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DIRECTORATE OF
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Intelligence Memorandum

US-China Trade Revisited

(written by Ed Allen)

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
May 1971

INTELLIGENCE MEMORANDUM

US-CHINA TRADE REVISITED

Introduction

1. The President's announcement of changes in US trade policy toward Communist China has been followed by optimistic estimates of the trade potential possible under renewed commercial relations. The policy shift, while it will result in the removal of some trade barriers and thereby in renewed trade activity, has been made primarily for political reasons.

2. There are a number of key factors which limit the potential level of US trade with Communist China, even in the longer run. First of all, China's total trade of about $4 billion is small in relation to total output – imports are less than 2% of GNP – which is a reflection of its basically subsistence agriculture economy. Second, the overall level of Chinese foreign trade is likely to grow only slowly, perhaps 3% to 5% annually, inhibited by a policy of economic self-sufficiency, highly conservative financial practices, and a limited range of export goods. Third, China already has well-established trading relationships with low-cost suppliers of its major import needs – grain from Canada and Australia, and capital goods, metals, and fertilizers from Japan and Western Europe. Furthermore, Hong Kong enjoys a unique trading relationship with China, absorbing over $300 million annually of Chinese goods, largely foodstuffs, and perennially being China's largest source of hard currency earnings. Finally, China's imports come through state trading organizations. Priorities are not likely to include much for consumers except foodstuffs; the "one aspirin for each of the 850 million Chinamen" dream is most unlikely to be realized.

Note: This memorandum was prepared by the Office of Economic Research.

3. The potential for Sino-US trade clearly is limited by these existing relationships. Nevertheless, there are obvious possibilities for commercial relations because of a US competitive advantage in high-technology industries such as aircraft and the existence of a high-income US market capable of absorbing quantities of Chinese exports of luxury items, including objets d'art.

Discussion

Relaxation of US Trade Controls

4. The United States, over the past two years, has gradually been easing the absolute barriers to trade with China that were imposed during 1949-50. In July 1969, US tourists were authorized to import up to $100 worth of Chinese-origin goods. In December 1969, the importation of non-commercial (not for resale) Chinese goods was further liberalized. At the same time, restrictions were removed on sales to China of non-strategic commodities by foreign subsidiaries of US corporations.

5. A further relaxation in April 1970 permitted the incorporation of US-made parts and components in non-strategic products being sold to Communist China. These steps stimulated small but positive reactions. Early deals included the sale of 80 Italian-made dump trucks incorporating US-produced engines and reported sales of some US earthmoving equipment and pesticides. With US tourist outlays and sales of US-owned foreign subsidiaries and licensees, including the incorporation of US-produced components, total trade with China probably grew to at least a few million dollars.

6. The April 1971 action, which required no new legislation or negotiations with China, added the following liberalizing steps:

a. US currency controls were relaxed to permit China to use dollars.

b. Restrictions are to be ended on US oil companies to permit fuel to be provided for ships or aircraft proceeding to and from China, except for Chinese owned or chartered carriers bound to or from North Vietnam, North Korea, or Cuba.

c. US vessels or aircraft may now carry Chinese cargoes between non-Chinese ports, and US-owned foreign flag carriers may now call at Chinese ports.

d. A list of commodities which will be put under general license for export to China is being drawn up.

7. The composition of the "shopping list" for China is probably all-important to the short-term prospects for exports, not only from the United States but also from US subsidiaries abroad. A few years ago, for example, Ford Motors of Canada had an order for trucks from China, but US trade controls blocked the transaction. If the shipping list includes trucks and truck components, commercial aircraft, reasonably advanced computers, scientific instruments, and other high-technology products, it would stimulate the flow of US goods to China. Export of wheat and other grains to China, if placed on the permitted list, will be unlikely to take place unless the current requirement that 50% of all such cargoes must move in US vessels is waived.

8. Imports from Communist China will require licensing by the Treasury Department. However, the basic limitation on imports is not this administrative requirement, but rather the array of goods China has available for export.

