The Chinese Economy Today (1)

- East Asia is the fastest-growing region in the world over the past two decades
- China is the fastest growing country in East Asia—10% p.a. since economic reform (1979)
- China is one of the very few socialist countries that have made a successful economic transition from a centrally planned to a market economy
- China and Hong Kong are the only two economies the currencies of which have not been devalued amidst the East Asian currency crisis
- China and Taiwan are the only two economies with significant positive rates of growth in 1998
The Chinese Economy Today (2)

<table>
<thead>
<tr>
<th></th>
<th>U.S.</th>
<th>China</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>US$ (current prices)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1999 GDP</td>
<td>9,248 bill.</td>
<td>1,005 bill.</td>
</tr>
<tr>
<td>1999 GDP per capita</td>
<td>33,857</td>
<td>805</td>
</tr>
</tbody>
</table>
### The Chinese Economy Today (3)

<table>
<thead>
<tr>
<th>Metric</th>
<th>1979</th>
<th>1999</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP</td>
<td>169 bill.</td>
<td>985 bill.</td>
</tr>
<tr>
<td>Real GDP per capita</td>
<td>174</td>
<td>793</td>
</tr>
</tbody>
</table>

US$ (1995 prices)
The Chinese Economic Reform
(1979-the present)

- The Open Door
  - International Trade
  - Foreign Direct Investment
- Marketization
  - Goods Market
  - Labor Market
  - Foreign Exchange Market
  - Housing Market
  - Capital Market
The Chinese Economic Reform
(1979-the present)

  - Empowering Provincial and Local Governments
  - Professional Management of Enterprises
  - Autonomy and Incentive
The Chinese Economic Reform (1979-the present)

- Creation of New, Non-State-Owned Modes of Organization for Production
  - Agriculture--Abolition of communes; return to a system of individual cultivators with fixed rents and taxes
  - Industry--Emergence of “Township and Village” (T&V) enterprises; (foreign) joint-venture, foreign and private enterprises
Economic Performance: Pre- and Post-Reform

Table 1. Average Annual Rates of Growth

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP</td>
<td>5.9</td>
<td>10.0</td>
</tr>
<tr>
<td>Real GDP/Capita</td>
<td>3.8</td>
<td>8.5</td>
</tr>
<tr>
<td>Real Gross Value of:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Agricultural Production*</td>
<td>2.9</td>
<td>6.1</td>
</tr>
<tr>
<td>Light Industry*</td>
<td>8.7</td>
<td>16.5</td>
</tr>
<tr>
<td>Heavy Industry*</td>
<td>12.8</td>
<td>14.4</td>
</tr>
<tr>
<td>Real Consumption/Capita*</td>
<td>2.0</td>
<td>7.1</td>
</tr>
<tr>
<td>Capital Stock</td>
<td>5.3</td>
<td>9.1</td>
</tr>
<tr>
<td>Employment</td>
<td>2.5</td>
<td>2.6</td>
</tr>
<tr>
<td>GDP Deflator</td>
<td>0.4</td>
<td>7.4</td>
</tr>
<tr>
<td>Exports (in current US Dollars)</td>
<td>10.5</td>
<td>16.1</td>
</tr>
<tr>
<td>Imports (in current US Dollars)</td>
<td>9.9</td>
<td>14.3</td>
</tr>
</tbody>
</table>
Monthly Exports, Imports and Trade Balance
Official Chinese Data

Export, Imports, Trade Surplus

Billion $US

Exports
Imports
Trade Surplus

International Trade

- Aggregate exports rose 6.1% in 1999 to US$195 billions; the increase is mostly attributable to the revival in exports to some of the affected East Asian economies (such as South Korea and Thailand) and Japan and continued strong growth in exports to U.S. and Europe.

- Aggregate imports rose 18.2% in 1999 to US$165 billions, mostly due to the replacement of previously smuggled imports by regular imports but also partly reflecting more robust domestic growth.

- Adjusted for the deflation factor of approximately 4% in export and import prices, aggregate exports have actually been growing very strongly in real terms.

