics in Washington D.C., the International Textiles and Clothing Bureau in Geneva, Switzerland, the World Trade Analyzer database of Statistics Canada, the Global Trade Analysis Project database, the U.S.-China Business Council, and the China Statistical Yearbook produced by China's State Statistical Bureau. A public hearing for this investigation was held on February 23, 1999. Testimony from the hearing, pre- and post-hearing statements, and written submissions also provided useful information on Chinese non-tariff barriers,

trade-related investment measures, and service sectors, and was integrated into this report.

Overview of China's Trade and Investment

To examine the overall impact on the U.S. economy of China's accession to the WTO, this study begins by examining the current relationship between the economy of the United States and that of China; the nature of the trade patterns between the United States, China, and the rest of the world; and the nature of the changes that would be made in China if China makes all of the commitments necessary to accede to membership of the WTO.

China's economy has been growing rapidly in recent years. According to Chinese data, the compounded annual growth rate of real GDP in China exceeded 11 percent per annum over the period 1990-97. This growth has produced a very large Chinese economy with a Gross Domestic Product (GDP) of \$1 trillion or more. The World Bank reports China's 1997 per capita income on an exchange rate basis to be \$860 a year. This gives a total GDP of \$1.1 trillion, the world's seventh largest and about 14 percent the size of the U.S. GDP. Because the cost-of-living in China is so low, the size of China's economy as measured on a purchasing-power-parity (PPP) basis is much larger than when measured on an exchange rate basis. On a purchasing-power-parity basis, China's per capita income is reported at \$3,570 and its total GDP at \$4.4 trillion. On this basis, China is the world's second largest economy, about 57 percent the size of the U.S. economy.

Despite the large size of China's economy and the significant amount of trade occurring between the United States and China, U.S. merchandise trade with China remains small relative to the overall size of the U.S. economy. Total U.S.-China trade in 1998 was estimated at \$84.7 billion using U.S. trade data, which is less than 1 percent of the U.S. GDP. Chinese data would indicate a smaller figure, due largely to the fact that China excludes goods passing from China through Hong Kong and then to the United States from its total figures on exports to the United States. Either figure, however, would leave our total trade with China as accounting for a small percentage of our overall GDP.

China's trade, both with the United States and with the rest of world, has grown rapidly in recent years. Overall, the gross volume of China's merchandise trade grew from \$21 billion in 1978 to \$324 billion in 1998. After running trade deficits for most of the

1980s, China's merchandise trade balance with the world moved toward surplus in 1990, and has grown to over \$43 billion in 1998. Moreover, the composition of China's trade has also shifted sharply from primary products to manufactures over the last 20 years. By 1997, approximately 87 percent of Chinese exports and 80 percent of Chinese imports consisted of manufactured goods. China's key exports include apparel, footwear, toys, games, sports equipment, and leather products. Key imports into China include aircraft, spacecraft, electrical machinery, fertilizer, and non-electrical machinery.

This study starts with these and other key factors about the U.S. and the Chinese economies and world trade patterns and then examines what changes would occur should China join the WTO. Accession to the WTO will require numerous policy changes in China, including significant reductions in China's tariffs, the removal of non-tariff barriers that currently impede U.S. exports to China, the opening up of China's service sector, the further protection of intellectual property rights, and the elimination of many barriers to trade in agricultural products. Because the United States is already a member of the WTO, the United States will not have to make any changes to its tariffs or other trade policies as a result of China's accession to the WTO, except for the application of the WTO's Agreement on Textiles and Clothing's phase out of quotas on textile and apparel imports. As such, the vast majority of the results presented reflect changes that must occur in China's economy and trade patterns, since it is China, and not the United States or the rest of world, that will be required to make significant changes as part of the process of acceding to the WTO.

Summary and Findings Regarding China's WTO Accession

Effects on the U.S. Economy of the Removal of China's Non-Tariff Barriers

The results of the qualitative analysis of the removal of China's non-tariff barriers (NTBs) show that U.S. exports to China and U.S. foreign investment in China are likely to increase as a result of the removal of NTBs in the context of China's accession to the WTO. Chinese NTBs operate as part of an industrial policy aimed at achieving economic development of specific industry sectors. Combined

with high tariffs, they overlap and serve as a web of protection for those industries that China desires to develop to maintain self-sufficiency in the Chinese economy. Given this policy approach, it is difficult to isolate the effect of an individual barrier or the impact of removing one relative to another.

Taking into account China's April 1999 offer, the study examined a broad array of NTBs, including licensing, quotas, tendering, transparency, national treatment, judicial review, state trading, offsets, and transfer and protection of technology and restrictions on many individual industries' operations. Further, this analysis assesses the effects of several trade-related investment measures, including export performance requirements, local content requirements, and trade and foreign exchange balancing. The

assessment is based on input received from industry and a review of the relevant literature.

As noted earlier, the study's analysis of the impact of NTB removal is primarily qualitative because of data limitations. However, in conjunction with an analysis of a hypothetical 50 percent cut in China's tariffs, the study found that the elimination of NTBs in 25 products, covering only 30 percent of China's imports, had a significant impact, effectively doubling the impact of the tariff reductions on such variables as growth in U.S. GDP and improvement in U.S. terms of trade. While these results cannot be generalized, they do give some measure of the restrictive effect of these non-tariff barriers.

A summary of the effects on U.S. trade and investment is presented in table ES-1 below.

Table ES-1
Summary of the effects on U.S. trade and U.S. foreign investment of removing certain Chinese non-tariff barriers as a result of China's accession to the WTO, including China's April 1999 offer

Chinese non-tariff barrier	Sectors affected	Effects
Licensing and quotas License—permission to import a particular product given by the government to importers and issued in the form of a license. Quotas—quantity limits on imports set by the government.	Pillar industries, such as grains, cotton, chemicals, motor vehicles, consumer electronics, cameras, and certain other products.	Trade: Increased U.S. export opportunities and reduced trade costs in fees and time. For some sectors, potential benefits may depend on Chinese Government industrial and agricultural policies, as well as the role of state trading enterprises. Investment: Little or no increase in U.S. investment opportunities. Licensing and quotas were used to protect Chinese industry from imports and in order to access the Chinese market, foreign companies would invest in manufacturing in China. With these barriers removed, the incentive to invest in China because of these barriers is significantly reduced.
Tendering A centrally administered procurement process that lacks transparency, is non-competitive, and may be used to limit imports.	Selected machinery and electronics.	Trade: Increased U.S. export opportunities due to the competition process becoming more transparent and less controlled. Potential benefits may, in part, depend upon the extent to which Chinese state-owned and state-invested enterprises operate in a commercial manner, as China has committed to in its April 1999 offer. Investment: Little or no increase in U.S. investment as U.S. exporters realize that they are not constrained to produce in China in order to gain an advantage in the tendering process.

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Table ES-1—Continued

Summary of the effects on U.S. trade and U.S. foreign investment of removing certain Chinese non-tariff barriers as a result of China's accession to the WTO, including China's April 1999 offer

Chinese non-tariff barrier	Sectors affected	Effects
National Treatment Treating imports on the same basis as domestic products and services.	All sectors.	Trade: Increased U.S. export opportunities as mandates for local products are eliminated. Potential benefits may, in part, depend upon the extent to which Chinese state-owned and state-invested enterprises operate in a commercial manner, as China has committed to in its April 1999 offer. In addition, benefits would also depend upon how China implements its industrial policies. Investment: Increased U.S. foreign investment opportunities in China as foreign investors would be allowed to invest in more sectors of the economy.
Transparency Laws, rules, regulations, procedures, and the like readily available to interested parties.	All sectors.	Trade: Increased U.S. export opportunities as transparency in the government decision-making process improves—that is, as access to the applicable rules and regulations that govern the process improves and as the ability to observe whether the decision was made in accordance with those rules and regulations improves. This outcome assumes most decisions will be made in accordance with published rules and regulations. Investment: Increased U.S. foreign investment opportunities due to the aforementioned reasons and assumptions with regard to trade.
Judicial review Impartial, independent, and accessible review and settlement of disputes.	All sectors.	Trade: Increased U.S. export opportunities due to bias removed from the system and improved transparency. Investment: Increased U.S. foreign investment opportunities in China as investors gain confidence about operation of China's trade and investment regime.
State trading Import and export activities limited to either state enterprises or entities designated by the government.	Grains, tobacco, cotton, vegetable oils, sugar, alcoholic beverages, and petrochemicals, as well as rubber, timber, wool, acrylic, and steel.	Trade: Increased U.S. export opportunities likely as a result of state trading being liberalized in certain sectors and trading rights for distribution forthcoming. However, WTO enforcement of rules on state-trading enterprises has been low. Investment: Negligible, since foreign investment is generally prohibited or limited.

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Table ES-1—*Continued*

Summary of the effects on U.S. trade and U.S. foreign investment of removing certain Chinese non-tariff barriers as a result of China's accession to the WTO, including China's April 1999 offer

Chinese non-tariff barrier	Sectors affected	Effects
Offsets Incentive payments used by the seller in order to secure procurement by the buyer. May take many forms, such as investment, technology transfer, co-production, barter, and countertrade.	Aerospace, automobiles, electronics, telecommunications equipment.	Trade: Increased U.S. export opportunities, depending upon the degree to which voluntary collaboration replaces government-mandated offsets in sales. Investment: Uncertain, since data are not available as to the current degree of investment due to government mandates or U.S. companies' desire to improve customer service or establish a presence in the Chinese market.
Transfer and protection of technology Official or unofficial rules and procedures to coerce transfer of technology. Official rules and mechanisms for the protection of intellectual property rights.	Manufacturing and processing industries.	Trade: Increased U.S. export opportunities because the transfer of technology will be increasingly protected in accordance with international norms. This outcome assumes most decisions will be made in accordance with published rules and regulations. Investment: Increased U.S. foreign investment opportunities in China as investors are not forced to transfer technology and China increases efforts to protect technology. This outcome assumes most decisions will be made in accordance with published rules and regulations.
Export performance requirements Government requirements stipulating minimum amounts of production that must be exported. Under China's April 1999 offer, China has agreed to go beyond the WTO Agreement on Trade-Related Investment Measures (TRIMS), which does not include export performance requirements.	Manufacturing, including aerospace, automobile, electronics, packaged foods, machinery, semiconductor, telecommunications equipment, and textile and apparel industries.	Trade: Possible decrease in U.S. imports from China. However, U.S. companies may incur costs in reorienting their operations toward the Chinese market. Investment: Increased U.S. foreign investment opportunities in China as export performance requirements may no longer influence the type of investment to be made in China.

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Table ES-1—Continued

Summary of the effects on U.S. trade and U.S. foreign investment of removing certain Chinese non-tariff barriers as a result of China's accession to the WTO, including China's April 1999 offer.

Chinese non-tariff barrier	Sectors affected	Effects
Local content requirements Government mandates requiring that production incorporate certain amounts of domestic rather than foreign inputs.	Manufacturing, including aerospace, automobile, electronics, packaged foods, machinery, semiconductor, telecommunications equipment, and textile and apparel industries.	Trade: Increased U.S. export opportunities as foreign or domestic manufacturers in China may then purchase foreign inputs rather than domestic inputs. Potential benefits, however, will depend in part how China implements its industrial policies. Investment: Fewer U.S. foreign investment opportunities as U.S. companies realize that there will be no official laws and regulations that require the use of local content, and therefore they will have the flexibility to import foreign inputs. However, pressures to use local content are likely to continue to impose operational constraints on U.S. firms.
Trade and foreign-exchange balancing requirements Production ventures are required to balance their foreign trade and foreign exchange so as to limit imports.	Virtually all foreign-invested enterprises in China.	Trade: Increased U.S. export opportunities as U.S. firms would be less likely to minimize imports and increase exports from China. Investment: Increased U.S. foreign investment opportunities in China, but tempered by Chinese informal pressure to control trade and foreign exchange flows.

Source: Compiled by USITC staff.

Effects on U.S. Trade and Investment in Services

Based on China's April 1999 offer, accession to the WTO would likely have a significant positive effect on U.S. trade and investment in services. China's offer proposes to liberalize a number of barriers faced by U.S. service providers. With respect to the services examined in this report, China offered 60 rollback commitments and 5 standstill commitments. The rollback commitments would liberalize or terminate a number of market access barriers faced by U.S. service providers, while the standstill commitments would identify trade impediments and deter the implementation of more restrictive measures. In addition, the Commission identified 11 barriers of uncertain status in the banking, securities, and insurance industries. The effect of implementing the April 1999 offer would be unclear with respect to these instances.

China currently maintains broad restrictions on forms of establishment and land ownership that pertain to all services (table ES-2). In addition, China maintains many industry specific restrictions, including

limitations on permissible services, geographic and quantitative restrictions, and limits on broadcasting and distribution. The confluence of these restrictions has limited the ability of U.S. firms to provide services to Chinese consumers. The U.S. embassy in Beijing estimated that China's current barriers to U.S. service suppliers result in \$3 to \$5 billion in lost sales each year (see chapter 5). If China's April 1999 offer becomes operative, U.S. service providers could expect to increase sales through affiliates in China.

Chinese restrictions on distribution service providers have been particularly onerous. China's current restrictions on wholesaling and retailing restrict the ability of foreign firms to establish a commercial presence in China. Similar restrictions prevent foreign firms from providing auxiliary distribution services such as maintenance and repair services; rental and leasing services; technical testing, analysis, and freight inspection services; and storage and warehousing services. China's April 1999 commitments would gradually liberalize restrictions in these areas, likely enabling U.S. firms to increase sales and direct investment in China, while enhancing control of the quality of services provided.

Table ES-2
Summary of Non-tariff barriers affecting services

Service sector	Non-tariff barriers	Effects of April 1999 offer
<i>Distribution services</i>		
Wholesaling and retailing services	• Restrictions on establishment. • Foreign equity restrictions. • Limitations on permissible services.	• Increases in sales and direct investment.
Auxiliary distribution services	• Restrictions on establishment. • Limitations on permissible services. • Foreign equity restrictions.	• Increases in sales and direct investment.
Accounting and management consulting services	• Restrictions on establishment. • Foreign equity restrictions. • Restrictions on employment. • Limitations on permissible services.	• Increases in sales and direct investment.
Audiovisual services	• Restrictions on importation and distribution. • Restrictions on establishment. • Quotas • Limits on broadcasting. • Censorship • IPR violations. • Local production requirements. • Foreign investment restrictions.	• Increases in sales and investment. However, a restriction maintaining the Chinese Government's right to examine the content of audiovisual products would likely delay the release of foreign products. • The Motion Picture Association estimates increased revenues of \$80 million for the motion picture industry.
Courier services	• Restrictions on establishment. • Restrictions on joint venture expansion. • Limitations on permissible services. • Restrictions on employment.	• Increases in sales and direct investment.
<i>Financial services</i>		
Banking and securities services	• Restrictions on establishment. • Minimum asset requirements. • Limitations on permissible services.	• Increases in sales and direct investment. • Broader scope of services. • Some restrictions were not addressed by the April 1999 offer, rendering the effects of operative offer uncertain. • One U.S. banking firm indicated revenues from China-based operations would increase by \$5.2 million.
Insurance services	• Limitations on operation. • Restrictions on establishment. • Limitations on permissible services. • Investment restrictions. • Foreign equity limitations. • Employment restrictions.	• Increases in sales and direct investment. • Broader scope of services. • Some restrictions were not addressed by the April 1999 offer, rendering the effects of operative offer uncertain.

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Table ES-2—Continued
Summary of Non-tariff barriers affecting services

Service sector	Non-tariff barriers	Effects of April 1999 offer
Financial services—Continued		
Telecommunication services	• Restrictions on establishment. • Restrictions on foreign investment. • Limitations on permissible services. • Foreign equity limitations.	• Increases in sales and direct investment.
Entire service sector ¹	• Restrictions on establishment. • Limitations on permissible services. • Foreign equity restrictions. • Restrictions on joint venture expansion. • Restrictions on employment. • Investment restrictions.	• U.S. Embassy, Beijing estimates increased revenues of \$3 to \$5 billion.²

¹ This includes all service sectors, both those treated above as well as those not treated in this study.

² U.S. Department of State telegram, "China: Draft 1999 National Trade Estimate," message reference No. 000721, prepared by U.S. Embassy, Beijing, Jan. 22, 1999.

Source: Compiled by USITC staff.

Effects on U.S. Trade in Selected Agricultural Products

China's April 1999 offer on agricultural products included several sectors identified by the United States as priorities: wheat, corn, rice, soybean oil, and cotton. In its offer, China made specific commitments to replace existing barriers with TRQs,¹ which if

¹ The WTO Agreement on Agriculture commits WTO members to tariffication, whereby quantitative restrictions on agricultural imports would be converted into tariffs. WTO members are allowed to replace non-tariff barriers with tariff-rate quotas, in which a low tariff rate is applied to imports of a product up to a particular amount, and a higher tariff is applied to imports in excess of that amount.

implemented, should increase U.S. market access opportunities. These proposed TRQs are at levels substantially above current import volumes. These products have been subject to a number of barriers, including tariffs, quotas, licensing requirements, and state trading. While export potential exists for U.S. industry, the extent of opportunity may be limited by the reserving of a share of imports and exports for state trading enterprises, as well as China's actions on its domestic support policies and third country exports. Foreign investment restrictions are unlikely to change (table ES-3).

Table ES-3
Summary of effects of Chinese institution of tariff-rate quotas on U.S. trade and U.S. foreign investment under WTO accession, including China's April 1999 offer

Product	Effects
Grains:	
Wheat	Trade: Market access opportunities would likely be created by a TRQ. However, the extent of any increase in U.S. exports would depend ultimately upon the role of state trading enterprises, China's production policies, and the competitiveness of U.S. wheat exports relative to Australian and Canadian wheat. Investment: There would be little or no effect on U.S. foreign investment in China resulting from a Chinese TRQ.

