CHAPTER 1

THE U.S.–CHINA TRADE AND ECONOMIC RELATIONSHIP

SECTION 1: THE U.S.–CHINA TRADE AND ECONOMIC RELATIONSHIP'S CURRENT STATUS AND SIGNIFICANT CHANGES DURING 2009

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 Web site—www.uscc.gov. They also are printed in full in appendix I of this Report, beginning on page 335.) 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 exclusively on—

. . .

"ECONOMIC TRANSFERS—The qualitative and quantitative nature of the transfer of United States production activities to the People's Republic of China, including the relocation of high technology, manufacturing, and research and development facilities, the impact of such transfers on United States national security, the adequacy of United States export control laws, and the effect of such transfers on United States economic security and employment.

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

Introduction

During a momentous 12 months, with the world experiencing a deep recession, the economic relationship between the People's Republic of China (PRC) and the United States changed in ways large and small. Few aspects of the relationship remained untouched. Trade disputes over such sectoral issues as tires, chicken, auto parts, and intellectual property rights occurred alongside major shifts: China has floated the idea that the world find a new reserve currency to replace the dollar that China hitherto had been only too happy to accumulate in record amounts. The U.S. government responded by promising to avoid the inflation that would harm Chinese investments in U.S. Treasury securities. China blamed the United States, its model of free market capitalism, and its lack of effective regulatory oversight for precipitating the credit crisis of September 2008 that threatened global trade. And the U.S. government reassured China and other global borrowers that their large investments in dollar-denominated bonds issued by the ailing mortgage giants Fannie Mae and Freddie Mac would be guaranteed by the U.S. government.

The United States and China approached the crisis in different ways. The United States experienced a sharp reduction in economic activity in the final quarter of 2008 (the gross domestic product [GDP] fell by 5.4 percent) and the first half of 2009 (down 6.4 percent). Meanwhile, according to Chinese government sources, China's economy grew 6.1 percent in the first quarter of 2009, 7.9 percent in the second, and is expected to grow even faster in the final two quarters, allowing Beijing to reach at least its target of 8 percent GDP growth for 2009.[1] American consumers reduced retail spending by 11 percent in the first half of 2009, year over year, as unemployment rose.[2] By contrast, retail sales in China were up by 17 percent in the 12 months ending in June 2009.[3] China's outbound foreign investment is set to exceed inbound investment for the first time.[4] The International Monetary Fund's (IMF) World Economic Outlook update in July 2009 forecast that China and India will be the engines of global growth, as they are the only major economies projected actually to grow in 2009.[5]

China's fast pace of growth, exceeding World Bank forecasts, is driven by the government's $586 billion in proposed stimulus spending, loose fiscal and monetary policies, record lending by state banks, and export-led growth policies. But the enviable statistics hide a darker side.* Economists in China and across the world have warned that the flood of bank lending in China may generate dangerous bubbles in the property and stock markets, squander financial resources, cause a rise in nonperforming bank loans, and further exacerbate the economic imbalances that have led to the present crisis. China's commitment to global rebalancing appears half-hearted, with aggressive efforts aimed at boosting exports and maintaining robust growth.

Indeed, a newly assertive China has used the global slowdown as an opportunity to seize the center stage and proclaim the superiority of its economic system over that of the United States. While Chinese Prime Minister Wen Jiabao never named the United

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*Considerable skepticism exists in regard to China's statistical reporting. China compiles its gross domestic product growth figures even faster than the United States despite having more than four times the population, far fewer computers, and less sophisticated sampling methodology. In addition, Beijing relies on provincial government officials to supply many of the details—the same officials who are assigned production quotas by the central government. For example, *see* Derek Scissors, "The Truth about China's Growth," The Heritage Foundation *WebMemo #2238*, January 22, 2009. *http://www.heritage.org/Research/AsiaandthePacific/wm2238.cfm*; Michael F. Martin, "What's the Difference?—Comparing U.S. and Chinese Trade Data," Congressional Research Service (CRS) Report to Congress RS22640 (Washington, DC: March 27, 2009); and "The Art of Chinese Massage," *Economist*, May 21, 2009. *http://www.economist.com/businessfinance/displayStory.cfm?story_id=13692907*.

States directly, his criticism at the January 2009 World Economic Forum in Davos of the "unsustainable model of development characterized by prolonged low savings and high consumption" was clearly aimed at the United States.[6] Chinese Central Bank Governor Zhou Xiaochuan, stressing the superiority of China's economic model, noted at the G–20 meeting in March 2009 that China "demonstrat[ed] its superior system advantage when it comes to making vital policy decisions."[7]

China has initiated two new World Trade Organization (WTO) cases against the United States and has sought a larger role in the affairs of the IMF and the World Bank. China has also introduced some programs, such as currency swaps with some of its smaller trading partners, that may eventually lead to the internationalization of China's currency.