- The net trade surplus is US$30 billions compared to an estimated smuggling adjusted trade surplus of US$20-25 billion in 1998.
Composition of Foreign Investment: China

Million US$

Composition of Foreign Investment, China

FDI  Portfolio Investment

Composition of External Debt
China

Stock of External Debt: China
Chinese Data

Long-term
Short-term

Billion U.S.$
External Debt v.s. Foreign Exchange Reserves
China
Marketization:
Domestic Prices

- The prices of all consumer goods and more than 99% of the producer goods are determined in the market (with the exception of within plan outputs of coal, natural gas, and steel)
- Only three agricultural commodities--grains, cotton, and tobacco--remain under the central plan
- The price of low-grade grain is controlled (subsidized)
- The price of energy is at world market levels
  - The prices of oil and gasoline are freely determined in the market
- China has been taken off the “non-market economies” list of the European Union (12/97)
Table 1. Phasing Out the Plan-Track: Agricultural Products (% of output value)

<table>
<thead>
<tr>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>plan price</td>
<td>94.4</td>
<td>37.0</td>
<td>35.0</td>
<td>29.4</td>
<td>24.0</td>
<td>35.5</td>
<td>31.0</td>
<td>22.2</td>
<td>12.5</td>
<td>10.4</td>
</tr>
<tr>
<td>guide price</td>
<td>0.0</td>
<td>23.0</td>
<td>21.0</td>
<td>16.8</td>
<td>19.0</td>
<td>24.3</td>
<td>27.0</td>
<td>20.0</td>
<td>5.7</td>
<td>2.1</td>
</tr>
<tr>
<td>market price</td>
<td>5.6</td>
<td>40.0</td>
<td>43.7</td>
<td>53.8</td>
<td>57.0</td>
<td>40.4</td>
<td>42.0</td>
<td>57.8</td>
<td>81.8</td>
<td>87.5</td>
</tr>
</tbody>
</table>
## Marketization-Industry

**Table 3. Phasing Out the Plan-Track: Industrial Goods (% of output value)**

<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>plan</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>60.0</td>
<td>44.6</td>
<td>36.0</td>
<td>18.7</td>
<td>13.8</td>
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<td>price</td>
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<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>guide</td>
<td>100.0</td>
<td>64.0</td>
<td></td>
<td></td>
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<tr>
<td>price</td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>market</td>
<td>0.0</td>
<td>23.0</td>
<td></td>
<td></td>
<td></td>
<td>19.0</td>
<td>18.3</td>
<td>7.5</td>
<td>5.1</td>
<td></td>
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<tr>
<td>price</td>
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<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>market</td>
<td>0.0</td>
<td>13.0</td>
<td></td>
<td></td>
<td></td>
<td>40.0</td>
<td>36.4</td>
<td>45.7</td>
<td>73.8</td>
<td>81.1</td>
</tr>
<tr>
<td>price</td>
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<td></td>
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</tr>
</tbody>
</table>
## Table 5. Phasing Out the Plan-Track: Total Retail Sales (% of sales)

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>plan price</strong></td>
<td>97.0</td>
<td>47.0</td>
<td>35.0</td>
<td>33.7</td>
<td>28.9</td>
<td>31.3</td>
<td>30.0</td>
<td>20.9</td>
<td>5.9</td>
<td>4.8</td>
</tr>
<tr>
<td><strong>guide price</strong></td>
<td>0.0</td>
<td>19.0</td>
<td>25.0</td>
<td>28.0</td>
<td>21.8</td>
<td>23.2</td>
<td>25.0</td>
<td>10.3</td>
<td>1.1</td>
<td>1.4</td>
</tr>
<tr>
<td><strong>market price</strong></td>
<td>3.0</td>
<td>34.0</td>
<td>40.0</td>
<td>38.3</td>
<td>49.3</td>
<td>45.5</td>
<td>45.0</td>
<td>68.8</td>
<td>93.0</td>
<td>93.8</td>
</tr>
</tbody>
</table>
Marketization:
Foreign Exchange

