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Getting to know China

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Getting to Know China

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About the Author: John A. Tatom is the Director of Research at Networks Financial Institute, part of Indiana State University, and Associate Professor of Finance at Indiana State University. He has published widely on international and domestic monetary and fiscal policy issues, especially inflation, capital formation, productivity and growth; the macroeconomics of supply, especially oil and energy price shocks; the relationship of exchange rate movements to international competitiveness, capital flows, trade, and international economic policy; and on financial innovations and their effects on monetary policy and the economy, among other areas.

Abstract: China, a low income country about the same geographic size as the US and with over four times the population, has had persistent rapid growth that averaged 9.6 percent per year since reform began in 1979. On a per capita basis, real GDP is eight times larger than it was 26 years earlier! China's population is expected to continue to slow, reaching near zero in 30 years. It has already slowed markedly due to the one-child policy from about 1.5 percent per year in the late 1970s, to about 0.6 percent in recent years. China is likely to become the US' third largest trading partner, supplying relatively cheap and high quality machinery, apparel and other goods, and a large market where US producers can produce and/or sell their products. At the same time, private Chinese investment is likely to become an important source of saving and financing for US economic activity. Doing business with China has always been a two-way street and that street is beginning to widen to include significant flows of entrepreneurial and financial resources in both directions.

Keywords: China, growth, financial regulation, demographics

The views expressed are those of the individual author and do not necessarily reflect official positions of Networks Financial Institute. Please address questions regarding content to John Tatom at john.tatom@isunetworks.org. Any errors or omissions are the responsibility of the author.

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Getting to Know China¹

John A. Tatom

- China is a rapidly growing and large economy; its GDP is likely to become the largest in the world by 2040, just as its population is today. The International Monetary Fund classifies China as a Lower-Middle Income country.
- China is very poor except, for several of its major cities.
- Its political institutions are also in transition, though much more slowly than its economy.
- China is a major emerging market for foreign investors, despite its political risk.
- As China grows and opens access for its domestic citizens and firms to invest abroad, it will become a major foreign investor in the US.

Greater China*



Greater China

GDP (\$, per capita)	2,062
GDP (\$ bn.)	2,759
FDI (\$bn)	110.3
Population (millions)	1,338

China



GDP (\$, per capita)	1,702
GDP (\$ bn.) ***	2,278
GDP Growth (%) ***	10.2
FDI (\$bn)	72
Population (millions)	1,308

Taiwan

GDP (\$, per capita)	15,197
GDP (\$ bn.)	346
GDP Growth (%)	4.2
FDI (\$bn)	1.6
Population (millions)	23

Hong Kong



GDP (\$, per capita)	25,759
GDP (\$ bn.)	177.7
GDP Growth (%)	7.3
FDI (\$bn)	36
Population (millions)	6.9

Macau



GDP (\$, per capita)	24,249
GDP (\$ bn.)	12.1
GDP Growth (%)	6.7
FDI (\$bn)	0.7
Population (millions)	0.5

* All dollar data are at market prices for 2005

** FDI = Net Foreign Direct Investment

*** So-called "Purchasing Power Parity based GDP" is much larger for China. In 2005, the International Monetary Fund estimates that GDP on this basis was over four times larger so that PPP-based per-capita GDP was \$7,197.

¹ This report was prepared for "China: a Two-way Street," a conference sponsored by Networks Financial Institute, Indiana State University and Liaoning University, January 24-25, 2007, Indianapolis, Indiana and indebted to Ozer Erdem and Martha McCormick for their assistance in preparing this report.

China's Political Structure

- One-party rule by the Chinese Communist Party (CCP), of which Hu Jintao is the General Secretary. He is also the President of the People's Republic of China.
- The State Council is the executive cabinet, approved by the National People's Congress (NPC); State Council members, including the premier, Wen Jiabao, may serve no more than two consecutive five-year terms.
- The Politburo (political bureau) of the CCP sets policy and controls all administrative, legal and executive appointments. The nine-member Politburo Standing Committee is the focus of power.
- Head of State: A president and a vice-president are approved by the NPC for a maximum of two consecutive five-year terms. The president, as the head of state, promulgates laws, appoints the premier, vice premiers, state councilors, and ministers of various ministries according to decisions of the NPC and its standing committee.
- National legislature: Unicameral NPC: 2,989 delegates are selected by provinces, municipalities, autonomous regions and the armed forces. The NPC approves the president and members of the state council, as well as the members of the standing committee of the NPC, which meets when the NPC is not in session. All units of the legislature and the executive sit for five-year terms.

Government Structure

- The People's Republic of China administers 34 province-level divisions, including 23 provinces, five autonomous regions, four municipalities, and two special administrative regions.

Elections in China

- Direct elections:
 - Elections for village leader in selected rural villages
 - Elections for local people congresses.
- Each people's congress then conducts an election for the next higher level of people's congress, culminating in elections for the national legislature: the National People's Congress.
- The NPC has 2,989 members, elected for five year terms.

China will play an increasingly important geopolitical role in Asia.

- Rapid growth and size will make it increasingly the dominant economic power in the region.
- A large military with increasingly strong political and commercial power will make it a strong political leader within the region.

China has military assets that dominate the region and rival the US in numbers (2005-2006)

	China	Japan	Russia	US
Army				
Personnel	1,600,000	148,200	395,000	633,630
Tanks	8,580+	980	22,950	7,620+
Navy				
Personnel	255,000	44,400	142,000	376,750
Frigates	42	9	19	30
Submarines	69	16	54	Up to 80
Air Force				
Personnel	400,000	45,600	170,000	562,700
Combat Aircraft	2,643	300	1,976	2,492

Source: International Institute for Strategic Studies, The Military Balance, 2005/2006.

