Withdrawal/Redaction Sheet
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DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. memo	Ted Truman to Secretary Rubin & Deputy Secretary Summers re: Dan Zelikow in Brazil (2 pages)	02/09/99	P5
002. memo	Daniel Zelikow to Assistant Secretary Truman re: Reflections on Brazil Trip (4 pages)	02/09/99	P5
003. notes	re: Meeting with Fund Mission Team (2 pages)	ca.1999	P5
004. notes	re: Meeting with Arminio Fraga, Ministry of Finance (3 pages)	02/04/99	P5
005. notes	re: Meeting at Finance Ministry with Finance Minister Pedro Malan, Pedro Parente, & Amaury Bier (3 pages)	02/05/99	P5
006. notes	re: Meeting with Think-tankers (1 page)	ca.1999	P5
007. notes	re: Notes from Meetings at Central Bank (3 pages)	ca. 1999	P5
008. memo	Robert E. Rubin to POTUS re: Economic issues for State Visit of Jiang Zemin (2 pages)	ca. 1997	P5
009. notes	Lawrence Summers to Sandy Berger re: Read-out from Meetings in China (1 page)	01/15/98	P5
010. notes	Lawrence Summers to Sandy Berger re: Read-out from Meetings in Hong Kong (1 page)	01/15/98	P5

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1999-SE-000922

From: Ted Truman
To: DOM3.DOPO5.SUMMERSL, DOM3.DOPO5.SandbergS, FLANDER...
Date: 1/23/99 9:27pm
Subject: Brazil Consensus or Non - Consensus

WATCH OFFICE:

Please fax the message that follows to Secretary Rubin along with the attachment.

Summary of Meeting with IMF on Brazil: Points of Agreement and Disagreement

We are agreed:

1. If the Brazilians decide they want to introduce a currency board system, they should be allowed to do so. The Fund would be inclinded to support the arrangement with additional disbursements. Enthusiasm for the currency board approach ranges from high (Fischer & Depler) and moderate (Summers?) to skeptical (Truman, Mussa). One thought is that a currency board might be the last best hope to avoiding a debt restructuring.

On the assumption that a currency board were not chosen by the Brazilians:

2. There should be no intervention in the spot, futures or any othe rmarket with the possible exception of a set amount of dollar sales, e.g. $1 - 2 billion per month that we be sold in equal amounts each trading day to cover the current account deficit (running at about $2 billion per month) and possible some debt repayments. [QUESTION: Should the central bank go into the market to obtain dollars for official debt repayments? How should intervention be defined, e.g., treatment of interest and increases or decreases in encumbrances?]

3. No system of exchange rate bands.

4. No capital controls; at least not without substantive consulation with the Fund.

5. We should communicate with the Brazilians a general concern about the market's focus on the need for a debt restructuring. The Brazilians should be expected to demonstrate to the market and to us why one is not needed. However, a nuanced message should be conveyed on this poont.

6. It would be a mistake to use the exchange rate as a target for interest rates.

7. We are concerned about a feedback from the exchange rate to interest rates.

8. Monetary policy should focus less on the exchange rate and more on inflation, but any policy must be tempered by (IMF) judgement.

Points of disagrreement:

9. The IMF (MD in particulare) is inclined to favor an immediate sharpo increase in interest rates (Mussa following Korea). (The MD has conditioned

sending the IMF mssion to Brazil on there being such an adjustment.)

10. Summers/Hooper/Truman (Greenspan) are inclinded to an approach that involves:

a. No increase in interest rates now and a decline if the exchange rate stabilizes.
b. Any incease dependent on a rule associated with an increase in interest rates if inflation increases beyond some point.
c. With an overriide from a monetary aggregate if inflation rises too far.

[An outline of such an approach is attached. NOTE: The thought is that any such policy should be very transparent, but I did not include this in the outline.]

11. Atkinson (possibly Zelikow and some in the Fund) prefer strong relance on a monetary aggregate, preferably NDA, with a tight feeback rule as providing clarity and the only sure defense against an inflation spiral. [The counter argument is that any credible and tight rule could lead to an immediate sharp rise in interest rates and, in the medium term, there is little basis upon which to design a credible target.]

CC: trumant

DRAFT
E..M. Truman
January 23, 1999

Possible Approach to Brazilian Monetary Policy

Objectives

1. No increase on in nominal interest rate (SELIC) now.

2. Hope that the exchange rate will stabilize in the next 3-8 weeks.

3. If the exchange rate stabilizes, allow the nominal interest rate to decline.

4. Regardless of whether the exchange rate stabilizes, if the cumulative price increase since the devaluation reaches, say, five percent raise the interest rate pari passu with any subsequent rise inflation. [NOTE: The price increase would be measured by the weekly Sao Paulo index, which recently has indicated zero inflation compared with the monthly national index that indicates 2 percent.] A cumulative increase from a particular week or multi-week base period might be used. [NOTE: We should check the seasonality in the Sao Paulo index.]

5. The rise in the nominal interest rate might be limited to 10 percentage points in order to prevent overshooting, subject to point 7 below.

6. Once inflation had peaked based on the 12-month change in the national consumer price index interest, the interest rate could be reduced pari passu with the decline in the national rate, subject to point 7 below.

7. The regime would be directed at containing inflation to less than 10 percent (December to December). To that end an NDA constraint would be constructed with quarterly targets, based on, say, assumption that growth in 1999 would be minus 5 percent and inflation 10 percent. If that constraint is hit, then the NDA constraint would be converted to a weekly target and effectively would govern monetary policy, i.e., interest rates would go wherever would be required in order to restrain inflation. [NOTE: There would be no intervention with the exception of sterilized intervention of a fixed amount per day that might be agreed with the IMF to cover the current account deficit, at least in part, for a limited period.]

8. There might be a consultation point on the absolute level of the level or change in the interest rate.

****
*** ACTIVITY REPORT ***
****

TRANSMISSION OK

TX/RX NO.	8697
CONNECTION TEL	82128612597
CONNECTION ID	
START TIME	01/24 07:03
USAGE TIME	01'55
PAGES	4
RESULT	OK

W.O. faxed to RER 1/24/99

DI cc: MF
SS
NC/DI/PA/AR

#131

UNCLASSIFIED
CLASSIFICATION

DATE 1/24/99

DEPARTMENT OF THE TREASURY
WATCH OFFICE
FAX COVERSHEET

– If received INCOMPLETE, call (202)622-1825

TO: SECRETARY RUBIN

FROM: TEO TRUMAN

OFFICE PHONE NUMBER: ______

FAX NUMBER: (202)622-1829 (unsecure) (202)622-1851 (secure)

HANDLE AS: ROUTINE ____ **PRIORITY** XX **URGENT** ____

Page 1 of 4 Pages

COMMENTS: BRAZIL

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FAX COVERSHEET.doc LAST REVISED 9/14/98

SERIAL NR. 131

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1999-SE-002559

ASSISTANT SECRETARY OF THE TREASURY

WASHINGTON, D.C. 20220

March 12, 1999

TO: Larry Summers

FROM: Ted Truman SS for

Attached is a short note done by Robert Kaproth outlining country risk provisioning practices in the G-10 plus Luxembourg and the impact on Brazil rollovers.

cc: Tim Geithner
Mike Froman
T. Checki
K. Johnson
Caroline Atkinson
Dan Zelikow
Peter Hooper
Wes McGrew
USED Lissakers

DRAFTED: IMB/Kaproth 3/12/99
REVIEWED: IMB/Murden, Blacker

Country Risk Provisions and Brazil Rollovers

We understand that the French focal point (de Larosière) expressed concern that the Banque de France is requiring French banks to reserve at a 30% rate against loans to Brazil, and that this may affect French banks' willingness to participate in a rollover.

While we cannot independently verify various countries' reserve requirements for Brazil (this regulatory information is usually confidential), a survey of the G-10 plus Luxembourg reveals that only 5 countries draw up specific country lists for risk provisioning. The general trend has been and continues to be away from imposing formal methodologies on banks, and toward making the banks themselves responsible for establishing adequate provisions for country risk.

As such, we do not expect à priori that regulator-mandated country risk provisioning will have a significant impact on the Brazil rollover agreement in the aggregate. However, it may be important for banks that do face such requirements – notably in Belgium, Canada, France, the Netherlands, and to a lesser extent, Italy. Lending from these five countries accounts for roughly 20% of the interbank lines monitored by the IMF. These five countries' cumulative rollover rates are generally slightly lower than the total cumulative rollover rate of about 70%.

Current Country Risk Provisioning Policies

A June 1998 survey of the G-10 plus Luxembourg shows wide disparity in country risk provisioning policies.

- On the one hand, regulatory authorities in five countries (Belgium, Canada, France, the Netherlands, and the U.S.) draw up specific lists of countries for which banks have to set aside country risk provisions.1 Belgium, Canada, the Netherlands, and the U.S. *recommend* "appropriate levels" of country risk provisions, and it is possible that the French *require* "appropriate levels" (although this is not explicitly stated).

  - The specific levels are usually confidential regulatory information. However, we do know that the U.S. does not impose a transfer risk provision on Brazil. (This would have been accomplished through an Allocated Transfer Risk Reserve by the Interagency Country Exposure Review Committee (ICERC)).

  Other countries (Italy, Japan, Switzerland, and the UK) do not draw up country lists but do establish formal criteria to help the banks identify high-risk countries. These criteria are not at all consistent among countries. A quick examination suggests that only the Italian criteria might apply to the majority of that country's bank exposure to Brazil. As of June 1998, Switzerland and the UK intended to discontinue use of such criteria, and may have already done so.

- On the other hand, three countries (Germany, Luxembourg, and Sweden) do not lay out general guidelines to banks for country risk. Instead, country risk exposures are dealt with under normal procedures for measuring impairment.

Trends in Country Risk Provisioning

Generally speaking, the country lists and formal criteria were instituted a number of years ago, and regulators have gradually backed away from the prescription of formal methodologies for country risk on banks. Rather, regulators hold the banks themselves responsible for assessing their exposures to country risk and making adequate provisions.

Impact on Brazil Rollovers

Given this longstanding trend, we would not expect regulator-mandated country risk provisioning to have a significant impact on Brazilian rollovers in the aggregate. However, it may be an issue for banks that do face such requirements: notably in Belgium, Canada, France, the Netherlands, and to a lesser extent, Italy. It would therefore be useful to clarify in the first central bank monitoring conference call the regulatory policies of these countries vis-à-vis bank claims on Brazil, and whether there have been any recent changes in country risk provisioning practices; this was done in the conference calls for Korea in 1998.

An examination of end-September 1998 stock data for the IMF monitoring exercise shows that France, the Netherlands, Canada, and Italy combined accounted for 16.4% of monitored interbank lines. Belgium is included in the "other" category. We estimate that adding Belgium could push the total percentage to just under 20%. This figure is fairly consistent with end-June 1998 BIS consolidated data on interbank claims.

Since the release of flow data from the monitoring system began in October 1998, cumulative rollover ratios for these five countries have been less than the total.2 The total for all countries currently stands at 69%, while Belgian banks have rolled over at a 66% rate, Italian banks at 64%, the Dutch and French banks each at 62%, and Canadian banks at only 30%. (Canadian rollover ratios have been close to zero for the last two months. This may or may not be related to regulator-mandated country risk provisioning.)

1999-SE-003885

to: Larry Summers
Tim Geithner
Ted Truman
Dan Zelikow
Caroline Atkinson

Department
of the Treasury

date: April 16, 1999

Office of the
Assistant Secretary
for International Affairs
Office of Latin American and
Caribbean Nations

Attached are three notes by the Brazil team. The first looks at interest rate developments, the second at recent public debt management, and the third at the fiscal numbers published this week.

Wes McGrew WM

room 4401
1440 NY Ave
622-2876

Recent Developments in Brazilian Interest Rates

Attached are two graphs that show developments this year in Brazil's *real* yield curve and a time-series of local interest rates.

Four key points are:

- In late January and February, the domestic yield curve was positive and quite steep -- apparently reflecting market fears of a depreciation-inflation spiral. But by early March, when the central bank raised the Selic to 45%, the *real* had appreciated from its low of 2.15/$ to 1.87/$, and favorable price data were easing inflation fears. By the second week of March, the one-month and one-year interest rates had fallen below the Selic. Subsequently, the central bank cut the Selic three times between March 25 and April 15.

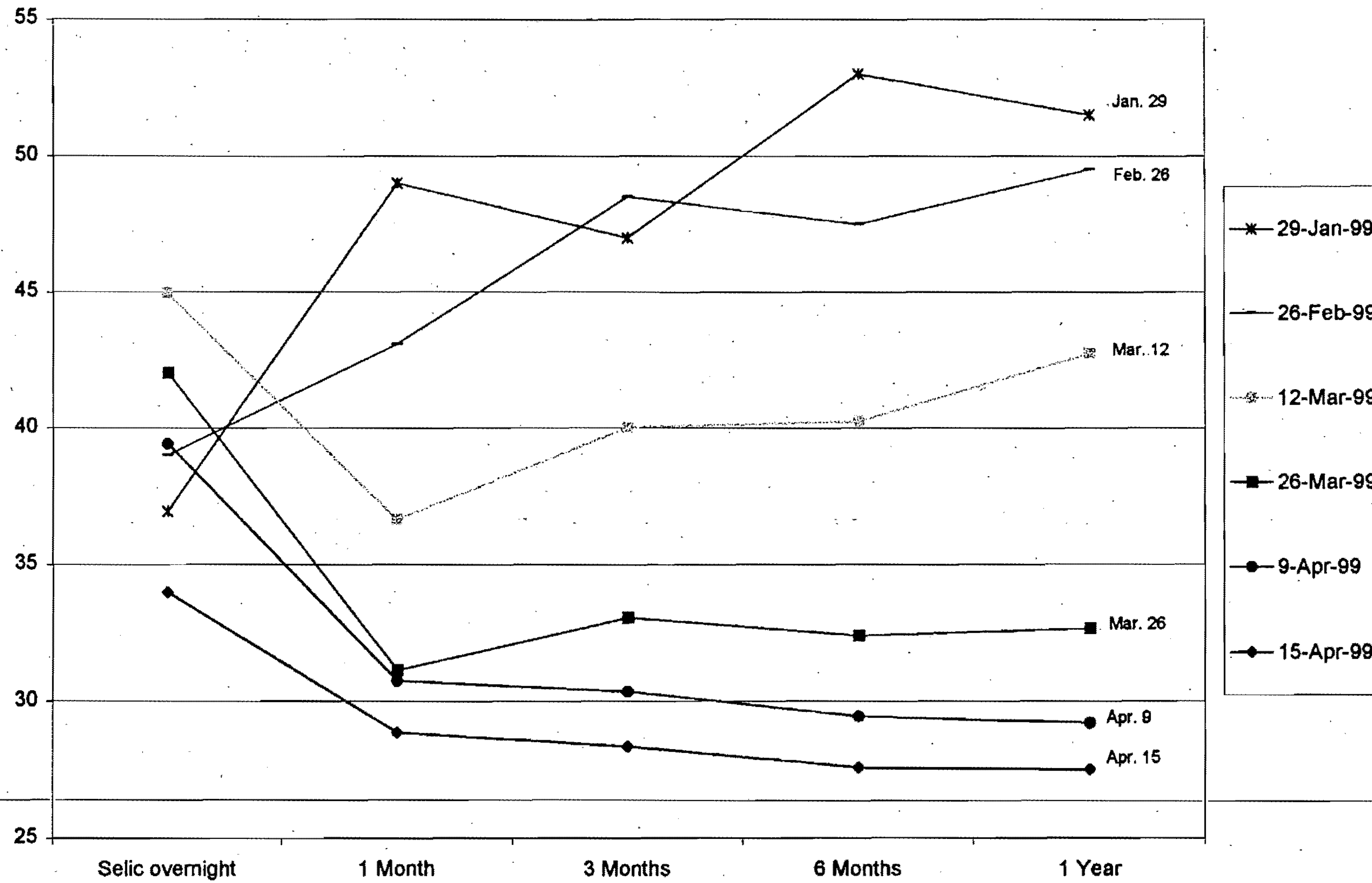
- The fact that one-month rates fell below the Selic (which is set by the central bank) indicates that markets expected the central bank to cut the Selic. The fact that one-year rates fell below the Selic indicates markets expected that financial stability would persist sufficiently to allow continued cuts in interest rates.