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Table ES-3—Continued

Summary of effects of Chinese institution of tariff-rate quotas on U.S. trade and U.S. foreign investment under WTO accession, including China's April 1999 offer

Product	Effects
Corn	Trade: Market access opportunities would likely be created by a TRQ. However, the extent of any increase in U.S. exports would depend upon the role of state trading enterprises, China's production policies, and the competitiveness of U.S. corn exports, relative to Argentine or third-country feedgrains. Investment: There would be little or no effect on U.S. foreign investment in China resulting from a Chinese TRQ.
Rice	Trade: Market access opportunities for U.S. rice would likely be created by a TRQ. However, the extent of any increases in U.S. exports would depend upon the role of state trading enterprises, China's production policies, and the competitiveness of U.S. rice exports. Investment: There would be little or no effect on U.S. foreign investment in China resulting from a Chinese TRQ.
Oilseeds:	
Soybeans	Trade: Current U.S. market access opportunities maintained. The nominal TRQ on soybeans (announced but never enforced) would be eliminated, and the current 3-percent duty continued. Investment: There would be little or no effect on U.S. foreign investment in China resulting from a Chinese TRQ.
Rapeseed	Trade: Uncertain. The United States is a net importer of rapeseed and is likely to remain so for the long-term. Investment: There would be little or no effect on U.S. foreign investment in China resulting from a Chinese TRQ.
Vegetable oils:	
Soybean oil	Trade: Market access opportunities would likely be created by a TRQ and by a lower in-quota tariff rate. However, the extent of any increase in U.S. exports would depend upon the role of state trading enterprises, China's production policies, and the competitiveness of U.S. soybean oil exports relative third-country palm oil, rapeseed oil, and soybean oil exporters, and the extent of the VAT. Investment: There would be little or no effect on U.S. foreign investment in China resulting from a Chinese TRQ.

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Table ES-3—*Continued*

Summary of effects of Chinese institution of tariff-rate quotas on U.S. trade and U.S. foreign investment under WTO accession, including China's April 1999 offer

Product	Effects
Vegetable oils—Continued	
Peanut oil	Trade: Uncertain. Total U.S. exports were valued at \$4.5 million in 1998, with no exports to China. Investment: There would be little or no effect on U.S. foreign investment in China resulting from a Chinese TRQ.
Palm oil	Trade: Uncertain. Since the United States does not produce palm oil, there would be a negligible effect on U.S. exports of palm oil to China. However, to the extent that a TRQ on palm oil is sufficiently open, U.S. exporters of some types of vegetable oils may face a decline in exports as Chinese consumers substitute palm oil for other oils. Investment: There would be little or no effect on U.S. foreign investment in China resulting from a Chinese TRQ.
Sunflower or safflower oil	Trade: Uncertain. China imports little sunflower or safflower seed oil. U.S. exports to China have been negligible, although U.S. exports to the world totaled \$265.5 million in 1998. Investment: There would be little or no effect on U.S. foreign investment in China resulting from a Chinese TRQ.
Rapeseed oil	Trade: Uncertain. U.S. exports to China have been negligible, although U.S. exports to the world totaled \$97.1 million in 1998. Investment: There would be little or no effect on U.S. foreign investment in China resulting from a Chinese TRQ.
Corn oil	Trade: Uncertain. China imports virtually no corn oil. U.S. exports to China have been negligible, although U.S. exports to the world totaled \$359.6 million. Investment: There would be little or no effect on U.S. foreign investment in China resulting from a Chinese TRQ.
Other:	
Cotton	Trade: Market access opportunities would likely be created by a TRQ. However, the extent of any increase in U.S. exports would depend upon the role of state trading enterprises, how the TRQ is implemented, China's production policies, and the competitiveness of U.S. cotton exports. China presently has a surplus of domestic cotton. China's policies regarding cotton from Xinjiang Province may limit cotton imports. Investment: There likely would be little or no effect on U.S. foreign investment in China resulting from a Chinese TRQ.
Sugar	Trade: Uncertain. The United States is a net importer of sugar. U.S. sugar producers would benefit from stability in world sugar trade that would result if China liberalized its sugar market and permitted the market to adjust production. Investment: A TRQ may possibly benefit foreign confectionary producers in China, as lower tariffs on their foreign inputs would prompt investment.

Table continues on next page.

Table ES-3—*Continued*

Summary of effects of Chinese institution of tariff-rate quotas on U.S. trade and U.S. foreign investment under WTO accession, including China's April 1999 offer

Product	Effects
Other—Continued	
Wool and wool tops	Trade: Uncertain. The United States is a net importer of wool. However, as U.S. consumption of wool drops due to a declining textile and apparel industry, U.S. wool producers expect to look toward export markets such as China and wool top producers desire to return to the Chinese market. Investment: There would be little or no effect on U.S. foreign investment in China resulting from a Chinese TRQ.

Source: Compiled by USITC staff.

Effects on the U.S. Economy of Reducing China's Tariffs

The USTR initially requested that the USITC assess the impact on the U.S. economy of a 25 percent and a 50 percent across-the-board cut in China's 1992 and 1997 tariff rates. Subsequently, the USTR requested an assessment of the specific tariff cuts offered by China in April 1999. Employing the China-WTO model, the study finds that the impact on the United States of the various tariff cuts considered is

positive, but minor, in terms of growth in U.S. gross domestic product, total exports and imports, consumption and wages (table ES-4). Accounting for growth effects leads to slightly larger changes in all of these economic variables, although they are still small. This result is consistent with the fact that U.S. trade with China accounts for less than 1 percent of U.S. GDP. Moreover, it is consistent with the fact that no changes in U.S. tariffs are required by China's accession to the WTO and thus only the indirect effects of China's changes would be noticeable in this analysis of the U.S. economy.

Table ES-4
Impact of April 1999 tariff offer on the U.S. economy

Item	Static effects		Static plus growth effects ¹	
	\$ Billions	Percent	\$ Billions	Percent
GDP ²	0.3	(³)	1.7	(³)
Household welfare gain ²	1.8	(⁴)	3.3	(⁴)
Total exports ⁵	1.5	0.2	1.9	0.2
Total imports ⁵	0.9	0.1	1.1	0.1
Exports to China ⁵	2.4	9.0	2.7	10.1
Imports from China ⁵	3.4	5.2	4.4	6.9
Terms of Trade	(⁴)	0.2	(⁴)	0.1
Skilled wages	(⁴)	(³)	(⁴)	(³)
Less skilled wages	(⁴)	(³)	(⁴)	(³)

¹ Growth effects include productivity growth and capital accumulation associated with China's trade liberalization.

² These estimates reflect flexible exchange rates.

³ Change less than 0.05 percent.

⁴ Not applicable.

⁵ Exports are valued at f.o.b prices. Imports are valued at c.i.f. prices. These estimates reflect fixed exchange rates.

Source: USITC staff estimates for base year 1998.

A more significant impact is found on U.S.-China trade flows. Imports into China would be stimulated by its tariff reductions; as a result, U.S. exports to China would likely be approximately 10 percent higher. U.S. imports from China are also estimated to be almost 7 percent higher as trade liberalization helps make China's export sectors more competitive. As a result of this increase, the model estimates an increase in the U.S. trade deficit with China. However, the U.S. trade balance with the world is estimated to remain unaffected as U.S. bilateral trade balances with other trading partners improve (table ES-5).

Economic impacts are more noticeable at the sectoral level, both in terms of overall sector and export growth (tables ES-6 and ES-7). The U.S. sectors most positively affected by China's trade

reforms would be agriculture, paper and pulp, chemicals, rubber, and plastics, other transport equipment (including aircraft) and machinery and equipment. Sectors that are expected to be negatively affected are footwear, wearing apparel, wood products, and other light manufactures.

Exports of cotton, beverages and tobacco, and vegetable oils to China are expected to increase significantly as a result of the tariff reductions proposed by China. Wheat and other grain (e.g., corn) exports, where tariff reductions are not as large, would also increase. In terms of value of sales to China, the largest increase is estimated to be in machinery and equipment, although competition from other countries would limit U.S. exports to China in most industrial goods.

Table ES-5
Impact of April 1999 tariff offer on the direction of change in U.S. bilateral trade balance

Partner	Static effects	Static plus growth effects ¹
	— \$U.S. millions —	
Canada	24	27
Mexico	89	83
EU	74	39
Japan	63	115
Other OECD	-21	-18
Korea	129	133
Tawan	300	329
Hong Kong	-172	477
China	-149	-586
ASEAN	126	47
South Asia	194	113
Rest of World	7	-83
World	664	674

¹ Growth effects include productivity growth and capital accumulation associated with China's trade liberalization.

Source: USITC staff estimates for base year 1998, reflecting fixed exchange rates.

Table ES-6
Impact of April 1999 tariff offer on U.S sector growth

Sector	Static effects % Change	Static plus growth effects ¹ % Change
Wheat	0.1	0.2
Rice	-0.1	-0.1
Other grain	0.1	0.1
Oilseeds	0.5	0.7
Sugar	-0.1	-0.1
Cotton	2.2	2.4
Vegetable oils	1.4	1.5
Wool	-0.1	0.2
Beverages and tobacco	0.2	0.2
Textiles	-0.5	-0.5
Wearing apparel	-1.1	-1.2
Footwear and leather	-1.7	-1.9
Wood products	-0.1	(²)
Paper and pulp	(²)	0.1
Petroleum products	(²)	0.1
Chemicals, rubber and plastics	(²)	(²)
Mineral products	(²)	(²)
Iron and steel	(²)	(²)
Other metals	(²)	(²)
Metal products	(²)	(²)
Motor vehicles and parts	-0.1	(²)
Other transport equipment	(²)	(²)
Electronic equipment	(²)	-0.1
Other machinery and	0.1	(²)
Other manufactures	-0.8	-1.0

¹ Growth effects include productivity growth and capital accumulation associated with China's trade liberalization.

² Change less than 0.05 percent.

Source: USITC staff estimates for base year 1998.

Table ES-7
Impact of April 1999 tariff offer on U.S. exports to China by sector

Sector	Static effects		Static plus growth effects ¹	
	\$ U.S. millions	% change	\$ U.S. millions	% change
Wheat	33.0	15.5	42.8	20.8
Rice	(²)	(³)	(²)	(³)
Other grain	56.6	27.6	66.4	33.6
Oilseeds	-5.6	-7.9	-1.9	-2.9
Sugar	(²)	3.4	(²)	11.
Cotton	230.1	59.2	252.3	67.7
Vegetable oils	288.5	145.8	294.4	154.1
Wool	(²)	3.4	(²)	7.8
Beverages and tobacco	222.9	124.5	217.7	127.3
Textiles	44.1	21.6	47.9	23.9
Wearing apparel	12.6	28.4	12.5	29.1
Footwear and leather	126.7	21.3	138.1	23.8
Wood products	4.3	1.7	10.1	4.2
Paper and pulp	84.5	11.6	102.3	14.5
Petroleum products	9.8	11.3	12.6	15.1
Chemicals, rubber and plastics	102.2	2.8	170.0	4.8
Mineral products	13.3	5.0	17.9	6.9
Iron and steel	10.0	3.0	16.4	5.1
Other metals	17.7	7.3	23.9	10.1
Metal products	62.5	12.3	70.9	14.3
Motor vehicles and parts	-592.8	-7.5	-329.2	-4.3
Other transport equipment	-107.6	-7.5	-75.2	-5.3
Electronic equipment	283.6	14.1	330.9	16.8
Other machinery and equipment	515.6	11.0	611.8	13.2
Other manufactures	205.6	114	208.4	119.1

¹ Growth effects include productivity growth and capital accumulation associated with China's trade liberalization.

² Change less than \$500,000.

³ Change less than 0.05 percent.

Source: USITC staff estimates for base year 1998.

Effects on the U.S. Economy of China's Participation in the WTO Agreement on Textiles and Clothing

China is the world's largest single country exporter of textiles and apparel products. Almost three-quarters of U.S. sector imports from China consist of apparel, virtually all of which are covered by some type of quota. Although the majority of apparel from China continues to be of low- to medium-quality, the Chinese apparel industry is becoming more quality oriented and is beginning to produce higher-valued goods, particularly in those operations being guided by producers in Hong Kong. The potential for growth is

greater in China's apparel industry because apparel production is highly labor-intensive and China has an abundance of skilled, low-cost labor. The production of textile products, such as fibers, yarns, and fabrics, is more capital intensive. China, however, is restructuring its textile industry, selling off excess and outdated capacity and modernizing production.

Under the Agreement on Textiles and Clothing (ATC), the textile and apparel quotas are being phased out over a 10-year period, with full elimination of quota restrictions on WTO members occurring on January 1, 2005. A multi-period version of the China-WTO model is employed to estimate the impact on the U.S. economy of China's inclusion in the ATC quota phase out. The model accounts for the

differences in country quota rates of growth² during the phase-out period. This assessment is done at the aggregate and not at the commodity level at which quotas are applied.

The model results suggest that the overall impact on the U.S. economy of China's participation in the ATC would be positive. The economy-wide welfare gains for the United States would amount to about \$2.4 billion in 2006, while GDP would increase by about \$1.9 billion from the elimination of quotas in the same year. This occurs as a result of efficiency gains from factor reallocation in the U.S. economy, as well as from lower-priced goods imported into the United States.

Certain data limitations prevented the Commission from providing estimates of changes in U.S. textile and apparel production, employment, imports, and exports. However, the simulation results suggest that inclusion of China in the ATC quota phase-out will likely have a small impact on U.S. imports of textiles and a larger effect on U.S. imports of apparel. Although much of this increase in China's exports of textiles and apparel comes at the expense of other suppliers to the U.S. market, the U.S. textile and apparel industries could also be affected, with U.S. apparel producers and workers experiencing the more adverse effects. Because the accelerated quota growth rates for China for many of the U.S. textile and apparel quota categories are low and the quotas are likely to constrain trade, the adverse effects are likely to be experienced after the end of the phase-out period (i.e., after December 31, 2004).

According to the model results, U.S. capital-intensive exports to China would increase by more than \$300 million a year after the elimination of textile and apparel quota restrictions in 2005. This is because the expansion of China's production and trade in labor-intensive manufactures would likely result in higher demand for capital- and skill-intensive manufactured goods in China.

The model also demonstrates the impact that China's inclusion in the ATC would have on U.S. import market shares. If China's textile products,

continue to face quota restrictions in the U.S. market China's U.S. market share would remain essentially unchanged (figure ES-1). The share of the U.S. textile import market captured by other restricted suppliers would expand somewhat during 1998-2004 because of the accelerated quota growth rate mechanism under the Agreement on Textiles and Clothing, and this group would continue to take a larger share of the U.S. market through 2010.

If quotas on China are eliminated, its share in the U.S. textile market would increase slightly, to about 11 percent by 2010. In the case of the U.S. apparel market, China's share would increase by about 18 percentage points if quotas are removed after December 31, 2004, resulting in China obtaining over 30 percent of the U.S. import market (figure ES-2). This increase in China's share in the U.S. import market would occur as Chinese products would displace exports from other suppliers, particularly suppliers whose exports currently are not restricted by quotas (i.e., the "rest of world" group).

Effects of WTO Accession on China

As in its analysis of the impact of WTO accession on the United States, the study assesses the effect of WTO accession on China using both quantitative and qualitative approaches. The China-WTO model was used to estimate the impact of China's tariff cuts; a qualitative discussion is provided to analyze the possible impact of WTO accession on the future course of China's economic reforms.

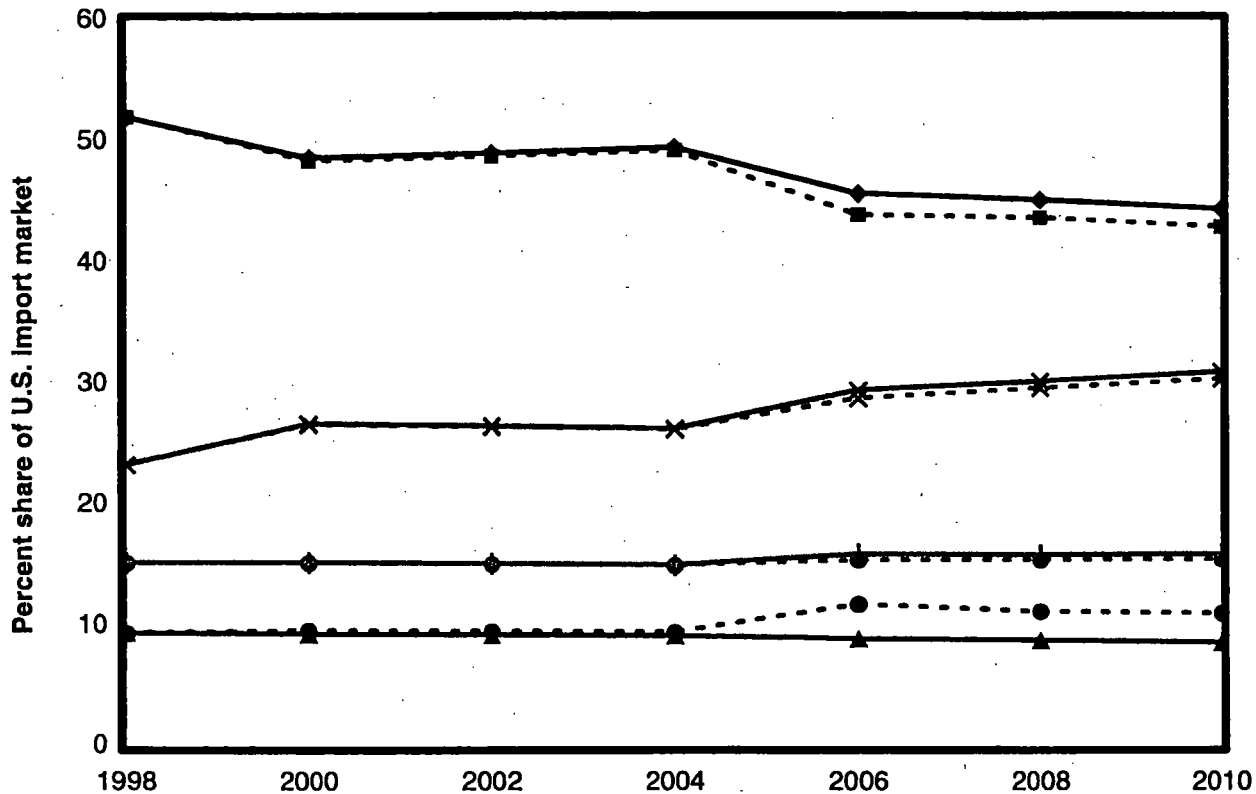
As noted earlier, China has undergone phenomenal change in recent years both in terms of GDP growth and changing trade patterns. Whether China joins the WTO or not, its growth and future trade patterns will continue to evolve due to broader economic forces. In particular, the ongoing relocation of industries among East Asian countries and China's participation in multi-country production arrangements with its East Asian neighbors are having a profound impact on China's trade patterns.