Many of China's major cities now look very modern and prosperous:



New Pudong District in Shanghai, by the Huangpu River, is home to the Lujiazui financial district.



The skyline of Lujiazui Finance and Trade Zone, Pudong.



Shenzhen city center viewed from Lychee park.

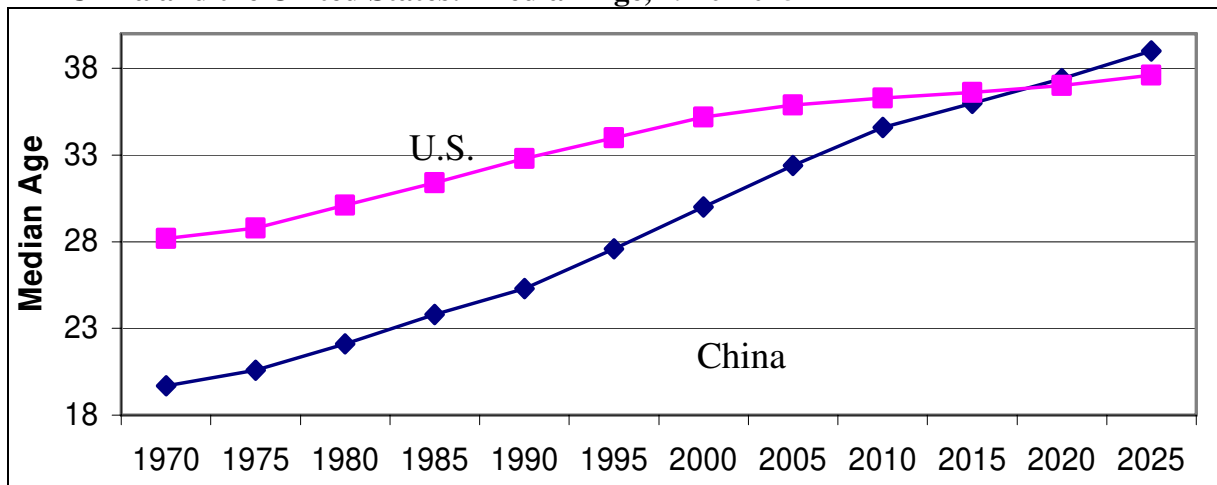


Qingnian Street at night, Shenyang, Liaoning Province

Demographics

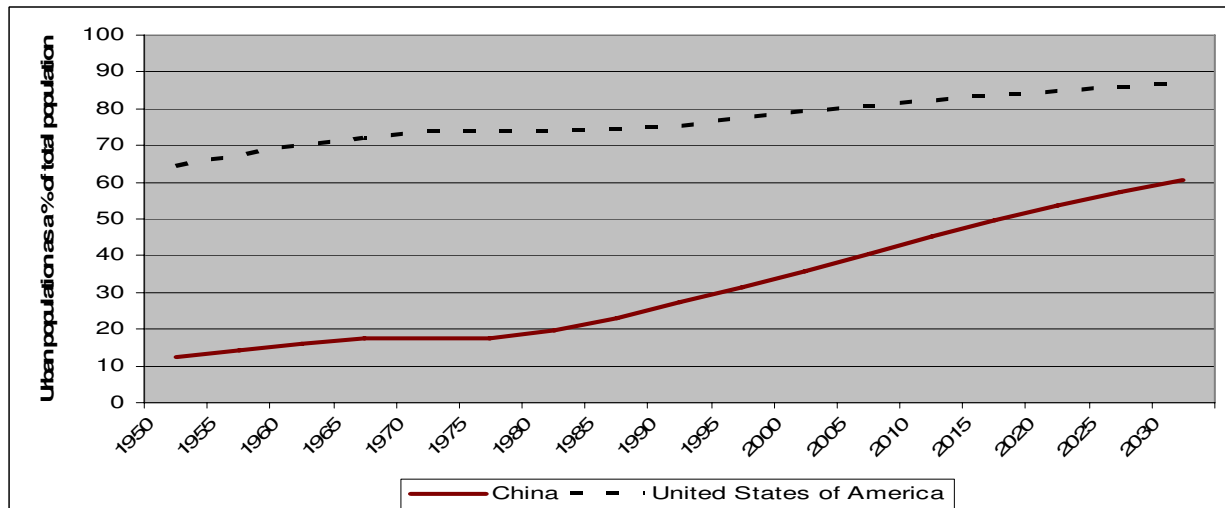
- Population: 1.31 billion, growing at a 0.6% rate in recent years.
- Population is expected to continue growing until the mid-2030s, when it will peak at around 1.5 billion.
- The major short-term demographic/ economic and political problem is the transition of labor from rural areas to cities.
- Mainly due to the one child policy, China has a rapidly aging population. As a result, the safety net for the aged and a shortage of labor force growth will be major long-term problems.
- Highly literate labor force: adult illiteracy rate (age 15+) was 4.9% for men and 13.5% for women in 2000.