- The central bank has lagged the market in its cuts of the Selic. Its first cut occurred only after two weeks of steep declines in market-determined rates took them well below the Selic.

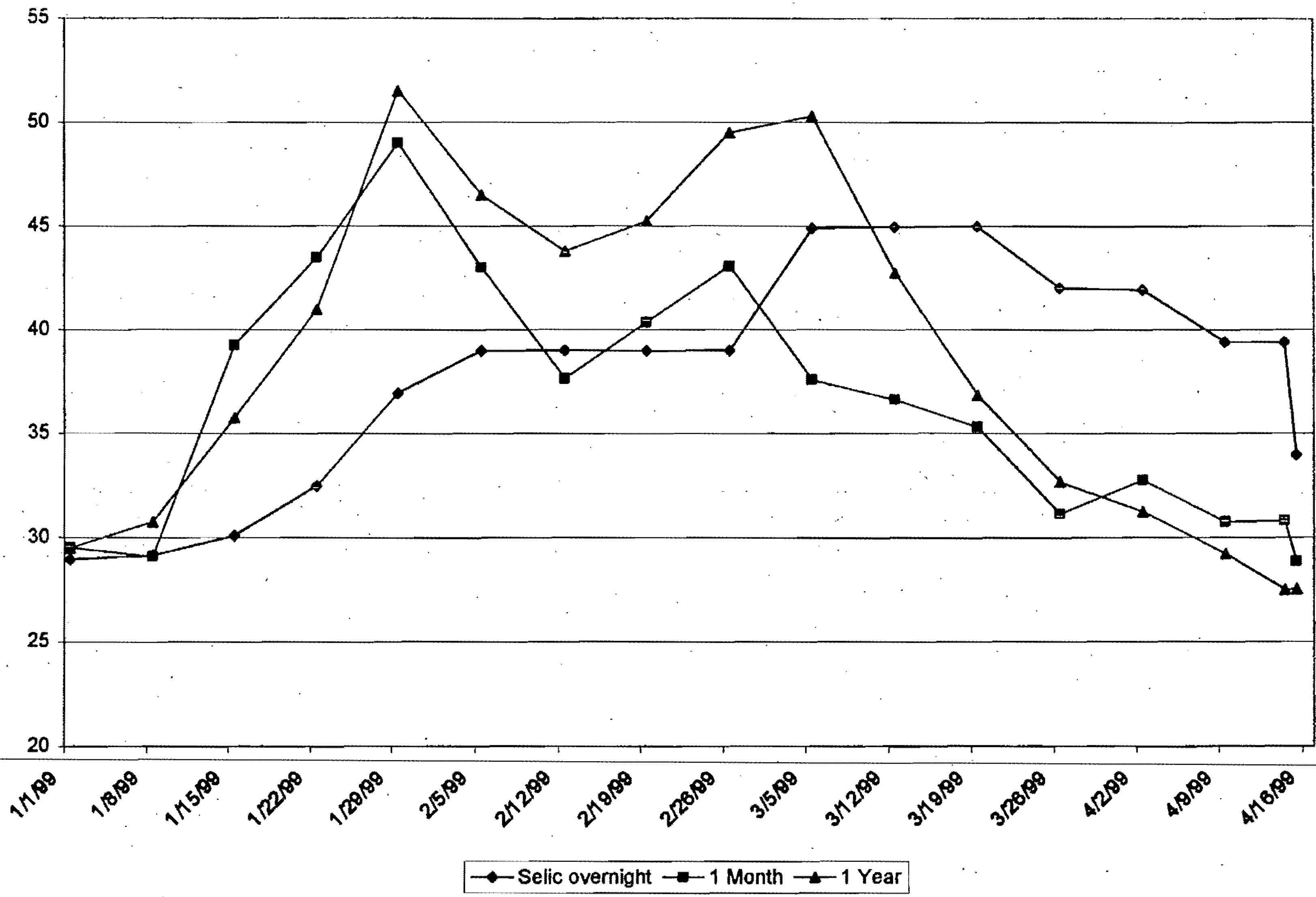
- The domestic yield curve remained inverted after Thursday's (April 15) 550 bps cut in the Selic (to 34.0%), with one-year swap rates presently about 28%. This suggests that the central bank is expected to, and has room to, cut rates in the near future. At the April 14 monetary policy council (COPOM) meeting, the central bank maintained its "easing" bias for the Selic, meaning that it is free to cut interest rates before the next COPOM meeting on May 19.

Doug Smith/INL
April 16, 1999

Brazil: Local Swap Rate Yield Curve



Brazil: Selic Overnight Rate and Select Swap Rates over Time



Update on Brazil's Public Debt Management

Arminio Fraga and the Brazilian Treasury have made some progress in achieving Fraga's goals of (1) gradually re-introducing fixed-rate debt into the market, and (2) eliminating the overhang of repurchase agreements used by the central bank to absorb liquidity from the market.

1. On March 23, the Treasury resumed weekly auctions of fixed-rate debt, which had been suspended since June, 1998. The following table is a history of the auction results and shows the declining yields on the fixed-rate debt:

Auction date	Amount sold	Tenor	Yield
March 23	R$ 500 million	28 days	42.8%
March 30	R$ 500 million	28 days	37.8%
April 6	R$ 1.0 billion	56 days	33.6%
April 8	R$ 1.0 billion	54 days	33.5%
April 13	R$ 1.0 billion	56 days	31.5%
April 15	R$ 1.0 billion	56 days	31.1%

Although market observers have told us that the auctions are oversubscribed, the central bank does not announce the numbers of bids relative to the amount offered. Also, the Treasury has restricted the supply of new fixed-rate issues to roughly 15-20% of weekly total public debt redemptions.

2. The central bank has issued new debt in excess of redemptions every week for the past 5 weeks. As a result it has cut the outstanding stock of central bank repos from R$32.7 billion on March 5 to R$20.1 billion today. Further, the central bank has lengthened the duration of the repurchase operations that it uses to remove liquidity from the system. Those repos are now up to seven days in length, depending on market conditions. Previously, the repos were all overnight operations.

Doug Smith/INL
April 16, 1999

RECENT BRAZIL FISCAL NUMBERS

The Central Bank of Brazil published this week fiscal data for January and February 1999. In general, the fiscal position was in line with or better than market expectations and IMF projections. Market analysts' reaction was positive, though they noted the role of special factors.

- **The primary surplus of the public sector at end-February was a greater-than-expected R$5.1 billion (3.7% of GDP).** A performance criteria in the IMF program is a primary surplus of the public sector for Q1 of R$6.0 billion, a target that almost certainly will be met.

    - <u>The primary surplus of the central government (federal govt plus BCB)</u> for the first two months of 1999 was R$4.5 billion compared to R$0.3 billion during the same period in 1998. The improvement came largely from a one-time revenue increase due to a tax amnesty in February. The Fund estimates that this one-time increase was as high as R$3.6 billion, although most private sector analysts place the increase at close to R$2.2 billion. March numbers, which should be posted within the next few days, should show a revenue decline according to IMF staff who, nevertheless, remain optimistic that the fiscal adjustment is on track.
    - <u>The primary surplus in the states, municipalities, and public-owned enterprises</u> was R$0.6 billion during the period compared to a surplus of R$0.4 billion during the same period in 1998. The states ran a small deficit of R$0.2 billion during the first two months of this year.

- **The overall deficit of the public sector for the 12 months to end-February was 7.4% of GDP excluding the effects of devaluation on dollar-indexed and external debt or 13.9% including devaluation effects.** The overall deficit for 1998 was 8.0% of GDP.

    - The IMF does not report operational balances, but our back-of-the-envelope calculations indicate that it would be on the order of 3.8% of GDP this year.
    - Central bank losses in the futures market in the first quarter were nearly 1.0 percent of GDP; these losses were classified as interest expense, thereby raising the PSBR but not the primary balance (typically, such losses would be classified in the primary balance but were probably classified as interest expense in this case due to optics).

- **Net debt of the public sector at end-February was 51.9% of GDP, up from 42.9% percent of GDP in December 1998 but below many market estimates.** The increase primarily reflects a stock adjustment in dollar-linked debt.

    - The debt to GDP ratio is expected to improve throughout the year in part to continued appreciation in the *Real* and in part to lower real interest rates and privatization receipts.
    - The IMF estimates that the public sector net debt to GDP ratio will fall to 49.3% by year end.
    - The change in net debt to GDP from December to February was not equal the nominal deficit due to different exchange rates used (avg v. end-period) and to below-the-line items including privatization and "skeletons" (i.e., putting hidden government liabilities on the books).

steve backes/INL
april 15, 1999

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

July 18, 1995

INFORMATION

MEMORANDUM FOR SECRETARY RUBIN

FROM: LAWRENCE SUMMERS

SUBJECT: STATUS OF DISCUSSIONS ON CHINA POLICY

Sandy Berger convened the fourth in his series of Deputies meetings on China yesterday. We reached broad inter-agency agreement on several of the "damage control" issues - upcoming senior-level visits to China, WTO accession, and Taiwan efforts to gain membership in the UN and other international organizations. These and other issues will eventually be put to the President as part of an overall China package for his approval.

On matters of direct interest to Treasury, I discussed possible Taiwan contributions to the GAB, IDA, and the IDB's Fund for Special Operations (FAO) in Latin America. While everyone recognized the sensitivity of tapping Taiwan's financial resources for these purposes, we did achieve a preliminary approval among the Deputies that Treasury would consult other G-7 countries on some means to garner Taiwan contributions to the GAB. If this is among the actions eventually approved by the President, our efforts will be to get several countries to approach Taiwan in order to reduce US exposure. The Deputies thought that possible approaches to Taiwan on IDA and the IDB would be inherently riskier at this time since China could veto World Bank related actions and the US would have to take the lead on the IDB.

On upcoming US visits to China, the Deputies agreed to support USTR efforts to engage the Chinese, as previously planned, on Intellectual Property Rights and to begin preliminary planning for another Ron Brown trip to Beijing in October for the annual US-China government and business consultations. The consensus among the Deputies was to keep open existing communications channels with the Chinese, as long as the general political environment is conducive.

Taiwan's interest in UN membership is a dead letter initiative since membership is open only to sovereign states. We will continue to review a long list of other non-UN international organizations in which Taiwan might gain membership or association. The NSC will expedite this review.

The outstanding WTO issue relates to Taiwan and China accession efforts. Neither country is prepared at this time to conclude bilateral negotiations with existing WTO members and thereby gain

EXECUTIVE SECRETARIAT

WTO entry. However, Taiwan is judged to be farther along in the process, especially with the US. We will not be pressed to resolve the accession issue for the two applicants in the immediate future since no other major country or country groups, specifically the EU and the Asians, want to commit on which applicant would come first or possibly how they both could join simultaneously. The Deputies' decision, which I anticipate will be forwarded to the President, was to "punt" the issue to the multilateral debate in Geneva where the EU, Japan and others will continue to delay the process and deflect the issue from the US-China agenda.

TREASURY CLEARANCE SHEET

NO. ____
Date 7/18/95

MEMORANDUM FOR: ☒ SECRETARY ☐ DEPUTY SECRETARY ☐ EXECUTIVE SECRETARY
☐ ACTION ☐ BRIEFING ☐ INFORMATION ☐ LEGISLATION
☐ PRESS RELEASE ☐ PUBLICATION ☐ REGULATION ☐ SPEECH
☐ TESTI[illegible]ONY ☐ OTHER ____

FROM: Under [illegible]ry Lawrence Summers
THROUGH: ____
SUBJECT: Sta[illegible]ns on China Policy

REVIEW OFFICES (Check

☐ Under Secreta[illegible]
☐ Domestic
☐ Economi[illegible]
☐ Fiscal
☐ FM
☐ Pr[illegible]

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☐ Public Affairs/Liaison
☐ Tax Policy
☐ Treasurer
☐ E & P
☐ Mint
☐ Savings Bonds
☐ Other ____

NCC to RER (reading) 7/18/95
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NAME (Please Typ[illegible]				OFFICE	TEL. NO.
INITIATOR(S)					
James H. Fall	JHF			[illegible]ng Nations	622-0667
REVIEWERS					
Jeff Shafer		7/18/95			622-0060
Barreda, Bill	WEB	7/18/95			622-0168
Robert Kahn	RBK	7/18/95	IMI		622-0138

SPECIAL INSTRUCTIONS

☐ Review Officer Date ☐ Executive Secretary Date

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INFORMATION

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

December 18, 1995

to: Jeff Shafer
Fm: Bob Rubin

MEMORANDUM FOR: SECRETARY RUBIN
DEPUTY SECRETARY SUMMERS

FROM: Shafer Assistant Secretary Shafer

SUBJECT: U.S.-China Joint Economic Committee

Overview

Treasury's relations with China have stagnated. In part, we have been subject to the overall downturn in relations that followed the decision to allow Taiwan President Lee Teng-Hui to make a private visit to the United States last summer. The lack of an ongoing, substantive dialogue is also partly our own doing. The principal forum for bilateral discussion on financial reform and macroeconomic issues is the U.S.-China Joint Economic Committee. The JEC is supposed to meet yearly, but our position so far has been that China must live up to the commitments it made to Secretary Bentsen at the last session in January 1994 before moving ahead with the next JEC session. This *quid pro quo* strategy has not produced the results we have sought. At the same time, it has meant that we have not engaged the Chinese on key macroeconomic and financial issues at a crucial time. It is time to change course.

