CHAPTER 1

THE UNITED STATES-CHINA TRADE AND ECONOMIC RELATIONSHIP

SECTION 1: THE RELATIONSHIP'S CURRENT STATUS AND SIGNIFICANT CHANGES DURING 2007

The legislation passed by Congress in 2000 to establish the Commission sets forth specific topical areas of concern with respect to the People's Republic of China and associated issues, and requires the Commission to investigate and report to Congress on those topics. Congress has modified those topical areas in the intervening years. Today there are eight "mandated" topics. (They can be found at 22 U.S.C. 7002 and at the Commission's website—www.uscc.gov.) At the beginning of each section of this Report, the mandated topical area (or areas) that section addresses is identified.

"The Commission shall investigate and report on—

"WORLD TRADE ORGANIZATION COMPLIANCE—The compliance of the People's Republic of China with its accession agreement to the World Trade Organization.

"UNITED STATES-CHINA BILATERAL PROGRAMS—Science and technology programs, the degree of non-compliance by the People's Republic of China with agreements between the United States and the People's Republic of China on prison labor imports and intellectual property rights, and United States enforcement policies with respect to such agreements."

China's New Responsibilities

This year marks another milestone in the relationship between the United States and the People's Republic of China. As the year began, China faced the deadline to implement the great majority of the commitments it made to gain entry into the World Trade Organization after negotiating for 15 years to gain admission, and after phasing in reforms during a five-year transition period.

China, indeed, has met many of its WTO obligations, particularly those relating to lowering tariffs and making progress in removing such import barriers as its previous restrictions on distribution and sales of foreign goods within China. China also has partially opened its doors to extensive foreign investment and foreign participation in its economy, although it has balked at outright foreign ownership in some sectors.[1 2 3]

In addition, authorities can point to thousands of changes in China's laws and regulations intended to comply with WTO rules and procedures. "A large number of trade-related laws have been reviewed and revised as part of China's accession to the WTO," according to a comprehensive WTO review of legal changes.[4] Officials of the central government in Beijing have been diligent in instructing their peers as well as provincial and local officials in their obligations under WTO membership.[5]

In the case of some important commitments, however, particularly those involving implementation and enforcement, China is lagging far behind schedule for meeting its actual WTO obligations for the marketplace. Three areas stand out starkly: China's extensive regime of state subsidies to favored industries, China's continued failure to stem the widespread theft of intellectual property, and China's manipulation of the value of the renminbi that creates an unfair trading advantage for China.[6]

As part of its agreement to join the WTO, China committed in 2001 to end government subsidies designed to spur exports. China, however, still maintains a wide array of such subsidies as part of a policy to attract foreign investment and to promote the development of certain sectors. China has not instituted an effective mechanism for protecting copyrights, trademarks, and patents from gross violations despite WTO requirements that it do so. In addition, China still manipulates the value of its currency through repeated intervention in the currency markets.[7] In 2007, the United States brought to the WTO two complaints relating to some of these unmet obligations, one about China's lack of intellectual property protection, the other about its extensive restrictions on access to the Chinese market for American films, books, and music. A third WTO complaint focused on China's export subsidies.[8]

Authorities in China also have been reluctant to undertake negotiations to liberalize the economy further. For example, despite promises to do so, China has not begun talks to join the WTO's Agreement on Government Procurement that ensures a fair and transparent system for bidding on government contracts. Because an estimated 40 percent of China's economy remains under government control or outright ownership, there is a huge potential market—in addition to government offices at the central, provincial, and local levels—in which foreign suppliers are at a considerable disadvantage.[9] China has agreed to follow generally accepted guidelines for government procurement, but use of WTO enforcement tools is not possible without a formal agreement.

In some cases, China appears to have backtracked on its WTO commitments. There has been "an upsurge in industrial planning measures as tools of economic development by China's central government authorities," according to the Office of the U.S. Trade Representative (USTR). "China appears to want to expand the government's role in directing the economy and in developing internationally competitive enterprises, while also restricting the role of international companies in certain sectors."[10] This issue is examined in Section 2 of this Chapter.