China and the United States: Median Age, 1970-2025



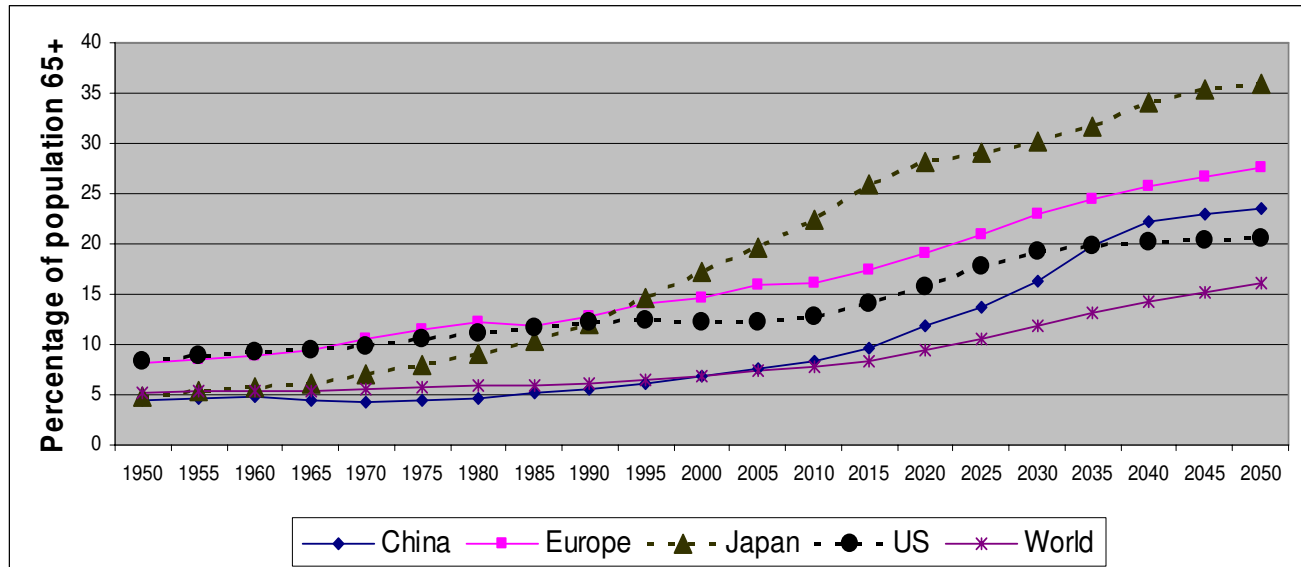
Source: Population Division of the Department of Economic and Social Affairs of the United Nations Statistics Division.

The massive transition from the rural to urban labor force has been carefully managed and will remain so.



Source: United Nations Statistics Division.

China will soon be aging more rapidly than major developed countries
 (Percentage of Population Ages 65+ in China, Europe, Japan, United States, and World)



Population Indicators

(Millions unless otherwise indicated; census results)

	1990	2000	2004
Population	1,143	1,267	1,299
Crude birth rate (per 1,000 population; %)	21.1	14	12.3
Natural growth rate (per 1,00 population; %)	1.44	0.76	0.59
Average size of household	3.96	3.44	3.36
Sex ratio (male/female)	1.063	1.067	1.063
Urban population	301.9	459	542.8
% of total population	26.4	36.2	41.7
Population aged 0-14 (% of total)	27.7	22.9	19.3
Population aged 15-64 (% of total)	66.7	70.2	72.1
Population aged 65 & over (% of total)	5.6	7	8.6

Source: National Bureau of Statistics, China Statistical Yearbook 2005.

China's development challenges

- Political freedom vs. economic freedom
- The transition from state-owned enterprises to a dominant private sector
- The transition of people from the traditional rural sector to cities and to the modern labor force
- Aging population
- Financial system reform
- Widening income disparity between rich and poor
- Huge demand for energy and resources
- Environmental pollution

China is an Asian economic powerhouse due to its size and rapid growth.

- Its sovereign risk rating (foreign currency debt) is an "A," according to Standard & Poor's and the equivalent with Moody's and Fitch. This is lower than Singapore (AAA), Hong Kong (AA) and Japan, but better than the rest of Asia and than most other emerging markets.
- China ranks 54th in the World Economic Forum's World Competitiveness Index, below Hong Kong's 11th place.
- China ranks 119th in the 2007 *Wall Street Journal*/Heritage Index of Economic Freedom. This is a key rating for political and credit risk as well as for income per capita. However, Hong Kong ranks first in the world.

Key Indicators of China's Economic Performance

- Exceptional growth, low inflation, relatively large trade
- Surplus trade balance
- Large and rapidly growing foreign exchange reserves
- Low debt and debt service cost

	2002	2003	2004	2005	2006*
GDP at market prices (US\$ bn)	1,454	1,648	1,937	2,278	2,676
Real GDP growth (%)	9.1	10	10.1	10.2	10.5
Consumer price inflation (av; %)	-0.7	1.2	3.8	1.8	1.3
Exports of goods fob (% of GDP)	22.4	26.6	30.6	33.5	36.5
Imports of goods fob (% of GDP)	-19.4	-23.9	-27.6	-27.6	-29.8
Current-account balance (% of GDP)	2.4	2.8	3.5	7.1	7.6
Foreign-exchange reserves excl gold (US\$ bn)	291.1	408.2	614.5	821.5	1028.8
Total external debt (US\$ bn)	186.4	208.7	248.9	280.3*	305.8
Debt-service ratio, paid (% of exports)	8	7.2	3.4	3.3*	3.4
Exchange rate (av) Rmb:US\$	8.28	8.28	8.28	8.19	7.97