Employing the China WTO model, the study finds that China's economy would expand by 4 percent as a result of China's April tariff offer, taking into account the growth effects of such liberalization (table ES-8). This reflects the efficiency gains from liberalization that would induce further investment in China's economy, thereby expanding production. In addition,

² The Agreement on Textiles and Clothing requires importing countries to increase the base quota growth rates for major supplying countries by 16 percent for WTO members on January 1, 1995; by an additional 25 percent on January 1, 1998; and by yet another 27 percent in 2002. The modeling data in this exercise were obtained from the International Textiles and Clothing Bureau in Geneva.

Figure ES-1

Share of U.S. imports of textiles: 1998-2010



LEGEND

Base:

- China
- South Korea, Hong Kong, Taiwan
- Other restricted suppliers
- Rest of world

China WTO Accession:

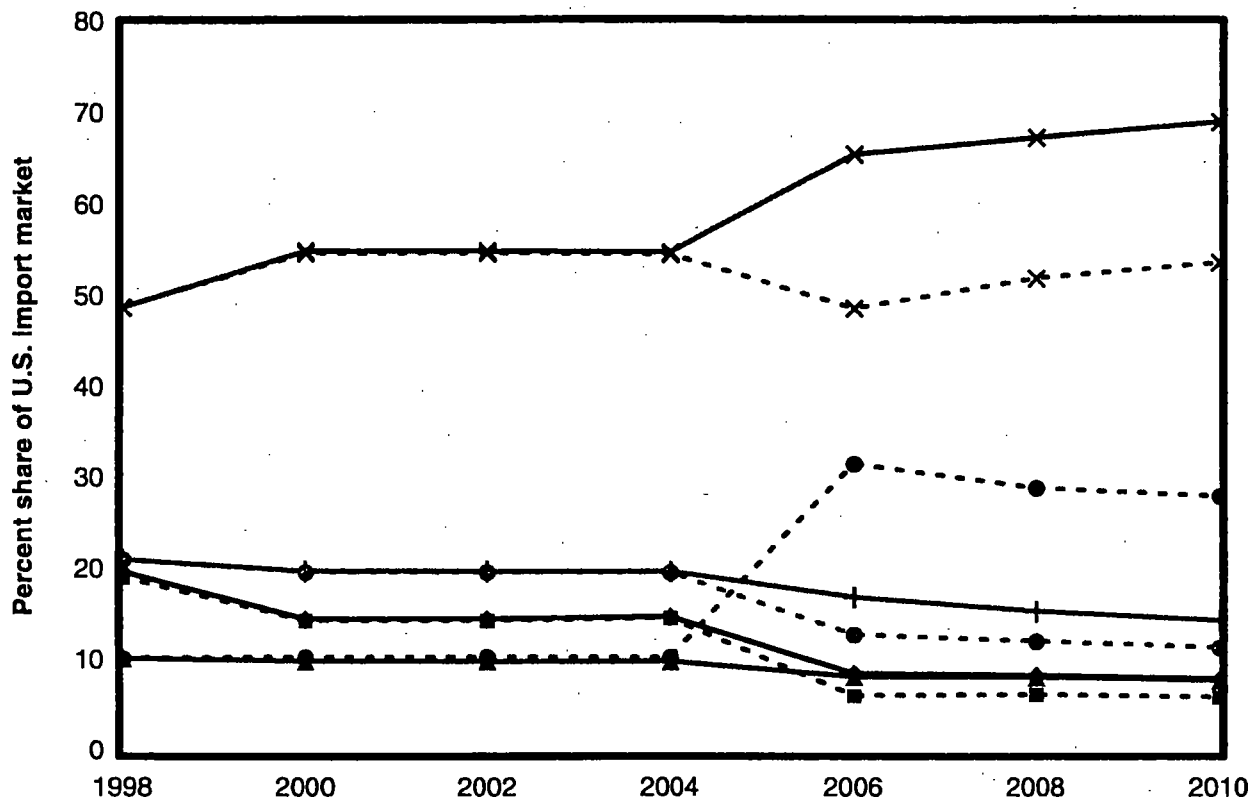
- - - - - China
- - - - - South Korea, Hong Kong, Taiwan
- - - - - Other restricted suppliers
- - - - - Rest of world

Note.—Other restricted suppliers includes three model regions: South Asia, ASEAN, and "other restricted suppliers." Rest of world includes six model regions: Canada, the EU, Mexico, Japan, other developed countries, and "all other countries."

Source: Based on USITC staff estimates.

Figure ES-2

Share of U.S. imports of apparel: 1998-2010



LEGEND

Base:

- China
- South Korea, Hong Kong, Taiwan
- Other restricted suppliers
- Rest of world

China WTO Accession:

- - - - - China
- - - - - South Korea, Hong Kong, Taiwan
- - - - - Other restricted suppliers
- - - - - Rest of world

Note.—Other restricted suppliers includes three model regions: South Asia, ASEAN, and “other restricted suppliers.” Rest of world includes six model regions: Canada, the EU, Mexico, Japan, other developed countries, and “all other countries.”

Source: Based on USITC staff estimates.

Table ES-8
Impact of April 1999 tariff offer on China's economy

	Static effects % change	Static plus growth effects ¹ % change
GDP	0.9	4.1
Welfare	-0.3	2.1
Terms of trade	-2.1	-1.8
Total Exports	10.1	12.2
Total Imports	11.9	14.3

¹ Growth effects include productivity growth and capital accumulation associated with China's trade liberalization.

Source: USITC staff estimates for base year 1998.

China would benefit from increased imports of capital goods, which are expected to improve its productivity. Overall, China's exports would increase by 12 percent, again taking into account growth effects, while its imports would increase by 14 percent.

The potential impact of WTO accession on the future course of China's economic reforms is complex. In general, countries that liberalize trade are likely to adopt more open economic policies in other areas as

well. WTO accession could lead to greater standardization of Chinese economic policies at the provincial and local level. Such standardization could be beneficial to U.S. firms in China, but could inhibit local-level experimentation with new reforms. China's state-owned enterprises, which enjoy substantial political influence and privilege, are currently weak financially, and would come under intensified pressure from international competition under WTO accession.

SHOULD CHINA DEVALUE? — DORN BUSELT (8/88)

CRANE
DILANEY
GIBSON
ATKINSON
GUTHRIE

A year ago, I published this essay "Is China Next?" in the *Financial Times* (August 4th). It is reproduced here, followed up with a more fundamental argument. What can be said a year later. The World Bank's chief economist is calling for devaluation and rumors abound. Is China about to throw the bomb? May be China is, but at least as interesting is the question: "should China devalue?" The answer given here is a clear no, the solution lies to its woes lies somewhere else.

Is China Next?

Pessimism has been a good rule of thumb of late in judging Asian financial prospects. Is it now time for China to join the Club, lose stability and become part of the ever-widening Asian problem? Chinese devaluation is on everybody's screen. China does not need a devaluation; its leaders would do well to reject it squarely rather than hold it out as a solution to the growth problem or a blackmail tool in high stake international poker.

The belief that China will devalue, sooner or later, rests on the fact that the country faces extraordinary restructuring challenges both in the banking system and the state enterprise sector. These problems are hard to solve at the best of times, but without high growth the prospect strains political and social stability. But unfortunately growth is down substantially, running somewhere between 5 and 7 percent according to most recent outside forecasts. That compares unfavorably with the 10 percent average of the past 15 years and lies below the official target of 8 percent. The growth problem is, of course, in large part a reflection of an export collapse: Asian markets are central for China and they are gone and so is export growth. In the past decade it amounted to 20 percent, in the first half of the year it was down to only 10 percent and by now it may well be running at zero. Since exports (in value added terms) account for 10 percent of GDP, going from 20 to zero growth costs directly 2 percent of GDP and including income effects perhaps as much as 4. The problem is real and not about to disappear. Hence the conclusion: devaluation to get back to export growth is inevitable. The problem is this conclusion is wrong.

China clearly has control of its exchange rate. True, all of Asia has undergone a competitive devaluation leaving China with an overvalued currency and poor export performance. Even so, the external front is not under siege. Capital controls are quite tight (and getting tighter as the Liberation Army is coming under scrutiny), there is a substantial current account surplus and there are sizable foreign exchange reserves. That picture differs sharply from all the economies that have gone under. Moreover, if an extra buffer is needed, capital inflows can be made substantial by allowing more flexibility on joint ventures. That appears to just have emerged in telecommunications and, with pressure, might come in further sectors. The point here is that China is not hanging on to the last penny in reserves, about to call in the IMF and the US Treasury for their emergency package. On the contrary, on the financial side they have the wherewithal to hang in and defend the present exchange rate if that is the policy choice.

Devaluation then is an option, a poor one, but not something inevitable. A small devaluation does little; a large devaluation will surely trigger a major round of financial instability and currency depreciation throughout the region, including Japan. A small devaluation does nothing because, in China's case, import content of exports is upward of 50 percent. A 10 percent devaluation thus gains barely 5 percent in competitiveness but of course highlights the prospects of further depreciation to come. A large devaluation will directly help competitiveness, but if it triggers repercussions (starting with a collapse of Hong Kong) and competitive devaluation everywhere, or higher interest rates to stem such an outcome, it does not help create better export opportunities. China is a big player; as such it cannot pretend it is inconsequential and get by with undercutting everybody. It is also the case that China's substantial trade relation with the US is already a problem—a bilateral trade surplus upward of \$US 50 billion. Reinforced by a Chinese devaluation, it will have every opportunist in the Congress complicate key policy objectives such as the WTO and permanent MFN. In sum, devaluation might be a really bad idea.

On the domestic front, too, devaluation is highly doubtful as a strategy. A large devaluation makes it obvious to every Chinese that the Yuan is not as good as the dollar. The obvious implication is the emergence of a black market in dollars and bank runs to convert deposits into currency on the way to dollars. Losing control of the shaky banking system under the pressure of a devaluation is distinctly less interesting than banking reform over the next few years in the context of domestic financial stability. The Chinese leadership abhors financial instability: they have long memories remember that the Kuomintang lost China when they allowed extreme inflation. In fact, in the late 80s, the authorities very deliberately pushed down growth to fight inflation and the same happened a few years ago. Financial stability is politically even more important than high growth.

Domestic expansion can make up for poor export performance. The Chinese budget deficit is very small and so is the domestic public debt and inflation. Accordingly, there is absolutely no reason not to move ahead with fiscal expansion to shore up growth. Such spending need not take the form of extra empty skyscrapers in Shanghai; it might just mean dealing with the pervasive bottlenecks in China's infrastructure. The substantial leeway for fiscal expansion offers some reassurance on the growth front and thus takes away some of the urgency of an export revival. Of course, it does not help much in calming pressure for devaluation from the export lobby.

Talking out of both sides of their mouth, Chinese officials have joined the discussion of devaluation. Threatening the prospect of devaluation, they have railroaded the US into trying to save the yen. At the same time they try and leave no doubt as to their commitment to being Asia's leading stable economy. China would do well committing itself to the current exchange rate (taking pressure off Hong Kong) and hunker down for a few years with a focus on domestic growth and reform. Growth at 6 percent is a miracle anywhere else, it should be enough for China to both raise the standard of living and deal with economic restructuring. If China gets too close to devaluation, what seems like a controlled event may turn out to be a loss of control. The Chinese leadership should get

on with the WTO and get off flexing international financial muscle with the devaluation blackmail. Devaluation is a loser's game.

The Debate Continues

That was last year's text; a year later, the debate continues. Chinese devaluation rumors abound and the most common view is that sometime next year a more flexible policy is inevitable, likely, to be expected or the thing to do. The continuing focus is the lack of growth in China, deflation, the formidable restructuring problem and the clear loss of competitiveness.

Table 9 The Chinese Macro Data				
	1997	1998	1999	2000
Inflation	2.8	-0.8	-1.8	0.5
Growth	8.8	7.8	8.2	8.4
Current Account (% of GDP)	3.3	2.3	1.1	1.5
Export Growth (%)	21.0	0.5	1.8	6.7
Reserves (Bill \$US)	143	149	150	150
Budget (% of GDP)	-1.6	-5.1	-6.0	-6.0
Source: Goldman Sachs				

World Bank chief economist, Joe Stiglitz, has called on China to pursue a beggar-thy-neighbor strategy", never mind that China is a surplus country, has large reserves and little debt and grows at more than 7 percent. Is devaluation really the answer to China's troubles and is it a good idea for the world economy? Surely not. Large countries cannot expect to recover at the expense of the rest of the world; they need to find ways to bootstrap domestic demand. Budget deficits and printing money, however effective, are only a limited answer. Tung Tsu in the *Art of War* instructs the commanders "When encircled in deep ground, break out!". Good advice for China's leadership today. With its huge state enterprise sector and the pervasive restrictions on just about anything, China has only one option: radical transformation of its economy.

Chinese devaluation rumors abound and the most common view is that sometime next year a more flexible policy is inevitable, likely, to be expected or the thing to do. Not before the 50-th anniversary of the revolution in October, but surely soon afterwards. The continuing focus is the lack of growth in China -- it has fallen to "only" 7.1 percent-- along with deflation, the lack of confidence on the part of households who face the formidable restructuring problem and the loss of competitiveness. If big budget deficits

don't do enough, monetary policy seemingly does not do the trick, so why not try devaluation?

China's current account surplus and export growth have fallen. In part that reflects an aggressive export strategy in Asian economies where the collapse of domestic demand brought about export dumping over and above what comes from increased competitiveness. But competitiveness is decidedly an issue, too. On the side of competitiveness the problem is real. All Asian crisis economies, as well as Japan, have a fall in their dollar price level. For Japan this is insignificant. But for the other economies the decline in price levels ranges from 15-25 percent to near 50 percent in Indonesia. Moreover, inflation rates are not high and hence will not rapidly eliminate their real depreciation. True, since 1998, with the rebound of Asian currencies and the strong Yen, there has been a significant improvement in China's competitiveness but not enough to return to 1997 or 1996 levels. A rough number for the loss in competitiveness is 10 to 15 percent—by no means negligible, by no means devastating. Accordingly, the numbers don't get us much further than arguing that there is a problem, that devaluation is the traditional medicine and the question of whether and when it will happen.

Even if there is some loss of Chinese competitiveness, devaluation surely is not the answer. From a point of view of the world trading system that is of course dead wrong. Urging on large surplus, low debt countries devaluation is an invitation for beggar-thy-neighbor policies 1930s style. No doubt, a Chinese devaluation would trigger a new round of devaluation all over Asia, or at the very least the expectation thereof. Asset prices would fall everywhere including in Japan, and growth would fall off. An already far too high dollar would be pushed even higher as Asia seeks to resolve its employment problems by ever-larger trade surpluses. Emerging market lending would once again get hit. WTO accession of China would become even more troubled as protectionists everywhere get hit by another cheap-Asia export wave. Clearly, this is not a good direction to go.

China has been right to use monetary and fiscal policy. As a temporary strategy, this cushions the impact on demand of a more difficult external environment. What is exchange controls useful for if not to cut rates dramatically? And what is a low debt situation useful for if not to run temporary budget deficits. And yet these are just temporary remedies that cushion the unfavorable external and domestic environment, they go no further than that. Something more needs to happen.

China's problems won't be resolved by a devaluation of 20 or even 40 percent. Much of the trouble is not the bit of loss in competitiveness from the recent devaluation of other Asian economies. China is stuck in a much more fundamental way, stuck a third of the way between inefficient statism and free enterprise. China needs to make major moves in the way it organizes economic activity. A vast number of people can be employed if only the government stops protecting State enterprises by restrictions on production and internal trade. China needs to decentralize by opening up the production system to private initiative; self-employment as well small and medium sized businesses have to be the way out. Aggressive lending of a cleaned up banking system with a new credit culture

supplements that strategy as does business friendly taxation. This is a time for very radical moves.

Opening up China to a major joint enterprise, foreign direct investment or privatization drive provides a one-time bonus to prosperity over and beyond the supply side effects. The proceeds can be divided between equally workers, local authorities, a general tax cut and the central government. In short time, money and self-interested initiative would create a boom in employment and activity. More so in that it has an immensely entrepreneurial culture that can't wait to be allowed to play the game. Its mistake has been an excessive attachment to the existing economic structure, which has turned deeply counterproductive and needs now to be dismantled very fast before the loss in the population's confidence pushes the economy much deeper under water.

Anyone who believes devaluation is an answer to China's problems misses the point. If the leaders look to devaluation as the answer, they will further add to the problems.

APPENDIX: DATA AND FORECASTS

Table A-1 Inflation and Growth

	<i>Growth</i>			<i>Inflation</i>		
	1991-2000	1999	2000	1991-2000	1999	2000

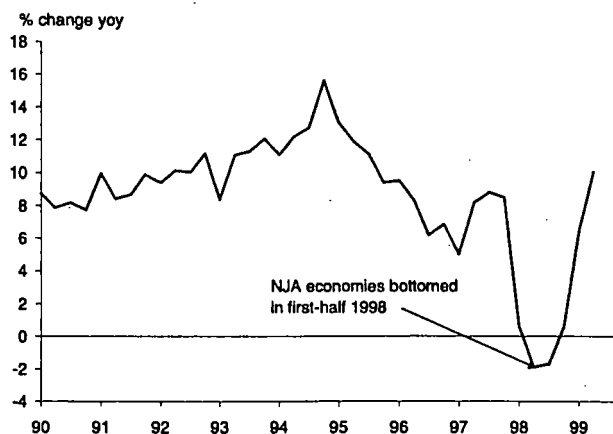
Ind. Countries	2.3	2.3	2.3	2.5	1.3	1.8
US	2.6	4.0	2.8	2.7	2.2	2.6
Japan	1.0	0.1	0.1	0.9	-0.2	-0.2
Euroland	1.8	2.0	2.7	2.6	1.1	1.5
France	1.8	2.2	2.7	1.7	0.6	1.1
Germany	2.0	1.5	2.4	2.3	0.6	1.3
Italy	1.3	1.2	2.3	3.6	1.6	1.8
UK	1.9	0.9	2.4	3.3	1.9	2.3
Spain	2.3	3.4	3.4	3.9	2.2	2.3
Canada	2.2	3.3	2.9	1.8	1.4	1.8
Source: IMF and <i>Economist</i>						

<i>Table A-2 East German Catch Up ^a</i>			
	1991	1995	1998
GDP per Inhabitant	31	55	56
Investment per Inhabitant	64	110	102
GDP per Worker	31.0	57	60
Unit Labor Costs	151	127	124
Net Government Outlays ^b	3.7	4.0	3.8
Unemployed or Special Programs ^c	32.8	38.7	30.4
^a All numbers except as noted are relative to West Germany. ^b % of German GDP ^c % of the labor force. Source: DIW			

Asia's Creditless Recovery: No Reason to Worry

- Skeptics of Asia's V-shaped recovery point to the lack of accompanying real credit growth to argue another fall in GDP is imminent. We disagree.
- Historically, after banking crises, GDP growth in advance of credit recovery has been the norm, especially for emerging markets.
- Besides, data on loans outstanding is misleading because NPLs that have been written-off or sold to government agencies explain some portion of the decline. Moreover, the effects of having curtailed the usual practice of borrowing anew to make interest payments are hard to quantify.
- The credit crunch that characterized the situation early this year no longer exists. Banks now have the capacity to lend, only demand for credit is poor.
- The collapse in fixed investment following the crisis is the culprit behind poor demand for credit. Firms now are operating below capacity. Moreover, businesses have generated enough cash flow to finance operations to meet initial pick-up in consumption.
- As long as banks have the capacity to lend to provide credit to firms when they need it, credit growth should pick up. When GDP growth ushers in increased fixed investment, credit expansion should be restored.