The U.S.-China Trade Relationship

Despite the global economic crisis, China seems on track to achieve at least 8 percent growth this year, after reaching 7.9 percent growth in the second quarter of 2009.[8] Aggressive stimulus measures, including massive expansion of bank lending, export rebates, subsidies for consumption, and continuing manipulation of its currency have helped the Chinese economy to continue expanding throughout the global downturn (see chap. 1, sec. 2, for a detailed discussion of China's role in and response to the global economic crisis). The U.S. GDP, by contrast, decreased at an annual rate of 1.0 percent in the second quarter of 2009.[9]

Despite the economic downturn and dramatic drop-off in U.S. consumption in the last quarter of 2008, China's exports to the United States were almost five times the amount of its imports: China exported $337.8 billion worth of goods to the United States and imported just $69.73 billion in goods from the United States, which left the United States with a bilateral trade deficit of $268.04 billion. There are some signs that the size of the U.S. trade deficit with China may grow at a slower pace due to the U.S. economic slowdown and higher transportation costs, among other factors. For the first eight months of 2009, China's goods exports to the United States were $184.9 billion, while U.S. exports to China were $41.2 billion, with China's trade surplus standing at $143.7 billion, a decrease of 17.8 percent over the same period last year ($169.2 billion).

Figure 1: U.S.-China Trade in Goods ($ billion), 2000–2008

	2000	2001	2002	2003	2004	2005	2006	2007	2008
U.S. Exports	$16.3	$19.2	$22.1	$28.4	$34.7	$41.8	$55.2	$65.2	$69.73
U.S. Imports	100.0	102.3	125.2	152.4	196.7	243.5	287.8	321.5	337.8
Balance	-83.7	-83.1	-103.1	-124.1	-162.1	-201.6	-232.5	-256.3	-268.04

Source: U.S. Department of Commerce, Bureau of Economic Analysis, 2009.

U.S. exports to China were down 16.7 percent in the first eight months of 2009 compared with the same period in 2008, while imports from China were down about 17.5 percent.

As the global recession reduced U.S. demand for imports, the U.S. trade deficit with the world and with China started to decline in late 2008. But the U.S.'s relative trade deficit with China, compared with the rest of the world, grew. The U.S. manufacturing trade balance with China continued to deteriorate and is far larger than that with any country or region. In 2008, the U.S. deficit with China accounted for 68.6 percent ($267.5 billion) of the total $389.8 billion U.S. trade deficit in manufactured goods, compared with 56.7 percent ($255.6 billion) of the total $450.8 billion in 2007.[10] The U.S. trade balance with China in advanced technology products is also deteriorating: the U.S. deficit has soared from $6.1 billion in 2001 to $72.7 billion in 2008.[11] In the first half of 2009, the United States exported $7.6 billion in advanced technology products to China and imported $38.1 billion, for a six-month deficit of $30.5 billion.[12]

The issue of the U.S.-China bilateral trade imbalance is one of the major points of contention between the two countries. The United States continues to push for improved access for U.S. manufacturers and service providers to the Chinese market and for better intellectual property protection for U.S. business software and entertainment products. China, however, prefers that the United States reduce its restrictions on exporting dual-use high-technology products to China.[13] (High-technology civilian goods that could also serve a military purpose are under a broad array of U.S. government export restrictions. Europe also maintains restrictions.) During the Commission's May 2009 trip to China, such arguments cropped up repeatedly in conversations with senior Chinese policymakers and academics. Assistant Minister of Finance Zhu Guangyao recommended liberalizing the U.S.'s high-tech goods export policy to correct the trade imbalance, while Zheng Xinli, deputy director of the Policy Research Office of the Chinese Communist Party's (CCP) Central Committee and permanent vice president of the China Centre for International Economic Exchanges, also suggested relaxing restrictions on nuclear power technology.

Washington has restricted sales of some dual-use technologies with possible military applications and crime-control items. Though the July 27–28 Strategic and Economic Dialogue produced an agreement to "accelerate" the easing of restrictions, critics in the United States have objected to such a move, pointing to numerous instances of Chinese violations of current rules against weapons-related proliferation activities.[14] In 2008, U.S. exports to China of advanced technology goods such as semiconductors and electronics amounted to $18.7 billion, or 26 percent of all U.S. sales to China, despite the restrictions.[15] China maintains that the relaxation in U.S. export controls will help reduce the U.S.'s trade deficit, but this is a spurious argument. In 2008, the U.S. Bureau of Industry and Security approved exports to China valued at around $2.7 billion, while the total value of denied license applications was only $142.6 million.[16] (This figure does not account for license requests that are never made, so it does not represent fully the magnitude of possible sales of controlled exports.)