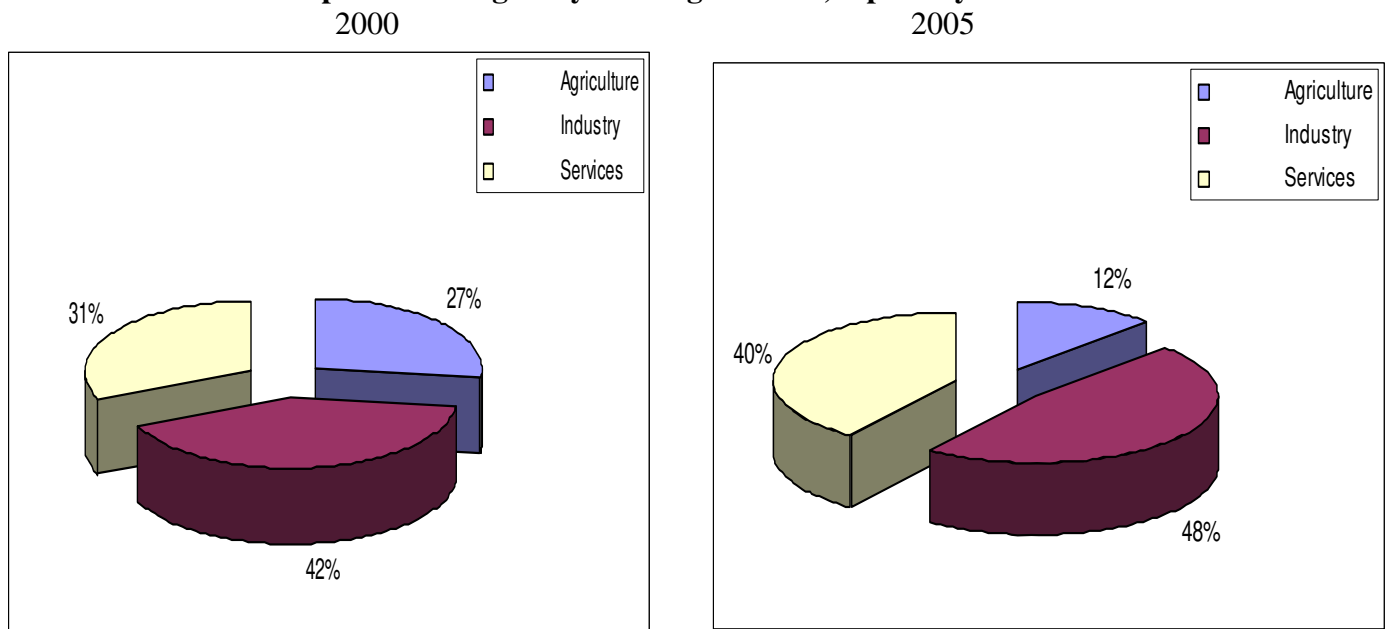
*Economist Intelligence Unit estimates.

China remains heavily industrial but is transforming away from agriculture, led by strong investment and trade and “small” government current spending

Origins of gross domestic product 2005	% of total	Components of gross domestic product 2005	% of total
Primary industry (Agriculture and related)	12.5	Private consumption	38
Secondary industry	47.3	Government consumption	13.9
Industry	41.8	Gross fixed investment	41.5
Construction	5.5	Exports of goods & services	36.7
Tertiary industry (Services)	40.3	Imports of goods & services	-31.3

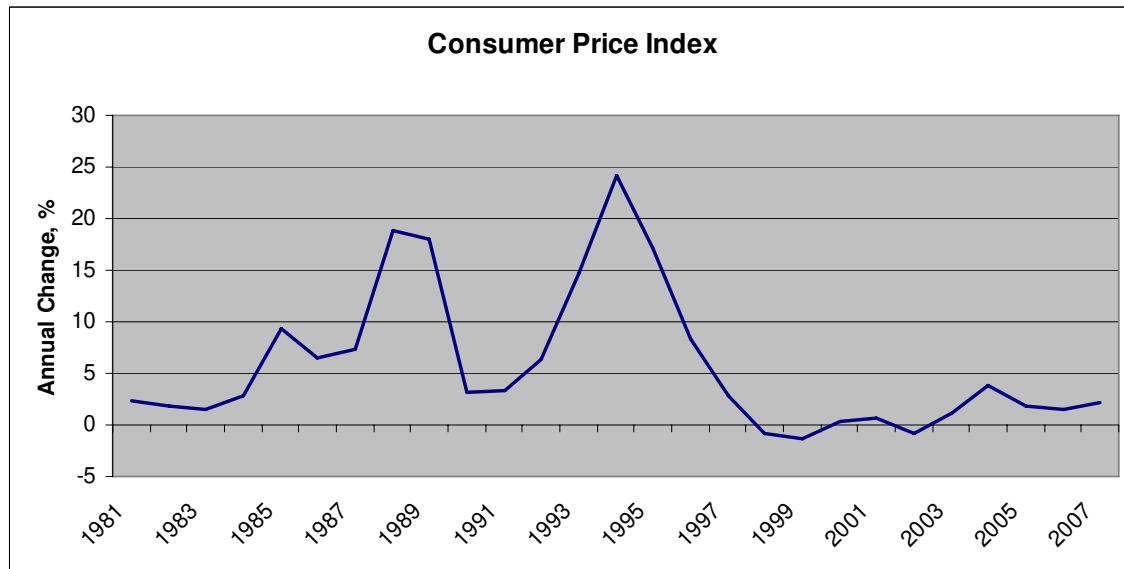
Source: Economist Intelligence Unit

The structure of output is shifting away from agriculture, especially to services