Figure 1: V-Shaped Recovery in Non-Japan Asia



Source: CEIC, IFS.

Table 1: Near Term, Businesses Have Cash to Finance Expansion

(US\$mn)

Cash Flows	1996	1997	1998
Korea	52	46	30
Malaysia	4	19	13
Thailand	63	56	31
Total	119	120	73

Change in Credit to Business	1996	1997	1998
Korea	123	124	(14)
Malaysia	29	32	1
Thailand	24	33	(10)
Total	176	189	(24)

Source: Datastream, GS estimates.

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Asia's Creditless Recovery: No Reason to Worry

Asia's Recovery Is V-Shaped ...

Asia's economies have come roaring back this year, ending much of the discussion about the shape of the recoveries. Korean industrial production is rocketing along at over 30%. Malaysia is growing at 20%-plus at a quarter-on-quarter annualized rate, matched by its southern neighbor, Singapore. Even Indonesia, plagued by continued political uncertainty, has clawed itself into positive growth. The only word to describe the shape of recovery is 'V', as can be seen in Figure 1.

... Not W, as Some Think

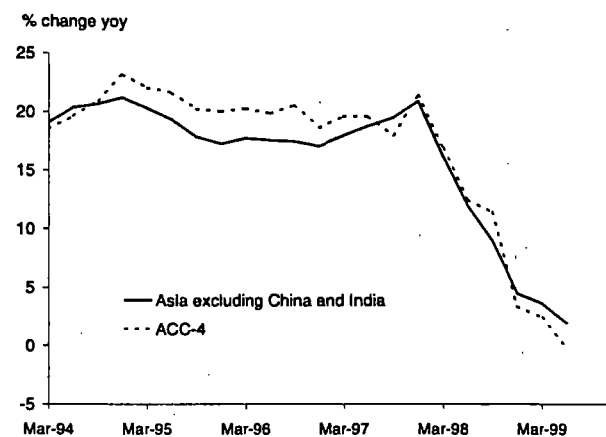
The main case for arguing that Asia's recovery will run out of gas leading to a 'W-shaped' recovery is the absence of credit—the fuel of Asia's earlier boom (see Figures 2 and 3). Real credit growth is one of the few indicators yet to show any improvement. The argument goes that without credit, firms' prospects will dim, and GDP growth slacken or reverse. The poor pace of loan restructuring is cited as a harbinger of an impending fall—do not believe it.

Past Banking Crises Managed Creditless Recovery

GDP growth leading credit growth out of a banking crisis is not unusual. Figures 4a and 4b show the average pattern of credit and GDP growth before, during, and after a banking crisis. The figures are based on 9 banking crises out of the 29 the IMF has identified in a variety of emerging and developed economies.¹ The data is benchmarked from the start of the crisis and includes the preceding and subsequent three years. The number of years in crisis varies, but is usually two to three. As one would expect, the run-up to a banking crisis shows a surge in credit and GDP growth. The advent of the crisis then leads to falling GDP and a fall in credit. Across the sample, GDP growth falls 4.3 percentage points relative to the immediate pre-crisis growth rate, while credit growth only falls in the final stage of the banking crises. However, as the economy pulls out of the banking crisis, credit growth lags GDP growth by 9-12 months. Only in the second year does credit growth begin to outstrip GDP growth.

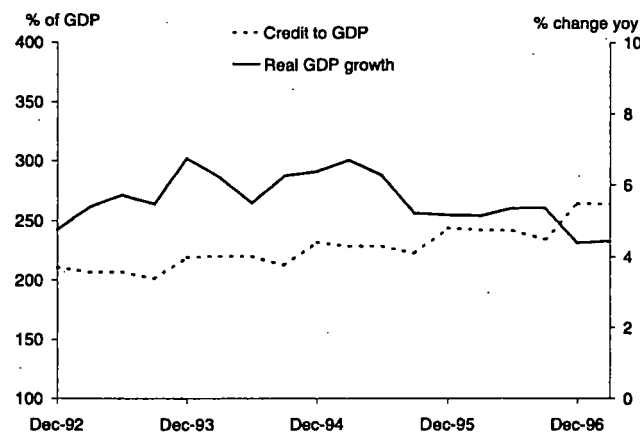
The leading recovery in GDP growth is even more noticeable if one excludes the developed countries from

Figure 2: Real Credit Growth in Non-Japan Asia



Source: CEIC, IFS.

Figure 3: Increase in Credit to GDP and GDP Growth



Note: Data refers to non-Japan Asia excluding China and India.
Source: CEIC, IFS.

the sample (Figure 4a). In this case, GDP growth rebounds while the banking system is still in crisis, leading the recovery in credit by well over a year.

Therefore, the current creditless recovery in Asian GDP growth is the norm. That other recoveries from banking crises have occurred with credit growth in their initial stages still leaves the question as to why this occurs, and why it is occurring in Asia? We now turn to that question.

¹ The 9 banking crisis episodes are: Colombia (1982-1985), Finland (1991-1994), India (1991-1994), Japan (1992-1994), Mali (1987-1989), Malaysia (1985-1988), Nigeria (1991-1994), Portugal (1986-1989), and Sweden (1990-1993).

Lack of Credit Is Exaggerated

It is difficult to get to the bottom of the figures on credit. It is also difficult to identify whether it is lack of demand or an unwillingness to lend that is the culprit. Credit figures are distorted by two factors:

1. **Increased non-performing loan write-offs/sales have reduced the credit stock.** Bank recapitalization in the ACC-4 (Asian crisis countries—Indonesia, Korea, Malaysia, and Thailand) has involved the sale of loans to government agencies with accounts that are not consolidated with the domestic banking system (see Figure 5). Aggressive write-downs of non-performing loans (NPLs) that remain on the books are also picking up. Both of these efforts reduce the measured credit expansion. However, these sales/write-downs are part of a restructuring process that ought to promote more robust recovery. Their effect on the stock of outstanding credit is misleading.
2. **Tighter prudential/provisioning standards and oversight have curtailed the scope for evergreening**—providing new loans to delinquent borrowers in an effort to avoid default. This effect is harder to quantify. Pre-crisis credit growth rates in the aggregate were higher than the local interest rate, implying that interest payments were made out of new loans, e.g. Peter borrowed from Paul to pay Pat, creating an illusion of credit boom. This is no longer the case, even with the lower levels of interest rates now holding in Asia.

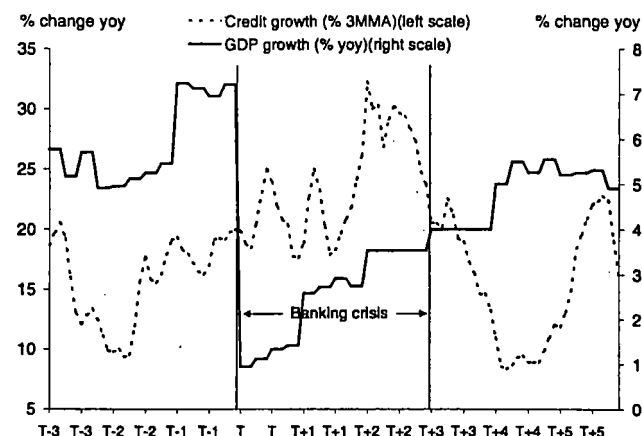
The combination of greater write-downs and less evergreening exaggerates the extent of the credit reduction, particularly as recapitalization and tighter standards have come to the fore this year.

Banks Have the Capacity to Lend

The concern about existing low credit growth figures reflecting banks' inability to lend appears overdone. Banks have improving liquidity as measured by increasing loan to deposit ratios (see Figure 6).

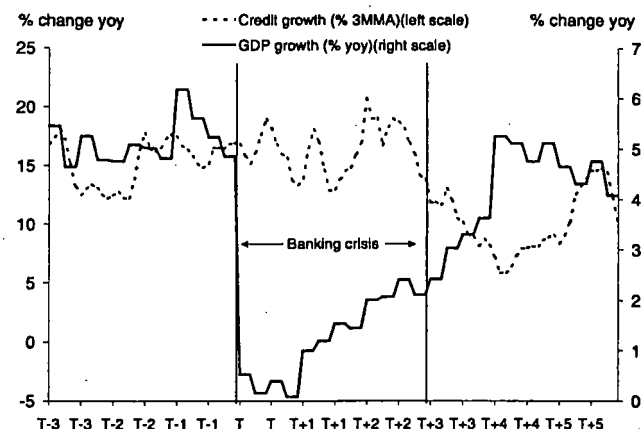
In addition, banks do not look constrained by their capital (see Figure 7). Given the injections of public money (Korea, Indonesia, Malaysia), or private funds (Thailand), the banking system's capital base in the aggregate has been restored. Regulators have also generally softened capital adequacy requirements, loosening this noose on lending.

Figure 4a: GDP and Credit Growth for Emerging Markets*



Source: CEIC, IFS, WB, GS estimates.

Figure 4b: GDP and Credit Growth for Emerging Markets*, Plus Finland, Japan and Sweden



Note: * emerging markets covers Columbia, India, Mali, Malaysia, Nigeria, and Portugal.

Source: CEIC, IFS, WB, GS estimates

Lack of Credit Growth Reflects Lack of Demand

Careful analysis shows the lack of credit growth in 1999 looks more like a result of weak credit demand rather than a credit crunch. By credit crunch, we refer to a situation in which the expected return of a project is higher than the cost of funds, but the borrower cannot get credit. With a credit crunch, credit is rationed not by the interest rate, but by a bank's willingness or ability to lend.

However, merely looking at credit growth figures does not tell you whether or not there is a credit crunch. Credit demand also matters. With the fall in investment

and output, credit demand has also fallen. Identifying a credit crunch comes down to saying that, given credit demand and the interest rate, borrowers were unable to receive credit.

Empirical work by the IMF on a credit crunch in Korea, Indonesia, and Thailand shows that after the initial stages of the crisis, credit demand, and not supply, was the binding constraint on overall credit.² The empirical work finds that there was no aggregate credit crunch in Korea at all during the crisis.³

The absence of strong evidence of a credit crunch makes it far more likely that current GDP growth is not a problem. Given that banks have the capacity to lend, when firms demand credit, credit growth should pick up. That leaves the question of when credit growth might be restored.

Firms Still Have Positive Cash Flow

Another reason to be sanguine about further recovery in Asia is that firm cash flows are still positive. Table 1 sets out the cash flow positions of a sample of listed firms in Korea, Malaysia, and Thailand. While cash flows in 1998 declined, they remained positive in these countries.

Positive cash flow allows firms to offset declining external finance with their own resources. Focusing on cash flow makes it far easier to understand how GDP could recover, while credit has not. Lower nominal interest rates have helped to improve cash flow. So too has the non-payment of interest by firms that choose to run arrears. Devaluation, at least for those firms in the tradable sector, has boosted cash flow. Some countries have also seen tax burdens fall, either through lower tax rates or because of tax arrears.

The weakness of credit growth springs from the collapse of demand from fixed investment in Asia. Looking forward, as fixed investment—as opposed to inventories—begins to recover, so too should credit demand and, most likely, credit growth.

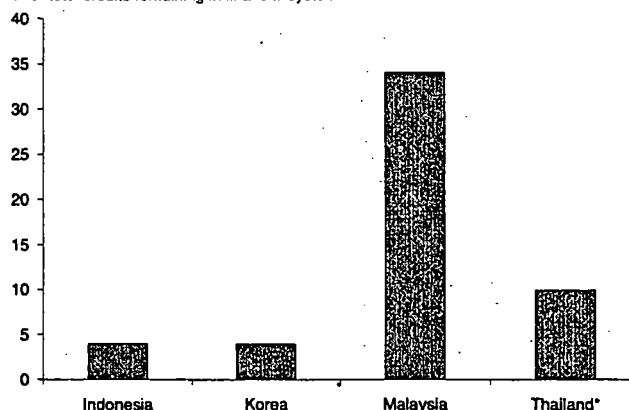
Don Hanna

² See Ghosh, Atish and Ghosh, Swati 'East Asia in the Aftermath: Was there a Crunch?', IMF Working Paper, WP/99/38, March 1999. The paper is available from the IMF Web site at www.imf.org.

³ We stress aggregate because many of the complaints about a credit crunch stem from stories regarding the difficulty of small and medium-sized firms in receiving credit. The work by Ghosh and Ghosh (1999), cited above, cannot distinguish between the treatment of small versus large firms.

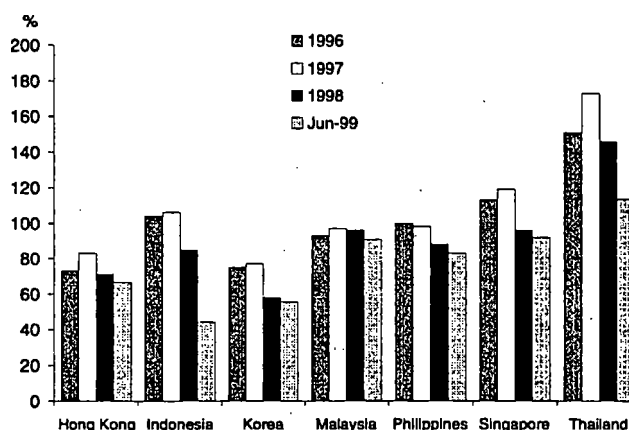
Figure 5: Total NPLs Carved Out

% of total credits remaining in financial system



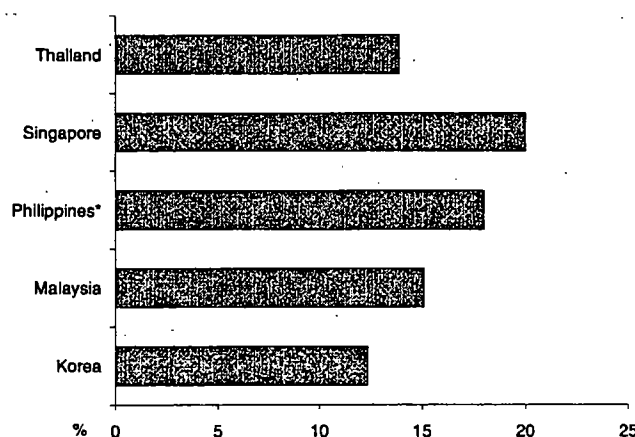
Source: CEIC, asset management agencies, GS estimates.

Figure 6: Loan to Deposit Ratio



Source: GS estimates.

Figure 7: First Half 1999 Capital Adequacy Ratio



Note: * as of March, 1999.

Source: Reuters, October 1, 1999.

COUNTRY UPDATE**China****September Exports Rose 20.2% Year on Year**

China's exports recovery continued to surprise on the upside. Stronger export growth has three positive implications to both China and Hong Kong: (1) Stronger exports kept trade surplus hefty despite a pick-up in imports, alleviating the burden of domestic demand to boost economic growth; (2) Wider trade surplus and stronger economic growth on the back of stronger exports allay market fears of an imminent renminbi devaluation; and (3) Hong Kong's external sector will continue to improve. Given trade services account for almost 20% of Hong Kong's GDP, the economy could continue to grow in the second half even with sluggish domestic demand recovery (amid high real interest rates). Stronger September exports make us more confident on our projection that China GDP will pick up in the second half and be above 7.0% for full-year 1999.

Details. Exports rose 20.2% yoy in September, much higher than our expectation of 10%-15% growth. Although details are not yet available, latest data through August suggested that recovery was mainly buttressed by intra-regional trade (including Japan) and exports to EU.

Most of China's exports are final products like clothing and toys as opposed to semi-manufactured goods (such as semi-conductor and electronic components) produced by southeast Asian countries. Therefore, China's export recovery was later than other Asian countries. Imports also picked up strongly, rising 32.5% year on year versus 24.0% in August. This is due to: (1) strong domestic demand; (2) decline in tariffs; and (3) higher oil prices.

As import growth outpaced exports, trade surplus narrowed slightly to US\$3.3 billion, down from 4.8 billion in August.

F. Hu, D. Li

Hong Kong**Policy Address Focuses on Long-Term Issues**

As expected, the chief executive's 1999 policy address only focused on long-term issues—how to position Hong Kong as a major city for China and as an international financial center for the region in the 21st century. The emphasis is still on better education, and

new environmental measures are proposed. However, the new environmental measures are unlikely to increase business costs significantly. In addition, the chief executive reaffirmed the launch of the Mandatory Provident Fund by the end of 2000. We are maintaining our GDP forecast at 0.6% for 1999 and 2.8% for 2000.

The chief executive reiterated the initiatives given in the budget speech and the previous policy address. These include commitment to infrastructure, strengthening the financial sector, civil service reform, and good progress on negotiations with the Walt Disney company for the construction of a theme park in Hong Kong.

August Deflation Deeper

Deflation widened further in August. After making adjustments for the property tax rebate, the consumer price index A fell 4.3% compared with -4.2% in July. While deflation deepened, retail sales showed a modest improvement in volume terms. The numbers support our views that: (1) domestic demand continues to improve in the second half; (2) private consumption recovery has been gradual; and (3) economic growth in the second half will be led by external sector and public fixed investment, since the recovery of private consumption is hurt by high real interest rates.