I agree

New Strategy

We stand a better chance of seeing positive movement if we reengage the Chinese, initially in a low-key way, and reinforce existing momentum for reform. We must also recognize and adjust to the fact that the agencies we normally deal with -- the People's Bank of China and the Ministry of Finance -- may no longer hold the key to the kind of concessions we have been seeking on financial services. The PBOC has confirmed several times, for example, that the decision to allow foreign banks to engage in local currency business now lies with the State Council. We should seek to get our message across to this body through Zhu Rongji, former head of the PBOC and now Vice Premier for Economic Affairs.

Steps to be Taken

It would be prudent to start planning on our end for a full session of the JEC sometime in the first half of 1996. Timing and political sensitivities will come into play, as we are also expected to participate in the second U.S.-Taiwan Subcabinet Economic Dialogue sometime this summer. I want to take several preparatory steps:

agree

- James Sasser has been confirmed as the new U.S. Ambassador to China. I intend to meet with him, lay out our objectives, and ask him to convey our message and desire for reengagement to the appropriate officials in Beijing.

- After touching base one-on-one, call for a Deputies Committee meeting to 1) lay out our objectives; 2) receive interagency blessing for an economic and financial dialogue building toward a JEC meeting with Secretary Rubin leading the U.S. side; and 3) co-opt State and the White House (NSC, NEC, CEA) into the process.

- I should follow up with a visit to Beijing no later than February. I will ask Sasser to see if he can obtain an invitation, but if not we can engineer an excuse to go.

- Encourage a meeting of the investment working group (led by State and USTR), which is the only one of the three working groups which has not met since the last JEC.

The Agenda

The Chinese have expressed a preference for a purely non-confrontational JEC -- one that would likely produce few concrete results. We have always looked for more from these sessions, and I believe that as we engage the Chinese in the process of planning the meeting and shaping an agenda, we can get China to include concrete results as part of the outcome. However, the poor record of follow-through on the last JEC suggests we should not be extremely ambitious and ensure that we have a well-defined implementation process.

Similar to their behavior re: MFN.

The JEC must have some "deliverable" outcomes to be viewed as a success. Some of the suggestions put forth by staff so far include: 1) steps the Chinese are prepared to announce on financial services liberalization and foreign exchange reform (i.e., allowing them to take credit for what they've already done); 2) a Customs Mutual Assistance Agreement, which is already being negotiated, could be presented to the JEC; 3) Treasury/Fed sponsored cooperation on Chinese banking reform; 4) further cooperation between the SEC and the Chinese Securities Regulatory Commission (Chairman Levitt is planning to visit China in March); and 5) some sort of technical assistance on tax issues.

For

We should not shy away from key macroeconomic issues that are of mutual concern. These would include: 1) the lack of timeliness and accuracy in Chinese economic data; 2) trade imbalances; 3) the health of the Chinese financial system and the link between reform of the banking sector and state enterprises; 4) access for foreign financial institutions, and domestic capital market development. Other topics will likely emerge in the interagency process, and in meetings with the Chinese.

INA/TSchneider
12/18/95

TREASURY CLEARANCE SHEET

NO.
Date January 17, 1996

MEMORANDUM FOR: ☐ SECRETARY ☐ DEPUTY SECRETARY ☐ EXECUTIVE SECRETARY
☐ ACTION ☐ BRIEFING ☐ INFORMATION ☐ LEGISLATION
☐ PRESS RELEASE ☐ PUBLICATION ☐ REGULATION ☐ SPEECH
☐ TESTIMONY ☐ OTHER

FROM: DAVID LIPTON
SUBJECT: KEY POINTS FOR CHINA STRATEGY MEETING

REVIEW OFFICES (Check when office clears)

☐ Under Secretary for Finance
☐ Domestic Finance
☐ Economic Policy
☐ Fiscal
☐ FMS
☐ Public Debt
☐ Under Secretary for Int'l Affairs
☐ International Affairs
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☐ ATF
☐ Customs
☐ FLETC
☐ Secret Service
☐ General Counsel
☐ Inspector General
☐ IRS
☐ Legislative Affairs
☐ Management
☐ OCC
☐ Policy Management
☐ Scheduling
☐ Public Affairs/Liaison
☐ Tax Policy
☐ Treasurer
☐ E & P
☐ Mint
☐ Savings Bonds
☐ Other

NAME (Please Type)	INITIAL	DATE	OFFICE/ROOM NO.	TEL. NO.
INITIATOR(S)				
T.SCHNEIDER	TS	1/17/96	INA/5221	622-0335
REVIEWERS				

SPECIAL INSTRUCTIONS

☐ Review Officer Date: ☐ Executive Secretary Date

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DEPARTMENT OF THE TREASURY
WASHINGTON, D. C.

UNDER SECRETARY

BRIEFING

MEMORANDUM FOR: **SECRETARY RUBIN**

FROM: JS Under Secretary Shafer

SUBJECT: Principals Plus One Meeting on China

DATE & TIME: January 26, 1996; 3:30 p.m.

LOCATION: Situation Room

PARTICIPANTS: Secretary Rubin
Deputy Secretary Summers

BRIEFING: Overview and Key Points
Background on Joint Economic Committee

OVERVIEW
PRINCIPALS PLUS ONE MEETING ON CHINA
January 26, 1996

PURPOSE: NSC has laid out several issues in U.S.-China relations for discussion (see below). As we see it, the overarching objective is to reach agreement between agencies to: 1) end freelancing and work together as an Administration; and 2) choose actions that realistically can produce results. In this context, the JEC is a good opportunity to engage China on economic issues.

Key Points on NSC Issues

- **Taiwan** -- No change in status quo with Taiwan: no escalation in relations, or cutting back. Activities like the Treasury-led Subcabinet Economic Dialogue should continue.
- **WTO** -- We should be resolute, but reasonable, with China. We can be flexible, but accession must be on commercially viable terms to generate necessary political support.
- **MFN** -- Human rights and MFN should remain de-linked.
- **IPR** -- Threaten sanctions only if we are prepared to implement them and if they are commensurate with the infractions.
- **Human Rights** -- Indiscriminate bashing isolates China and does not serve our long-term objectives.
- **Nuclear Nonproliferation and Military Cooperation** -- State and DOD have the lead, and appear focused on actions with likelihood of success.
- **Gore-Li Peng Dialogue** -- Proposed by the Vice President's office, China would see it as a big plum this year. They haven't earned it; we wouldn't get much for it.

You may want to seek support for reinvigorating the JEC

- Treasury-led Joint Economic Committee (JEC) is low-cost (in political capital) option for engaging China on economic issues. Does not raise expectations.
- Agenda could include "deliverables" like a customs agreement. Substantive issues could include: 1) the state of the Chinese economy; 2) trade imbalances; 3) deregulation and development of markets, including financial markets; and 4) quality and timeliness of Chinese economic data.
- Treasury has the lead, but wants substantive involvement from State, USTR, Commerce, FRB, and possibly the CEA and NEC (if China brings in the State Planning Commission).
- Flexible on how to develop the JEC (i.e., build up with subcommittees or use more rapid approach) but want to begin with visit from senior-level Treasury official next month.

U.S.-CHINA
JOINT ECONOMIC COMMITTEE

The U.S.-China Joint Economic Committee (JEC) was established in 1980 by President Carter and Vice-Premier Deng Xiaoping. The JEC serves as a forum for: (1) addressing major economic issues of importance to the two finance ministries; and (2) discussing the structure and performance of the U.S. and Chinese economies. The latter task, carried out by working groups chaired at the Assistant and Deputy Assistant Secretary level, has constituted the bulk of the effort and time of the annual meetings. The three working groups are:

1) Foreign Exchange Reform - Chaired by Treasury

2) Monetary and Banking Issues - Chaired by Treasury

3) Investment and Economic Cooperation - Chaired by State/USTR

The last session of the JEC was held in Beijing in January 1994, co-chaired by Secretary Bentsen and Finance Minister Liu. This was the first session to be held in seven years -- the normal schedule of annual meetings being suspended in the wake of Tienanmen. The meeting was generally regarded as a success, although China has yet to fully implement pledges it made to Secretary Bentsen on financial services -- particularly allowing foreign banks to engage in local currency business. The next JEC session would be held in Washington, chaired by Secretary Rubin and a Chinese counterpart. A session could be held this summer, although political sensitivities dictate that planning for the next JEC take into account similar plans for the next session of the U.S.-Taiwan Subcabinet Economic Dialogue -- scheduled to take place in Taipei sometime this summer.

INA/TSchneider
1/25/96

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NO.____________
Date January 25, 1996

MEMORANDUM FOR: ☐ SECRETARY ☐ DEPUTY SECRETARY ☐ EXECUTIVE SECRETARY
☐ ACTION ☐ BRIEFING ☐ INFORMATION ☐ LEGISLATION
☐ PRESS RELEASE ☐ PUBLICATION ☐ REGULATION ☐ SPEECH
☐ TESTIMONY ☐ OTHER ____________

FROM: DAVID LIPTON
SUBJECT: BRIEFING FOR CHINA STRATEGY MEETING

REVIEW OFFICES (Check when office clears)

☐ Under Secretary for Finance
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☐ Economic Policy
☐ Fiscal
☐ FMS
☐ Public Debt
☐ Under Secretary for Int'l Affairs
☐ International Affairs
☐ Enforcement
☐ ATF
☐ Customs
☐ FLETC
☐ Secret Service
☐ General Counsel
☐ Inspector General
☐ IRS
☐ Legislative Affairs
☐ Management
☐ OCC
☐ Policy Management
☐ Scheduling
☐ Public Affairs/Liaison
☐ Tax Policy
☐ Treasurer
☐ E & P
☐ Mint
☐ Savings Bonds
☐ Other ____________

NAME (Please Type)	INITIAL	DATE	OFFICE/ROOM NO.	TEL. NO.
INITIATOR(S)				
T.SCHNEIDER	TL	1/25/96	INA/5221	622-0335
REVIEWERS				
A/S LIPTON	MG for DL	1/25/96	I/3430	622-1270
DAS FALL	JAF	1/25/96	IN/3209	622-0667
DAS BARREDA	WEB	1/25/96	IT/3208	622-0168
T.CRAWFORD	TWC	1/25	INA/5221	622-0359
J.WALLACE	[illegible]	[illegible]	ITT/4436	622-1727

SPECIAL INSTRUCTIONS

☐ Review Officer Date: ☐ Executive Secretary Date

China

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3:30 pm - NSC China

1996-SE-002573

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

UNDER SECRETARY

April 15, 1996

MEMORANDUM FOR SECRETARY RUBIN

FROM: Under Secretary Shafer

SUBJECT: My Visit to Beijing and Strategy for U.S.-China Joint Economic Committee

I will be travelling to Beijing May 1-3 after the annual ADB meetings in Manila to meet with senior economic officials and discuss timing and an agenda for a session of the U.S.-China Joint Economic Committee. I wanted to offer some thoughts on objectives for the trip and the JEC.

Context -- A Rough Year Ahead

There seems little doubt that this will continue to be a very tough year for U.S.-China relations. We have significant quarrels with the Chinese in almost every area, and particular concerns in human rights, nonproliferation, and bilateral economic/trade issues. Stanley Roth may well be correct in his assertion that all we can hope for this year is to keep the relationship from completely collapsing. Taken in this context the JEC has the potential to be one of the few positive developments we are likely to have in 1996 (although successful MFN renewal will be vital to creating the basis for rebuilding relations).

Managing the Home Team

Ensuring that the JEC does in fact become a positive and constructive bilateral exchange will entail considerable work on our part. As the lead agency we will have to manage participation by other agencies and accommodate their respective agendas. USTR is likely to be the most difficult case in this regard. Close coordination at senior levels will be necessary to ensure that the JEC does not collide with USTR's negotiating agenda, or that USTR not attempt to fashion the JEC into a bargaining session. Similar concerns apply to State, NSC/NEC, Commerce, and CEA, although these agencies are far more likely to work with us in shaping a positive outcome.

Objectives for My Trip to Beijing

My schedule for Beijing is still tentative, but I have asked for meetings with Vice Premier Zhu Rhongji, Vice Finance Minister Liu, PBOC Deputy Governor Chen Yuan, officials from the State Planning Commission and Securities Regulatory Commission, and the Beijing AmCham. My objectives for this trip are fairly straightforward: 1) meet with MOF, advance a tentative agenda, and discuss what topics the Chinese would like to discuss; 2) discuss timing for the JEC (the fall might be best); and 3) discuss recent macroeconomic and financial developments with counterparts at Chinese agencies. This is the first step in a process that will last over several months, and I hope to establish a number of good working relationships.

Our Objectives for the JEC

We must be realistic in setting our goals for the JEC. Our decision earlier this year to alter Treasury's approach to China -- from a *quid pro quo* strategy to one of engagement and dialogue -- implies a tacit acceptance of a non-confrontational approach for the JEC. We must avoid the mindset that the JEC will allow us to resolve the key issues that divide us, or that we will be able to secure concrete commitments for future action. This being the case, concrete results from this year's session will likely be limited to cooperation on enforcement issues (the Secret Service is now providing assistance to Chinese authorities on counterfeiting), and perhaps some form of technical assistance on tax, banking, and securities issues. Such deliverables can be worked out beforehand, and I will raise these matters with the Chinese during my visit. A cautionary note is warranted here, however. U.S. institutions, including the Fed and the SEC, have been disappointed in the past by China's failure to respond to offers of U.S. technical assistance. For their part, the Chinese have been disappointed by what they perceive to be the U.S.' failure to live up to its commitment to support China's WTO accession.