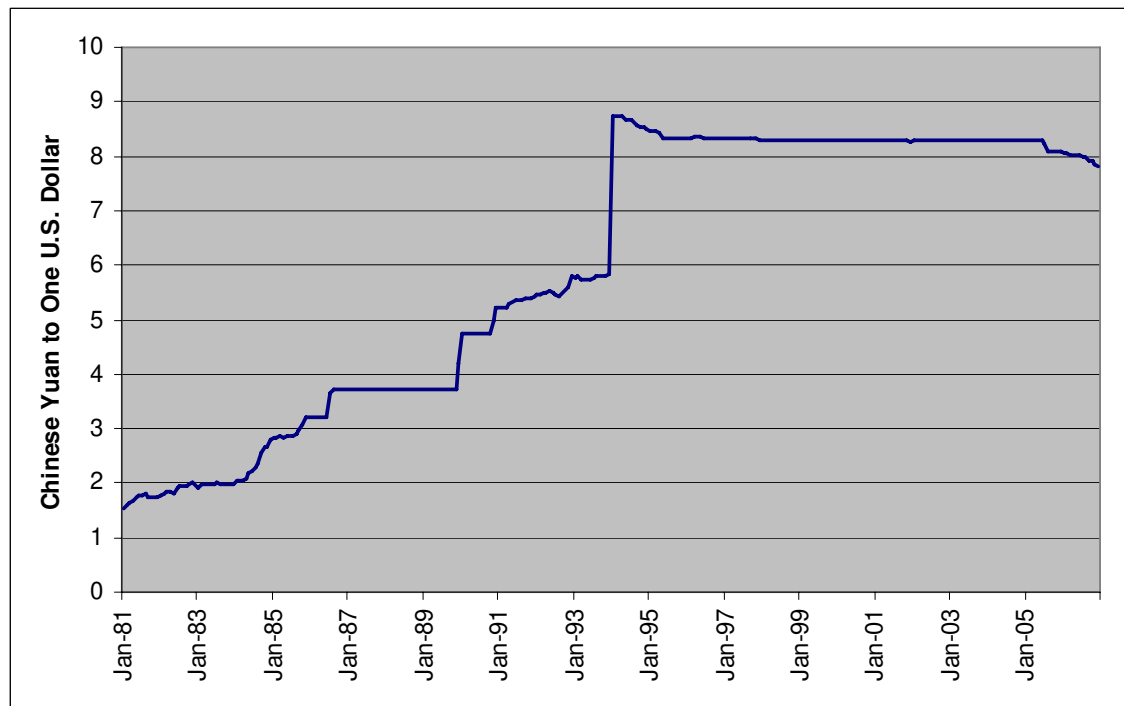
Source: Asian Development Bank

Inflation has been controlled since the mid-1990s when a new exchange rate regime was adopted



Source: Asian Development Bank

China / U.S. foreign exchange rate



- The Renminbi was devalued and pegged to the U.S. dollars in January 1994, experienced managed appreciation from April 1994 to October 1998, and then was pegged until June 2005.
- Since June 2005, the yuan has risen 5.8%, including 3.2% over the year ending in December 2006

Government expenditure, revenue and deficits on budget are typical of a poor emerging market

Central Government Finance

% of GDP	2000	2001	2002	2003	2004	2005
Total revenue	15.0	16.8	18.0	18.5	19.3	17.3
Total expenditure	18.1	19.7	21.2	21.2	20.8	18.5
Overall budgetary surplus/deficit	-3.1	-2.8	-3.2	-2.7	-1.5	-1.1

Source: Asian Development Bank

China has relatively low debt and debt service, but short-term debt is growing relative to income

	1999	2000	2001	2002	2003	2004
External debt as % of Gross National Income	15.6	13.7	16.0	14.8	14.8	15.1
Long-term debt as % of total debt	90.0	91.0	69.5	64.6	57.7	52.8
Short-term debt as % of total debt	10.0	9.0	30.5	35.4	42.3	47.2
Debt service as % of exports of goods and services	11.7	9.3	7.9	8.3	7.4	3.5

Source: Asian Development Bank

China has surpluses in its trade (current account), but its net capital inflows are as persistently large (% of GDP)

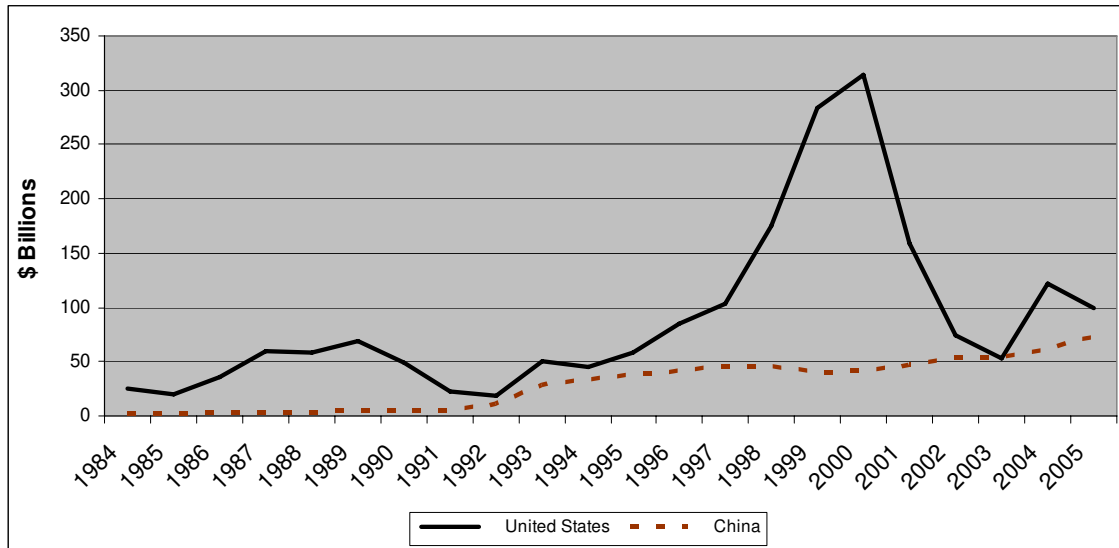
	2000	2001	2002	2003	2004	2005
Exports	23.1	22.6	25.6	30.9	35.9	34.3
Imports	-19.9	-19.7	-22.2	-27.8	-32.3	-28.2
Balance on goods	3.2	2.9	3.5	3.1	3.6	6.0
Current account balance	1.9	1.5	2.8	3.2	4.2	7.2
Capital account balance	0.2	3.0	2.5	3.7	6.7	2.6
Overall balance (Foreign exchange inflows)*	1.0	4.0	5.9	8.3	12.5	9.3

* Current and capital balance do not add to overall balance, largely due to measurement error.