Details. Consumer Price Index A fell 5.1% year on year in August compared with -5.0% in July. The property tax rebate in the third quarter exaggerated the fall. The statistical office estimates the policy has raised deflation 0.8 percentage points. Even adjusting for this effect, consumer price deflation still averaged 4.3% in August.

Analyzed by components, clothing and footwear registered the biggest decline, falling 24.1% year on year in August. This was followed by rentals, which were down 9.4% (due to the property tax rebate) and durable goods, down 7.5%. Increasing competition in the supermarket sector has also contributed to the further decline in August consumer prices.

Retail sales rose 0.5% year on year in volume terms in July (versus -0.2%). However, it fell 8.0% year on year in value terms, suggesting a significant price cut has underpinned the volume term improvement. Analyzed by components, consumer durables (up 18.6% year on year in volume terms), food (up 1.5%), and jewelry and gifts (up 5.8%) were the major source of growth. Clothing was the most disappointing sector. Despite a 24% year-on-year price cut, sales volume rose only 1.8% in July.

F. Hu, D. Li

Indonesia

Political Agenda Accelerated—the Economy As Well?

Over the weekend, the Indonesian Upper House (MPR) voted to advance presidential elections to October 20. This will resolve uncertainty more quickly and help rally Indonesian assets, in addition to strengthening the chances that Megawati and the Indonesian Democratic Party (PDI) will lead the next government. However, economic recovery is still shaky and will need political change. August trade data showed exports expanding for the first time in two months (+11.4% year on year in US dollar terms), and a trade balance of over US\$2 billion—a positive sign for the economy. However, non-oil imports were still contracting at double-digit rates (-17.6% year on year), and September and October trade flows are likely to have been disrupted by the problems in East Timor and concerns about the upcoming election. The seventh month of price declines in September was also an indication of a weak economy, especially as it implies higher real interest rates. With politics the key for the near term, our call for a stronger rupiah—Rp6,700 per US\$1.00 on a three-month horizon—remains unchanged, but now looks more likely.

Details. The MPR started in a pro-change fashion, voting over the weekend to accelerate presidential elections and selecting Amien Rais as its Speaker. The October 20 election date will cut out three weeks of uncertainty. This strengthens the chances that Megawati and the PDI will lead the next government. Such a government would have the broadest popular support and spur a rise in both the currency and the equity market.

The economy remains fragile, although August trade data was encouraging. Non-oil exports reversed their June/July declines (+3% year on year), hinting that political uncertainty had held back orders, not the competitiveness of the rupiah. Oil exports jumped almost 60% year on year due to positive prices. Indonesia stands to gain about US\$350 million per year per US\$1 increase in oil prices.

However, imports remained weak, contracting 17% year on year. While not as sharp a contraction as seen in June and July, this is nonetheless a sign of economic fragility. Trade recovery is likely to stall in September and October due to presidential election uncertainty and East Timor.

Inflation is dead. September CPI showed the seventh monthly decline in prices. Inflation is now only 1.3%, and annualized year-to-date, it is 0%. This is not only due to falling food prices, but also to the huge negative output gap created by the crisis and the 14% drop in GDP growth from its peak in third-quarter 1997. However, going forward, the need to improve the fiscal balance by price adjustments in fuel and electricity will reintroduce inflation. Some fuel prices have not changed since January 1993. With fuel 5% of the index, the 300%-400% change needed will add at least 5%-7% to the index annually, even if spread out over three years. Folding in electricity prices and the knock-on effects to transport costs and other sectors means keeping headline inflation at 10% will be tough.

At present, real interest rates are high, hurting recovery. Bank Indonesia Certificate rates continue to hover at 13%. Even with higher expected inflation, real interest rates are a drag on economic recovery, again reinforcing the fragility of the current environment.

Despite economic fragility, the rupiah and equities should rally on the back of better political prospects (much as they did in June). We are more confident in our three-month forecast of Rp6,700 per US\$1.00. Longer term, we expect the rupiah will likely weaken from this figure as the economic drag of 100% public debt to GDP, and the hard task of remaking Indonesia's political institutions, takes its toll on economic prospects.

D. Hanna

Korea

Thoughts on the Bond Market Stabilization Package

The government announced (ahead of schedule) its latest financial stabilization measures, which include setting aside some W20 trillion to shore up the beleaguered bond market and delaying the move toward requiring investment trust companies (ITCs) to mark to market by July 2000. These proposed measures failed to impress the market, as evident in the stock index shedding 2.5% yesterday.

Our thoughts:

1. The latest package is **not** about carving out Daewoo debt from the ITCs with the help of public funds. Rather, it is a reaffirmation that the Bond Market Stabilization Fund will purchase bonds more aggressively (if needed) from ITCs facing redemption pressure.

2. Essentially, the government is trying to recycle liquidity into the ITCs from the banking system, whose deposit base has grown rapidly as investors flee the ITCs.
3. The government is hoping that its promise to boost bond market liquidity will: (1) dampen investor fears ahead of November 11, when beneficiary certificate holders can redeem Daewoo debt at 80 cents to the dollar; and (2) keep interest rates down.
4. The market remains clearly skeptical about the effectiveness of simply boosting liquidity in the bond market in the absence of a clear framework for loss allocation and how public sector funds will be deployed to cushion the burden on the financial system.
5. In the absence of such a framework, the incentive for investors to redeem bond funds will likely remain. The problem is that on average, for every W1 of Daewoo bonds that ITC investors want to dump, they need to dump W8-9 of non-Daewoo bonds, as bond funds have bundled bond investments of different risk classes.
6. The contingent liability of the ITCs to the government is a moving target as is always the case with financial systems under stress. The more delay there is, the larger this contingent liability may become. Focusing on ITC's exposure to Daewoo alone, which is about W27 trillion, then the contingent liability of ITC will amount to about 6% of 1998 nominal GDP (W450 trillion).
7. We continue to expect that public funds will end up being deployed in the loss allocation surrounding Daewoo, though investors should clearly be mindful of further near-term downside risk until such a framework emerges.

August Current Account Surplus Shrinks

August current account shrank on the back of stronger imports. In addition to strengthening domestic demand, imports are boosted by increasing oil prices. The capital account, after adjusting for repayment of the IMF loan, was in surplus. This indicates that through August, there has not been significant capital outflow due to the flare-up of the Daewoo problem.

Details. Current account surplus shrank to US\$1.4 billion in August from US\$2.8 billion in July. Smaller merchandise trade surplus was the main cause, falling to US\$1.6 billion in August from US\$2.9 billion in July.

Export recovery continued, rising 16.6% year on year. Hence, it was strong import growth (up 40% year on year) trimming the merchandise trade surplus in August.

It is interesting to note that higher oil prices (in addition to strong domestic demand recovery) have been an important factor contributing to recent strong import growth. On a year-on-year basis, import prices of crude petroleum and natural gas rose 26% year on year in July, and 59% in August. Meanwhile, crude oil imports climbed to US\$1.12 billion in August (11.5% of total imports), an increase of almost US\$400 million from the same period last year. Accordingly, trade surplus dropped by this amount—the direct impact of higher oil prices. Including the indirect impact through higher import prices of chemicals and other petroleum-related products, the total effect of higher oil prices could be even larger.

Capital account recorded a deficit of US\$1.69 billion. Adding the repayment of IMF loans of more than US\$3.0 billion, the capital account for the private sector alone is in surplus, indicating that through August, there has not been significant capital outflow due to the flare-up of the Daewoo problem.

S. B. Kim

Philippines

September Headline CPI Strong, But Core CPI Still Abating

Philippine CPI rose 5.7% year on year in September. The market was expecting 5.6%. The uptick was due to surges in food and fuel prices. Core CPI (CPI less food and fuel) continued to abate. The central bank indicated continued cautious stance, which is consistent with our forecast of 9% 91-day T-bill rate in three months.

Year-to-date, Philippine CPI increased 7.4% from the same period last year. This is well within the Philippines' inflation target for the year, between 7% to 8%.

Food prices were 3.9% higher in September compared to the same month last year. The corresponding number for August was 3.5%. Prices of fuel surged 14.6% year on year in September, compared to 8.9% in August. Core CPI (headline CPI less food and fuel) showed continued slowdown—to 7.66% year on year in September from 7.71% year on year in August.

Surge in August Exports Surprises Market

The Philippine economy continues to show signs of improvement. August exports expanded a better-than-expected 21% year on year. Our forecast was 16%, and the market's expectation was 11%. More importantly, non-electronics exports were up almost 10% year on year, showing more balanced growth than earlier in the year (see Figure 1). These export figures should help the peso, especially given: (1) slightly-better sentiment following last Friday's agreement with the IMF on more bullish growth and current account forecasts; and (2) expectations of a seasonal surge in workers' remittances. The implications for equities are less clear cut as the market continues to focus on political jitters rather than economic prospects.

Details. Growth in exports were again led by electronics and electronic-related exports. However, more importantly, growth in the non-electronic sector posted much stronger year-on-year growth compared with growth in July. In August, all non-electronic exports ('other' exports) expanded 14.9% year on year. This compares with July's year-on-year growth rate of 1.6%. On a three-month moving average basis, 'other' exports grew 9.2% year on year in August, from 1.7% in July.

The surprising growth in exports, particularly in the non-electronic sectors, should make investors less skeptical about Philippine growth. These figures support the conclusion we came to after looking at the seasonally adjusted second-quarter data, of a relatively balanced GDP growth.

The export numbers should then help Philippine assets look more attractive. However, the issues surrounding a possible change in the Philippine constitution continue to worry investors, and will therefore remain a drag on asset prices. Export numbers cannot do much to assuage these fears.

D. Hanna, W. Maxino

Thailand

Baht Update

There has been much brouhaha in the market place about what to make of the October 5 announcement by the Bank of Thailand that it is tightening regulations on baht lending by Thai financial institutions to non-residents. We do not believe this move presages a fundamental policy shift to strengthen the baht. Nor do we believe that the policy announcement comes in anticipation of a marked deterioration in Thai economic

fundamentals that increases the risk of the baht coming under significant depreciation pressure. We therefore leave our short-term (three-month) forecast unchanged at Bt39.0 per US\$1.00, and recommend flat position on the baht.

Details. Since January 1998, baht lending by onshore banks to a non-resident counterparty has been limited to a maximum of Bt50 million, as long as there are no underlying trade and investment activities in Thailand. The October 5 announcement makes the definition of counterparty stricter, requiring '... all transactions undertaken by the head office, branches, representative offices, and all affiliated companies of a particular non-resident to be counted as one'. In other words, non-residents cannot circumvent the Bt50 million borrowing limit through multiple-sourcing.

Thailand has effectively had a form of capital control that limits the outflow of baht from onshore to offshore. In a bid to provide a more favorable backdrop to bank and corporate restructuring and spur economic recovery, local interest rates have been driven sharply lower. Short-term onshore rates have actually been driven to levels well below US rates for most of this year. A gap has also emerged between the onshore baht rate and the implied interest rate offshore, with offshore rates being persistently higher. The October 5 announcement is intended to make onshore-offshore arbitrage more difficult.

Given the large output gap and lack of inflationary pressure, combined with the need to bring NPLs down in the banking system, we continue to believe it is highly unlikely interest rates will be increased by the Bank of Thailand in the foreseeable future. This necessitates the maintenance of controls that limit baht outflow from onshore to offshore. The key question is whether, at the margin, there has been (or is likely to be) a deterioration in fundamentals to significantly raise the incentive to take baht offshore. We believe this is unlikely for the reasons given below.

- First, recent indicators point to a buildup in recovery momentum. Manufacturing output increased nearly 18% year on year on the back of stronger exports. Second-quarter GDP data released last month also showed private consumption and investment posting positive year-on-year growth for the first time in two years. Therefore, we remain confident that Thailand should be able to post real GDP growth of 3.7% in 1999.
- Second, we do not see material downside risk in the Thai balance of payments. Foreign exchange reserves now exceed US\$32 billion, versus short-

term private sector debt of US\$17.4 billion as of end-June 1999 (the latest figure available). During the second half of this year, we can conservatively expect inflows of US\$7-US\$8 billion—US\$6 billion through the current account, US\$1.5-US\$2.0 billion in official financing packages (ADB, IBRD, Miyazawa initiative). This ignores possible additional inflows through foreign direct and portfolio investments. On the outflow side, Thailand has been paying back, on average, US\$3.5 billion of private external debt per quarter—about 80% consisting of short-term debt. Even in the absence of significant direct or portfolio investment inflow, we expect Thailand will post a moderate balance of payments surplus during the second half of the year.

Encouraging Output Growth in August

Manufacturing output rose 17.7% year on year in August on the back of strong external demand. This suggests that export-led growth will continue in the third quarter, making us more confident on our recent GDP upgrade. Meanwhile, stronger exports have improved consumer sentiment and corporate earnings, helping private consumption and fixed investment. With banks saddled with high non-performing loans (NPL), credit growth continues to be sluggish, posing the biggest threat to continued recovery. However, we believe continued recovery in Asia and subdued inflation should allow the Bank of Thailand to keep domestic interest rates low. In addition, strong export performance should improve corporate earnings. These should help set banking system recovery in motion.

Details. Manufacturing output, underpinned by strong export performance, rose 17.7% year on year in August (or 2.1% month on month) compared with 13.7% year on year in July. Better exports have improved corporate earnings and increased employment opportunities, supporting private consumption and fixed investment. The Composite Consumption Index rose 2.4% month on month, while contraction in private investment moderated to 9.0% year on year.

Saddled with high NPLs (around 47% by end-August), bank credit growth remains sluggish despite lower interest rates. Excluding BIBF loans, commercial bank credit rose only 0.7%, the same as the previous month. External trade data compiled by the Bank of Thailand did not show a materially different picture from an early estimate by the customs department. Exports and imports rose 15% year on year and 25% year on year, respectively, leaving a trade surplus of US\$750 million. The current account surplus was US\$900 million, suggesting tourist receipts remain strong.

Overall balance of payments recorded a surplus of only US\$25 million, pointing to continued net outflow in the capital account, reflecting the loans repayment by domestic corporations to foreign banks with the aim of reducing their leverage ratio. This is a healthy development, but is one of the reasons behind the recent poor performance of the baht.

The government cash deficit widened to Bt14.4 billion versus Bt0.2 billion due to seasonal factors. Government expenditure has actually declined from previous months as fiscal stimuli under the Miyazawa program abated in the second half of the year. Government revenue increased 31.5% year on year on higher tax revenues—additional evidence for economic recovery.

S. B. Kim

UPCOMING DATA RELEASES

(Note: Figures shown in brackets represent previously released data)

October 15

- United States: Business inventories for August (+0.3%).
- Producer price index (+0.5%), industrial production (+0.3%), and capacity utilization (80.8%) for September.

RECENT PUBLICATIONS

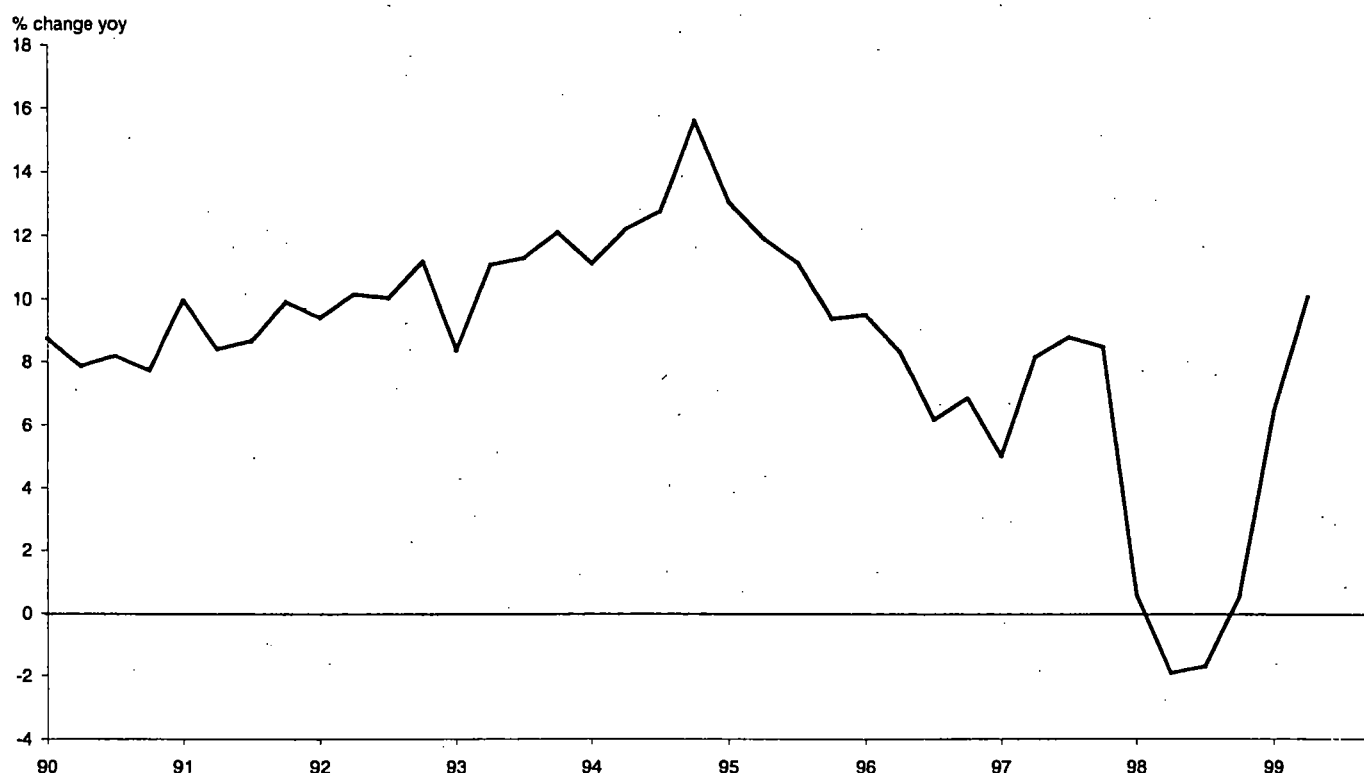
- | | |
|-----------------|--|
| April 16 | Japanese Monetization? Implications for Non-Japan Asia |
| April 26 | WTO Membership: What This Means for Greater China |
| July | Asian Economic Quarterly |

WEEKLY FOCUS INDEX

- | | |
|---------------------|---|
| August 19 | Will the Renminbi's Greater Flexibility Shake Asian Currencies Loose? |
| September 1 | How Large is the Output Gap in Korea? |
| September 14 | China's Banking Reform: Progress and Implications |
| September 28 | Taiwan: Trembling but Still Standing |

ACTIVITY

Industrial Production



Source: CEIC, GS estimates, IFS.