Certain practices such as currency manipulation, which some have labeled mercantilist and are detailed below, have contributed directly to China's reputation as an unfair trader.[11] These practices have helped to make China the world's factory floor and provided it with the world's largest goods and services trade surplus, which reached $177 billion in 2006.[12] By the end of September 2007, China's global trade surplus, at $187 billion for the first nine months, had already surpassed last year's figure.[13] The implications of China's export-oriented industrial policy also are apparent in China's rapidly increasing global current account surplus: $250 billion in 2006, a 55 percent increase from the $161 billion surplus in 2005.[14] Also significant is China's enormous amount of foreign exchange reserves, reported by Beijing to be $1.4 trillion by mid 2007, the largest in the world.[15]

China's most unbalanced trading relationship is with the United States. In 2006, China exported $287.8 billion worth of goods to the United States and took in $55.2 billion in imports from the United States. That left the United States with a trade deficit of $232.5 billion. Imports from China exceeded exports to China by a ratio of more than five to one. China accounted for 26 percent of America's global trade deficit. (While U.S. exports to China are growing at a faster rate than are imports from China, the ratio is so imbalanced that the trade deficit continues to grow and it is inconceivable that the value of U.S. exports to China will equal imports from China in the foreseeable future.)

Table 1.1 U.S.-China Trade (US$ Billions)

	1999	2000	2001	2002	2003	2004	2005	2006
U.S. Exports to China	13.1	16.3	19.2	22.1	28.4	34.7	41.8	55.2
Percent Change	-8%	24.4%	18.3%	14.6%	28.5%	22.2%	20.5%	32%
U.S. Imports from China	81.8	100	102.3	125.2	152.4	196.7	243.5	287.8
Percent Change	14.9%	22.3%	2.2%	22.4%	22.7%	28%	23.3%	18.2%
U.S. Balance	-68.7	-83.7	-83.1	-103.1	-124	-162	-201.7	-232.5

Source: U.S. International Trade Commission, 2007

In 2007, China's exports are growing faster still. For the first nine months of 2007, China's exports rose 27 percent, year over year, to $878 billion.[16] China's global current account surplus for the first four months of 2007 stood at $63.3 billion, an increase of 88 percent from the same period last year. At this rate, China's current account surplus easily will exceed 10 percent of China's GDP this year, a record amount. In comparison, the U.S. global current account deficit reached a new high in 2006, rising to $858 billion or 6.5 percent of GDP.[17]

China's exploding trade surplus illustrates just how central China's export-dependent industrial policy is to its overall economic strategy and helps explain why Chinese authorities are so reluctant to institute some particular reforms. In 2006, China's net export growth accounted for 25 percent of its overall economic expansion.[18] Export growth's contribution to overall Chinese GDP remains at that level for the first half of 2007. In fact, net exports, or the trade surplus, constituted the largest single factor in China's economic expansion.[19] By contrast, the U.S. trade deficit, (or net exports) subtracted 0.5 percentage points from U.S. GDP growth in the first quarter of 2007.[20]

In the first seven months of 2007, China's exports of goods and services grew by 29 percent, compared with the same period last year. That created a trade surplus of $137 billion,[21] an 80 percent increase from the same period a year earlier.

Causes of the Imbalance

Economists and policymakers identify several causes for China's growing trade surplus with the United States, but no consensus exists on their relative importance. Also, not all the causes stem from unfair trade practices or WTO violations by China. For example, America's high productivity provides its manufacturers with a competitive edge. In the case of the most labor intensive industries, however, America's productivity does not compensate for the advantage conveyed by China's low wages and employee benefits and its restrictions on labor rights. In China in 2004, the average hourly wage rate of all workers was $0.67.[22] The average U.S. hourly production wage in 2004 was $15.65.[23]

Today, average hourly wages of production workers in the United States (exclusive of the value of fringe benefits) are about $17.40.[24] This gives Chinese manufacturers a substantial edge in production costs, particularly after America's higher business expenditures on health care, pensions, worker and consumer safety, and environmental protections are taken into account.

Too much can be made of the wage differential, however. Wages account for only five percent of the total production cost for semiconductors and no more than 20 percent for clothing, for example.[25] The United States and Germany, whose workers enjoy among the world's highest earnings, also historically have been the world's largest exporters. Futher, some nations with even lower wages than China are not large exporters proportionately.