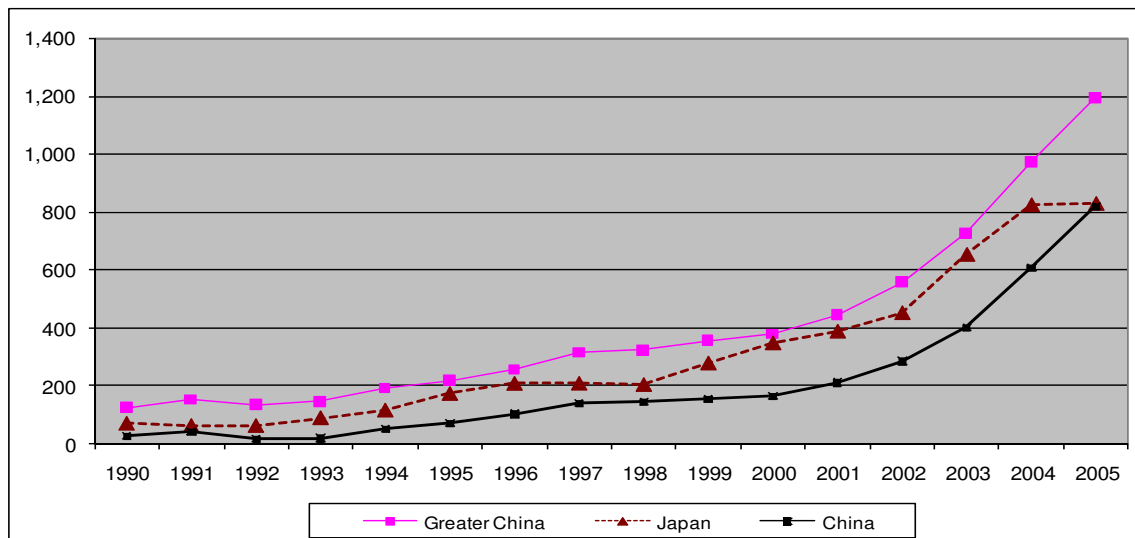
Source: Asian Development Bank

China has become one of the largest recipients of foreign investment

- FDI inflows have rivaled those in the US since 2000 and generally have been second in the world. In 2005, China received nearly US\$72.5 billion.



China leads the world in holdings of foreign exchange reserves (\$ billion)



- Some analyst warns that if China stopped adding reserves or dumped their dollar holdings for other assets (e.g. yen or euro), US interest rates would rise sharply and the value of US dollar would plummet.
- Others argue that if China sold its dollar reserves, other countries would find them attractive to purchase with little overall effect on the dollar's value.
- China's foreign exchange reserves seem very large but they are not much out of line with the size of their imports or GDP, compared with other Asian regions like Japan, Singapore, Hong Kong and Taiwan.

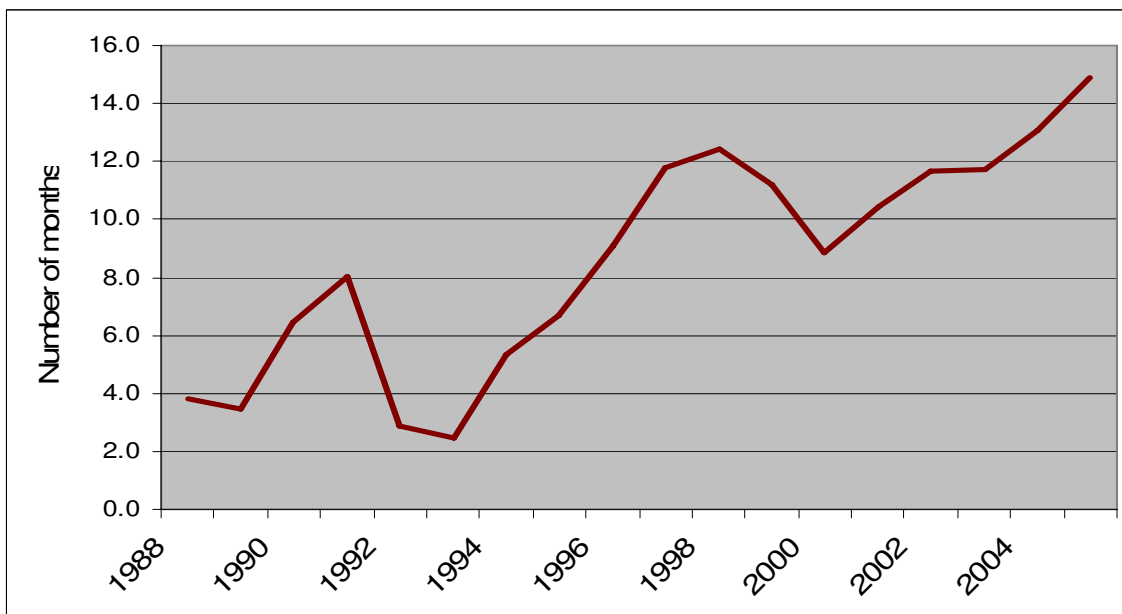
Asian countries and regions of China hold relatively large foreign exchange reserves
Foreign exchange as a percentage of GDP

	1990	1997	2005
Greater China	20	23	44
China	7	16	37
Hong Kong	32	53	70
Taiwan	44	28	73
India	0	6	18
Japan	2	5	19
Singapore	75	74	99
Thailand	16	17	29
S. Korea	5	4	27
Malasia	21	20	53

- Reserves have boomed up since the Asian financial crisis in 1997.
- China's foreign exchange reserves are not as large relative to GDP as many of its richer neighbors.