<u>The Role of Trade</u>

9. Total production of goods and services in Communist China in rounded numbers was about $120 billion, or $145 per capita, in 1970. 1/ Overall output has been growing about 4% a year under the Communists, with industry advancing at about 8% annually and agriculture about 2%. No significant acceleration of these rates is anticipated over the next few years.

10. The Chinese regime has pursued a long-run policy of spurring industrial development, relying heavily on imports of machinery and equipment. Its industrial development has a distinctly military coloration, with emphasis on the production of modern weapons, particularly advanced nuclear weapons systems. In the late 1950s, most industrial equipment came from the USSR, but imports from the Free World now completely overshadow those from the Soviet Union.

11. A second feature of China's foreign trade has been the annual import of about 4 million tons of grain from the Free World, starting in 1961. China is a net exporter of food on balance, largely because of the volume supplying of meat, vegetables, and specialty products to Hong Kong and to the Chinese communities in Southeast Asia.

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12. Foreign trade rose by 10% in 1970 to a total volume of $4.25 billion, as shown by the following tabulation on exports and imports, and was about equal to the 1959 peak, as shown in Figures 1 and 2.

Billion US $

	1966	1967	1968	1969	1970
Exports	2.17	1.92	1.89	2.02	2.15
Imports	2.03	1.94	1.82	1.84	2.10
Total	*4.20*	*3.86*	*3.71*	*3.86*	*4.25*

13. The most striking feature of China's foreign trade in 1970 was the sharp increase with its number one trading partner, Japan -- from a volume of $654 million in 1969 to $840 million in 1970. This increase was concentrated on the import side. Imports from Japan climbing from $415 million to $605 million while exports were holding even at about $240 million. Imports from Japan in 1970 were divided as follows:

	Million US $
Chemicals (mainly fertilizer)	145
Manufactures (mainly steel products)	320
Machinery and transport equipment	120
Crude materials and miscellaneous	20
Total	*605*

Figure 1

Communist China's commodity composition of imports in 1959 and 1969...

Million US $

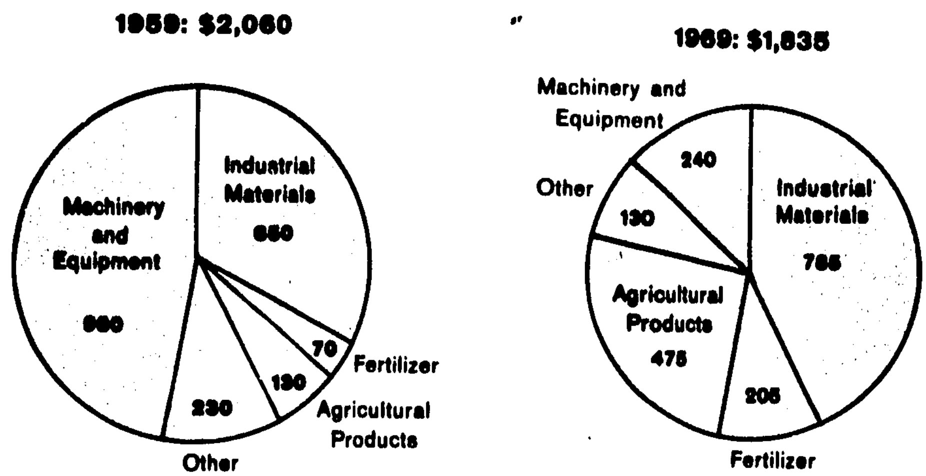

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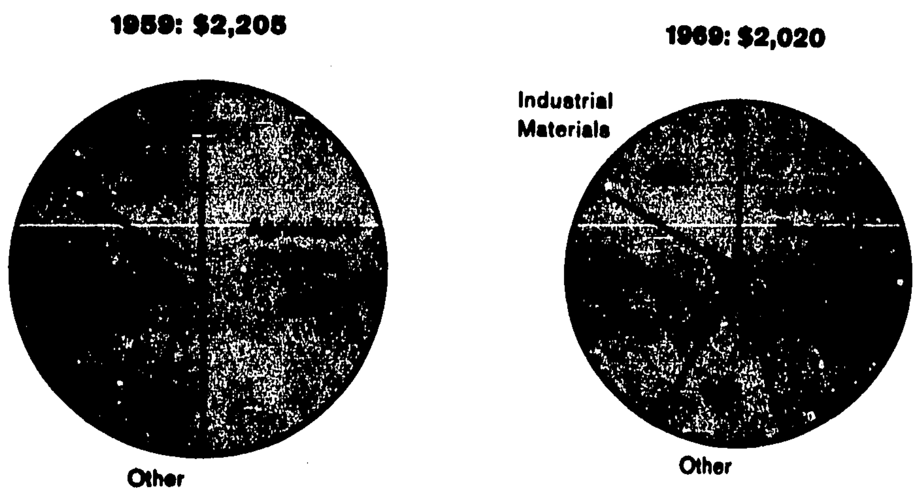
Figure 2