The real objective in this exercise is to bring the Chinese to the table for a serious discussion of economic issues and, if possible, achieve a convergence of views on areas of mutual interest. Achieving this objective in a year otherwise fraught with bilateral tension will be a significant accomplishment. Key among our goals should be to sell the Chinese on the merits of greater transparency in economic planning and policy development. China is in the midst of a self-proclaimed transition to a "socialist-market economy." While this indicates that market forces will play an increasing role in the Chinese economy, we do not have a clear picture of how this is to take place, what the scope of transition will be, nor any notion of a timeframe. This lack of transparency limits our ability to work with the Chinese, to measure their progress, or to shape our demands for liberalization and market access. While it is likely that the Chinese do not have a clear picture of the transition themselves, they may respond positively to our interest in this regard. Establishment of even a loose framework would provide a hook for continued dialogue.

On a more concrete level, we should also pursue two other objectives that have eluded us in the past year. First, Treasury and other agencies should clarify and reaffirm the basic tenets of our bilateral economic relationship. Clarity and consistency on economic issues is something that the Chinese understand and appreciate. Recent political developments have sometimes clouded the picture, and rhetoric on both sides has cast some fundamental principles into doubt. Some examples would include:

- **Economic Transition:** The United States supports China's transition to a socialist market economy insofar as we see this transition in China's (and the region's) best interest. We are willing to provide technical assistance to support this process.

- **WTO Accession:** The United States <u>supports</u> China's accession to the WTO, but only on commercially viable terms. It is in our interest to bring China into the WTO, but not if China is seeking exceptions to basic WTO rules. The Chinese also have a message for us in this regard -- about what they have accomplished to date, and how far they are willing to go.

- **Bilateral Agreements:** The United States expects faithful implementation of bilateral trade and market access agreements. Threatening to impose sanctions when implementation is incomplete is not China-bashing, but is done out of economic interest. The Chinese will want to tell their side of the story on this issue.

The second objective should be to reach a convergence of views on economic and financial issues of mutual concern. Care must be taken not to let this part of the JEC degenerate into an exchange of statements. Beginning with my trip to Beijing, we must highlight those issues we see as key, gauge our two relative positions, and work to come to an understanding of how these issues should or are likely to develop in coming years. Issues we could discuss in this regard include:

- **Macroeconomic Outlook:** China has achieved a temporary soft landing, but there is serious question as to whether this is sustainable in the medium to long-term. Inflationary pressures may resurface with the removal of administrative controls, and the fiscal position remains complicated by transfers to state owned enterprises (SOEs).

- **State Enterprise/Banking Reform:** SOE reform may prove the linchpin to sustained growth in China. Progress in reforming the vast number of inefficient SOEs has been minimal, and a clear policy direction has not emerged. Banking reform cannot move forward until a decision is made on SOE reform.

- **Banking Supervision:** Chinese banks have been unable to establish branches in the U.S. because China does not have consolidated banking supervision. Banking supervision development is thus key to Chinese banks' access to the U.S. market. Because the Chinese have employed some reciprocity in this area (i.e., refusing to move forward on branch applications for U.S. banks in China), forward progress in this area could eventually benefit U.S. banks seeking to establish in China.

- **Institutional Development:** Institutional responsibility for setting economic policy in China is ill-defined in a number of areas. The People's Bank of China, for example, is just beginning to establish itself as a "central bank" in the Western sense, and the Ministry of Finance has little or no role to play in fiscal policy. We could explore Chinese views and plans in this regard.

- **Capital Markets:** China is slowly making progress in developing its capital markets. How far China is willing to go, and how closely it is willing to integrate with global capital markets is an unanswered question, however. Closely linked to this is the issue of liberalization if insurance and funds management activities.

These are our concerns as we look at China's economy. But, if we are to stimulate China's interest in a sustained dialogue, we need to identify issues on which China would welcome consultation. Therefore, I will also investigate topics of interest to the Chinese.

TREASURY CLEARANCE SHEET

NO.______
Date April 5, 1996

MEMORANDUM FOR: ☐ SECRETARY ☐ DEPUTY SECRETARY ☐ EXECUTIVE SECRETARY
☐ ACTION ☐ BRIEFING ☐ INFORMATION ☐ LEGISLATION
☐ PRESS RELEASE ☐ PUBLICATION ☐ REGULATION ☐ SPEECH
☐ TESTIMONY ☐ OTHER ______

FROM: JEFFREY SHAFER
SUBJECT: VISIT TO BEIJING AND STRATEGY FOR JEC

REVIEW OFFICES (Check when office clears)

- ☐ Under Secretary for Finance
  - ☐ Domestic Finance
  - ☐ Economic Policy
  - ☐ Fiscal
    - ☐ FMS
    - ☐ Public Debt
- ☐ Under Secretary for Int'l Affairs
  - ☐ International Affairs
- ☐ Enforcement
  - ☐ ATF
  - ☐ Customs
  - ☐ FLETC
  - ☐ Secret Service
- ☐ General Counsel
  - ☐ Inspector General
- ☐ IRS
- ☐ Legislative Affairs
  - ☐ Management
  - ☐ OCC
- ☐ Policy Management
  - ☐ Scheduling
- ☐ Public Affairs/Liaison
- ☐ Tax Policy
- ☐ Treasurer
  - ☐ E & P
  - ☐ Mint
- ☐ Savings Bonds
- ☐ Other ______

NAME (Please Type)	INITIAL	DATE	OFFICE/ROOM NO.	TEL. NO.
INITIATOR(S)				
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T.SKUD	TS for	4/8/96	OOT/4004	622-0220
A/S LIPTON	DL	4/8/96	I/3430	622-1270

SPECIAL INSTRUCTIONS

☐ Review Officer Date: ☐ Executive Secretary Date

1997-SE-003014

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

ASSISTANT SECRETARY

March 25, 1997

MEMORANDUM FOR DEPUTY SECRETARY SUMMERS

FROM: **David Lipton** ᴰᴸ
Assistant Secretary for International Affairs

SUBJECT: **Note on China for the NEC**

ACTION FORCING EVENT:

Attached is the revised version of the note on China that you discussed with Tim Geithner and me. The note discusses some of the macroeconomic factors underlying our bilateral trade deficit with China and suggests that focusing too much attention on this imbalance may not be productive.

RECOMMENDATION:

That the attached note be sent to the NEC.

Agree ___ Disagree ___ Let's Discuss ___

BACKGROUND:

At the last NEC principals meeting on China, the NEC requested that Treasury prepare a note discussing its views on the macroeconomic context of our bilateral trade imblance.

ATTACHMENTS:

Note on the macroeconomic factors underlying our bilateral trade deficit with China.

A Macroeconomic Perspective on Sino-U.S. Trade

The growth of our bilateral trade deficit with China over the last five years has had an important impact in shaping public and Congressional perceptions of our overall economic relationship. This will be particularly important in the coming year, as we grapple with China's accession to the WTO and renewal of Most Favored Nation (MFN) status. This note reviews some of the factors underlying our bilateral trade imbalance with China and suggests that focusing unduly on this imbalance may not be the most productive strategy. While aggressive trade liberalization by the Chinese is undoubtedly in our national interest, the bilateral trade deficit with China is likely to persist for the foreseeable future given the continuing importance of macroeconomic factors.

China's global current account position (a small surplus in 1996) is determined by macroeconomic balances, which in turn reflect the aggregate levels of savings and investment in the Chinese economy. Exchange rate and trade policies will influence these macroeconomic balances through their impact on the relative prices of imports and domestically-produced goods. Trade policies also place constraints on the trade balance through their impact on consumption.

Within China's overall trade balance, their bilateral balance with the United States is affected by a number of microeconomic factors: [1] China's trade barriers, price and tax policies, and procurement practices that limit penetration of imports; [2] our own export finance and control policies, as well as the relative openness of our import regime; and [3] large discrepancies in trade data, created in part by differing treatment of transhipment of goods through Hong Kong.

These microeconomic factors point to the need to continue to press China on trade liberalization on both a bilateral and multilateral basis. We should not, however, be under the illusion that our bilateral trade deficit with China will necessarily decline substantially in the wake of successful bilateral trade negotiations or WTO accession. In addition to the microeconomic foundations of our bilateral trade deficit, there are also a number of macroeconomic factors that may well persist even after significant Chinese trade liberalization.

- U.S. macroeconomic fundamentals. Strong economic growth and low rates of savings relative to investment imply that the U.S. will continue to run a sizable current account deficit for the foreseeable future. A bilateral trade deficit with China is likely to be an important component of our global deficit given China's comparative advantage in producing unskilled labor-intensive consumer goods such as clothing and toys.

- Shifting patterns of production and trade in Asia. During the late 1980s, the U.S. ran large trade deficits with the newly-industrialized countries (NICs) of Asia (Hong Kong, Korea, Singapore and Taiwan). As real wages have risen in these countries, however, production of unskilled labor-intensive goods has increasingly shifted toward countries with cheaper labor, such as China and Indonesia. In addition, rising standards of living in the NICs enable them to increase their purchases of the more sophisticated and skill-intensive products which the U.S. produces. The net result has been a sharp decline in the size of our bilateral deficits with the NICs that coincides with the rise in our deficit with China.

    - In 1987, the U.S. bilateral trade deficit with the NICs was $34.1 billion, while our deficit with China was only $2.7 billion. Last year, the trade deficit with the NICs was \$7.1 billion, while our deficit with China rose to \$39.5 billion. The combined deficit for China and the NICs has actually shrunk as a share of GDP, from 0.79% of GDP in 1987 to 0.62% of GDP in 1996.

- China's exchange rate regime. The Chinese have maintained a *de facto* exchange rate link to the dollar since unifying the exchange rate in 1994. Given China's global current account position, rapid reserve accumulation, and maintenance of an anti-inflationary macroeconomic policy stance, a strong case can be made for greater exchange rate flexibility on the part of the Chinese.

  - Most rapidly growing economies in Asia run substantial current account deficits (investment exceeds existing, albeit high, levels of national savings). In contrast, China is estimated to have run a small current account surplus of approximately \$1 billion in 1996. This occurred despite net private capital inflows of about \$40 billion last year. China responded to these inflows by increasing its foreign currency reserves on an almost one-for-one basis. Reserves increased by over \$30 billion during 1996 and now total more than \$100 billion.

  - Allowing for greater exchange rate flexibility, which would most likely translate into appreciation of the renminbi, would be a more economically rational policy for China than continued reserve accumulation. It does not make sense for China to be diverting foreign capital flows away from badly needed domestic investment in infrastructure and capital goods toward purchases of U.S. Treasuries and the securities of other reserve currency countries. This is particularly true given the fact that China is also actively borrowing in international markets, often at interest rates above the returns it earns on its reserves.

  - Increased flexibility of Chinese exchange rate policy would not only be beneficial for China, but would also be in the interest of the United States and other industrial countries. By reducing the relative price of capital goods, more rapid real appreciation of the yuan would tend to boost imports from countries such as the U.S. and other industrialized countries which have a comparative advantage in producing those products.

These macroeconomic factors suggest that focusing too much attention on the bilateral trade deficit may well prove to be a hindrance to the development of our overall economic relationship with China. A focus on macroeconomic balances and policies could nonetheless have a significant bearing on the U.S.-China trade and investment relationship and reinforce our liberalization message. Put simply, the Chinese authorities can be told that the magnitude of current reserve levels should reduce balance of payment problems that are sometimes associated with further trade liberalization. It is therefore important that our continued pressure on China for aggressive trade liberalization not be viewed in isolation from the macroeconomic context of our relationship and that this context be used to reinforce such pressure. ***While WTO accession and other trade liberalization measures are critical to bringing China into a global trading system based on the rule of law, it is unclear that progress on the microeconomic front will eliminate a bilateral trade deficit which is at least partially macroeconomic in origin.***

TREASURY CLEARANCE SHEET

No.

Date: March 24, 1997

MEMORANDUM FOR: ☐ SECRETARY ☐ DEPUTY SECRETARY ☐ EXECUTIVE SECRETARY ☐ ACTION ☐ BRIEFING ☐ INFORMATION ☐ LEGISLATION ☐ PRESS RELEASE ☐ PUBLICATION ☐ REGULATION ☐ SPEECH ☐ TESTIMONY ☐ OTHER

FROM: Assistant Secretary Lipton

SUBJECT: Note on China for the NEC

REVIEW OFFICES (Check when office clears)

☐ Under Secretary for Finance
- ☐ Domestic Finance
- ☐ Economic Policy
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  - ☐ FMS
  - ☐ Public Debt

☐ Under Secretary for International Affairs
- ☐ International Affairs

☐ Enforcement
- ☐ ATF
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- ☐ Secret Service

☐ General Counsel
☐ Inspector General
☐ IRS
☐ Legislative Affairs
☐ Management
☐ OCC

☐ Policy Management
- ☐ Scheduling

☐ Public Affairs/Liaison
☐ Tax Policy
☐ Treasurer
- ☐ E & P
- ☐ Mint
- ☐ Savings Bonds

☐ Other

NAME (Please Type)	INITIAL	DATE	OFFICE	TEL. NO.
INITIATOR(S)				
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REVIEWERS				
Todd Crawford	TC	3/24/97	INA	622-0359
Daniel Zelikow	DMZ	3/24/97	DO/IN	622-7222
Timothy Geithner	TFG	3/24/97	DO/IA	622-0656

SPECIAL INSTRUCTIONS

☐ Review Officer Date ☐ Executive Secretary Date

DO F 80-02.1 (04/89)

1997-SE-007745

DEPARTMENT OF THE TREASURY
WASHINGTON

July 17, 1997

MEMORANDUM FOR DEPUTY SECRETARY SUMMERS
ASSISTANT SECRETARY LIPTON
SENIOR DEPUTY ASSISTANT SECRETARY GEITHNER

FROM: Daniel M. Zelikow DMZ
Deputy Assistant Secretary for Asia, Africa, and the Americas

SUBJECT: The U.S. Trade Deficit with China

Attached is a note on the factors underlying the rise in the U.S. trade deficit with China. We would appreciate your comments on this draft and look forward to meeting with you to discuss it.

NCC to LS (reading)

NU cc to MF SS

7/17/97

Please Log IN

July 17, 1997

THE US TRADE DEFICIT WITH CHINA

SUMMARY

THE SITUATION: China is an important market for our exporters. Our share of the Chinese market is in line with our share of the global markets. Yet our bilateral deficit with China has grown rapidly in recent years.