- Unified exchange rate since 1/94
- Interbank market in foreign exchange established 4/94
- Current account convertibility since 12/96
- Exporters permitted to retain 15% of foreign exchange proceeds as of 10/97
- However, full capital account convertibility unlikely in the near future
The Growth of the Non-State Sector-Industry

Distribution of Gross Value of Industrial Production by Ownership

1978:
- State-Owned: 78%
- Collective: 22%

1996:
- State-Owned: 28%
- Collective: 40%
- Private: 15%
- Other: 17%
The Growth of Industrial Output by Sector of Ownership

The Rate of Growth of Industrial Output by Sector of Ownership

- **Total Industry**
- **State-owned**
- **Non-State owned**

Lawrence J. Lau, Stanford University
The Growth of Industrial Output of the Non-State Sector

- Non-state Owned Enterprises
- Township and Village Enterprises
Share of Rural Enterprises in Industrial Output & Employment

Figure 6. TVEs and Rural Private Enterprises in China

- Proportion of Gross Value of Industrial Production
- Proportion of Industrial Employment

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The Growth of the Non-State Sector (2)-Retail

The Distribution of Retail Sales by Ownership

1979
- State: 49.3%
- Collective: 41.2%
- Private: 0.4%
- Foreign & Others: 9.1%

1995
- State: 30.0%
- Private: 30.4%
- Collective: 19.8%
- Foreign & Others: 19.8%
The Private Sector

- Private enterprises accounts for approximately 11% of GDP in 1998
- Private agriculture accounts for approximately 17% of GDP in 1998
- Proposed constitutional change to be enacted by the National People’s Congress (Chinese parliament) recognizing that the private sector is “an important part of the socialist market economy” thus giving it increased acceptance and legitimacy
- The non-state sector accounts for approximately two-thirds of GDP in 1998
The Stock Market

- Market capitalization (US$369 billion); Market turnover (US$1.7 billion a day)
- 7/8/99 -- introduction of indexed funds in China
- 8/99 -- 16 billion Yuan bonds issued and traded on the domestic stock exchanges
- 9/99 -- state-owned enterprises permitted to trade stocks
- New boards for high-tech companies will be set up in Shanghai and Shenzhen stock exchanges with relaxed requirements for annual profits and capitalization (Chinese NASDAQs?)
The Decline in the Government Expenditure-GDP Ratio

The Ratio of Government Expenditures to GDP

Percent


Central Government

Provincial & Local Government
Central Government Budget Revenue, Expenditure, and Surplus as a Percent of GDP

Central Government Budget Revenue and Expenditure as Percent of GDP

Revenue
Expenditure
Surplus/Deficit

Lawrence J. Lau, Stanford University
Distribution between Current and Capital Expenditures
<table>
<thead>
<tr>
<th>Year</th>
<th>Real GDP</th>
<th>RPI</th>
<th>CPI</th>
</tr>
</thead>
<tbody>
<tr>
<td>1997</td>
<td>8.8</td>
<td>0.8</td>
<td>2.8</td>
</tr>
<tr>
<td>1998</td>
<td>7.8</td>
<td>-2.6</td>
<td>-0.8</td>
</tr>
<tr>
<td>1999</td>
<td>7.1</td>
<td>-2.9</td>
<td>-1.3</td>
</tr>
<tr>
<td>2000 (proj.)</td>
<td>6.0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2000 (proj.)</td>
<td>7.5</td>
<td></td>
<td>1.5</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>(Lau)</td>
</tr>
</tbody>
</table>
YoY Quarterly Rates of Growth of Real GDP

Lawrence J. Lau, Stanford University
Are the Reported Rates of Growth of Real GDP Reliable? 1999

The expenditure approach

- Rate of growth of real gross fixed investment = 9.2% with a share of GDP of 27% ( = 2.5% )
- Rate of growth of changes in stocks estimated at 3% with a share of 13% ( = 0.39% )
- Rate of growth of real retail sales = 10%; rate of growth of real per capita disposable income ( = 9.3% urban; 4% rural ); rate of growth of real personal consumption = 5.6% with an estimated share of GDP of 40% ( = 2.2% )
- Rate of growth of government consumption = 7.1% with a share of GDP of 17% ( = 1.21% )
- Rate of growth of net exports estimated at between 20% and 50% ( trade surplus was US$30 billion in 1999 with the crackdown on smuggling; smuggling adjusted trade surplus in 1998 may be estimated at between US$20-25 billion) with a share of GDP of 3% ( = 0.6% )

The sum of the real rates of growth of the components of expenditure = 2.5 + 0.39 + 2.2 + 1.21 + 0.6 = 6.9%
Is GDP Growth Compatible with the Growth of Electricity and Freight Traffic?