Communist China's commodity composition of exports in 1959 and 1969...

Million US $



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14. The increase in trade with Japan illustrates China's fundamental dependence on Japan and Western Europe for modern plant and equipment, advanced industrial products (such as alloy steels), and industrial technology. Sino-Soviet trade, which once aggregated $2 billion, was about $50 million in both 1969 and 1970. China's imports from the Communist world consist largely of ordinary industrial materials, equipment, and spare parts. Thus China now depends very little on other Communist countries for support in economic modernization. 2/

Trade and Credits

15. Communist China has practiced extreme conservatism in its international financial dealings. In contrast to the other major underdeveloped nations -- many of which have accumulated crushing external debts -- China has been a net exporter of capital. China's moderate indebtedness to the Soviet Union in the 1950s was rapidly paid off through export surpluses in the early 1960s in spite of grave internal economic problems. The wheat imports of the 1960s have been financed on ordinary 18-month commercial credits which have been paid off on schedule or even in advance.

16. In the period 1966-70, China's foreign aid deliveries have averaged nearly $400 million annually, as follows:

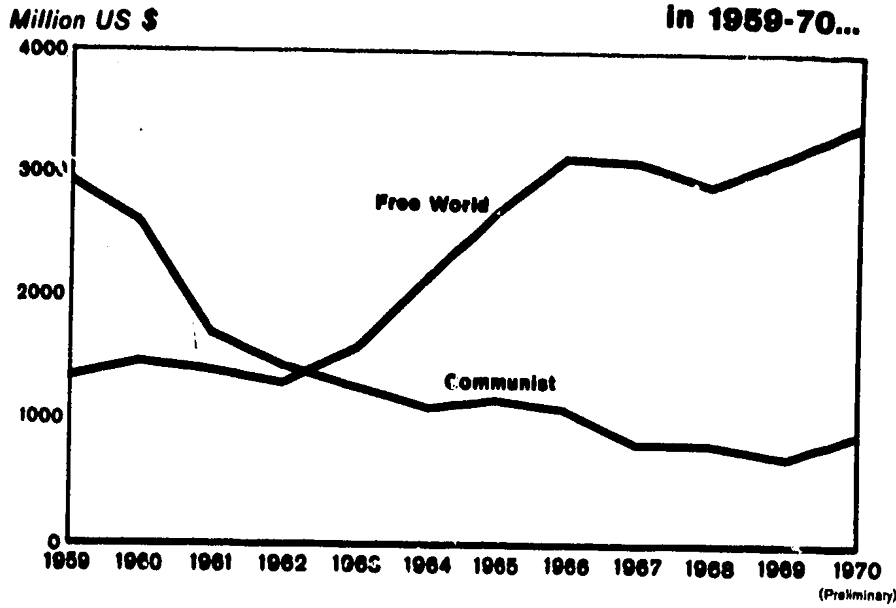
	Million US $
To Free World countries	87
Economic	65
Military	22
To Communist countries a/	291
Economic	185
Military	106
Total to all countries	*378*

a. Of the economic aid to Communist countries in 1966-70, roughly half has been to North Vietnam and a one-fourth each to Cuba and Albania. All the military aid to Communist countries has been to North Vietnam; the small shipments of military goods to North Korea in this period probably were paid for in cash.