(% change yoy)	Jan-1999	Feb-1999	Mar-1999	Apr-1999	May-1999	Jun-1999	Jul-1999	Aug-1999
Asia	9.7	1.2	8.6	9.4	11.0	12.4		
NIE	10.8	(1.4)	10.3	9.7	14.0	17.5		
AEE	9.0	2.7	7.4	9.1	9.1	9.2		
ACC-4	(0.7)	1.6	3.9	6.6	6.6	6.9		
China	17.9	2.1	9.0	9.1	8.9	9.1	9.3	9.5
Hong Kong	NA	NA	(9.7)					
India	5.2	3.9	5.1	5.4	5.8	5.3	5.4	6.3
Indonesia	4.9	4.9	4.9	20.2	20.2	20.2		
Korea	14.8	3.9	18.8	17.1	21.7	29.7	33.2	30.0
Malaysia	(12.3)	3.1	2.8	4.2	6.3	9.3	8.8	12.9
Philippines	(5.7)	(1.7)	6.1	5.3	5.5	(1.0)	(4.6)	
Singapore	9.9	3.8	6.5	5.9	18.5	18.6	17.9	18.4
Taiwan	15.3	(7.0)	8.2	7.6	11.2	9.9	7.9	9.0
Thailand	0.5	2.7	11.3	10.6	9.2	12.1	14.6	17.8

Note: ASIA refers to non-Japan Asia (NJA). NIE refers to new industrialized economies (Hong Kong, Korea, Singapore, and Taiwan). AEE refers to Asia emerging economies (China, India, Indonesia, Malaysia, the Philippines, and Thailand). ACC-4 refers to Asian crisis countries (Indonesia, Korea, Malaysia, and Thailand).

Source: CEIC, IFS.

PRICES

Inflation^a

(a) Inflation refers to CPI; WPI is applied in India.

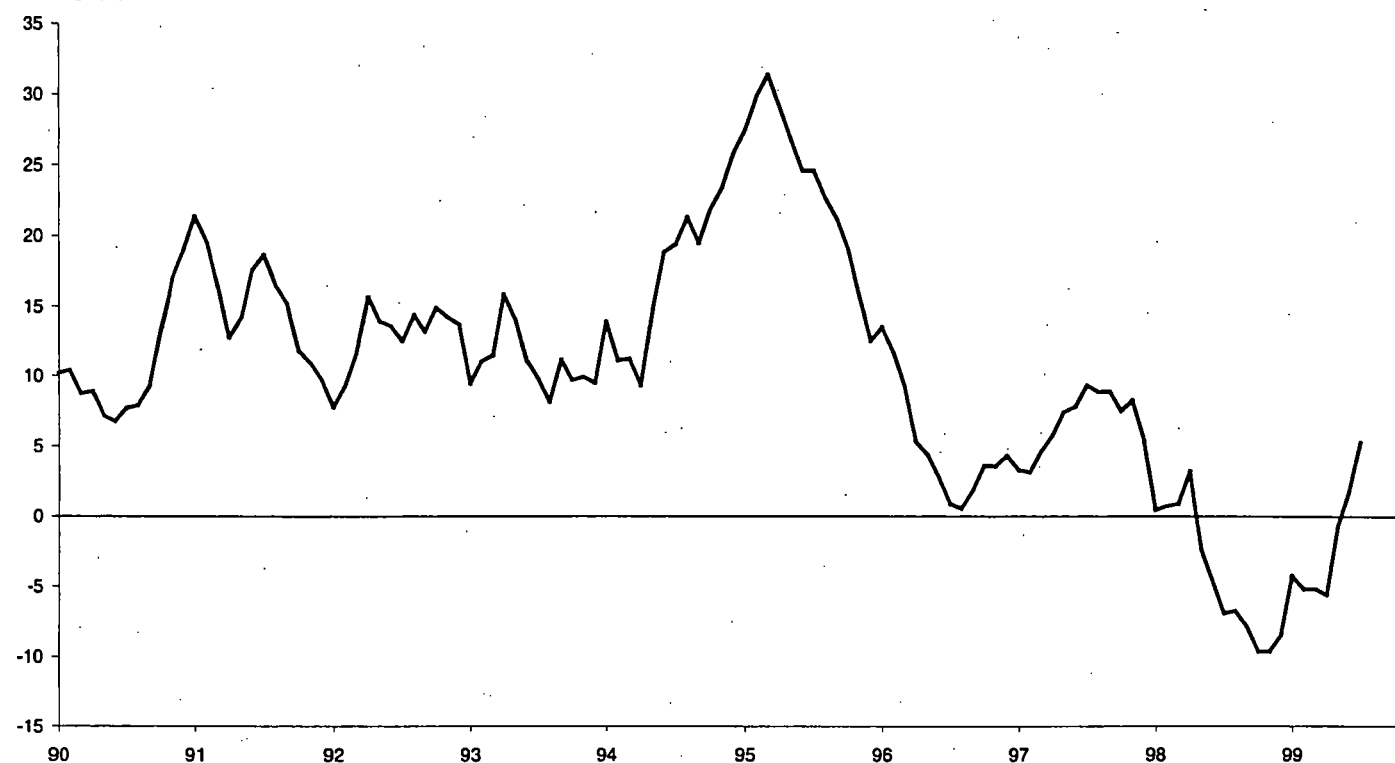
Source: CEIC, GS estimates.

(% change yoy)		Feb-1999	Mar-1999	Apr-1999	May-1999	Jun-1999	Jul-1999	Aug-1999	Sep-1999
Asia	Headline	4.6	3.5	2.6	2.1	1.3	0.5	0.5	
	Core	4.4	3.6	2.8	2.1	1.7	0.8		
NIE	Headline	0.4	(0.3)	(0.4)	(0.0)	(0.5)	(0.8)	0.1	
	Core	0.2	(0.2)	(0.4)	(0.4)	(0.4)	(0.7)	(0.5)	
AEE	Headline	7.2	5.8	4.5	3.5	2.3	1.4	0.7	
	Core	7.6	6.8	5.6	4.4	3.5	2.3		
ACC4	Headline	10.9	9.3	7.6	6.3	4.9	2.7	1.6	
	Core	8.8	7.6	6.2	4.7	3.4	1.9		
China	Headline	(1.3)	(1.8)	(2.2)	(2.2)	(2.1)	(1.4)	(1.3)	
	Core	1.2	1.3	1.0	0.9	0.7	0.5	0.3	
Hong Kong	Headline	(1.5)	(2.3)	(3.3)	(3.5)	(3.6)	(5.0)	(5.2)	
	Core	(1.6)	(2.5)	(4.2)	(4.4)	(4.4)	(6.6)	(7.3)	
India	Headline	5.3	4.9	4.3	3.8	2.0	1.3	1.8	1.9
	Core	53.4	45.4	38.0	30.7	24.5	13.5	5.8	1.3
Indonesia	Headline	39.7	34.4	30.4	23.4	19.1	11.2	6.7	5.4
	Core	0.2	0.5	0.4	0.8	0.6	0.3	0.9	0.8
Korea	Headline	0.2	0.2	0.0		(0.2)	(0.3)	0.0	(0.1)
	Core	3.8	3.1	2.9	2.9	2.2	2.5	2.3	
Malaysia	Headline	3.1	2.6	1.6	1.2	0.4	(0.4)		
	Core	10.0	8.7	7.9	6.7	5.7	5.7	5.5	5.7
Philippines	Headline	9.0	8.2	8.2	7.7	8.3	8.3	7.8	7.8
	Core	(0.6)	(0.6)	(0.3)	0.1	0.6	0.6	0.9	
Singapore	Headline	(1.4)	(1.1)	(1.0)	(0.6)	(0.1)	(0.1)	0.4	
	Core	2.1	(0.5)	(0.1)	0.5	(0.8)	(0.8)	1.1	0.6
Taiwan	Headline	2.0	0.0	0.2	0.1	0.4	0.4	0.8	0.9
	Core	2.9	1.6	0.4	(0.6)	(1.2)	(1.1)	(1.1)	(0.8)
Thailand	Headline	5.5	4.4	2.1	1.2	(0.1)	0.2	0.0	
	Core								

Source: CEIC, GS estimates.

EXTERNAL TRADE: EXPORTS**Growth in Non-Japan Asia**

% change yoy, 3MMA



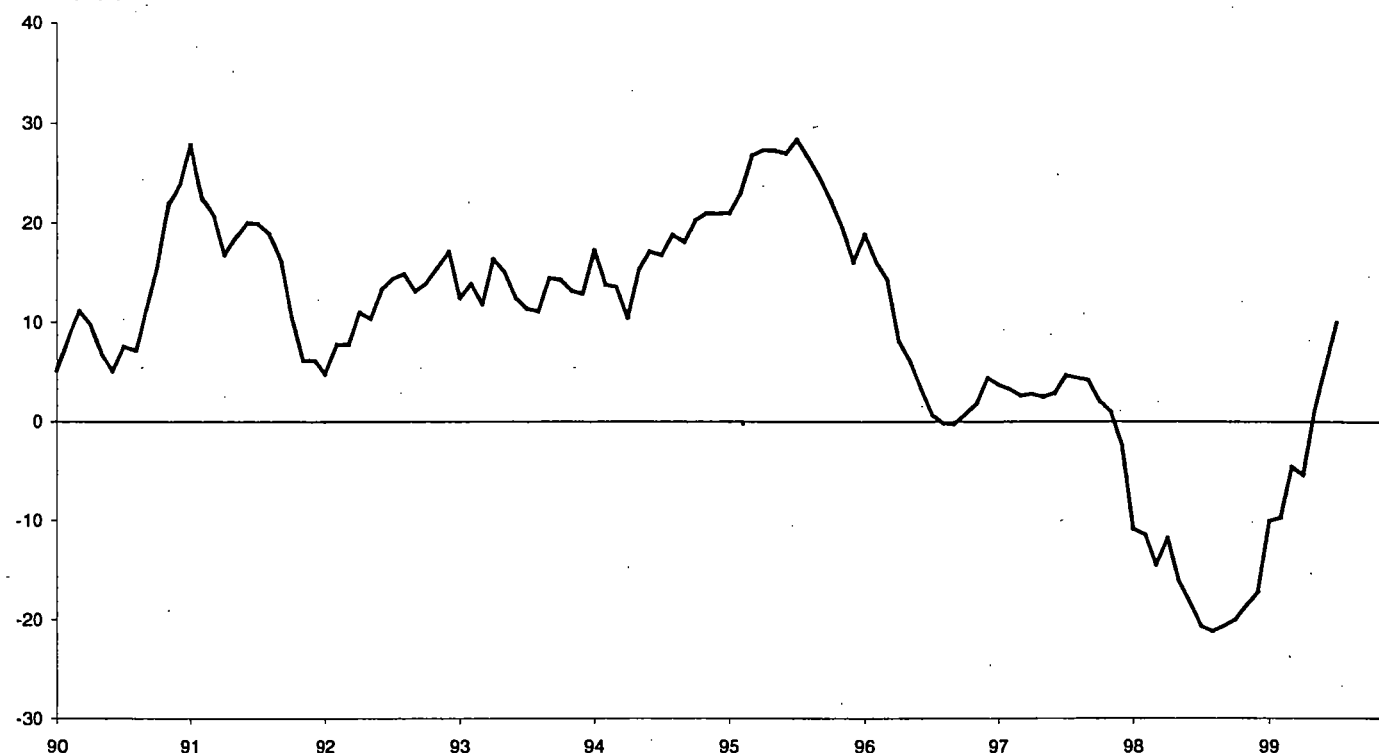
Source: CEIC, IFS, GS estimates.

(% change yoy)	<u>Feb-1999</u>	<u>Mar-1999</u>	<u>Apr-1999</u>	<u>May-1999</u>	<u>Jun-1999</u>	<u>Jul-1999</u>	<u>Aug-1999</u>	<u>Sep-1999</u>
Asia	(10.7)	(4.5)	(2.2)	4.7	2.9	8.2		
NIE	(14.2)	(6.6)	(4.2)	2.5	3.3	8.3	9.6	
AEE	(6.3)	(1.8)	0.3	7.5	2.4	8.1		
ACC-4	(5.1)	(2.0)	8.4	11.0	6.0	10.1		
China	(10.3)	(4.0)	(7.4)	4.1	(2.2)	7.4	17.7	20.4
Hong Kong	(10.1)	(10.6)	(8.1)	(4.2)	(5.4)	2.8	4.1	
India	5.0	10.1	(2.7)	4.8	6.4	0.1	7.9	
Indonesia	(16.2)	(13.2)	6.4	3.1	(20.6)	(13.3)		
Korea	(16.8)	(2.9)	(4.6)	1.1	12.0	18.0	17.3	11.8
Malaysia	(5.3)	1.5	14.5	17.0	23.1	28.8	23.8	
Philippines	15.4	9.2	2.7	13.8	19.6	14.0	21.1	
Singapore	(17.5)	(10.4)	(1.9)	3.4	1.9	4.0	9.0	
Taiwan	(12.7)	(1.7)	0.5	13.6	8.1	11.5	11.4	0.9
Thailand	(5.6)	(1.9)	4.7	8.4	4.0	7.8	14.6	8.2

Source: CEIC, IFS.

EXTERNAL TRADE: IMPORTS**Growth in Non-Japan Asia**

% change yoy, 3MMA



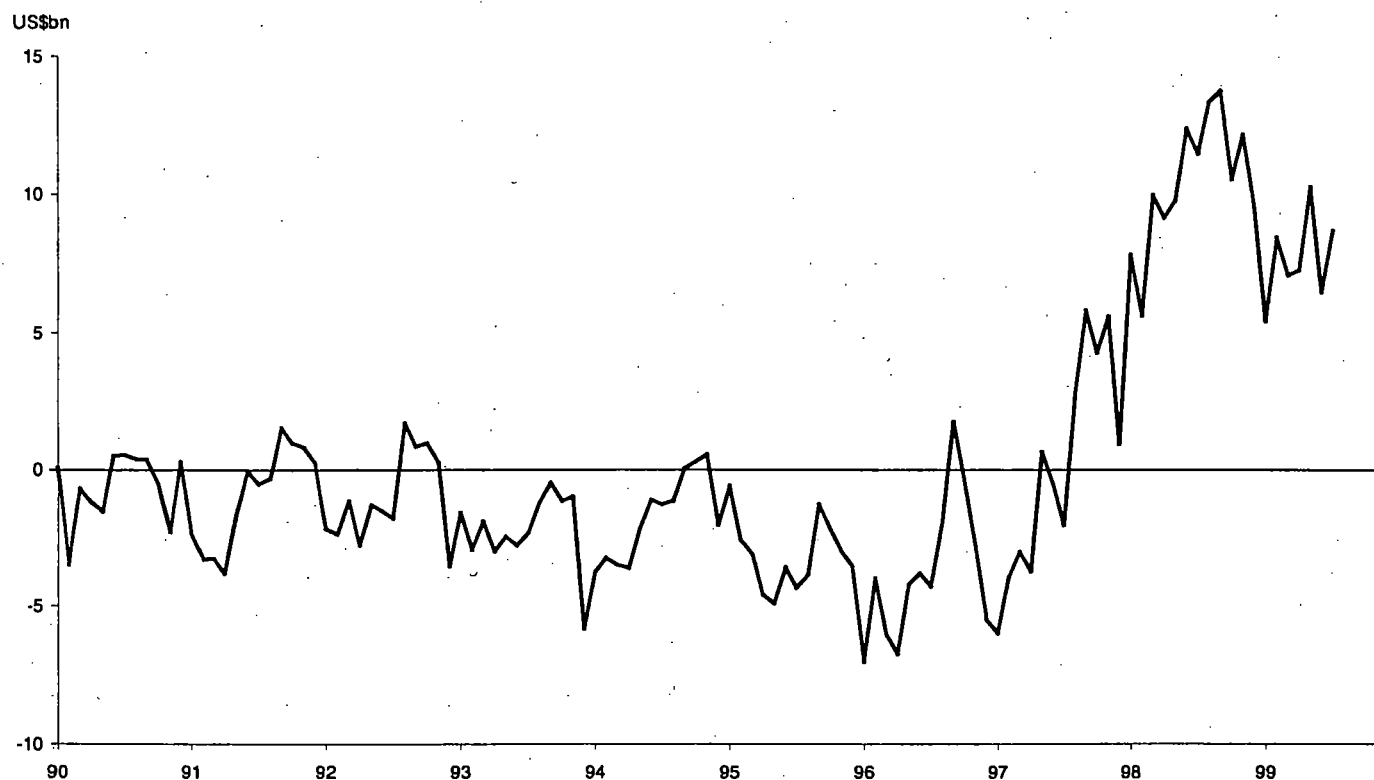
Source: CEIC, IFS, GS estimates.

(% change yoy)	<u>Feb-1999</u>	<u>Mar-1999</u>	<u>Apr-1999</u>	<u>May-1999</u>	<u>Jun-1999</u>	<u>Jul-1999</u>	<u>Aug-1999</u>	<u>Sep-1999</u>
Asia	(15.8)	(1.2)	0.1	4.8	12.2	13.0		
NIE	(20.8)	(6.6)	(5.0)	1.8	6.2	15.3	16.4	
AEE	(8.2)	6.9	7.8	9.1	21.1	10.0		
ACC-4	(10.5)	(4.1)	4.5	1.9	19.9	9.2		
China	(4.3)	22.1	18.7	21.5	22.6	16.7	23.9	32.8
Hong Kong	(24.9)	(12.4)	(14.9)	(12.5)	(6.3)	3.5	1.4	
India	(9.7)	1.6	(14.7)	(3.2)	20.0	(7.9)	17.6	
Indonesia	(19.9)	(16.4)	10.3	(3.2)	(11.8)	(19.6)		
Korea	(3.2)	12.3	10.7	24.6	31.5	37.7	38.5	40.0
Malaysia	(17.1)	(9.3)	2.6	5.3	32.0	22.8	25.3	
Philippines	(12.8)	1.5	5.7	(3.5)	18.1	13.2		
Singapore	(20.8)	(11.2)	2.1	10.8	7.7	14.1	23.1	
Taiwan	(29.8)	(8.5)	(7.4)	0.2	5.1	20.2	19.0	(0.1)
Thailand	7.8	6.8	3.3	4.2	25.8	8.0	23.9	28.4

Source: CEIC, IFS.