FACTORS CONTRIBUTING TO THE GROWTH OF OUR TRADE IMBALANCE: Part of the growth in our trade imbalance with Chinese reflects cyclical developments in both economies. China's emergence as one of the most competitive producers of low-cost labor intensive goods has also contributed to the growth of our trade deficit with China. While these two classes of contributing factors can be viewed as "natural" outcomes of market economics, there is also evidence of significant import demand suppression in China.

FACTORS CONTRIBUTING TO THE SUPPRESSION OF IMPORT DEMAND: A variety of factors can be identified as major contributors to China's relatively low, income- inelastic, import demand. The three key classes of factors are trade barriers, structural impediments and macroeconomic policy. Key among the trade barriers are the non-tariff barriers. Key among the structural impediments are the nation's underdeveloped financial structure, the lack of reform of the state-owned enterprise (SOEs) sector, and the system of credit allocation that is related to both. Within the area of macroeconomic policy, de facto Keynesian tax policy, a lack of indirect monetary policy management tools (which is obviously also a structural issue), exchange rate policy and the related reserve accumulation policy appear to the keys.

- The direct impact of exchange rate policy on trade performance is clouded by other rigidities and distortions in the Chinese economy.

PROSPECTS FOR REDUCTION IN OUR BILATERAL DEFICIT: Rapid reduction in our bilateral trade deficit with China should not be expected, regardless of whether China adopts what we might consider a more appropriate macroeconomic policy mix or of how successful we are in promoting Chinese trade liberalization.

- Given the absolute size of our trade deficit with China, our exports to China would have to grow more than four times faster than our imports from China just to prevent further expansion in our bilateral deficit.

THE SITUATION: China is an important market for our exporters. Our share of the Chinese market is in line with our share of the global markets. Yet our bilateral deficit with China has grown rapidly in recent years.

China is one of the fastest growing markets for U.S. exports.

U.S. Export Growth

	91	92	93	94	95	96
Global	7.3	6.1	4.0	10.1	13.7	6.5
Emer.Asia	11.3	9.5	10.9	11.8	25.9	3.2
China	30.8	18.8	17.4	5.9	26.6	1.9

- U.S. exports to China have grown at an average annual rate of nearly 17% over the past six years, compared to U.S. export growth of 12% to the rest of emerging Asia and 8% to the rest of the world.

- Exports of capital goods, including industrial equipment, which make up nearly half of U.S. sales to China, doubled over the past five years. Industrial supplies, mostly chemicals, another 35% of U.S. exports to China, also doubled. Food exports, wheat and corn, in particular, roughly tripled.

- As a result of these gains, China has become a major customer for key U.S. products. In 1996, China purchased 30% of all U.S. fertilizer exports, 26% of U.S. cotton textile fiber exports, and 18% of U.S. steam boiler exports. China also purchased $1.7 billion of civilian aircraft and $640 million of telecommunications equipment.

- However, apart from the food and fertilizer exports, it appears that the bulk of U.S. exports to China go to firms operating in the free-trade enterprise zones. These firms produce for the export market.

- Growth in U.S. exports to China fell sharply last year as overall Chinese import demand growth slowed (see below).

The U. S. share of the Chinese import market does not support the view that U.S. exporters are not competitive in the Chinese market.

- In general, using data reported by importing economies (left table below), U.S. exporters do not appear to be disadvantaged in the Chinese market relative to other markets, particularly the lower income markets (India, Indonesia and even Thailand).

- The U.S. share of China's imports exceeds U S. average share of imports in rest of world (excluding Canada and Mexico).

- While the size of the shares differ, the story is similar using data reported by the exporting economies (right table below).

U.S. Share of Import Markets
As reported by importing economies

	1985	1990	1995
World	12.0	11.5	12.5
Adj.-World	9.4	8.7	**9.7**
China	**12.2**	**12.2**	**12.2**
Hong Kong	9.5	8.1	7.7
India	10.8	11.0	9.5
Indonesia	16.7	11.5	9.5
Korea, S	21.1	24.3	22.5
Malaysia	15.3	16.9	16.3
Philippines	25.1	19.5	18.4
Singapore	15.2	16.1	15.1
Taiwan	23.6	23.0	20.1
Thailand	11.4	10.8	11.5

Note: Adjusted world excludes Canada and Mexico.
Source: IMF: Direction of Trade.

US Share of Import Market
As reported by exporting economies

	1990	1995
China	9.7	8.0
Hong Kong	8.4	8.4
China Plus Hong Kong	8.9	8.2
China /HK Single Market (Excl. exports to each other)	14.0	11.7
Emerging Asia	14.0	12.3
Indonesia	10.7	9.5
India	10.9	9.1
Philippines	18.7	17.7
Thailand	9.9	9.8

Source: IMF, Direction of Trade

- Using exporting economies' data, we can also adjust for the growing interdependence of the Chinese and Hong Kong economies.
    - The "hollowing-out" of the Hong Kong economy (shift of industrial activity across the border to China) and port role that Hong Kong plays, keeps the trade between Hong Kong and China huge. Nearly 60% of Hong Kong's imports are from China. Nearly 7% of China's imports are from Hong Kong (the smaller number reflecting China's improved efforts to attribute imports to their source economies).
- Treating Hong Kong and China as a single market (i.e., exclude their exports to each other from their total combined imports), the U.S. market share of the combined market is as large as it is for the emerging Asia economies and larger than for the other low income dynamic Asian economies.

Despite growth in exports to China and what appears to be a healthy share of the Chinese import market, our bilateral deficit with China has ballooned.

- Since 1990, our trade deficit with China has quadrupled, rising from $10 billion to $40 billion.

FACTORS CONTRIBUTING TO THE GROWTH OF OUR TRADE IMBALANCE: Part of the growth in our trade imbalance with Chinese reflects cyclical developments in both economies. China's emergence as one of the most competitive producers of low-cost labor intensive goods has also contributed to the growth of our trade deficit with China. While these two classes of contributing factors can be viewed as "natural" outcomes of market economics, there is also evidence of significant import demand suppression in China.

U.S. Macroeconomic Factors At Play.

Since 1991, our global trade and current account deficits have ballooned in absolute terms. Relative to the size of our domestic economy (GDP), our trade and current account deficits have not grown significantly since 1994.

U.S. Trade Performance
In Billion of US$

	90	91	92	93	94	95	96
Trade Balance	-102	-67	-85	-116	-151	-159	-168
(as % GDP)	-1.7	-1.1	-1.4	-1.8	-2.2	-2.2	-2.2
With China ($b)	-10	-13	-18	-23	-30	-34	-40
(% of total)	9.8	19.4	21.2	19.8	19.5	21.3	23.5
Current Acct	-94	-9	-61	-100	-148	-148	-165
(as % GDP)	-1.6	-0.2	-1.0	-1.5	-2.1	-2.0	-2.2

Source: U.S. Census data

- This reflects US economic fundamentals -- our persistent savings /investment gap and the fact we have been on the strong end of our business cycle while many of our key trading partners have been on the weak end of theirs.
- Over this same period, our trade deficit with China ballooned in absolute terms.
- However, over the five years between 1991 and 1995, China's share of our trade deficit fluctuated in a very narrow range between 19% and 21%.
- Last year, China's share of our trade deficit jumped to 23.5% as China's total import demand growth fell to 4.1%.

Chinese Macroeconomic Factors Affect Chinese Import Demand Growth.

China's Savings and Investment As % of GDP

	92	93	94	95	96
Investment	36.2	43.3	39.9	40.5	41.0
Savings	37.7	40.6	40.5	40.7	41.5
Gap	1.5	-2.7	0.6	0.2	0.5

- China's savings and investment balance has tended to be in surplus in recent years.
- The notable exception was 1993, the peak of the last macroeconomic upswing and the year the overall trade balance fell to a deficit of $10.7 billion.

China's economic performance over the decades since the economic reform began has been highly cyclical. The cycles have had a profound impact on import demand and export performance.

China's Trade Performance
In billions of U.S. dollars

	90	91	92	93	94	95	96
Export Growth, %	19.2	14.1	18.1	8.8	35.5	24.8	0.3
Import Growth, %	**-13.3**	**18.5**	**28.3**	**34.0**	**10.4**	**15.5**	**4.1**
Trade Balance	9.2	8.7	5.2	-10.7	7.3	18.1	13.9
(% of GDP)	2.6	2.3	1.2	- 2.5	1.3	2.6	1.7
Current Acct. Bal	12.0	13.3	6.4	-11.9	7.7	1.6	7.2
(% of GDP)	3.4	3.5	1.5	- 2.7	1.4	0.2	0.9

- Cyclical upswings have been characterized by a sharply a deteriorating external position, as domestic demand has tended to increase relatively rapidly.
- At the height of the last upswing, import growth peaked at 34%.

- While the current slowdown has been hailed as the nation's first "soft-landing", the impact on import demand has not been moderate.

China Has Become One of the Most Competitive Producers of Low-Cost, Labor-Intensive Goods. This Has Contributed to the Erosion of Our Bilateral Trade Balance with China.

China's emergence as one of the most cost-effective producers of such goods has coincided with a gradual move of the more advanced Asian economies out of the production and export of such goods as their costs of production (especially labor costs) rose. This phenomenon is often referred to as the **"flying geese"** pattern of development in Asia.

- China's emergence as a highly competitive producer of low cost goods has had a profound impact on our bilateral trade balances.
- 70% of U.S. imports from China are low value-added goods such as toys, sporting goods, plastic tableware, apparel, footwear and low-end consumer electronics.
- The increase in China's share of the U.S. market since 1989 for these low value-added goods has been largely offset by declines in the market shares of Japan and the NIEs.

Footwear: China's share of U.S. imports rose to 50% last year from 9% in 1989, while Japan's and the NIEs' combined share fell to 5% from 51%.

Toys & Sporting Goods: China's share rose to 54% from 22%, while Japan's and the NIEs' share declined to 23% from 58%.

Plastic Tableware: China's share jumped to 44% from 11%, while Japan's and the NIEs' fell to 25% from 61%.

- As a reflection, in part, of the flying geese phenomenon, between 1993 and 1996, as our deficit with China grew by $17 billion, our deficit with the Japan and the NIEs fell by $16 billion in nominal terms, and by even more as a share of GDP or of our total deficit.

U.S. Bilateral Trade Balances
Billions of U.S. Dollars

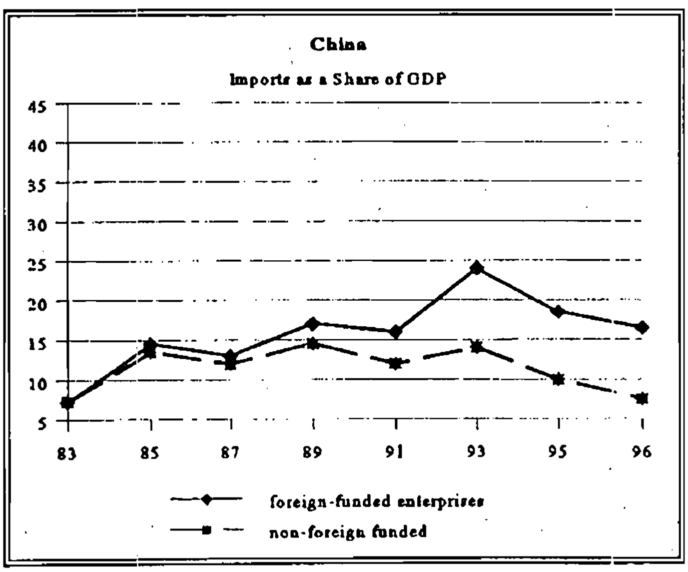
	93	94	95	96
Japan	-59	-66	-59	-48
NIEs	-12	-12	-8	-7
Japan& NIE	-71	-78	-67	-55
China	-23	-30	-34	-40

Source: U.S. Census Data

- The U.S. deficit with the NIEs and Japan fell as China's exports of low valued-added goods to the United States displaced the exports of Japan and the NIEs.
- A rise in the incomes of the NIEs (and an easing of their trade barriers) also contributed to the reduction in bilateral surpluses of the NIEs with us, by increasing their demand for high quality, high value-added U.S. goods.

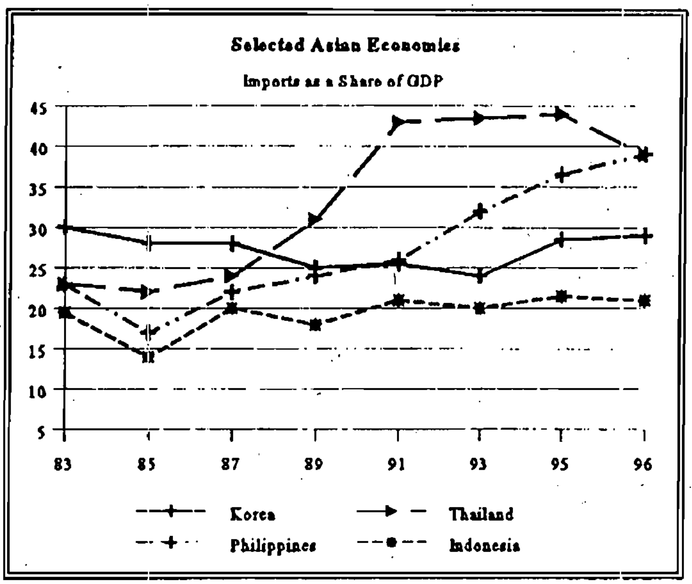
Suppressed Import Demand.

Chinese import demand is low relative to GDP compared to other outward-oriented Asian emerging economies. There is also evidence that import suppression is more severe for domestic-funded enterprises as compared to foreign funded enterprises. The latter are permitted to operate primarily in the export sector.



- Even at the height of the last expansionary cycle in 1993, China's imports as a share of GDP barely reached the 1983 levels of other Asian economies (see below).
- This, and similar ratios on exports, suggest that the direct effects of China's external opening have so far failed to permeate the whole economy.
- In addition, the drop in import penetration during periods of consolidation (such as 94-96) has been particularly sharp.

- Low import penetration ratios in the domestic sector appear to reflect still significant trade barriers and the selective nature of demand management techniques (see below).