◆ The rate of growth of electricity production is 6.4% in 1999
◆ The rate of growth of freight traffic is 0.4% (1-11/99)
◆ Common factors:
  ▶ The rate of growth of the manufacturing sector has slowed down relative to the construction sector and the service sector
  ▶ Differences in the rates of growth between heavy and light industry
  ▶ Intra-industry changes in the composition of outputs, including upgrading of the qualities (and hence values-added) of products
  ▶ Effects of changes in the loci of production and consumption
◆ Factors specific to electricity production:
  ▶ Effects of changes in prices--the price of electricity has risen 3-4 fold since 1990
  ▶ Effects of changes in efficiency
  ▶ Other “economic” and technical reasons for changes in the rates of transmission losses
  ▶ Effects of co-generation--under-reporting and marginal users
◆ Factors specific to freight traffic:
  ▶ Effects of environmental regulation--60% of freight traffic was for coal
Has Deflation Stopped?

- Deflation has slowed:
  - In Jan-Jun/1999 the retail price index declined 3.2% YoY; In Jan-Dec/1999 the RPI declined only 2.9%
  - In Jan-Jun/1999, the consumer price index declined 1.8% YoY; In Jan-Dec/1999 the CPI declined 1.3%
  - In 1/00, the CPI grew 0.9% YoY (a lagging indicator)

- The “core” rate of inflation is positive
  - The decline in prices over the last twenty-four months was due in part to the fall in the prices of energy and in particular oil and food because of the good harvest
  - The long-term core inflation rate--inflation rate net of changes in the prices of energy and food--may be estimated at a little bit above zero--there is no deflation
Government Deficit as a Percent of GDP--Selected Countries

Government Deficit as a Percent of GDP, Selected Countries

% of GDP

Belgium
Canada
France
Germany
Italy
Japan
UK
US
China
India
Indonesia
Korea
Thailand

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The Stock of Public Debt as a Percent of GDP--Selected Countries

Public Debt as a Percent of GDP, Selected Countries

Belgium
France
Germany
Italy
Japan
UK
US
China
India
Indonesia
S. Korea
Thailand
Long-Term Economic Outlook

- A relative abundance of natural resources
- A potentially huge domestic market (Economies of Scale and "Coordination Externalities")
- An almost unlimited supply of surplus labor
- A high domestic saving rate of 35-40%
- A cultural preference for education
- The agricultural sector has been performing well
- Existing and expected fiscal reforms should reduce structural government deficit
Three Paradigms of Economic Growth

- Growth through domestic demand--the domestic market paradigm a la the United States in the 19th century
- Industrial migration over time--the "wild-geese-flying pattern" metaphor applied to Chinese provinces and regions
- Privatization is not always necessary--shrinking the state sector without privatization--the experience of Taiwan
- What does it take?
  - Availability of infrastructure (transportation and communication, including the internet)
  - Continued marketization of the economy
  - Maintenance of a domestically open economy (the equivalent of the “interstate commerce” clause of the U.S. constitution)
  - Affirmation of property rights and the rule of law
  - Adequacy of domestic resources (savings and labor)
  - The role of the "open door"--WTO
## Long-Term Projections

<table>
<thead>
<tr>
<th>Year</th>
<th>Real GDP</th>
<th>Real GDP/Per Capita</th>
</tr>
</thead>
<tbody>
<tr>
<td>1998</td>
<td>880 bill.</td>
<td>690</td>
</tr>
<tr>
<td>2010</td>
<td>2.5 trill.</td>
<td>1,800</td>
</tr>
<tr>
<td>2020</td>
<td>5 trillion</td>
<td>3,500</td>
</tr>
</tbody>
</table>