2. As shown in Figure 3, China's trade with the Communist world was 70% of its total trade in 1959 but only 20% in 1970.

Figure 3

Comparison of trade by Communist China with the Free World and Communist countries in 1959-70...



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17. Conservative financial practices have been reflected in increased Chinese holdings of gold and foreign exchange, which were estimated at about $800 million at the 1970 yearend. Imports from the industrial Free World increased sharply in 1970 compared to exports, resulting in a deficit in this sector of China's trade balance. However, net earnings from Hong Kong and the less developed countries probably enabled China to settle its international accounts with little reduction in its carefully accumulated reserves.

18. Although China's excellent reputation for scrupulous financial dealing undoubtedly would enable it to obtain long-term credits from Free World countries interested in expanding their exports to China, China almost certainly would not accept them. The volume of imports, therefore, is largely limited by its ability to export. At the same time, because of its large net export earnings from Hong Kong, China need not balance its trade on a bilateral basis with major Free World partners such as Japan.

Potential Chinese Exports to the US

19. In 1950, more than one-third of China's $150 million of exports to the United States were made up of bristles, tung oil, and feathers – commodities that the United States no longer imports in large quantities. Since the 1969 relaxation on China trade, there have been some imports of resin from China.

20. Of some $2 billion of total Chinese exports in 1969, more than $600 million was foodstuffs and an equal amount consisted of textile fibers, yarn, fabric, and cloth. China would have difficulty in achieving large-scale penetration of US markets with its major exports of textiles and staple foodstuffs. In view of longstanding opposition to textile imports, the United States would probably be unwilling to permit large-scale imports of such Chinese products. While staple foodstuffs would not enjoy a large market in the United States, China could probably sell substantial quantities of specialty foods to American consumers. There would be some market for Chinese exports of consumer products such as tea, silks, and light manufactures. Also, if China were to make available greater quantities of tungsten, tin, and other metals, US firms probably would place orders for these items.

21. For Chinese luxury products, however, the US market would be much larger than in 1950 because of the great rise in disposable income. In some cases, these products would be unique and face little competition from domestic or foreign sources. Typical of potential luxury exports would be rugs, embroideries, antiques, art objects, and curios. China no longer enjoys most-favored-nation tariff treatment in trade with the United States, and its exports of luxury-type goods would have to face this added barrier.

22. Even under normalized relations with Communist China, under which US unilateral controls were dismantled and a shopping list of US exports satisfactory to China agreed to, at least a few years would be necessary for exports to the United States to develop. In the short-run, consumer acceptance probably would be limited because of China's assistance to the North Vietnamese military effort.

23. One estimate of the possible level of Chinese exports to the United States would be to assume that they would reach a per capita level equal to Canadian per capita imports. If this came about, the result would be a flow of Chinese goods of about $200 million annually. Based on relative per capita GNPs ($3,400 in Canada compared with $4,600 in the United States), this total might seem low. Two-thirds of Canada's imports from China consist of textile products, and the import of some of these items would be strongly resisted by US manufacturers. Foodstuffs, crude

materials, some chemicals, silks, objets d'art, and other luxury goods together with tourist earnings could total as much as $200 million after a period of years for trade relations to be established. Clearly, considerable uncertainty surrounds the estimate of $200 million.

24. There undoubtedly would be some tourist earnings accruing to China from American visitors. However, US tourist experience has shown that such expenditures take time to reach meaningful amounts. In the 1960-65 period, US tourists accounted for about $5 million of Soviet revenue annually; by 1969 these revenues increased to $14 million. For several years, at least, the volume of US visitors to China would probably be less than the range of error in the estimate of total US imports.

Potential Chinese Imports from the United States

25. Exports of US grain to China hinge very largely on the waiver of the current requirement that 50% of such shipments be transported in US vessels. Since US freight charges are much higher than other Free World rates, China would not purchase grain from the United States except in an extreme emergency. On the other hand, if the US vessel requirement no longer applied and China continues to import grain in large tonnages, it is possible that the United States could gain perhaps a third of China's annual grain imports – or $100 million out of an annual total of $300 million.