In an attempt to delineate the reasons for China's low export prices, University of California professor Peter Navarro examined "major drivers" of Chinese competitiveness. He ranked the three most important drivers when he testified before the Commission:

> *Almost half of the China price advantage is [the result of] unfair mercantilist beggar-thy-neighbor policies which, in effect, are transferring jobs in a zero sum game between the U.S. and China. . . . . [There are three predominant factors. The first is] currency manipulation. It's important, but not as important as you might think. The big item in the unfair trade practices is the export subsidies. [China provides] subsidized energy, water, virtually free capital to underper-*

forming industries because the banks don't call in the loans, VAT tax rebates. There's just a whole web of complex subsidies that should be subject to WTO complaints and other types of complaints, but for some reason this town is silent on that. The third element is counterfeiting and piracy. The cost advantages vary by sector, but they include things like not having to pay for Information Technology, not having to pay marketing expenses to market your brand, and not having to do things like research and development which for pharmaceutical companies and industries like automobiles is particularly important.[26]

Another factor frequently cited by economists to explain China's trade surplus with the United States is China's extremely high savings rate contrasted to the extremely low rate of savings in the United States. Chinese consumers save half their income according to some estimates; Americans save less than five percent of their disposable income and in some months dip into their savings. The personal savings rate in the United States was minus one percent in both the first quarter of 2006 and the first quarter of 2007, for example. U.S. business savings are in the positive range but are overwhelmed by government and household borrowing.[27] The U.S. Federal Government, which accounts for roughly a quarter of GDP, routinely runs large deficits in financing its expenditures—$248.2 billion in fiscal 2006.[28] Total outstanding federal debt, the accumulation of all Federal Government borrowing, is nearly $9 trillion or about 69 percent of GDP in 2006. China's public finances are in good shape, with a budget deficit below 1 percent of GDP in 2004 and public debt around 23 percent of GDP, down from 50 percent in 1999.[29]

In fiscal 2006, the U.S. government paid $406 billion in interest on its accumulated debt—$80 billion of that to Chinese holders of U.S. Treasury securities.[30] For the past 20 years, foreigners have been buying more Treasury securities than has the U.S. public and an estimated 54 percent of Treasury securities are now in foreign hands. The United States is now the world's largest debtor.[31]

In contrast to "dissavings" by the U.S. Federal Government and citizens, Chinese personal savings add to China's ability to finance investments and infrastructure improvements, a fact that has been acknowledged by economists and U.S. policymakers alike. There is general consensus on the cause as well. Chinese workers exercise "precautionary savings" in order to make up for a lack of government-sponsored education, pensions, and health care. Meanwhile, insurance and consumer and home mortgage credit are far less available to Chinese consumers.[32]

Only about one-seventh of the [Chinese] population, for example, is covered by basic health insurance, so many households save to cover medical expenses. Families also save for retirement because the basic pension scheme covers only about 16 percent of the economically active population—and in any case provides a pension equal to just 20 percent of average wages. Finally, households save for education. Primary school fees are a large financial burden, particularly for poorer rural households.[33]

Particularly hard hit are those who live in rural areas where closings of health clinics and schools formerly operated by now-defunct state-owned companies have created great hardship. China has not yet developed a pension system, which forces the elderly to rely on China's traditional means of providing for old age—their children. But China's one-child policy has limited this means of retirement support. Chinese officials have acknowledged these problems and have stated an intention to provide better government services.

Economic theory holds that a high savings rate encourages businesses to invest in factories, equipment, and software. This shift stimulates investment-led growth in the economy and leads to industrial over-capacity. This is typical of China today, where businesses have easy access through banks to the considerable savings of Chinese workers.

Because savings are inversely proportional to spending, Chinese workers who choose to save much of their earnings necessarily limit their purchases. Workers therefore pass up luxury items and discretionary purchases, which tend to be imported goods, in order to concentrate their spending on essentials that generally are produced within China. What goods China does import from the United States tend to be manufacturing inputs such as metal scrap, electronics for recycling, or capital goods such as electrical machinery and commercial aircraft used to generate business income. In fact, while 70 percent of GDP in the United States is consumption, the figure for China is 41 percent.[34]

Another explanation for China's rising global trade surplus is its role as the final assembler of Asian and American parts and components into finished products. Manufactured goods assembled in China from imported parts now account for about 55 percent of China's total exports and about 65 percent of the goods China exports to the United States, according to one estimate.[35] The entire value of such goods exported from China to the United States is counted as Chinese exports, regardless of where their components originated or the amount of value added in China.