- Import penetration in other key emerging Asian economies had already reached 20%, or above, by 1983.
- A modest decline was recorded in these market-oriented economies during their cyclical downturns in the mid-1980s.
- An easing of FDI restrictions and the establishment of export processing zones after 1985, triggered a surge in import penetration in the Philippines and Thailand.
- The phenomenon was less pronounced for Korea, which already had a high penetration level, and Indonesia, whose regime has remained more restrictive than the others.
- In contrast to the mid-1980s downturn, only Thailand experienced a significant slide in import penetration during the 1996 slowdown in economic performance. Even in Thailand's case, the slide in import penetration was more modest than in China's case.

Cyclical Trade Performance by Sector: One of the more interesting features of China's trade performance is the variance in cyclical behavior of the foreign-financed enterprise (FFE) sector and the domestic (non-FFE) sector.

Export & Import Performance By Type of Enterprise
Percent change

	1994	1995	1996
Exports			
Domestic	24.8	25.4	-12.2
FFEs	38.8	38.3	32.2
Imports			
Domestic	2.4	9.9	- 7.4
FFEs	30.6	20.5	20.0

Source: IMF, RED 1997

- The 1993 jump in import demand [38% growth] reflected a surge in FDI-related imports by FFEs and strong imports by domestic enterprises associated with booming investment demand.
- Subsequently, imports of FFEs moderated but, nevertheless, continued to grow on average by more than 20%.
- In contrast, imports by domestic sectors slowed sharply, increasing on average less than 2%.
- Export performance also differed significantly by type of enterprise. FFEs' export growth remained robust from 1994 through 1996. Exports of domestic enterprises first accelerated. Then, in 1996, growth turned negative.

Trade balance differs significantly by type of enterprise: As a result of differentials in recent export and import behavior, the trade surplus of the non-FFE sector rose to greater than 3.0% of GDP on average for 1993-96 from an average surplus of less than 0.25% of GDP for the 1985-92 period. In contrast, the trade deficit of the FFE sector rose in the 1993-96 period to an average of greater than 2.0% of GDP.

FACTORS CONTRIBUTING TO THE SUPPRESSION OF IMPORT DEMAND: A variety of factors can be identified as major contributors to China's relatively low, income- inelastic, import demand. The three key classes of factors are trade barriers, structural impediments and macroeconomic policy. Key among the trade barriers are the non-tariff barriers. Key among the structural impediments are the nation's underdeveloped financial structure, the lack of reform of the state-owned enterprise (SOEs) sector, and the system of credit allocation that is related to both. Within the area of macroeconomic policy, de facto Keynesian tax policy, a lack of indirect monetary policy management tools (which is obviously also a structural issue), exchange rate policy and the related reserve accumulation policy appear to the keys.

China's trade regime remains relatively restrictive for all but export firms.

- Like the structural and macroeconomic factors discussed below, non-tariff barriers, such as canalization, licensing and quota restrictions, appear to be binding constraints on trade

Non-tariff Barriers
Share of imports affected in percent

	1992	1996
Canalization	32.0	18.3
State trading	......	11.0
Designated trading	......	7.3
Licenses, quotas and controls	32.8	18.5
Licenses	25.1	18.5
Quotas	....	16.3
Controls	7.7	...
Import tendering	....	7.4
All non-overlapping measures	51.4	32.5

- A quota system restricts the types of goods that can be purchased by domestic Chinese firms.
- Foreign firms operating in China must obtain permission to import goods, and even with permission they can sell to the domestic markets only indirectly, through a Chinese trading company.
- Foreign firms exporting to China often face some form of licensing requirement, such as quality certification or "automatic registration requirements". The latter apply to about 400 products, typically electrical and machinery products.

- IMF staff attributed much of the differential in import demand by type of firm to non-tariff trade barriers, from which most foreign-funded enterprises (in the export sector) are exempt.
- In contrast, given the vast array of non-tariff barriers, tariff barriers, while still significant on paper, do not appear to be a binding constraint on import penetration at this point in time.

Tariff Barriers

	1992	1996
Tariff rates (%, end of year):		
Weighted average	39.2	23.4
Maximum rate	220	122
Exemptions and their revenue impact: (% of total imports)		
Concessional imports	50.4	65.0
Tariff revenue	4.4	2.8

- Not only have tariff barriers been reduced significantly in recent years, but also the percent of actual imports that are subject to tariffs has fallen -- from one-half to one-third.

- The large percent of actual imports that are exempt from tariffs reflects the fact the vast majority of imports are brought in by firms in the export processing zones, mostly foreign-financed enterprises

Both the IMF and USTR have identified the removal of China's non-tariff trade barriers as one of the keys to expanding global (and U.S.) exports to China.

- According to USTR, the easing of the non-tariff barriers since 1991, contributed to the strong growth in U.S. exports to China over the past five years.

  - For example, China's elimination of over 1,000 quotas and licensing requirements on imports of key high-tech products has contributed to a rise of nearly 200% in U.S. exports of telecommunications equipment to China since 1992.

- In its recent Article IV review of the Chinese economy, IMF staff emphasized that given still high constraints on trade, the key to external adjustment "was to accelerate the liberalization of the relatively restrictive trade regime."

Structural Factors Contributing to Import Suppression. *[To be further developed.]*

Key among the structural impediments to import demand are the nation's underdeveloped financial structure and the lack of reform of the state-owned enterprise (SOEs) sector.

Macroeconomic Policy Tools & Their Trade Implications.

Economic retrenchment since 1993 -- cooling off of the economy -- has been achieved primarily through monetary policy. And since indirect tools of monetary policy remain undeveloped, the implementation of monetary policy has depended heavily on the use of direct control of credit expansion.

In recent years, other tools of macroeconomic management, i.e., fiscal and exchange rate policy, have not been consistently employed to complement the macroeconomic objective of slowing the economy.

Credit Control: Implementation of monetary policy through the use of credit expansion targets, in combination with close linkages between the major banks and SOEs, appears to have resulted in a distortion in the allocation of credit. Rather than being allocated to its most productive use, credit has been allocated to the loss-making SOEs. A large proportion of this credit appears to have been used to fund the social safety net. This has contributed to a situation in which non-SOE domestic enterprises lack sufficient credit for productive investment. The sharp drop in import demand (and import penetration) in the domestic sector in recent years may well reflect these developments.

Fiscal Policy: One of the key changes in fiscal policy in the 1994-96 period was the extension of the VAT exemption for exports to domestic firms. This was followed by a reduction in the exemption rate and delays in the rebates. The initial policy change had a stimulative effect, and therefore was not consistent with the overall objective of dampening demand. The subsequent adjustment in the exemption rate and delays in rebate payments appear to have been directed toward the more general macroeconomic goal of cooling-off the economy.

The differential in export performance by type of firm since 1993 can be attributed, in a large part, to these changes in tax policy.

- The 1994 extension of the VAT zero rating for exports to domestic firms, unification of the exchange rate and the elimination of the foreign exchange retention quota (which applied only to domestic firms), significantly increased the incentives for domestic firms to export.

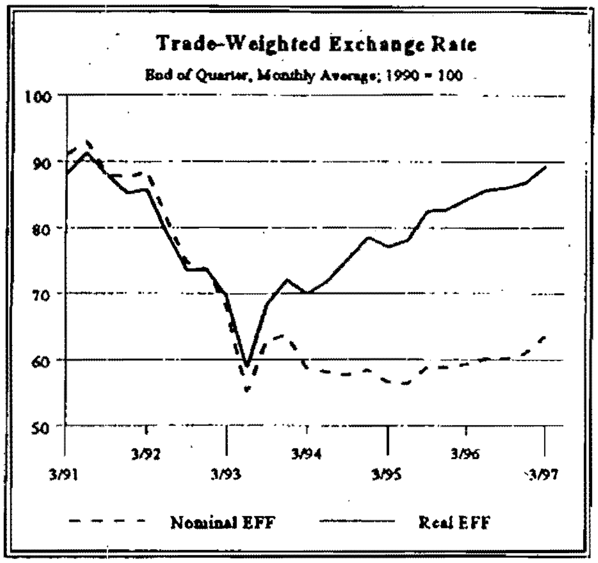
- The early 1995 announcement that the VAT rebate for exports would be reduced effective July 1, caused a front-loading of exports. Growth of exports by domestic firms surged to 68% in the first quarter of 1995, and then fell sharply. In the final quarter of 1995, domestic firms' exports were down 7.5% from the corresponding period of 1994.

- The slide in domestic exports continued into early 1996 following a further reduction in the VAT in January and increasing delays in rebate payments by the government. Exports by domestic firms in the first quarter of 1996 were 26% below the corresponding period of 1995. An acceleration in rebate payments in the latter half of the year contributed to a modest recovery in export performance in late 1996.

Exchange Rate Policy: The impact of nominal exchange rate policy on China's trade balance is far from clear. Since the exchange rate system was unified in early 1994, the Chinese authorities have shied away from using the exchange rate as a macroeconomic policy tool, adopting instead a fixed nominal exchange rate policy .

- But the nominal fix has not prevented a significant real appreciation of the nation's currency.

    - The early 1994 unification of the exchange rate at the prevailing swap market rate implied a 50% devaluation of the official rate.



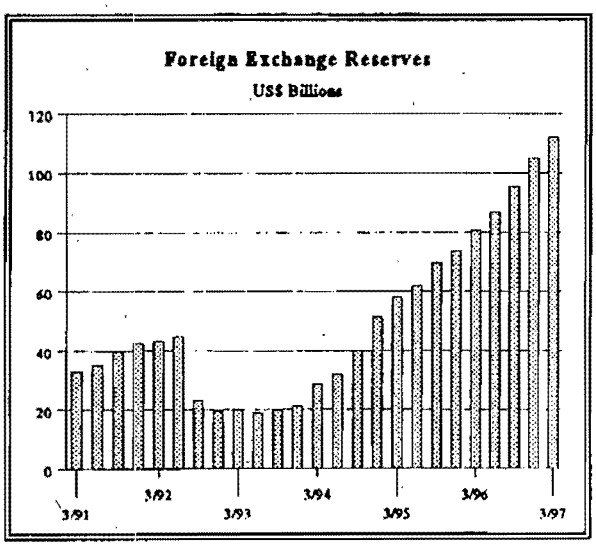
- However, since a large share of foreign exchange transactions were carried out at the swap market rate by the end of 1993, the effective depreciation of the currency is estimated by the IMF to have been less than 10%.

- By the end of 1996, the real effective exchange rate (based on relative consumer prices) had appreciated by 25% from its early 1994 level.

- The real and nominal depreciation of the trade-weighted exchange rate in the early 1990s, reflected the gradual shift in trade transactions from the official rate to the swap rate (which was facilitated by the government) and depreciation of the swap rate.

It not clear whether the real appreciation of the currency would have been greater without the nominal fix. Nor is it clear, given the trade and credit constraints, how responsive Chinese trade performance is to the real exchange rate.

- What is clear, is that the nominal fix has resulted in a rapid accumulation of reserves.



- This in turn implies an inefficient allocation of resources away from productive investment to official foreign assets, and a related negative return on imported capital.

- Furthermore, as a result of the impact on domestic liquidity of the reserve accumulation, it is likely that tighter constraints on credit were necessary to achieve the China's soft-landing than otherwise would have been necessary.

KEY CONCLUSIONS

Our trade deficit with China reflects the fact that we are in deficit overall and that China is one of the most efficient producers of low-cost, low valued-added, labor intensive consumer goods.

Our deficit with China is likely to persist unless:

- **Our savings/investment gap narrows significantly** (i.e., our trade deficit declines sharply) and/or
- **China loses competitiveness** as a low-cost, labor intensive producer (as the NIEs have).

The size of our trade deficit with China also reflects relatively low Chinese import demand (low import to GDP ratio compared to other outward-oriented economies in the region). China's low import demand appears to reflect both the absence of a significant savings/investment gap in China (i.e., macroeconomic policy mix -- fiscal, monetary and exchange rate), structural impediments and Chinese barriers to trade (tariff and non-tariff).

- A change in **China's macroeconomic policy** mix **would** result in an increase in import demand.
- **Structural adjustment**, in particular, further movement toward a market-based credit / financial system and reform of the state enterprise system, is likely to increase the income and price elasticity of import demand, and therefore import penetration.
- A further **easing of China's barriers** to trade **is likely to result** in an increase in Chinese import demand.

Our overall share of Chinese imports is not out of line with our share of other Asian markets.

- In general, U.S. exporters are as successful in the Chinese market as they are elsewhere in the world, or even more so.

China is an important market for U.S. exporters. Yet, despite strong export growth to China, our bilateral deficit with China has grown.

- This reflects, in part, U.S. and Chinese macroeconomic conditions, China's competitiveness in the production of labor intensive goods, China's trade barriers, and a lack of access to our own export promotion programs.
- **But we're not unique.** It's important to bear in mind that other key industrialized economies, even those with current account surpluses (saving/investments surpluses), run bilateral trade deficits with China.

1997-SE-008696

CHINA: EXCHANGE RATE

Suggested Talking Points:

- With Chinese reserves at a very high level and its trade and current accounts in surplus, this may be an opportune time to reconsider your exchange rate policy, and in particular to think about introducing more flexibility.
  - -- Developments elsewhere in the region point to the risks of maintaining a fixed rate.
- While it may have produced some benefits in the past, the fixed rate is no longer in China's interest.
  - -- It has led to a vast accumulation of reserves. While it is important to have a healthy reserve cushion, excessive reserves represent an inefficient use of assets that could be invested more productively in developing the Chinese economy.
  - -- While the fixed rate has provided an appearance of price stability, it has actually worked against domestic price stability. This is because the reserves accumulation adds to the money supply, and because preventing appreciation raises the price of imports.
- Greater exchange rate flexibility would also be helpful to our bilateral relations.
  - -- The size and growth of our bilateral trade imbalance has drawn significant attention in Congress and elsewhere. As long as the exchange rate remains fixed, China remains open to the criticism that it is manipulating the exchange rate for trade purposes.
- I understand that a prestigious Chinese academy has recently concluded that the purchasing power value of the yuan is 4 to the dollar, far from the 8.3 official rate.

Background

The exchange rate was unified and fixed in 1994. Reasons for the fixed rate policy likely include:

- to build reserves (now the second-largest in the world at $120 billion);
- to create a perception of stability and relative price predictability; and
- to stem further erosion of the competitiveness of the nation's state-owned enterprises, which are vital providers of social services.