EXTERNAL BALANCE

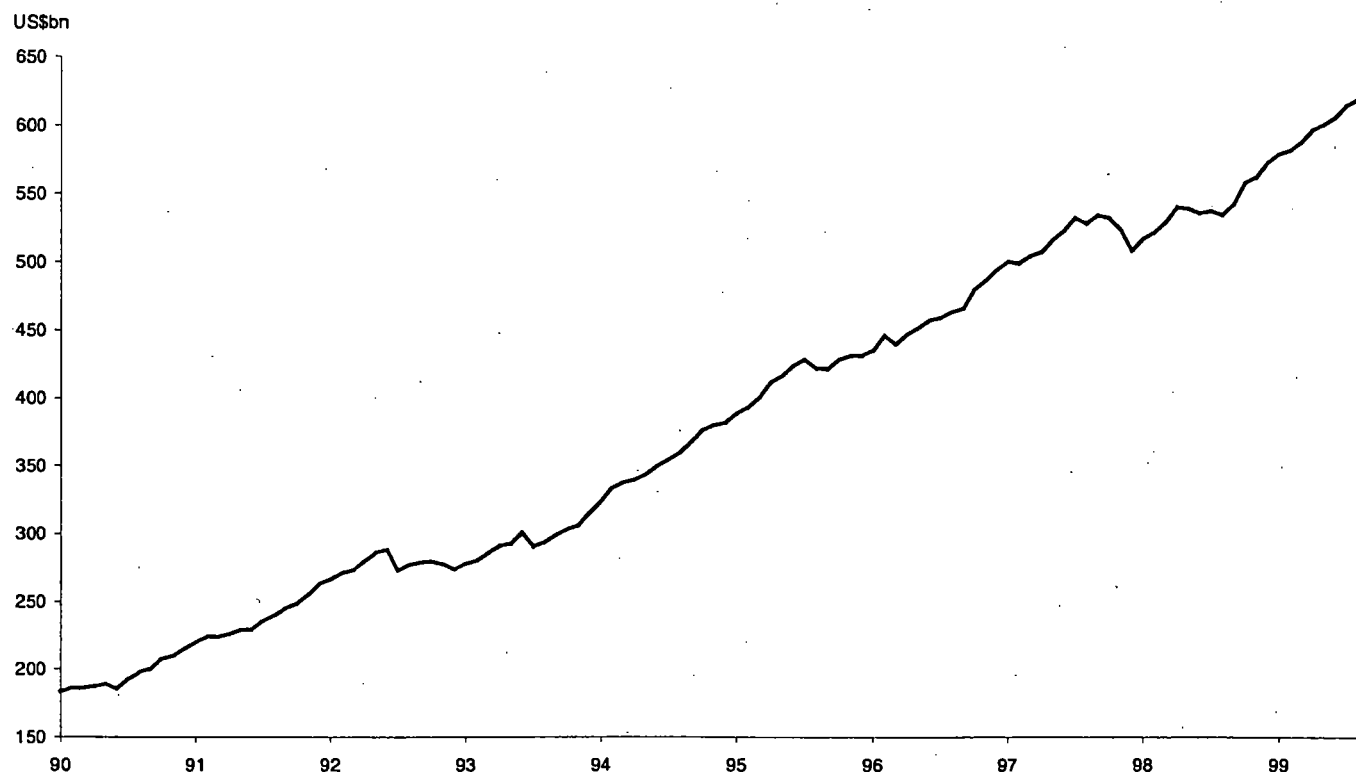
Trade Balance



Source: CEIC, GS estimates, IFS.

(US\$ billion)	Feb-1999	Mar-1999	Apr-1999	May-1999	Jun-1999	Jul-1999	Aug-1999	Sep-1999
Asia	8.4	7.1	7.2	10.1	6.4	8.7		
NIE	2.9	2.6	2.9	4.0	3.2	1.5	2.4	
AEE	5.5	4.5	4.4	6.1	3.2	7.1		
ACC-4	3.6	4.2	3.9	5.2	3.5	4.2		
China	2.3	0.4	1.0	1.9	0.8	3.4	4.9	3.3
Hong Kong	(0.1)	(1.4)	(0.9)	(0.0)	(0.7)	(0.7)	0.3	
India	(0.3)	(0.2)	(0.5)	(0.9)	(1.0)	(0.5)	(0.8)	
Indonesia	1.4	2.0	1.7	2.1	1.7	1.6		
Korea	1.7	2.4	2.4	2.0	2.7	2.1	1.5	1.9
Malaysia	1.3	1.7	1.6	1.7	1.4	1.5	1.8	
Philippines	0.3	0.1	(0.3)	0.2	0.2	0.1		
Singapore	0.3	0.6	0.4	0.3	0.4	(0.3)	(0.3)	
Taiwan ^a	1.1	1.1	1.0	1.8	0.8	0.5	0.8	1.2
Thailand	0.6	0.5	0.8	1.2	0.2	1.1	0.8	0.7

Source: CEIC.

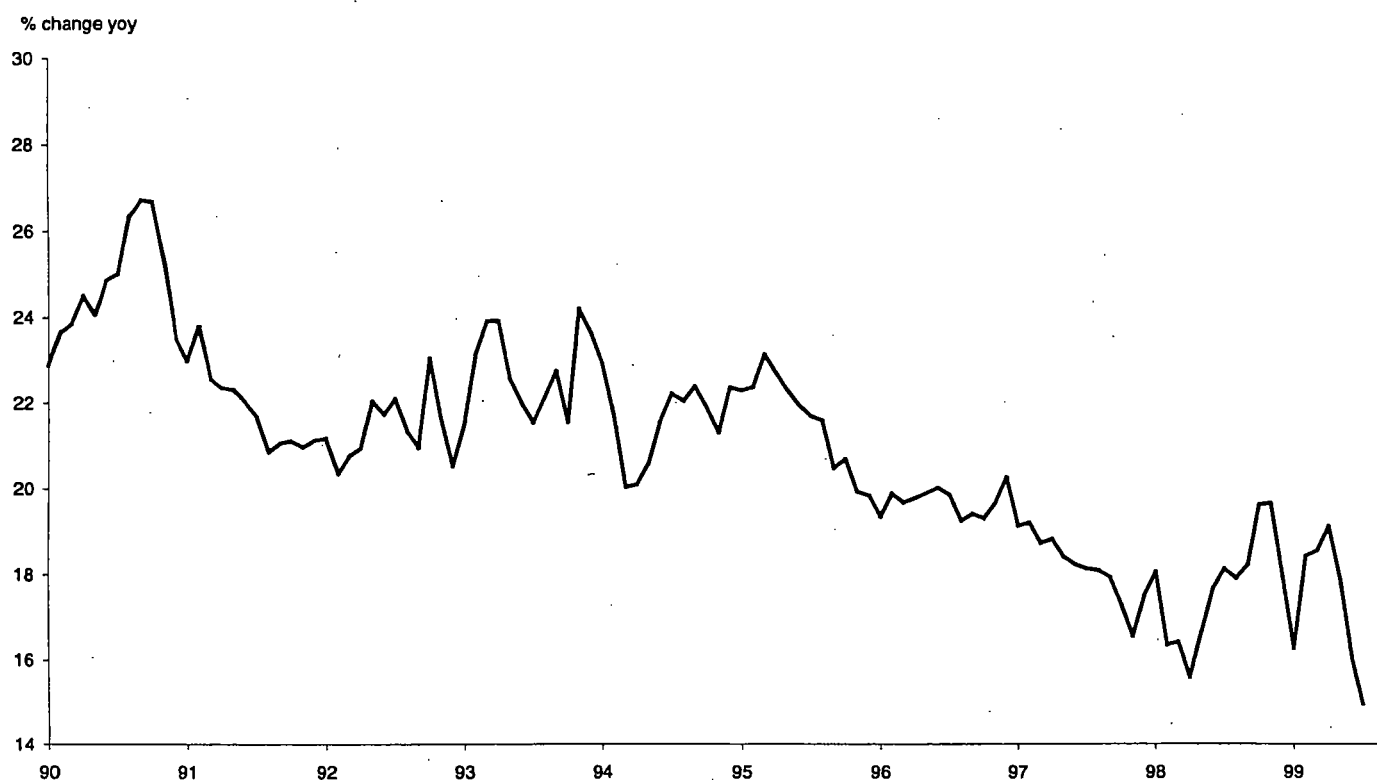
EXTERNAL BALANCE**Foreign Reserves**

Source: CEIC, GS estimates, IFS.

(US\$ billion)	Feb-1999	Mar-1999	Apr-1999	May-1999	Jun-1999	Jul-1999	Aug-1999	Sep-1999
Asia	581.3	587.2	596.3	600.1	605.7	614.4	619.2	
NIE	310.2	311.8	318.6	319.9	322.2	328.2	330.1	334.0
AEE	271.1	275.4	277.7	280.2	283.5	286.2	289.1	
ACC-4	93.8	96.3	98.5	100.0	103.2	104.0	105.4	
China	146.5	146.6	146.7	146.7	147.1	148.7	150.4	
Hong Kong	89.8	89.5	89.5	88.9	88.5	89.1	89.2	90.4
India	30.8	32.5	32.5	33.5	33.3	33.4	33.3	33.0
Indonesia	24.3	25.8	26.0	26.0	26.9	26.6	26.8	
Korea	55.5	57.5	59.3	61.4	62.0	64.9	64.8	65.5
Malaysia	28.7	27.7	28.6	29.8	31.1	31.7	32.3	31.4
Philippines	12.1	12.8	13.7	13.6	13.7	13.8	14.1	14.5
Singapore	72.4	71.8	74.7	73.9	73.9	75.6	75.9	76.4
Taiwan	92.6	93.0	95.1	95.7	97.7	98.6	100.1	101.7
Thailand	28.7	29.9	30.2	30.6	31.4	31.9	32.2	32.5

(a) Foreign exchange reserves.

Source: CEIC, GS estimates.

MONETARY**Money Supply**

Source: CEIC, GS estimates, IFS.

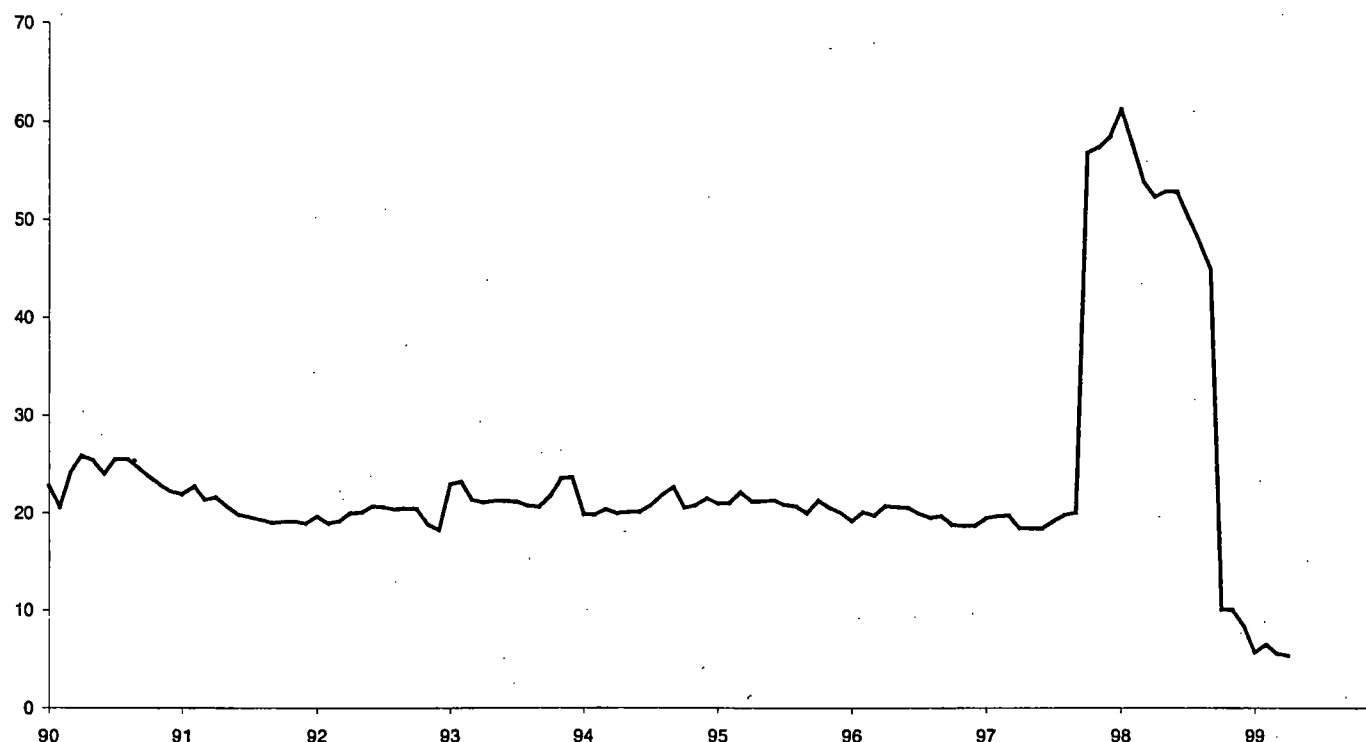
(% change yoy)	Feb-1999	Mar-1999	Apr-1999	May-1999	Jun-1999	Jul-1999	Aug-1999	Sep-1999
Asia	18.4	18.6	19.1	17.9	16.0	15.0		
NIE	18.6	20.6	21.5	19.7	18.1	16.0	15.9	
AEE	18.3	17.3	17.7	16.7	14.8	14.3		
ACC-4	10.2	9.1	9.6	8.5	4.6	5.2	5.1	
China	18.0	17.8	17.9	17.2	17.1	15.7		
Hong Kong	9.4	9.4	11.0	11.3	10.4	6.3	4.6	
India ^a	19.2	17.8	18.0	18.0	18.1	18.5	16.4	
Indonesia	40.1	34.1	35.2	27.2	8.8	12.7	17.7	
Korea	29.9	33.7	34.6	30.6	27.1	24.2	24.9	26.9
Malaysia	4.1	4.6	8.1	10.8	10.7	12.4	11.3	
Philippines	8.4	7.7	7.7	8.9	9.1	10.8		
Singapore	8.6	8.2	9.2	9.7	10.5	9.3	9.7	
Taiwan	7.9	8.6	9.1	9.3	9.6	9.7	9.1	
Thailand	8.4	8.6	8.5	8.7	5.8	3.7	3.9	

(a) M3 growth.

Source: CEIC.

MONETARY**Domestic Credit to the Private Sector**

% change yoy



Source: CEIC, GS estimates, IFS.

(% change yoy)	Jan-1999	Feb-1999	Mar-1999	Apr-1999	May-1999	Jun-1999	Jul-1999	Aug-1999
Asia	5.7	6.6	5.6	5.4				
NIE	1.9	2.8	3.6	3.9				
AEE	8.1	8.9	6.9	6.3				
ACC-4	(4.5)	(2.3)	(6.3)	(7.4)				
China	16.5	16.5	16.5	16.0	16.0	16.0		
Hong Kong	(3.0)	(3.0)	(3.6)	(4.6)	(5.3)	(6.2)	(5.8)	(6.0)
India	13.6	11.6	12.7	13.9	14.3	14.3	14.2	14.6
Indonesia	(6.7)	(2.9)	(26.4)	(30.9)	(48.9)	(61.1)	(58.7)	(54.0)
Korea	(2.7)	(1.7)	(0.0)	(0.9)	(1.1)	(0.2)	0.8	
Malaysia	(1.3)	(0.4)	(2.3)	(2.7)	(1.8)	(1.9)	(2.4)	(3.1)
Philippines	(7.2)	(5.0)	(4.0)	(6.0)				
Singapore	7.4	6.6	6.2	6.9	7.1	7.9	7.4	
Taiwan	10.5	12.2	12.6	15.5	12.8	12.2	11.7	
Thailand	(13.2)	(6.5)	(4.2)	(4.5)	(5.5)	(7.5)	(6.1)	

Source: CEIC, IFS.

INTEREST & EXCHANGE RATE OUTLOOK**Interest Rates**

(%)		Current		3-Month Horizon		6-Month Horizon		12-Month Horizon		
		Oct 8		Forward	Forecast	Forward	Forecast	Forward	Forecast	
AEE										
ASEAN										
	Indonesia	3M	13.6		14.3	10.2	NA	9.4	NA	11.9
	Malaysia	3M	NA		NA	5.8	NA	6.0	NA	4.8
	Philippines	3M	9.5		10.6	10.2	NA	11.2	NA	11.7
	Thailand	3M	7.5		8.4	6.3	NA	6.1	NA	6.3
	China	3M	NA		NA	NA	NA	NA	NA	N
	India	3M	9.5		NA	9.5	NA	9.0	NA	9.5
NIE										
	Hong Kong	3M	6.2		7.0	6.3	NA	6.6	NA	6.
	Korea	3M	5.6		6.3	6.8	NA	7.0	NA	7.0
	Singapore	3M	2.4		3.4	3.3	NA	3.8	NA	4.
	Taiwan	3M	5.1		NA	4.8	NA	4.8	NA	4.8

Note: Hong Kong: 3M Offshore implied, GS estimates, India: 91D T-Bill Auction, Bloomberg (GINAY91), Indonesia: 3M Offshore implied, GS estimates, Korea: 3M Offshore implied, GS estimates, Philippines: 3M Offshore implied, GS estimates, Singapore 3M Offshore implied, GS estimates, Taiwan: 61-90D New Taiwan dollar, Secondary, Bloomberg (NTSEC90), Thailand: 3M Offshore Interest Rate, GS estimates.