Foreign investment flows provide another explanation for China's trade surpluses. The large amount of foreign investment in China is concentrated in manufacturing, which frequently produces goods intended for export. The cumulative level of foreign direct investment (FDI) in China at the end of 2006 reached $698 billion, placing it among the world's largest destinations for FDI. (U.S. investors accounted for $54 billion of that total.) China's largest recipient sector last year was manufacturing, accounting for 58 percent of the total.[36] More than half of China's exports in 2006 originated from foreign-invested factories.[37]

Table 1.2 Top Ten Origins of Foreign Direct Investment in the People's Republic of China*

Country/Region of Origin	Amount Invested 2005 ($ billion)	Amount Invested 2006 ($ billion)	Year-on-Year Growth (%)
Hong Kong	$17.95	$20.23	13
British Virgin Islands	$9.02	$11.25	25
Japan	$6.53	$4.60	−30
South Korea	$5.17	$3.89	−25
United States	$3.06	$2.87	−6
Taiwan	$2.15	$2.14	−1
Singapore	$2.20	$2.26	3
Cayman Islands	$1.95	$2.1	8
Germany	$1.53	$1.98	29
Western Samoa	$1.36	$1.54	13

*Note: Does not include financial sector flows. Source: MOFCOM, U.S.-China Business Council

One cause for the trade imbalance between China and the United States on which most economists and policymakers agree, however, is China's manipulation of its currency. In simple terms, maintaining a low value for the renminbi means that Chinese exports will be cheaper than they would be if the currency were allowed by the central government to rise in value in response to market forces. Conversely, U.S. exports to China are more expensive when purchased with undervalued renminbi. The result is that Chinese goods are cheaper in the United States and American exports are more expensive in China. How much of an advantage that disparity provides to China is in dispute. Not in dispute is the fact that the undervalued renminbi provides China with an off-budget job and export subsidy.[38] Mr. Grant Aldonas, former Under Secretary of Commerce in the George W. Bush Administration, told the Commission, "There is no doubt that the Chinese have to intervene massively in the currency markets in order to maintain their peg to the U.S. dollar. And, there is no doubt in my mind that the intent is mercantilist—they want to keep exporting to the United States because of the employment that their export production provides in an economy where they have to create many millions of jobs every year just to keep up with the growth in their population." [39]

Economists who have studied the issue have estimated that the renminbi is from 20 percent to 50 percent below where it would be relative to the dollar if it were traded freely on international currency markets.[40] No one can be certain because the international currency markets have not been given the opportunity to set a price for the renminbi. As a point of reference, the Peterson Institute for International Economics estimates that a 20 percent revaluation of the renminbi, matched by other Asian currencies now pegged to the dollar, would reduce the U.S. global current account deficit by up to $80 billion per year, or about 10 percent.[41] In contrast, most developed nations do allow their currency to be traded on the open market and intervene only occasionally to try to temporarily influence short-term price swings. Such nations include the United States, the United Kingdom, the European Union, Sweden, Switzerland, Australia, Canada, and Japan. Some of China's Asian neighbors also keep their currencies undervalued against the dollar so as to remain competitive with China on exports. As China has done, Hong Kong, Taiwan, Malaysia, and Korea have purchased U.S. dollars in an effort to control the value of their currencies.[42]

There is somewhat less agreement on why China's government has been so adamant about controlling the value of the renminbi rather than letting it seek its natural market value. China contends that it must limit the renminbi's rate of appreciation to protect China's fragile banking system, citing the example of Japan whose yen rose in the mid 1980s after which there was a decade of declining asset values, bank failures, and slow growth. Critics of China point out that currency manipulation has long been an effective tool for gaining an export advantage—so much so that rules of the International Monetary Fund proscribe members from pegging their currency except in very limited circumstances—for example, when a country is about to run out of foreign exchange entirely.