China's Exchange Rate Regime and Investment in U.S. Government Assets

The current economic crisis has brought into stark relief many contributing factors, such as the global saving and spending imbalances, which are addressed in chapter 1, section 2, of this Annual Report. The issue of currency valuation—specifically the undervaluation of the renminbi (RMB)—attracts attention whenever the U.S.-China trade imbalance is discussed, and the Commission has addressed this topic in detail in previous Reports. China's deliberately undervalued RMB has unfairly conferred substantial economic advantages on China, to the detriment of major trading partners, including the United States and Europe, by making China's exports cheaper and imports more expensive and encouraging foreign direct investment into China. The refusal by China to allow its currency to be traded on international markets has contributed to China's massive trade surplus and its accumulation of more than $2.27 trillion in foreign exchange reserves by September 2009, the world's largest cache of foreign currency and other foreign liquid assets.[17]

The Chinese Central Bank has maintained its strict control of the value of the RMB by buying dollars entering the country through export earnings or investment and swapping them for newly printed RMB. Consequently, the exchange rate between the RMB and the dollar stayed within a narrow trading band determined by Beijing despite an announcement in July 2005 that the RMB's value would become "adjustable, based on market supply and demand with reference to exchange rate movements of currencies in a basket" of currencies. The composition of this basket still has not been revealed.[18] Between 2005 and the summer of 2008, the RMB appreciated by about 21 percent, at which point Beijing set its value at around 6.8 to the dollar. The RMB remains undervalued. The extent of the RMB's undervaluation is hard to estimate, because it has never been freely traded, but economists suggest anything from 12 percent to 40 percent.[19]

China's foreign exchange reserves, accumulated as a partial result of China's manipulation of the value of the RMB, are largely invested in U.S. dollar-denominated assets. As of July 2009, China owned $800.5 billion of U.S. Treasury bonds and is the biggest holder of U.S. Treasuries in the world.[20] Although much has been made in China's state-run media over the $25 billion sell-off of Treasury securities from May to June 2009, the message appears aimed at domestic critics of China's economic dependence on the United States. When the U.S. subprime mortgage market collapsed, China responded by selling some dollar-denominated assets, in particular debt issued by mortgage giants Fannie Mae and Freddie Mac, but its purchases of U.S. Treasury debt continued while stock and commodity markets were fluctuating wildly.[21] As a result, total Chinese holdings of U.S. Treasury debt grew by more than 45 percent between July 2008 and July 2009.

The perceived dependence of the United States on China's lending has overshadowed the debate about China's trade practices in general and China's manipulation of its currency in particular. When U.S. and Chinese officials met for the revamped Strategic and Economic Dialogue on July 27–28, 2009, the American negotiators did not raise the issue of China's currency manipulation, instead relegating the issue to a subset of its push for broader economic reforms in China.[22] Beijing has taken to lecturing Washington on the need to safeguard its $2.27 trillion in reserves, the bulk of which are parked in U.S. dollar-denominated assets. "The [United States] has for now given up on pushing China on currency issues, partly because Washington has less leverage over Beijing than at any other point in recent history," said Eswar Prasad of The Brookings Institution.[23] Premier Wen Jiabao said in March 2009 that he was "worried" the dollar would weaken as U.S. President Barack Obama sells record amounts of debt to fund his $787 billion economic stimulus plan. Yet since June 2008, the RMB has been strictly pegged to the dollar in order to help support exports during the global recession.[24]

For all the concern that the dollar's role is waning and that it may be a risky investment, China has continued to lead in the purchase of U.S. government assets. (China does not disclose the currency composition of its reserves, but the dollar is thought to make up around 65 percent of the portfolio).[25] The reason that China continues to buy dollars is simple: China's policy of strictly controlling the value of the RMB depends upon it. China's commitment to a pegged currency means that under its current approach China must swap the dollars flowing into the country for RMB.[26]

Analysts, including David Pilling, the Asia editor of the *Financial Times*, and Brad Setser, an economist formerly at the Council on Foreign Relations and now at the National Economic Council, argue that far from a sign of strength, "Beijing's accumulation of vast foreign reserves is the side-effect of an economic model too reliant on exports."[27] Writes Pilling:

> *The enormous trade surplus is the product of an undervalued [RMB] that has allowed others to consume Chinese goods at the expense of the Chinese people themselves. Beijing cannot dream of selling down its Treasury holdings without triggering the very dollar collapse it purports to dread. Nor are its shrill calls for the U.S. to close its twin deficits—which would inevitably involve buying fewer Chinese goods—entirely convincing. Rather than exposing the superiority of China's state-led model, the global financial crisis has laid bare the compromising embrace in which the U.S. and China find themselves.*[28]