US$ (1990 prices)
The Structure of the Economy: Output
The Structure of the Economy: Employment

1995

2020
Will the Chinese Yuan Go the Way of the Thai Baht and the Korean Won?

No! Chinese fundamentals are strong

- High domestic savings rate and no savings-investment gap
- Current account surpluses of US$40 billion in 1997 and US$29.3 billion in 1998
- Foreign capital mostly in the form of foreign direct investment (FDI)
- External debts (US$149 billion at the end of June 1999) have staggered, medium to long maturities; short-term debt amounted to US$17.1 billion as of June 1999
- Rate of inflation is low (negative since 1998)
- Yield on ten-year Yuan-denominated bonds below 6%; yield on seven-year Yuan-denominated bonds 3.2%
- Foreign exchange reserves (US$154.7 billion as of 12/31/99) second highest in the world
Composition of Foreign Investment: China

Composition of Foreign Investment, China

Lawrence J. Lau, Stanford University
Composition of External Debt
China

Stock of External Debt: China
Chinese Data

Billion U.S.$

Long-term
Short-term

Lawrence J. Lau, Stanford University
External Debt v.s. Foreign Exchange Reserves
China

China's External Debt v.s. Foreign Exchange Reserves: Chinese Data

- Total outstanding debt
- Foreign exchange reserve

Billion US$
Should/Will the Renminbi be Devalued? (1)

- Fundamentals are strong
- Devaluation will be an intentional policy decision
  - Renminbi is not freely convertible and cannot be easily attacked by international currency speculators
  - All the senior Chinese leaders--Jiang Ze-Min, Li Peng, Zhu Rong-Ji and Dai Xiang-Long have said that the Renminbi will not be devalued
  - There are diplomatic and political benefits for China in maintaining the value of the Renminbi, providing a pillar of stability in East Asia--a concrete gesture of cooperation with and support for the other East Asian countries
  - It must be in accord with China’s self-interest
Monthly Exports, Imports and Trade Balance
Official Chinese Data

Exports, Imports, Trade Surplus

Billion $US

Exports, Imports, Trade Surplus

Exports
Imports
Trade Surplus


Lawrence J. Lau, Stanford University
Impact on exports of the devaluation in other East Asian currencies has been managed

- Exports constitute only 20% of Chinese GDP (even less in PPP (Purchasing-Power-Parity) terms)
- Exports facing potential competition from Southeast Asian economies such as apparel, electrical appliances, footwear, and toys may be quota-constrained
- High import content of such exports (imported intermediate inputs constitute 60% of costs) and high financing (20%) costs mitigate potential impact
- Chinese competitiveness can be enhanced without devaluation, through tariff reduction on equipment and intermediate inputs, VAT rebates, discounting of export letters of credit, reduction of port fees, relocation inland and quality improvement
- Devolution of direct trading privileges to the level of enterprises (state-owned, joint-venture, collective, private, and foreign) also reduces the costs of exports

As of 4/1999, 74 private enterprises have been granted independent export rights
Should/Will the Renminbi be Devalued? (3)

- Exports have been rising in the past 6 months, in part due to the recovery in East Asia except Indonesia
- The exchange rates of East Asian currencies have risen 35% from their troughs
- In real terms, because of the “deflation” in China, the Renminbi has already effectively devalued by approximately 6% since 1997; in addition, the export prices have fallen even further
Should/Will the Renminbi be Devalued? (4)

- Official data do not fully reflect true underlying trade and payments flows
  - The declines in exports in mid-1999 due in part to the existence of fictitious exports in the 1998 data for the sole purpose of obtaining tax rebates
  - Recent double-digit growth in imports due to the substitution of smuggled imports of 1998 by legal imports of 1999
    - Customs duties and import tax collections by Chinese Customs increased by 80.8% in 1999
    - “Errors and Omissions” item in balance of payments declined
  - Exports rose 6.1% while Imports rose 18.2% in 1999
  - In real terms, aggregate exports and imports have not declined
Should/Will the Renminbi be Devalued? (5)