With China holding the world's largest foreign exchange reserves, it is in no danger of running low on foreign currencies to pay for imports. Chinese officials also worry that any deviation from China's high economic growth rate, averaging about nine percent over the past two decades, would make it difficult to provide jobs for a growing population and for the workers who increasingly leave rural areas for higher wages in the coastal manufacturing hubs. However, using currency manipulation to accomplish such economic policy goals amounts to exporting unemployment.

China accomplishes its dollar peg by purchasing about $20 billion each month at a fixed rate against the dollar. Without those purchases, the supply of dollars in circulation in China would rise and lose value relative to the renminbi. Without the fixed rate, the value of the renminbi also would be expected to rise. Critics of China's currency policy have suggested that China revalue its currency by fiat, much as it last did in July 2001, and reduce its purchases of dollars and allow Chinese citizens to hold and invest dollars.

Under considerable pressure from the U.S. Administration and Congress, China has taken some small steps in this direction, all the while claiming that the government will not respond to pressure. In July 2005, China engineered a 2.1 percent overnight rise in the value of the renminbi and announced a policy that would allow a "managed float" of the renminbi within a very narrow daily trading band of 0.3 percent. Shortly before the second Strategic Economic Dialogue in May 2007, the trading band was raised to 0.5 percent. In July 2007, China announced that it no longer will attempt to purchase all the dollars flowing into the country—as a result of exports or foreign investment—but rather that it will leave some of the dollars in the hands of Chinese citizens who presumably will invest them.[43] In theory, this step should add to the upward pressure on the renminbi. China also has announced that it plans to allow its citizens to buy the shares of some foreign stocks listed on the Hong Kong exchange, although the date of the proposed change has been postponed indefinitely and questions persist about the methodology that will be employed.

These are all welcome steps, but they are too small to have a significant effect on the growing trade imbalance between the United States and China. Since a small 2.1 percent revaluation July 21, 2005, at which time the renminbi was allowed to fluctuate within a narrow trading band, the renminbi has increased in value only an additional 7.4 percent against the dollar because the Chinese central bank seldom allows it to climb the maximum amount within its daily trading band.[44]

The suppression of worker rights in China also has been identified by critics as a reason for China's unfair export price advantage and its trade surplus. The AFL-CIO twice has petitioned the Administration to undertake a Section 301 investigation[45] of the violation of workers' rights as an unfair trade practice.[46] The Administration rejected the petitions, filed in 2004 and 2006, and has not launched an investigation. In its response, the USTR said an investigation was not necessary "to know that there are serious concerns with labor rights and working conditions in China."[47] The Administration said it preferred to pursue the matter in negotiations and by providing "technical cooperation to further advance labor laws and workplace protections."

But workers in China still are not provided basic rights. China has developed "a political agenda that requires repression of free speech and free association, and the prohibition of independent unions or other non-governmental organizations that might challenge the government's power," Ms. Thea Lee, the AFL-CIO's policy director, told the Commission. "Labor [in China] is not just cheap. It is deeply disenfranchised and disempowered, which leads to horrible abuses of workers' individual liberties, but also to dangerous and unsafe working conditions, unpaid wages, and abuse of prison labor."[48] Bringing a case to the WTO alleging the suppression of workers' rights as an unfair trade practice is supported by Mr. Aldonas: "Even if we lost, [it would be desirable] just to highlight the fact that this ought to be on the agenda in any trade negotiation we enter into."[49]

The WTO Cases

The Administration thus far has chosen not to bring a WTO case against China on the currency issue or to bring a formal complaint to the International Monetary Fund that has some jurisdiction over international currency matters. Nor has the U.S. Department of Treasury in its biannual reports on global currency manipulation been willing to cite China for that transgression. The Administration has justified its decision not to cite China by pointing to the 1988 law that requires the report, to a provision stating that a country can be cited only if it has deliberately manipulated its currency value to gain an export advantage.[50] The Administration argues that it cannot discern Chinese leaders' intent and therefore cannot cite China for currency manipulation. Several bills have been introduced in the U.S. House and Senate to address this discrepancy.

The Administration did bring three WTO cases against China in 2007, citing China's lack of intellectual property protection; the limited market access in China for U.S. books, journals, movies, videos, and music; and China's widespread industrial subsidies. As of this Report's publication, none of the three cases has yet been adjudicated by a WTO panel.