26. A second possibility is fertilizers, another very large Chinese import, amounting to about 5 million tons in 1970, valued at $240 million. These were divided roughly 50-50 between Japan and the West European group (NITREX). Because of their competitive advantage, it is probable that the Japanese will normally supply a larger share of China's imports of fertilizer. If the United States, because of lower shipping costs, could capture a portion of current West European fertilizer deliveries to China, these sales could amount to $25-$50 million. Since worldwide fertilizer capacity is several million tons above current demand, the entrance of the United States as a third major supplier would enable the Chinese to further exploit their position as a major customer for a surplus commodity, by intensifying price competition.

27. There are already indications of serious Chinese interest in US manufactures. Trucks and large commercial aircraft have already been mentioned.

28. The Chinese have also been purchasing chemical plants abroad; in this general area there is a large body of unique US technology. However, most of this US-designed equipment can be purchased abroad at lower prices

from US licensees, which is the standard practice of East European countries. In these transactions, royalties accrue to the parent US company, but they are a small fraction of the total selling price. For example, M.W. Kellogg will receive less than $5 million in technology royalties from a $70 million Japanese sale of ammonia plants to the USSR. There are a few important areas, such as advanced computers, where US licensees do not exist abroad. The immediate US sales to China, therefore, may be limited to industrial goods embodying advanced technology and not available from other sources. The key question now is whether or not such goods will be included on the US shopping list currently being drafted. If the shopping list is limited to standard industrial products, where the technological levels in Western Europe and Japan are on a par with those in the United States, there will be little incentive for the Chinese to break out of existing commercial relationships. [redacted] 25X6 China imported an average of about $300 million annually in machinery and equipment from all sources in 1967-69; the United States could perhaps get 10% of this, including royalty payments, by 1975.

29. China has also been a major importer of certain ferrous and nonferrous metals and metal products. Japan, with one of the largest steel industries in the world and certainly the lowest cost producer, has an obvious competitive advantage in the steel trade. Recently, Peking signed a long-term trade agreement with Chile, whereby the latter will ship copper (and nitrates) direct to China in exchange for Chinese-produced goods. The 1971 agreement bypasses the London Metal Exchange for the first time in selling Chilean copper to China. Some US specialty steels and nonferrous products probably will sell in China, but the amounts are unlikely to be large.

30. In summary, it would appear that if the US vessel requirement on grain shipments is relaxed, and if the US general license list is attractive to China, US exports could grow to a level exceeding probable imports. However, the level of exports is likely to be low enough so that annual trade will be "lumpy" – that is, the sale of a few large items, such as aircraft, in a single year, could boost exports sharply, but this experience would not be repeated each year.

Long-Run Prospects

31. There has been an academic study which estimates possible levels of Sino-US trade in 1980. 3/ This study, largely the product of Professor

3. *See J.A. Cohen, R.F. Dernberger and J.A. Gasson,* China Trade Prospects and United States Policy, *National Committee on United States China Relations, 1970.*

Dernberger, contains an optimistic and a pessimistic projection. The optimistic projection envisions total Sino-US trade of about $900 million in 1980, including $650 million of US exports (minerals, industrial equipment, and machinery) and $250 million of US imports from China (largely agricultural products and textiles). Without attempting any detailed critique of the academic study, it should be noted that relatively small changes in assumed rates of development lead to very large differences at the end of a decade of compounding. For example, a growth rate of 5% annually means an increase of 63% in 10 years, whereas a 7-1/2% rate leads to 106% of compounded growth in the same period. The academic projection also rests on a series of assumptions of doubtful validity, such as a US willingness to take large quantities of Chinese textiles. Even so, the optimistic projection would place Sino-US trade at less than one-half of 1% of total US foreign trade expected in 1980.

32. There are other factors which could change the picture. One of these, which has been mentioned, is Chinese oil exports. China produced an estimated 18 million metric tons of crude in 1970, and output could rise to 40 million tons by 1975. If so, China will almost certainly be in the export market, perhaps for 10 million tons, which could bring an additional $120-$150 million in hard currency earnings, or a boost of 5%-6% in export earnings. China's petroleum reserve position is not well enough known to make even a rough estimate of 1980 exports, but clearly oil is a significant potential earner of foreign exchange for the future.