Foreign Direct Investment (FDI)

- Impact on FDI not critical
  - FDI, including recycled Chinese investment, accounts for only 10% of total domestic gross fixed investment
  - Recycled, or “round-tripped”, Chinese investment constitutes a third of FDI
  - FDI motivated by low labor costs may be affected
  - FDI aimed at access to the Chinese market will be unaffected -- the inflows from U.S. and Europe have actually been rising
  - FDI originating from Japan and Southeast Asian countries have been affected
  - The nature of FDI has also changed -- from export-oriented to domestically oriented; from light industry to heavy and high-technology industries, and from small projects to large projects
Should/Will the Renminbi be Devalued? (6)

Foreign Direct Investment (FDI)

- FDI arrivals and commitments
  - FDI arrivals increased 0.7% to US$45.6 billion in 1998 from US$45.3 billion in 1997 with FDI from Asia falling by 9% and U.S. and Europe rising by 21%
  - FDI commitments increased 2.1% from 1997 to US$52.1 billion in 1998
  - FDI arrivals totaled US$40.39 billion in 1999, compared to US$18.6 billion in 1H/1999, an 11% decline from 1998--however, the sources of the FDI were different--real FDI probably rose if “round-tripped” capital were excluded
  - FDI commitments amounted to US$41.24 billion in 1999, a decline of 20.9% YoY
Should/Will the Renminbi be Devalued? (7)

- Domestic macroeconomic stimulus can make up for the slowdown in the growth of net exports
  - Reduction of the rate of interest on loans (7 times in 3 years)
  - Acceleration and increase of infrastructural investment
  - The strategy of “Developing the Great West”
  - Promotion and encouragement of the development of affordable residential housing
- Domestic bond market sentiment does not indicate the expectation of a devaluation
  - Issuance of 7-year Yuan-denominated bonds on 6/18/99 at an interest rate of 3.2% p.a., lower than U.S. Treasury security of comparable maturity
Devaluation may not do any good

- In order to have a significant effect on the rate of growth of real GDP, it must increase net exports, which is much more difficult to do than to increase gross exports
- It may lead to another round of devaluation in Southeast Asia--even if a government wishes to hold the exchange rate, it may not be able to withstand the speculative attacks that will almost surely follow
- Exports to the East Asian countries are already recovering even without a devaluation--further devaluation may not be useful or necessary
- It will increase the cost of imports of intermediate goods and capital equipment as well as the burden of the external debt
- It is difficult to have a “controlled” devaluation in the current environment
- It may undermine the confidence of the Chinese citizens in their Government and in its currency
Devaluation may not do any good

- The devaluations of the Southeast Asian currencies and the Japanese Yen and the Russian Ruble in 1998 provide dramatic and timely examples that devaluation does not always help the domestic economy.
- The experience of the Japanese Yen also showed that a devaluation does not cure deflation, if any.
Why are There So Many Rumors?

- Political pressure from powerful domestic interest groups
  - Exporters always favor a devaluation, because they will always make more money in domestic currency terms, regardless of whether it is good for the economy as a whole or not
  - Domestic manufacturers also support a devaluation as insurance against Chinese entry into the WTO. A devaluation increases the price of imports for Chinese users, and hence acts like a tariff in terms of protecting domestic producers, but is not itself subject to abolition or withdrawal after Chinese accession to the WTO.
  - Short-term speculative motives of Chinese enterprises with access to foreign currency, e.g. exporters

- Constituencies benefiting from a stable value of the Renminbi are diffused and lacking in influence
Should/Will the Renminbi be Devalued? (11)

Recent Developments

◆ The Renminbi has been gaining strength:
  ◆ The foreign reserves have been rising once again, amounting to US$154 billion at the end of 1999
  ◆ The appreciation and stabilization of the Japanese Yen at a level between 100 and 110 Yen/US$
  ◆ The stepped up enforcement of foreign exchange regulations ranging from repatriation of export proceeds, tax rebates and purchases of foreign exchange for imports
  ◆ A devaluation is incompatible with the “Developing the Great West” strategy