Like all WTO members, China is required to comply with international norms to protect copyrights, patents, and trademarks. Although China has passed many regulations and laws to comply, and has signed nine memoranda of understanding and other agreements with the United States and others to adhere to international standards, even it agrees that its enforcement is lacking. In marked contrast to his statements the previous year, during the Commission's April 2007 trip to China, Mr. Jin Xu, the Deputy Director General of the Ministry of Commerce, acknowledged that China‘s actual protection of intellectual property rights (IPR) is lagging behind its promises. Mr. Qui Zhongyi, from the State Intellectual Property Office (SIPO), acknowledged that IPR protection now is considered important for China's own economic and political development.

Losses to U.S. industries have been severe, according to the USTR complaint. Citing 2006 industry sources, the USTR reports that piracy in China "across all lines of copyright business ranges between 85 percent and 93 percent, indicating little or no improvement over 2005."[51] Those industries include "films, music and sound recordings, publishing, business and entertainment software, pharmaceuticals, chemicals, information technology, apparel, athletic footwear, textile fabric and floor coverings, consumer goods, food and beverages, electrical equipment, [and] automotive parts and industrial products, among many others." The Congressional Research Service estimates that counterfeits constitute 15 to 20 percent of all products made in China and account for about eight percent of China's GDP.[52]

Most critics of China's intellectual property protection record fault its weak enforcement rather than point toward inadequacies in its laws and regulations. The vast majority of cases are handled as civil rather than criminal matters, and moderate fines are the typical outcome. Such fines are not sufficient to deter counterfeiters from their highly profitable businesses. For example, retailers are able to stock 499 pirated DVDs and CDs without facing criminal prosecution.[53] Even that is an improvement. The previous 2006 judicial threshold for criminal prosecution required 1,000 or more pirated DVDs or CDs. Some high profile cases are concluded with press conferences in which the media record bulldozers running over pirated DVDs and CDs. Inside the adjacent counterfeit factory, however, the owners are permitted to dismantle the reproduction equipment and ship it to another facility where the counterfeiting starts anew.[54] The U.S. complaint to the WTO notes that Chinese "rules appear to permit goods to be released into commerce following the removal of fake labels or other infringing features, when WTO rules dictate that these goods normally should be kept out of the marketplace altogether." [55]

China is moving very slowly to comply with WTO requirements on IP protection, such as lowering the threshold for some criminal prosecutions by considering the retail value of counterfeit goods seized rather than the raw material or production value. Mr. Qui of SIPO insisted to the Commission in April 2007 that China's measures were not the result of pressure from the United States, but have been taken because they are in China's own interests. Regardless of whether it is doing so because of pressure from the United States and other WTO members or for its own self interest, China's pace in reforming its IPR regime indicates reluctance rather than willingness.

There have been encouraging signs of increased cooperation by China in the pursuit of large counterfeiters. In July 2007, for example, a joint investigation by the Federal Bureau of Investigation and Chinese authorities resulted in 25 arrests and the seizure of 290,000 CDs containing counterfeit Microsoft and Symantec software.[56] One organization that tracks compliance with intellectual property enforcement, the International Intellectual Property Alliance, surveyed members in China and found the raid had little effect. Eric Smith, President of the organization, testified before Congress that the highly visible "100 days campaign" resulted in "very little change in the market." Mr. Smith said, "The [authorities] take the pirated product out of the store, but the store reopens the next day and the pirated product goes into a catalogue and is sold online the next day." [57]

The Chinese government historically has undertaken high profile enforcement actions just prior to major diplomatic meetings with U.S. officials. A better indicator of China's intent would be weekly, if not daily, enforcement actions receiving prominent coverage in government controlled media.

The WTO case against China on market access is directly linked to the piracy problem. While China has dismantled its state-owned distribution networks for most imports into China, it still maintains state restrictions for U.S. copyright-intensive industries such as books, movies, CDs, DVDs, and video games and their distribution. China severely limits the showing of foreign films. The American film industry, which counts on foreign sales for half its total revenue, pegged its losses in 2005 at $244 million in China alone, not counting pirated DVDs exported from China. Nine of every 10 DVDs sold within China are counterfeit, according to Mr. Dan Glickman, President and CEO of the Motion Picture Association of America (MPAA).[58] The industry lost $6.1 billion to piracy worldwide according to MPAA figures,[59] due in part to exports of those Chinese DVDs.