Foreign exchange reserves have grown a little faster than imports since 2003
Imports Cover Ratio

(Months of imports held in foreign exchange reserves)



China's principal trading partners

Main destinations of exports 2005	% of total	Main origins of imports 2005	% of total
US	21.4	Japan	15.2
Hong Kong	16.3	South Korea	11.6
Japan	11.0	Taiwan	11.3
South Korea	4.6	US	7.4
Germany	4.3	Germany	4.7
Netherlands	3.4	Malaysia	3
UK	2.5	Singapore	2.5
Singapore	2.2	Australia	2.5
Top Eight	65.7	Top Eight	58.2

Source: Economist Intelligence Unit

Indiana's exports are booming, especially to China

Rank	Country	2000 (mil \$)	2005 (mil \$)	2002 % Share	2005 % Share	% Change 2004 - 2005
---	Total Indiana Exports and % Share of U.S. Total	14,923	21,476	2.2	2.4	12.4
---	Total, Top 10 Countries and % Share of State Total	12,600	18,093	84.4	84.2	13
1	Canada	6,819	9,550	45.7	44.5	11.9
2	Mexico	1,942	2,618	13	12.2	3.0
3	United Kingdom	1,007	1,516	6.7	7.1	18.3
4	France	638	1,467	4.3	6.8	24.6
5	Japan	714	769	4.8	3.6	6.7
6	Federal Republic of Germany	525	691	3.5	3.2	19.4
7	Netherlands	295	427	2	2	15.7
8	China	187	418	1.3	1.9	42.0
9	Australia	228	334	1.5	1.6	24.9
10	Korea, South	245	303	1.6	1.4	23.5

Source: U.S. Census Bureau, Foreign Trade Division, Data Dissemination Branch

The China- US trade imbalance has created strong US pressures on China to raise the value of their currency.

The US trade deficit with China is a large share of the total trade deficit*

US Goods Trade	US total	With China	China as % of total
Exports	\$1014.5 bn.	\$54.3 bn.	5.4%
Imports	1855.0	284.1	15.3
Balance	-840.4	-229.8	27.3

*Data are for the 12 months ending in November 2006.

Source: U.S. Department of Commerce

- Some analysts argue that China manipulates its currency to preserve a competitive advantage over the US and that this is reflected in the large deficit the US runs with China.
- Senator Charles Schumer and Rep. Lindsay Graham have proposed that the US impose a 27.5 percent tariff, representing the undervaluation of their currency, if China does not push up the value of their currency or allow it to float up. They believe it would rise by a like amount if China allowed.

Critics counter that:

- As the World Economic Forum index above indicates, China is not very competitive globally.
- The exchange rate chart above shows that there was no change in the exchange rate for many years, hardly evidence of trying to push down the currency's value.
- A large fall in the value of the dollar against the yuan would not eliminate China's surplus or the US deficit. Eliminating The US deficit with China would move the trade imbalance to other countries but leave the total little affected.
- The US has a trade and current account deficit because of the attractiveness of its assets. Eliminating the attractiveness of doing business in the US or improving the climate abroad are the principal ways that the US trade imbalance can be eliminated.

Major barriers to the appreciation of the Renminbi

- China is opening the ability of domestic firms, banks and individuals to purchase dollars and make investments abroad, which formerly could not be done or was very limited. This will reduce the net dollar inflow, putting downward pressure on the Chinese currency. (These changes also open new possibilities for US financial institutions, mutual funds and other financial intermediaries to attract large pools of Chinese assets for US investment.)
- An appreciation of the Renminbi could foster speculative capital inflows to China, reminiscent of the sources of the 1997 Asian financial crisis. Appreciation can also be deflationary, while inflation is already near zero. The appreciation, to the extent it will continue, will have to be closely managed to avoid excesses. Similar concerns and policy actions to foster domestic investment abroad and, in some cases, to limit foreign investment from abroad, are currently evident in Thailand and South Korea.

Financial Sector

- Stock Exchanges
 - Shanghai Stock Exchange (SSE)
 - Shenzhen Stock Exchange (SZSE),
 - Hong Kong Stock Exchange (SEHK).
- Foreign investors can invest in B shares in the Shanghai and Shenzhen stock exchanges. A shares are for Chinese Nationals. C shares are held by state-owned companies.

2 of the biggest 3 IPOs in 2006 were in China

Top 10 Global IPOs, 2006

Date	Issuer Name	Deal Nationality	General Industry	Total Value (\$bn)
Oct. 20, 2006	Industrial Commercial Bank of China - ICBC	China	Finance	21.9
May 24, 2006	Bank of China Ltd	China	Finance	11.2
Jul. 14, 2006	Rosneft	Russian Federation	Oil Gas	10.7
May 3, 2006	KKR Private Equity Investors LP	United States	Finance	5
Jul. 7, 2006	Standard Life plc	United Kingdom	Insurance	4.4
Jan. 27, 2006	Lotte Shopping Ltd	South Korea	Retail	3.7
Nov. 6, 2006	Aozora Bank Ltd	Japan	Finance	3.2
May 12, 2006	Saras SpA	Italy	Oil Gas	2.6
May 24, 2006	MasterCard Inc	United States	Finance	2.6
Dec. 11, 2006	China Communications Construction Co Ltd	China	Construction/Building	2.4

Source: Dealogic, *The Financial Times*

- When China joined the World Trade Organization (WTO) in 2001, they pledged to implement WTO standards for treatment of foreign financial institutions in 5 years. Effective Dec. 11, 2006, ten foreign banks were allowed to apply for domestic bank charters to offer retail banking services in China for the first time. This will include accepting renminbi deposits, making loans and offering credit cards. After this date, foreign banks who do not incorporate domestically will have to hold twice as much capital and will be restricted to taking only large deposits, making no loans, and issuing no credit cards.
- Bank restructuring prepared the four largest banks for successful initial public offerings (IPO's) in 2006, but these banks and most others are largely state-owned. Allowing foreign banks to enter the domestic retail banking market is potentially a more important source of competition and factor in whether China develops globally competitive banks and other financial service firms.