While the nominal rate has remained fixed, the real (inflation-adjusted) rate has appreciated significantly. Nevertheless, greater flexibility -- if accompanied by trade liberalization and relaxation of certain credit controls -- could significantly reduce China's global trade and current account surpluses. We expect that some of this improvement would be manifested vis-a-vis the U.S.

Treasury/OASIA/INA/A. Marcus August 8, 1997

NCC to LS
NCC to MF
8/8/97

Please
Log IN

1997-SE-011425

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

ASSISTANT SECRETARY

ACTION

MEMORANDUM FOR THE SECRETARY

THROUGH: Deputy Secretary Summers

FROM: Timothy F. Geithner
Assistant Secretary (International Affairs)

SUBJECT: China -- State Visit of Jiang Zemin

ACTION FORCING EVENT:

President Jiang will be in Washington on Wednesday, October 29. The attached memo to the President provides background and talking points on the exchange rate and trade balance issue and on our desire for cooperation with China as we work to resolve the Asian financial crisis.

RECOMMENDATION:

That you sign the attached memo to the President.

Agree ______ Disagree ______ Let's Discuss ______

BACKGROUND/ANALYSIS:

We currently expect you to participate in three events: the welcoming ceremony at 10:00, the President's expanded bilateral with Jiang at 11:30 a.m. and the state dinner at 8:00 p.m. It now appears that you will not have a separate bilateral with Jiang, for scheduling reasons on the Chinese side. Your Council on Foreign Relations speech, on October 27, should also be viewed in the context of the Summit.

Without a bilateral meeting, we will have an opportunity to raise only the most important items on our agenda, although a separate conversation with Jiang -- perhaps at the state dinner -- might allow you to raise several additional issues, including financial services, the proposed Customs Mutual Assistance Agreement, final resolution of the Xinhua dispute (if necessary), and a possible Treasury-organized seminar on resolving banking crises. We will provide you with a separate briefing for your participation.

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DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
008. memo	Robert E. Rubin to POTUS re: Economic issues for State Visit of Jiang Zemin (2 pages)	ca. 1997	P5

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MEMORANDUM FOR: ■ SECRETARY ☐ DEPUTY SECRETARY ☐ EXECUTIVE SECRETARY
■ ACTION ☐ BRIEFING ☐ INFORMATION ☐ LEGISLATION
☐ PRESS RELEASE ☐ PUBLICATION ☐ REGULATION ☐ SPEECH
☐ TESTIMONY ☐ OTHER

FROM: Timothy F. Geithner
Assistant Secretary (International Affairs)

SUBJECT: China – State Visit of Jiang Zemin

REVIEW OFFICES (Check when office clears)

☐ Under Secretary for Finance	☐ Enforcement	☐ Policy Management
☐ Domestic Finance	☐ ATF	☐ Scheduling
☐ Economic Policy	☐ Customs	☐ Public Affairs/Liaison
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D. Zelikow	DMZ	10/22	IN	622-7222
R. Monk	RZM	10/22	GI	622-1899
E. Knight	Hw for	10/22	G	622-0287

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E. Knight	[illegible]	10/22	G	[illegible]

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009. notes	Lawrence Summers to Sandy Berger re: Read-out from Meetings in China (1 page)	01/15/98	P5

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010. notes	Lawrence Summers to Sandy Berger re: Read-out from Meetings in Hong Kong (1 page)	01/15/98	P5

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1998-SE-005040

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

BRIEFING

MEMORANDUM FOR SECRETARY RUBIN
DEPUTY SECRETARY SUMMERS

FROM: Timothy F. Geithner
Assistant Secretary (International Affairs)

SUBJECT: Briefing for Principals' Meeting on China

DATE/TIME: Tuesday, April 21; 4:00

PARTICIPANTS:

Secretary Rubin
Secretary Albright
D/S Summers
Others TBD

BRIEFING:

Overview and Suggested Talking Points

Principals' Meeting on China
April 21, 1998

Overview: The China agenda is rapidly gaining pace, with the MFN renewal exercise getting underway, and detailed planning for the Presidential visit now beginning. The meeting will cover both of these issues, as well as upcoming visits from USTR Barshefsky (already en route) and Secretary Albright (planning to leave this weekend). Other issues include possible easing of U.S. post-Tiananmen sanctions and commercial deliverables for the Summit.

Participants will want to hear about our plans for meetings with the Chinese, and about some of our issues, particularly as they relate to the Summit. In this context, you may want to discuss technical assistance, China's role in the Asia crisis and WTO financial services issues.

1. Treasury/China Meetings

Our current thinking is that we will hold a scaled-down JEC in Washington in late May. In addition, you might hold meetings in Beijing (with Premier Zhu, PBOC Governor Dai and Finance minister Xiang) on the first day of the President's trip, while he is in Xian or Guilin. Both of these will help frame the economic message for the President's trip. D/S Summers has also indicated his willingness to visit China in June, although it is not clear that this will be necessary if we do the JEC in May.

Suggested talking points:

- We are currently exploring the idea of having the JEC in May, in Washington. We will in any case see Finance Minister Xiang at the APEC Finance Ministers' Meeting in Canada on May 22-24.

- In addition, I would plan to have separate discussions with economic leaders (Zhu, Dai and Xiang) in Beijing, probably on the first day of the President's trip, while he is in another city.

2. Technical Assistance

We have come under some pressure from other agencies to put together a technical assistance package that could be announced on the President's trip. We are exploring this, but are willing to proceed only if it will be useful and if we can find funding. We discussed the issue with People's Bank officials last week, and they are now examining their needs, while we explore what is already being provided by U.S. agencies and IFIs.

We will compare notes with the Chinese again early next month (when Anthony Marcus accompanies Janet Yellen to China), and decide whether and how to proceed. Funding would have to come from the Chinese and/or other agencies, most likely AID.

Suggested talking points:

- We are discussing technical assistance needs and capabilities with the Chinese. Our next discussions are planned for May 4 or 5.
- If both sides agree that expanded technical assistance makes sense, we will decide how to proceed. Funding will have to come from the Chinese or from other USG agencies.

3. Asia Crisis

There continues to be speculation about a possible devaluation. The Chinese continue to reiterate their commitment to maintaining the fixed exchange rate, however (although without reference to a time frame), and we believe that they do not see a devaluation as a solution to their slowing growth.

Despite the crisis, China's trade situation remains strong: its surplus in the first quarter was $10.5 billion, up 57% over the 1997 figure. Exports were up 13% (although only 9% in March). The capital account is also holding up well: according to figures from Xinhua, first quarter investment flows totaled $8.6 billion, up 9.7%. While a devaluation could boost exports, it would also strike a blow to confidence and to the Chinese Government's credibility, likely impacting investment, which the Chinese have identified as key to boosting growth. It would also increase inflation, control of which is one of Zhu's major achievements.

Suggested talking points:

- We continue to be pleased with China's role in the crisis, in maintaining its exchange rate, participating in multilateral processes (Manila framework and Willard Group) and offering direct financial assistance.

- We do not believe that China's economic situation indicates a need to devalue.

4. WTO Financial Services

At his meeting with PBOC Deputy Governor Liu last week, D/S Summers raised the issue of WTO financial services talks. Liu indicated that the Chinese were willing to resume discussions, and it was agreed that a Treasury technical team would go to Beijing, possibly accompanying D/S Summers (if he goes). While WTO accession negotiations have been generally disappointing, progress on financial services has been particularly elusive. We want to reenergize discussions to ensure that we not be left behind if progress is made on the rest of the WTO package.

Suggested talking points:

- We have discussed with the Chinese our desire to resume talks on WTO financial services issues.

- The Chinese have agreed, and we plan to send a technical team to Beijing in May or June.

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☐ TESTIMONY ☐ OTHER

FROM: Timothy F. Geithner
Assistant Secretary (International Affairs)

SUBJECT: Briefing for Principals' Meeting on China

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T. Crawford	TC	4/21	INA	622-0359
D. Zelikow			IN	622-7222

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To PA/NCC 4/21/98

PA to RER 4/21/98

PA to LS 4/21/98

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SS

Shirley/Lisa

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SPECIAL INSTRUCTIONS

☐ Review Officer Date ☐ Executive Secretary Date

DO F 80-02.1 (04/89)

1998-SE-007510

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

June 22, 1998

MEMORANDUM FOR THE PRESIDENT

FROM: Robert E. Rubin R. E. R.

SUBJECT: China -- Economic Issues for your Visit

China's reform effort is now at a critical stage. At the same time, economic growth is slowing, due both to domestic factors and to the souring of the external environment. There have been recent statements that have raised concerns about their commitment not to devalue, but we have received assurances that they will not devalue at least in the near term. Zhu Rongji and many of China's other leaders have a sophisticated understanding of the economic challenges they face. The key is to stay the course of reform, rather than resort to short-term palliatives. Three issues are critical:

1. Growth Prospects

The Chinese -- including Zhu Rongji personally -- are heavily committed to a target of 8% growth for 1998, a target that is almost surely out of reach. China's growth could fall to 5% or lower, and even there, its statistics may be questionable. (It is also worth noting that Hong Kong is in recession and is suffering from serious declines in land and stock prices.) The Chinese government may be tempted to take additional, imprudent steps to stimulate short-term growth, such as a fiscal program they cannot afford, a monetary expansion that could worsen their banking problems, or a devaluation. Our view as to the principal issues is the following:

- Even a growth rate of 6-7% is well ahead of population growth, and would be envied elsewhere.
- China should avoid any temptation to damage hard-won progress through short-term expediency, especially in the current Asian context.
- Instead, it should focus on its reform efforts, which will provide the basis for high rates of sustainable growth in the future.

2. Reforms

China's daunting economic challenge is to conduct three interconnected reforms simultaneously:

- Restructure and preferably privatize money-losing, state-owned enterprises (SOEs) that are left over from central planning. China is believed to have some 300,000 SOEs, which employ 100 million people. Despite this scale, Zhu Rongji has pledged to restructure them within three years;

- Reform the banking system that finances the SOEs, and which consequently is awash in bad loans. China's banking system is probably the worst in Asia, with non-performing loans as high as 30% of the total. The four major banks need to be radically restructured -- a daunting challenge given that they have as many as 50,000 branches and 500,000 employees each; and

- Move responsibility for providing social services from the enterprises to the market or the government. Under the current system, workers are unwilling to change jobs since most depend on their employers for housing, health care, pensions, and education for their children.

Some questions you could raise:

- What are your thoughts about how best to address the problems of China's banking system?

- How do you plan to reemploy the large numbers of people who are likely to be displaced with SOE restructuring?

- Opening the market to foreign financial institutions -- as part of China's WTO accession -- could be an important step in strengthening the system. What are your thoughts on this issue?

<u>3. China's response to the Asian financial crisis has been in its own interest, as well as the region's</u>

Chinese authorities have repeatedly pledged not to devalue the renminbi, a policy that has served China well, and that has also made a useful contribution to the restoration of financial stability in the region. Despite widespread speculation, a devaluation is not necessary, given China's continued strong growth and trade performance. Key points you can make and that we can agree on:

- Maintenance of the renminbi's stability is in the interests of China and of the world economy.

- A devaluation would have serious negative effects:

  -- It could have a chilling effect on foreign investment in China.

  -- It could set off another round of devaluations in the region, possibly negating any beneficial trade effect.

  -- It would almost certainly add to the recent market pressure on Hong Kong.

China's leaders will almost certainly be interested in discussing Japan with you as well, and your response should be a realistic appraisal of the problems the Japanese face and the difficulties they have in acting -- and the importance that they act to address their problems.

7510

- Prepared by DAN Zelikow
  (Anthony Marcus)
- NCC to RER
- NCC revised per RER
- RER OK to autopen per NCC
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- AK original to WH
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EXECUTIVE SECRETARIAT CORRESPONDENCE MEMO COVER SHEET

Monday, June 22, 1998

PROFILE #: 1998-SE-007510

DATE CREATED: 06/22/1998

ADDRESSEE: Robert E. Rubin
Secretary

AUTHOR: Lipton, David A.
International Affairs

SUBJECT: China--Memorandum For The President

ABSTRACT: China--Memorandum for the President.

RM 3419

TO REVIEWERS

IN:

TO EXECUTIVE SECRETARY

IN:

TO THE SECRETARY

DATE SIGNED:

DISTRIBUTION: AS, INTERNATIONAL AFFAIRS

*ORIGINAL MEMO WAS TAKEN DIRECTLY TO THE SECRETARY'S OFFICE ON 6/22/98.

1999-SE-003453

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

April 7, 1999

MEMORANDUM FOR THE PRESIDENT

FROM: Robert E. Rubin R.E.R.

SUBJECT: Your Meeting with Premier Zhu Rongji: Key Economic Issues

This year will be a difficult one for China's economy, with uncertain prospects for economic growth. The GOC expects GDP growth in 1999 to slow to about 7%, from (statistically suspect) 7.8% in 1998. Some estimates of actual 1998 growth are as low as 4% and growth this year almost certainly will be lower than last, due to weak consumer confidence and signs of over-capacity which make private firms reluctant to invest. In addition, price deflation (retail prices fell 2.6% last year) is hitting corporate profits and encouraging consumers to save rather than spend. The GOC is relying heavily on state-led infrastructure investment to spur growth and contain rising unemployment.

China's external position remains strong, with a current account surplus of $24 billion in 1998 (2.5% of GDP) and foreign exchange reserves of $146 billion. However, China's exports have been falling since mid-1998 on a year-on-year basis, mainly due to weak regional demand. In addition, inflows of foreign direct investment are expected to decline to $25 billion in 1999, from $35 - 45 billion in recent years. Foreign investor sentiment has been affected by China's slowing growth and frustration with administrative hurdles, including tightened foreign exchange controls.

In your meeting with Zhu, you should recognize that he faces difficulties in managing China's economy in 1999. You should also express the view that improving the efficiency of China's economy through structural reforms will be critical to ensuring that growth is sustained over the medium term. This will involve addressing the interlocking issues of financial sector reform, restructuring of state-owned enterprises (SOEs) and development of an adequate tax base.

An important source of vulnerability is China's financial sector, dominated by large state-owned banks with very high proportions of nonperforming loans (estimated at 25-40% of total loans). The banks have inadequate capital and reserves to cushion against the enormous potential losses indicated by such a high level of bad loans. Zhu has been attentive to the role of weak banking systems in the Asian financial crisis. He has initiated a financial sector reform program intended to recapitalize the banks, improve prudential regulation, and allow banks to operate on commercial principles. The scope of the problem is daunting, however. Fully recapitalizing China's banking system is estimated to cost on the order of 20-30% of GDP.