Unable in many cases to see the movies that they read so much about, Chinese consumers turn to pirated DVDs sold cheaply on the street. The central government, despite its protestations and the evidence it offers of strengthened laws and regulations, plays an indirect but strong role in encouraging piracy of American entertainment software by limiting legitimate distribution.

The third U.S. complaint against China filed in 2007 with the WTO concerns a different matter entirely: China's subsidies to favored industries intended to support China's goal of boosting China's net exports. At issue are six subsidies tied to export performance and three subsidies meant to discourage purchases of imports in favor of domestically produced goods.

Both categories of activities violate the letter and the spirit of the WTO's rules. Among the subsidies prohibited by those rules, according to the complaint, are income tax reductions and refunds for companies that satisfy certain export requirements, value-added tax (VAT) exemptions and tariff reductions for exporters, discounted lending rates for exporters, exemptions from mandatory worker benefit contributions for exporters, and VAT refunds for companies that purchase Chinese-made equipment and accessories rather than imports.

The Chinese government has noted that many of these subsidies are available to U.S.-based manufacturers that have moved some operations to China. The argument is that since such subsidies also benefit American companies operating in China, there is no harm. Those subsidies, however, certainly have harmed small and medium-sized enterprises (SMEs) that have maintained their operations in the United States and so cannot take advantage of the subsidies.[60] These SMEs compose a critical portion of the U.S. manufacturing sector, providing 40 percent of the value and 60 percent of the number of manufacturing jobs in America.[61] About 90 percent of U.S. exporters to China are SMEs, and these account for over 35 percent of U.S. merchandise exports to China. "Every sale lost to subsidized products disproportionately impacts SMEs and can threaten a company's continued financial viability, given the smaller size of SMEs and more limited financial resources."[62]

Conclusions

- China's trade surplus with the United States is growing dramatically, due in large part to its financial and economic policies that stimulate exports and discourage imports. China's trade surplus with the United States in goods through August 2007 rose to $163.8 billion, an increase of 14 percent over the $143.3 billion surplus during the equivalent period in 2006. By mid-2007, China had accumulated $1.43 trillion in foreign currency reserves, up from $1.2 trillion in 2006. An estimated 70 percent of those reserves, or about $1 trillion, are invested in dollar denominated assets, mostly U.S. government and corporate bonds.

- Following a five-year phase-in period, China is largely complying with the World Trade Organization's procedures, rules, and regulations, at least on paper. While China has rewritten thousands of laws and regulations, major improvements are still needed in implementation and enforcement. China's performance is notably weak in the areas of intellectual property protection, maintenance of a market-based currency regime, and compliance with the WTO's prohibitions on export subsidies.

- China's economy remains heavily dependent on manufactured exports to sustain its rapid economic growth and to provide jobs for a rural population moving to urban areas in search of higher pay and benefits. Chinese authorities have not been willing to alter this pattern, even if pushing exports means violating WTO rules or free market principles.

- China's trade relationship with the United States is severely out of balance, with its exports to the United States exceeding its imports by a ratio of more than five to one.
- Beijing has been slow to translate three decades of record economic growth into a better life for all its citizens by enhancing government programs for education, pensions, and health care. Nor has China encouraged financial services reform to allow its citizens to enjoy the benefits of consumer credit and affordable insurance. As a result, Chinese workers save much of their income to enable them to contend with life's vicissitudes and they purchase few imported goods.
- The artificially low value of the renminbi provides a subsidy for Chinese exporters and serves as a hindrance to Chinese importers and consumers.
- China's mercantilist policies are taking a huge toll on small and medium-sized manufacturing facilities and their workers in the United States. While U.S.-based multinationals can transfer and have transferred much of their production to China to serve that market, small and medium-sized manufacturers in the United States are not as mobile. They face the full brunt of China's unfair trade practices, including currency manipulation and illegal subsidies for Chinese exports. This is significant because small and medium enterprises (SMEs) represent 60 percent of the manufacturing jobs in America.