Financial Institutions

- The People's Bank of China and the Ministry of Finance are the two principal monetary and financial authorities.
- The China Banking Regulatory Commission is charged with supervising the banking sector.

Top 10 Domestic Banks (end-2005, \$ billions)

	Assets	Pre-tax profit*	Non-performing loans (%)
Bank Industrial and Commercial Bank of China	799.7	7.4	4.7
Agricultural Bank of China	591.2	1.0	26.2
Bank of China	587.3	6.7	4.9
China Construction Bank	568.3	6.9	3.8
Bank of Communications	176.3	1.6	2.8
China Merchants Bank	91.0	0.8	2.6
China Citic Bank	75.8	0.7	4.1
Shanghai Pudong Development Bank	71.1	0.5	2.0
China Minsheng Banking Corp	69.0	0.5	1.3
Industrial Bank	58.7	0.4	2.3

Source: *The Banker*, The Economist Intelligence Unit

Top 10 Foreign Banks in China (June 2006)

Bank	Origin	Branches	Representative offices
HSBC	UK	12	2
Standard Chartered Bank	UK	10	4
Bank of East Asia	Hong Kong	10	6
Nanyang Commercial Bank	Hong Kong	5	0
Sumitomo Mitsui Banking Corp	Japan	5	4
Bank of Tokyo Mitsubishi	Japan	5	3
Citibank	US	5	2
Société Générale	France	5	1
OCBC	Singapore	4	2
JP Morgan Chase	US	4	1

Source: The Economist Intelligence Unit

Top 10 Securities Brokerages (2005, \$ billion)

Bank	Origin	Branches	Representative offices
HSBC	UK	12	2
Standard Chartered Bank	UK	10	4
Bank of East Asia	Hong Kong	10	6
Nanyang Commercial Bank	Hong Kong	5	0
Sumitomo Mitsui Banking Corp	Japan	5	4
Bank of Tokyo Mitsubishi	Japan	5	3
Citibank	US	5	2
Société Générale	France	5	1
OCBC	Singapore	4	2
JP Morgan Chase	US	4	1

Source: Shanghai Stock Exchange

Top 10 Domestic Insurance Companies

Ranked by premium income in 2005. (mil \$)

Life insurance companies	Premium income	Market share (%)
China Life	19,611	48.4
Ping An	7,176	17.7
CPIC Life	4,418	10.9
New China Life	2,575	6.4
Tai Kang Life	2,172	5.4
Tai Ping Life	952	2.3
Sino Life	391	1.0
Minsheng Life	85	0.2
Union Life	73	0.2
Great Wall	12	0.1
Total market	40,540	100

Property insurance companies	Premium income	Market share (%)
PICC	8,042	52.1
CPIC Property	1,757	11.4
Ping An (Property)	1,550	10.0
China United Property	1,269	8.2
Tianan Insurance	781	5.1
China Continent	464	3.0
Yong An Property	391	2.5
Sinosure	268	1.7
Sinosafe General Insurance	256	1.7
Tai Ping Insurance	171	1.1
Total market	15,425	100

Source: Economist Intelligence Unit, China Insurance Regulatory Commission.

Summary and Conclusion

- China, a low income country about the same geographic size as the US and with over four times the population, has had persistent rapid growth that averaged 9.6 percent per year since reform began in 1979. On a per capita basis, real GDP is eight times larger than it was 26 years earlier!
- China's population is expected to continue to slow, reaching near zero in 30 years. It has already slowed markedly due to the one-child policy from about 1.5 percent per year in the late 1970s, to about 0.6 percent in recent years.
- This slowing has created a major challenge for the future labor force and for the social safety net. Currently the major demographic problem is the management of the huge migration from the countryside with its very traditional economy, to the modern cities with better employment opportunities.
- The second major transitional challenge is the fact that most companies are state-owned (which implies loss-making, low productivity and drains on the financial system), including the financial system itself.
- China will be the largest economy in the world in 30 years or so and will continue to converge toward the standard of living in high income countries.
- Because of its rapid growth and other strong economic fundamentals (low inflation, low debt, open and large trade, exchange rate stability and low central government spending, taxes and budget deficits), China has a strong sovereign debt risk rating and is the largest attractor of foreign capital and investment among emerging economies.
- Political risk remains the biggest risk problem and associated poor legal protection of property rights, rule of law and corruption.
- Financial sector reform has been the biggest laggard in economic reform, but that began to change in 2006 as foreign banks gained access to the Chinese market and Chinese investors and financial firms began to gain access to the world capital market. Unlocking Chinese wealth will put huge competitive pressures for reform on Chinese policy makers and markets.
- Indiana, a major US exporter, saw its exports to China expand 223% from 2000 to 2005, more than to any other country, so that China has moved up to Indiana's 8th largest export market at over \$400 million.
- China will become one of the largest sources of foreign investment for the US in the long term. In the near term, the US is the premier target for countries that are opening their market to higher-return, lower-risk investments abroad. This will put downward pressure on the yuan, frustrating US pressures on the Chinese to push up the value of the yuan.
- China is likely to become the US' third largest trading partner, supplying relatively cheap and high quality machinery, apparel and other goods, and a large market where US producers can produce and/or sell their products. At the same time, private Chinese investment is likely to become a dominant source of saving and financing for US economic activity.
- Doing business with China has always been a two-way street and that street is beginning to widen to include significant flows of entrepreneurial and financial resources in both directions.