Success of financial sector reform depends heavily on restructuring of the SOEs, the banks' principal clients. While SOEs account for less than a third of economic output, they soak up over two thirds of bank lending. SOE reform is complex: it must proceed in tandem with development of local government responsibility for social functions (health, education) that are being shed by the SOEs and the establishment of social safety net programs for workers who lose their jobs due to restructuring. The GOC's strategy for moving forward remains well-intentioned but ill-defined.

A key economic challenge over the longer term is the creation of an effective, revenue-generating tax system necessary to achieve fiscal sustainability. China's official fiscal deficit of 2.4% of GDP is modest, but masks extra-budgetary governmental activities amounting to an additional 6-8% of GDP annually. In addition, the GOC faces potentially enormous costs associated with bank recapitalization and transition to a financially viable pension system.

Declining foreign investment growth, along with falling exports and an apparent increase in capital flight, has rekindled rumors of a possible devaluation of the yuan. Such a step would not be without risks, however, as it could undermine domestic confidence in China's fragile banking system or spark further devaluations in the region (which would dampen the intended boost in China's exports and threaten regional economic recovery). *If raised, you should note that the stability of the yuan has been in China's interest and has played a constructive role in the region, where recovery remains fragile. You should emphasize that progress in economic reform efforts is also critical to the stability of the yuan.*

The high-profile, October 1998 closure of GITIC, a large non-bank financial entity, reflects a new determination to deal forcefully with financial sector problems. However, the lack of transparency in dealing with this case has taken a toll on investor confidence. *In your meeting with Zhu, you should emphasize that the adoption of stronger accounting/disclosure practices and more transparent rules and regulations will be critical to bolstering international lender/investor confidence in China going forward.*

China's leaders are approaching WTO negotiations at a time of growing fears about unemployment and the competitiveness of many domestic firms. On the other hand, a good WTO agreement could help restore weakening foreign investor confidence. From our perspective, a strong agreement, on commercially meaningful terms, including in the financial sector, remains very much in the interests of the United States, China, and the global trading system.

TREASURY CLEARANCE SHEET

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MEMORANDUM FOR:
■ POTUS ☐ SECRETARY ☐ DEPUTY SECRETARY ☐ EXECUTIVE SECRETARY

■ ACTION ☐ BRIEFING ☐ INFORMATION ☐ LEGISLATION ☐ PRESS RELEASE
☐ PUBLICATION ☐ REGULATION ☐ SPEECH ☐ TESTIMONY ☐ OTHER

FROM: Secretary Rubin

SUBJECT: POTUS Meeting with Premier Zhu Rongji: Key Economic Issues

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☐ E & P
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☐ Legislative Affairs

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REVIEWERS				
LQuinn	by e-mail	4/2/99	HK Atttache	
C McCoy	DC for		INA	622-0337
D. Zelikow	DmZ	4/6/99	IN	622-7222
A/S Truman				

SPECIAL INSTRUCTIONS

☐ Review Officer Date ☐ Executive Secretary Date

DO F 80-02.1 (04/89)

1999-SE-003453

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

April 6, 1999

ASSISTANT SECRETARY

ACTION

MEMORANDUM FOR SECRETARY RUBIN

FROM: EMT Ted Truman, Assistant Secretary (International Affairs)

SUBJECT: POTUS Note on China for the Visit of Premier Zhu Rongji

Action Forcing Event

Chinese Premier Zhu Rongji will be in Washington on April 8-9 on an official visit.

Background

A note to the President is an effective means of bringing to the President's attention key economic issues which we believe he should raise with the premier. Since Premier Zhu has responsibility for providing leadership to China's economic reform program, it is important that economic issues receive due attention during his visit.

Recommendation

That you sign the attached memo.

Agree NL ok for autopen per NER Disagree _______ Let's Discuss _______

Attachment:

Tab A: Memorandum to the President

cc: D/S Summers
U/S Geithner

EXECUTIVE SECRETARIAT

EXECUTIVE SECRETARIAT CORRESPONDENCE MEMO COVER SHEET

Tuesday, April 06, 1999

PROFILE #: 1999-SE-003453

DATE CREATED: 04/06/1999

ADDRESSEE: Robert E. Rubin
Secretary

AUTHOR: Truman, Ted
AS, International Affairs

SUBJECT: POTUS Note on China for the Visit of Premier Zhu Rongji

ABSTRACT: POTUS note on China for the visit of Premier Zhu Rongji

RM 3419

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1999-SE-003518

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

ASSISTANT SECRETARY

April 7, 1999

Recommended Telephone Calls

MEMORANDUM FOR DEPUTY SECRETARY SUMMERS

THROUGH: Linda L. Robertson
Assistant Secretary
(Legislative Affairs & Public Liaison)

FROM: Rick Sinkfield
Deputy Assistant Secretary (International)

SUBJECT: Calls to Rep. LaFalce, 225-3231 and Rep. Roukema, 225-4465, to update them on China WTO negotiations.

BACKGROUND:

Negotiations on China's accession to the WTO are making good progress. We are very close to an agreement on market access and agriculture. We are still working on autos and protocols (dumping, technology transfers). On textiles, we have only make modest progress in light of the remaining 9 years with respect to the quota.

We are still waiting on the timing. We believe there are three scenarios: 1) Since arriving in the U.S., Mr. Zhu agrees to everything and we announce a deal some time on Thursday; 2) we get almost everything we want, but have some negotiations left on major pieces, thus Mr. Zhu leaves, and we kept working; or 3) we have agreements on almost everything but China leaves the table because they feel we are not serious.

The outreach strategy is to have the POTUS speech today on China policy and a big press conference on Thursday (so presumably there will be something leaked to the press on status sometime tonight.)

For the Hill, the White House would like us to make Member calls today on the negotiation status. On Thursday, the White House expects House and Senate Leadership to set up briefings. Treasury will be sending a representative.

Treasury has been asked to call the following Members: Sen. Gramm, Sen. Sarbanes, Rep. Roukema, Rep. Bonior, Rep. Hoyer, and Rep. LaFalce. Note: Rep. Roukema was one of 18 Members who just met with Prime Minister Zhu in China.

DISCUSSION:

Talking Points attached.

Talking Points – Calls re China WTO Negotiations

- Our negotiations with the Chinese have continued and intensified in the past several days.

- These negotiations involve a set of broad market access concessions by China. Our market is already open to China. These negotiations do not affect American import policies. Our goal is a fair commercially meaningful agreement that helps to level the playing field by gaining access for our goods and services to their market.

- Our talks have covered all major areas of the WTO accession, including agriculture, industrial goods, services and Protocol issues including safeguards and others. We have set no artificial deadline to complete the work by Premier Zhu's arrival. It appears the visit has motivated the Chinese to move further towards accepting our demands, but this is not affecting our posture and we are not lowering the bar to accommodate an announcement. If China does not make a commercially meaningful offer in all areas of concern, we will reject the accession as we did in the '97 and '98 summits.

- A number of outstanding issues remain. Let me review with you briefly where we stand. In tariffs, for example, China has committed to an average tariff of 7.1% in U.S. priority areas – well below that of most U.S. trade partners. China's present average tariffs are 24.6%.

- With respect to agriculture, China has made significant offers in all major areas -- tariffs, TRQs, export subsidies and domestic supports. For example, the tariff offer would bring agricultural tariffs down to 14.5% in priority areas, which is well below the level of most major U.S. trading partners. China will also accept WTO rules on sanitary and phytosanitary standards immediately on accession, e.g. for citrus, meat and Pacific Northwest wheat. We are continuing, however, to discuss both the quality of market access commitments and phase-in times.

- In goods, China has made concessions in a number of sectors of high priority to the United States, for example trading rights (ability to import/export), distribution, tariffs, and quota elimination. We are continuing to negotiate over the quality of commitments and the phase-in details. Generally, China will agree to 3-year phase-ins, but we are still working on specifics in a few sectors.

- In services, China has made good offers in some sectors. Distribution is an especially strong point, and we have broken new ground in telecommunications and financial services, but we have remaining concerns which must be resolved. Similarly, in other areas we remain unsatisfied and intensive negotiations continue.

- We are also addressing the application of rules, including dumping, safeguards, technology transfer, offsets, measures related to the protection of intellectual property, and investment restrictions as well as other areas. Discussions in these areas have progressed much more slowly as we are asking for commitments that no other WTO member is required to make. We are also continuing to work on textiles. We will continue to insist that China meets the high bar we are setting even if it means extending the talks. It is important to recognize, that the application of the full spectrum of trading rules for China is also addressed in the multilateral negotiations that will be on-going in Geneva in the months ahead. The United States is committed to ensuring that our concerns are addressed both in our bilateral talks as well as the formal negotiations at the WTO (Protocol) in which we will play a leading role.

- The talks are still underway as we speak. The issues which remain outstanding are important enough to both sides that we may wind up with no result. From our perspective, the U.S. remains prepared to walk away from an unsatisfactory deal. We will try to keep you informed as we work toward the conclusion of these negotiations.

- It should be noted that China's accession into the WTO is a long process. First, China must negotiate a bilateral agreement with the U.S. Then, China must also negotiate a bilateral agreement with every other WTO member country. Once this is completed, China must negotiate WTO Protocol issues with the U.S., to be concluded by China negotiating these WTO Protocol issues with every member country.

- Because this is such a long process, there will be a period for significant consultations with the Congress. As part of the consultation process, we will confer with Congress on next steps regarding China's normal trading relations status.

1999-SE-004616

DEPARTMENT OF THE TREASURY
Washington

May 6, 1999

TO: SECRETARY RUBIN
DEPUTY SECRETARY SUMMERS

FROM: Timothy Geithner TFG

SUBJECT: China WTO Update

Attached is update from Meg on China WTO that describes ongoing difficulties in making progress on our issues. A U.S. delegation is likely to return to China during the week of May 17.

cc: Mike Froman

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

May 6, 1999

MEMORANDUM FOR UNDERSECRETARY GEITHNER
ASSISTANT SECRETARY TRUMAN

FROM: **Meg Lundsager** ML
Deputy Assistant Secretary (Trade and Investment Policy)

SUBJECT: **China's WTO Accession Negotiations: Status Report**

In almost exclusively staff level talks in Beijing running through April 26, China pulled back from earlier positions in services market access and did not even seek to respond to new compromises put forth by the United States, including in the financial services area. Our largest concern relates to a Chinese pull back on national treatment for banking. They waited over two days before responding very summarily to a U.S. paper outlining areas of difficulty, by which time European negotiators had arrived, to be followed soon by other supplicants. The cold shoulder reception was not accompanied by rancor, though, and it is likely we will reengage soon. Bob Cassidy will call Long today to nail down our return for the week of May 17. The White House expects to send a letter from President Clinton to Premier Zhu prior to our return to China.

There are a number of possible circumstantial explanations for Chinese behavior. Against the preference of China's negotiator, our team arrived the same day that Zhu returned from North America, meaning their negotiators were tired and had not had time to get new instructions. (Their negotiator claimed illness in justifying his absence, just as he was ill and missed the talks in December which registered so little progress.) Moreover, the Chinese may have calculated that they could come to terms with the EU prior to Sir Leon Brittan's visit to China May 5-6, isolating us, but little progress was reportedly made in those talks either. Finally, the Chinese indicated displeasure at USTR's release of information on concessions China had made in Washington during the Zhu visit and may have wanted to punish us for not having reached closure at that time.

Start of a Securities Dialogue?

As Vice Minister Long had suggested after his meeting with Tim, a meeting was set up with the China Securities Regulatory Commission during our stay, and I initiated a second (without MOFTEC presence) while waiting for Long to signal how we were to proceed with the broader talks. The CSRC said they plan to open up their market to foreign participation, but stated repeatedly that they cannot commit to anything more in securities with a firm schedule. They recognized that the integrity of China's foreign exchange controls was not affected by letting foreign affiliated securities firms trade A shares (as opposed to own them). They sought to justify their position by citing the illiquidity/instability of their stock market, lack of transparency, and the rudimentary nature of their regulations, but in the end said flat out that this was their position because it was their position.

The document we left behind requested, in relevant part,: (1) foreign equity share of 49% by 2005 for securities operations doing everything but A share trading, (2) a one-year trial in A share trading within five years, and (3) a process of bilateral cooperation on the development of China's securities market. I mentioned the latter idea to the CSRC during my second meeting without reference to the negotiating document, which I don't presume MOFTEC would have shared. They agreed to consider it. The seed of hope is thus twice planted in case we ultimately don't get all we want in this area.

Attached is a draft U.S. letter (not shared with the Chinese) which might serve to launch such a dialogue. Your comments on it would be welcomed.

Attachment

The successful conclusion of our bilateral negotiations on China's entry into the WTO will further China's integration into the global economic system to the benefit of both our nations. In view of the pivotal role of financial services in this achievement, the importance of China to the regional and world economy, and the broad range of reforms which China is undertaking, the United States proposes to launch a mutually beneficial special bilateral consultative process on financial sector issues. Initially, discussions would concentrate on financial sector restructuring and modernization, including the potential for sustaining exchange and capital market stability while progressively allowing foreign financial institutions to play a constructive role in the development of Chinese capital markets. The responsible national regulatory authorities, including securities market regulators, would participate in the consultations with a view to enhancing cooperation and increasing transparency and market confidence in China.

This proposed consultative process would focus on China's expressed concern that it could not yet open its market to majority foreign-invested securities companies trading domestic equities (A shares) because of the low level of trading in China and evolving development of its regulatory capacity. The United States assured China that it was not seeking to limit China's capital controls, but rather to contribute to the development of the domestic securities market via establishment of strong, foreign-invested securities companies with the highest standards of disclosure, management efficiency, and market-making expertise. The United States suggested that such foreign participation would contribute to the development of more efficient capital markets in China and the development of a dynamic, domestically-based private sector, the importance of which was recently recognized in China's constitution. In furtherance of these objectives, the United States suggested that within a five year period China allow foreign-invested securities firms to engage in A share trading on a one year trial basis, the conditions of which could be discussed as part of this special dialogue.

I would like to propose that this enhanced dialogue on capital markets be conducted principally in the context of the China-U.S. Joint Economic Committee, with interim meetings convened by mutual consent. At times, we may wish to consider including private sector experts and representatives of international organizations.

I look forward to your reply indicating that you can agree to establishing this bilateral consultative process.