Exchange Rates

(Local/US\$)	Current	3-Month Horizon		6-Month Horizon		12-Month Horizon	
	Oct 8	Forward	Forecast	Forward	Forecast	Forward	Forecast
AEE							
ASEAN							
Indonesia	7,738	7,955	6,700	8,115	6,800	8,490	7,200
Malaysia	3.80	NA	3.80	NA	3.80	NA	3.80
Philippines	40.58	40.80	39.50	41.25	40.50	42.33	42.00
Thailand	40.28	40.11	39.00	40.33	37.00	40.69	37.00
China	8.28	NA	8.28	NA	8.28	NA	8.28
India	43.45	44.09	44.00	44.75	45.00	46.05	47.00
NIE							
Hong Kong	7.77	7.78	7.78	7.79	7.78	7.84	7.80
Korea	1204	1201	1150	1202	1050	1207	105
Singapore	1.68	1.67	1.65	1.65	1.63	1.63	1.63
Taiwan	31.73	31.82	32.20	31.89	32.00	31.98	32.00

INTEREST & EXCHANGE RATE OUTLOOK

Interest Rate Differentials

(%)	Current	3-Month Horizon		6-Month Horizon		12-Month Horizon	
	Oct 8	Forward	Forecast	Forward	Forecast	Forward	Forecast
AEE							
ASEAN							
Indonesia	7.7	8.1	4.5	NA	3.6	NA	5.8
Malaysia	NA	NA	0.2	NA	0.5	NA	(1.0)
Philippines	3.7	4.4	4.5	NA	5.4	NA	5.6
Thailand	1.7	2.2	0.8	NA	0.5	NA	0.
China	NA	NA	NA	NA	NA	NA	NA
India	3.3	NA	3.8	NA	3.3	NA	3.5
NIE							
Hong Kong	0.4	0.8	0.7	NA	1.0	NA	1.0
Korea	(0.2)	NA	1.2	NA	1.4	NA	1.
Singapore	(3.4)	(2.8)	(2.1)	NA	(1.6)	NA	(1.0)
Taiwan	(0.1)	NA	(0.7)	NA	(0.7)	NA	(0.9)

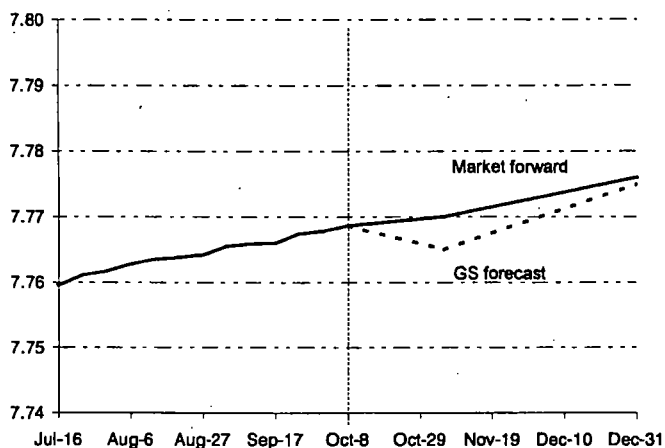
Excess Returns

(%)	3-Month Horizon	6-Month Horizon	12-Month Horizon
AEE			
ASEAN			
Indonesia	91.2	39.6	16.9
Malaysia	NA	NA	NA
Philippines	15.4	4.4	1.2
Thailand	15.7	20.9	11.0
China	NA	NA	NA
India	(1.6)	(3.3)	(3.9)
NIE			
Hong Kong	0.1	0.4	0.6
Korea	19.8	31.5	15.2
Singapore	4.0	3.1	0.3
Taiwan	(6.3)	(2.3)	(1.7)

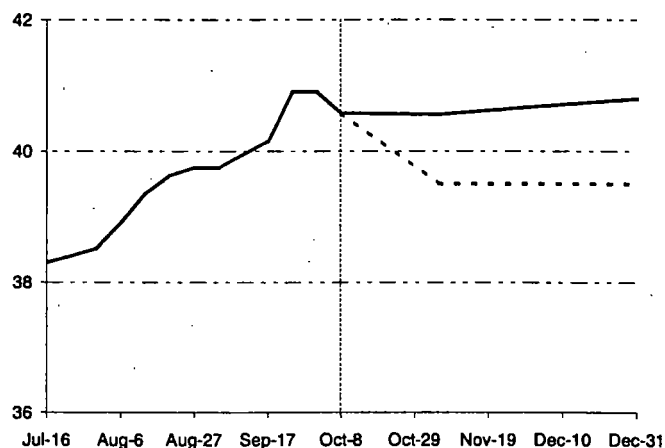
Note: Calculated as the excess returns of carrying 3-, 6-, or 12-month paper over corresponding U.S. rates.

EXCHANGE RATE FORECASTS 1999

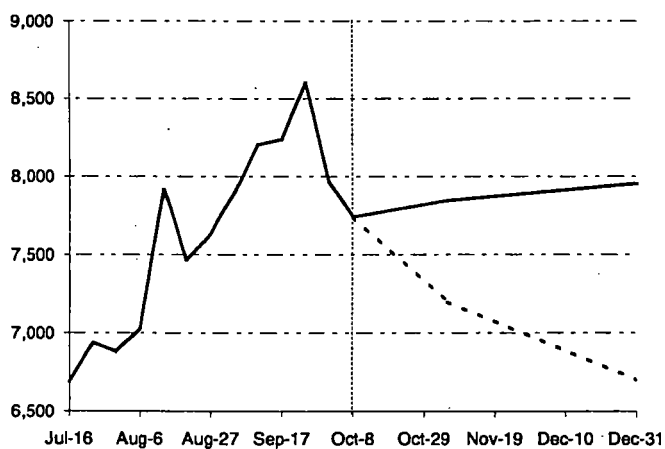
Hong Kong Dollar



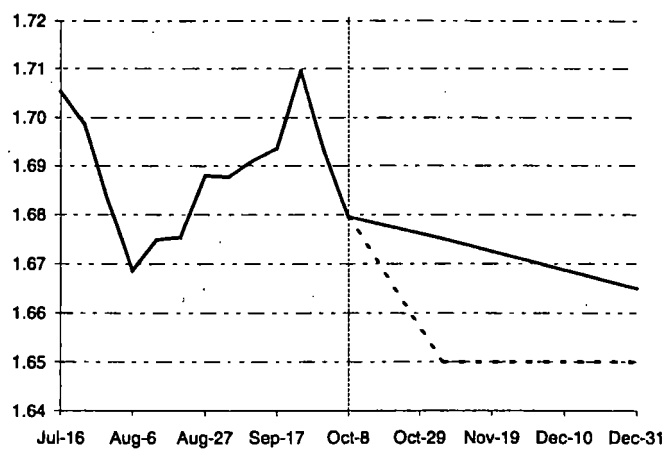
Philippine Peso



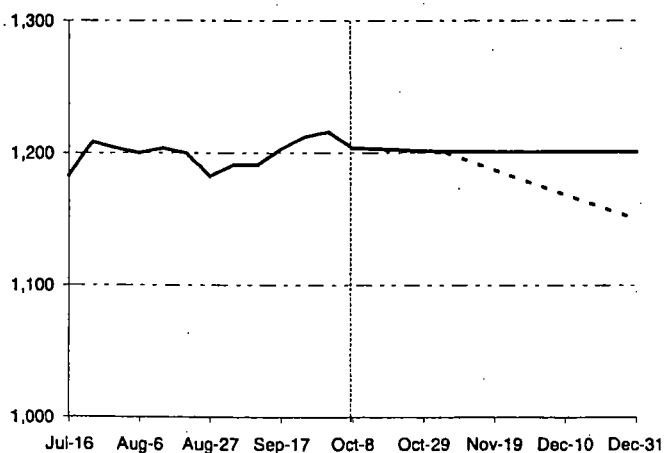
Indonesian Rupiah



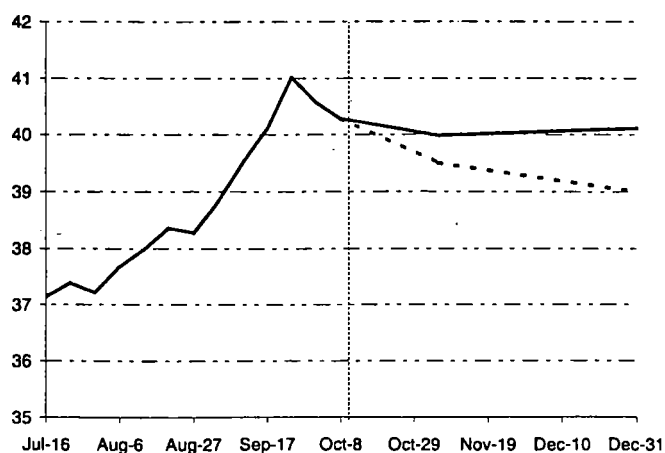
Singapore Dollar

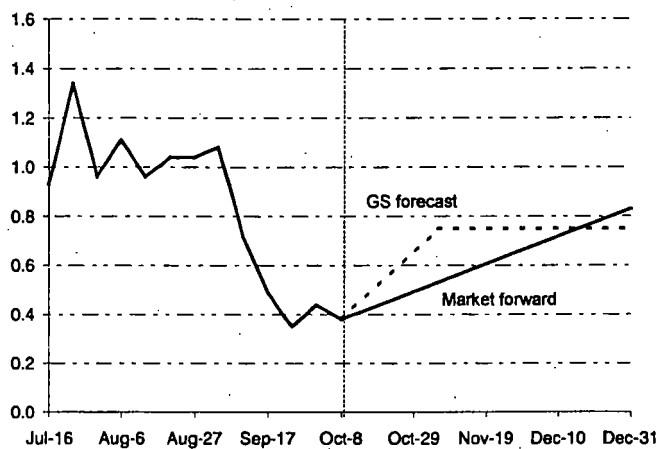
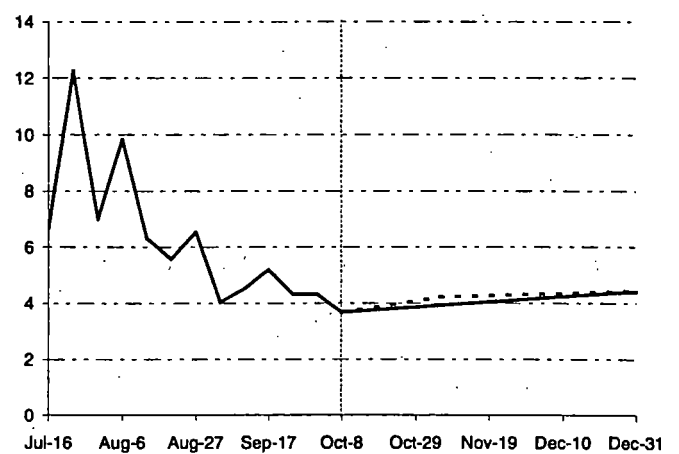
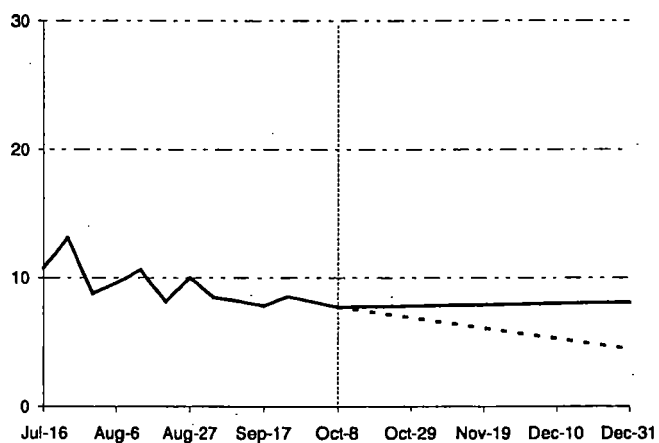
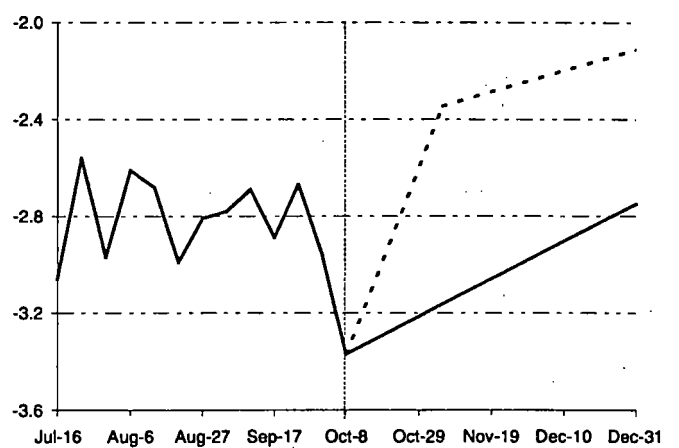
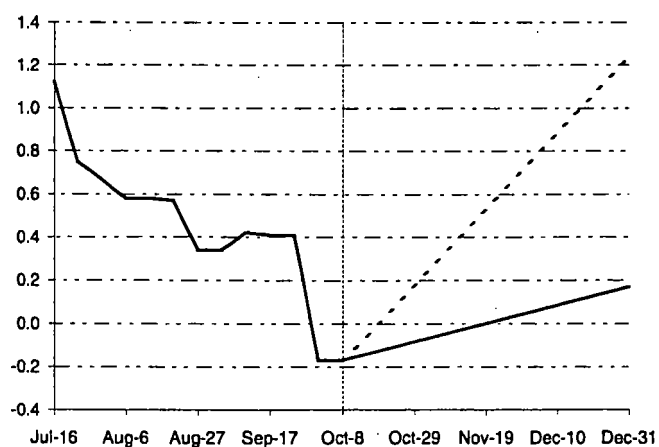
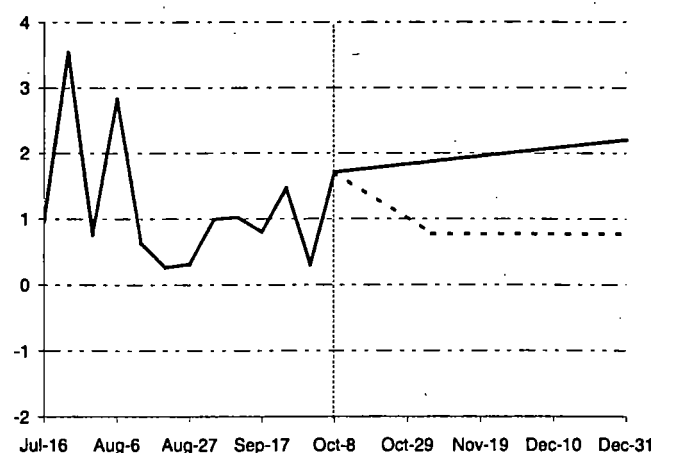


Korean Won



Thai Baht



INTEREST RATE DIFFERENTIAL FORECASTS 1999**Hong Kong****Philippines****Indonesia****Singapore****Korea****Thailand**

MAIN ECONOMIC INDICATORS

	GDP					Inflation				
	1997	1998	1999F	2000F	Latest (yoy)	1997	1998	1999F	2000F	Latest (yoy)
Asia	6.3	2.2	5.7	5.9		3.8	5.2	1.3	2.8	
AEE	6.5	4.1	5.7	6.2		4.0	5.7	1.8	3.5	
ASEAN	3.7	(8.5)	2.0	3.6		5.4	21.8	9.1	7.1	
Indonesia	4.9	(13.4)	(1.7)	2.5	1.8 (Q2)	6.6	58.4	20.9	13.0	1.3 (Sep)
Malaysia	7.5	(7.5)	5.2	5.0	4.1 (Q2)	2.7	5.3	2.9	3.0	2.1 (Sep)
Philippines	5.2	(0.5)	3.0	4.0	3.6 (Q2)	5.1	9.7	7.1	7.3	5.7 (Sep)
Thailand	(1.3)	(9.4)	3.7	4.0	3.5 (Q1)	5.6	8.1	0.3	1.8	(0.8) (Sep)
India	5.0	6.0	5.8	5.8	5.5 (Q1)	4.7	7.1	2.6	7.0	1.9 (Sep)
China	8.8	7.8	7.3	7.6	7.6 (H1)	2.8	(0.8)	(1.5)	0.5	(1.3) Aug
NIE	5.9	(1.8)	5.5	5.3		3.4	4.2	0.4	1.6	
Hong Kong	5.0	(5.1)	0.6	2.8	0.5 (Q2)	5.7	4.1	(2.8)	1.0	(5.2) (Aug)
Korea	5.0	(5.8)	8.0	6.0	9.8 (Q2)	4.4	7.5	1.0	2.3	0.8 (Sep)
Singapore	9.2	0.3	4.0	4.8	6.7 (Q2)	2.0	(0.3)	0.5	1.2	0.9 (Aug)
Taiwan	6.8	4.7	5.3	5.5	6.5 (Q2)	0.9	1.7	1.2	1.0	0.6 (Sep)

	3M Interest Rates					Exchange Rates				
	1997	1998	1999F	2000F	Latest (yoy)	1997	1998	1999F	2000F	Latest (yoy)
AEE										
ASEAN										
Indonesia	14.2	38.3	9.9	12.2	14.1	4650	8100	6733	7467	7738
Malaysia	8.7	6.4	3.8	5.0	3.2	3.89	3.80	3.80	3.80	3.80
Philippines	17.7	13.5	9.3	10.5	8.5	39.90	39.16	39.83	42.67	40.58
Thailand	16.8	7.4	6.1	6.6	6.1	48.15	36.65	39.00	37.00	40.28
China	—	—	—	—	—	8.31	8.28	8.28	8.28	8.28
India	7.0	9.5	9.3	9.9	9.5	39.25	42.51	44.17	46.50	43.45
NIE										
Hong Kong	9.3	5.4	6.6	7.1	6.4	7.75	7.75	7.79	7.80	7.77
Korea	25.0	7.7	7.0	6.8	7.5	1415	1200	1150	1025	1204
Singapore	7.2	1.6	2.7	4.2	2.3	1.68	1.66	1.64	1.63	1.68
Taiwan	8.5	5.5	4.8	4.8	5.1	32.64	32.23	32.13	32.00	31.73

Note: GDP and inflation are annual averages. Interest rates and exchange rates refer to end-period. Figures in bold indicate revisions. Latest interest and exchange rate data as of last Friday's close.

Hong Kong: 3M HIBOR, (HIHD03M), **Korea:** 3M certificate of deposit, Bloomberg (KWCD3M), **Taiwan:** 61-90D New Taiwan dollar, Secondary, Bloomberg (NTSEC90), **Indonesia:** 3M Offshore implied, Reuters, **Malaysia:** 3M KLIBOR, Bloomberg (KLIM3M) **Philippines:** 91D T-Bill, Bloomberg, (PPTB91D), **Singapore:** 3M Interbank, Bloomberg (SISD03M), **Thailand:** 3M Offshore Interest Rate, Reuters. **India:** 91D T-Bill Auction, Bloomberg (GINAY91).