SECTION I

U.S.-CHINA TRADE AND ECONOMIC TRANSFERS

The first three chapters of the Report focus on the economic dimension of the U.S.-China relationship. Bilateral trade and investment flows between the two countries are taking place on a massive and rapidly increasing scale. Assessing how these flows are impacting the U.S. economy—and with that U.S. economic security—is an essential area of the Commission's work. In this section, the Commission examines three significant components of U.S.-China trade and investment: China's industrial, investment, and exchange rate policies and their impact in particular on the U.S. manufacturing base, China's record of compliance to date with its World Trade Organization (WTO) commitments, and U.S. financial flows to China via the global capital markets.

Chapter 1 details the ways in which China's industrial, investment, and exchange rate policies are impacting the nature and scope of U.S.-China trade. The chapter focuses on the growing U.S. trade deficit with China, China's undervalued exchange rate, China's mercantilist trade and industrial policies, and the impact of these policies in particular on the U.S. manufacturing sector.

The dominant feature of U.S.-China economic relations is the U.S. goods trade deficit with China, which rose by more than twenty percent in 2003 to a record $124 billion. Over the past ten years, the U.S. deficit with China has grown at an average rate of 18.5 percent, and if it continues growing at this rate, it will double in approximately four years. The U.S. deficit with China now constitutes over twenty-three percent of the total U.S. goods trade deficit, and China is by far the largest country component of the overall U.S. deficit. Moreover, U.S. goods trade with China—with $28 billion in exports to China as compared with $152 billion in imports—is by far the United States' most lopsided major manufacturing trade relationship as measured by the ratio of imports to exports. China is heavily dependent on the U.S. market, with exports to the United States constituting thirty-five percent of total Chinese exports in 2003, while only four percent of U.S. exports go to China. The trade deficit with China is of major concern because (i) it has contributed to the erosion of manufacturing jobs and jobless recovery in the United States, (ii) manufacturing is critical for the nation's economic and national security, and (iii) the deficit has adversely impacted other sectors of the U.S. economy as well.

A key factor contributing to the deficit is the undervaluation of the Chinese yuan against the U.S. dollar, which gives Chinese manufacturers a competitive advantage over U.S. manufacturers. Economic fundamentals suggest that the Chinese yuan is undervalued, with a growing consensus of economists estimating the level of undervaluation to be anywhere from fifteen to forty percent. However, China persistently intervenes in the foreign exchange market to peg its exchange rate at 8.28 yuan per dollar. A second factor contributing to imbalances in U.S.-China trade is China's mercantilist industrial and foreign direct investment policies. These policies involve a wide range of measures including technology transfer requirements, government subsidies, discriminatory tax relief, and limitations on market access for foreign companies. A third factor is China's refusal to recognize workers' rights which results in artificial barriers to wage increases.

Chapter 2 reports on China's progress in meeting its commitments as a member of the WTO. China joined the WTO in December 2001. Its accession agreement is extremely complex, reflecting the need for special arrangements to address the fact that China joined the WTO without having met the requirements of a market economy. To protect against trade distortions and unfair trade practices resulting from China's nonmarket status, the agreement includes a special WTO review mechanism—the Transitional Review Mechanism—to monitor China's compliance and special safeguard provisions giving WTO members the right to protect themselves against sudden surges of Chinese imports. The Commission reviews China's WTO compliance record to date and the effectiveness of U.S. government and WTO monitoring and enforcement measures.

Though China has made progress in reducing tariffs and otherwise formally meeting a large number of its WTO accession commitments, significant compliance shortfalls persist in a number of key areas for U.S. trade. Among areas of concern, the Commission examines China's continued provision of direct and indirect subsidies to Chinese producers, use of unjustified technical and safety standards to exclude foreign products, poor enforcement of intellectual property rights, and discriminatory tax treatment for domestic semiconductor production.

Chapter 3 examines China's presence in the global capital markets, with special focus on equity markets. The Chinese government has selectively chosen firms—predominantly state-owned enterprises (SOEs)—to list on international capital markets, primarily in Hong Kong and New York, and may bring as much as $23 billion in initial public offerings to global capital markets in 2004, a marked increase over the past few years. This process may increase the resources under Chinese government control because the government maintains majority control of these firms, while minority shareholder rights are virtually nonexistent.

Chinese corporate governance standards lag far behind those in the United States. Accounting and reporting standards are weak, and China lacks a sound, transparent system of credit ratings. As a result, even the most sophisticated investors lack adequate information when it comes to Chinese debt and equity listings in the market. This problem is compounded for investors in China-focused mutual funds, which are reliant on their fund managers. Many such funds outsource their research and due diligence to smaller firms in Hong Kong.

Another important issue explored in Chapter 3 is China's WTO commitment to open its financial sector to foreign competition. Owing to years of politically driven, noncommercial-based lending, the Chinese banking system is beset by massive numbers of non-performing loans (NPLs). Many banks are technically insolvent and it is unlikely that they will be able to compete with foreign banks. Consequently, China appears to be dragging its feet on financial sector opening. These NPLs may also constitute a form of WTO-illegal subsidized capital.

A final area of investigation is the possible nexus between firms listing on U.S. and international capital markets and weapons proliferation and/or China's defense-industrial complex. Many SOEs were previously controlled by the People's Liberation Army (PLA) and there is concern that unofficial links to the PLA remain intact after privatization. One firm listed in China's capital markets (China North Industries Corporation), and available for purchase by qualified U.S. investors, has been sanctioned for proliferation by the U.S. government and there are concerns that other Chinese firms listed or trading in China or the United States may be engaging in similar activities. The Commission examines whether appropriate U.S. government agencies are focused on this problem and sufficiently coordinating responsive measures.