Dr. Setser further suggests that although China still matters for financing the U.S.'s external and fiscal deficit (it controls a $1.5 trillion portfolio), U.S. reliance on borrowing to support the trade deficit has diminished as the U.S.'s trade deficit has shrunk.[29] The latest official U.S. statistics show that while U.S. government borrowing to support the federal budget deficit has been growing rapidly, U.S. households have purchased 86 percent of all new Treasury issues in the first quarter of 2009. American households held about $643.9 billion by the end of the same period, while the Federal Reserve held about $704 billion by the end of July 2009.[30] The diminished role of foreign financing is only natural, since U.S. borrowing to finance imports is down, with the U.S.'s current account deficit actually halved—from $829 billion in 2005 to an annualized $409.5 billion in the first quarter of 2009.[31]

China's exchange rate regime appears to have created a policy dilemma for the Chinese government. An undervalued RMB subsidizes China's exports, but it also compels China to keep buying up U.S. dollars. Chinese officials have expressed concern that the growing U.S. debt will eventually spark inflation in the United States and a depreciation of the dollar, which would reduce the value of China's holdings of U.S. securities. But if China stopped purchasing U.S. dollars, it would seriously impact the RMB's peg to the dollar. As Michael Pettis, professor at Peking University's Guanghua School of Management, writes, as long as China remains dependent on boosting the value of the dollar to support its own export-driven growth, it "will have to recycle the surplus into the dollar pool that ultimately funds the U.S. fiscal deficit." [32] There is an irreconcilable conflict between China's words and actions: Despite high-level criticism of the growing U.S. debt, China continues to buy Treasury bonds and to buy up dollars flowing into the Chinese economy. As economist Paul Krugman notes, China remains captive in a "dollar trap" of its own making.[33]

China's Criticism of the U.S. Dollar's Reserve Currency Status

During the July 26–27 Strategic and Economic Dialogue in Washington, Chinese Vice Premier Wang Qishan said at an event with Treasury Secretary Tim Geithner that "[a]s a major reserve currency-issuing country, the U.S. should properly balance and properly handle the impact of the dollar supply on the domestic economy and the world economy as a whole." He later pronounced himself content with Washington's assurances that the United States would meet its financial commitments.[34] Chinese concerns over China's large dollar holdings also have been reflected in a paper issued by the governor of the People's Bank of China, Zhou Xiaochuan, on March 24, 2009. The paper called for replacing the U.S. dollar as the international reserve currency with a new global system based on special drawing rights, an international reserve asset developed by the IMF, whose exchange rate is calculated by a mix of dollars, euros, pound sterling, and yen.[35]

The Dollar as a Reserve Currency and Special Drawing Rights

A reserve currency is held by governments, businesses, and individuals as an asset whose value is market based and, when in the form of bonds issued in the reserve currency, an investment that will pay interest. Parties hold reserves for a variety of reasons: as a medium of exchange to pay for imports, as a hedge against inflation, and as a guard against the effects of a run on a country's own currency. Central banks hold a reserve currency in lieu of gold or other precious metal deposits.

The Dollar as a Reserve Currency and Special Drawing Rights—Continued

The U.S. dollar became the world's official reserve currency following World War II and was used to establish a fixed rate of exchange among currencies. The dollar assumed an even larger, though unofficial, role in 1971 after the United States and most nations abandoned the gold standard, and currencies of industrialized countries came to be freely traded on international markets. Dollars make up about two-thirds of the world's currency reserves, followed by the euro and the Japanese yen. The dollar has been favored as a reserve currency because the United States has the world's largest economy and is its largest trading country, the global market for dollars is large and highly liquid, and the U.S. economy and its political system have proved to be stable. The choice of the dollar constitutes a vote of confidence in the U.S. political system and the U.S. economy.

The International Monetary Fund, which was founded after World War II to oversee the international payments system, created in 1969 a unit of account and a partial substitute for gold and the dollar called "special drawing rights." [36] This essentially established a medium of exchange whose value is linked to the dollar, as gold once was, but is not freely traded. The IMF determines the value of the special drawing rights daily by calculating the worth, in dollars, of four currencies traded on the London exchange (a trade-weighted dollar, euro, yen, and pound sterling). The special drawing rights can be exchanged for currencies of some IMF member countries, and holders of special drawing rights receive interest payments from the IMF. In March 2009, Zhou Xiaochuan, a governor of the People's Bank of China, proposed substituting special drawing rights as the reserve currency in place of the dollar.[37] However, only 204 billion special drawing rights are in existence, worth about $317 billion, far too few to constitute a reserve currency.[38] China alone is thought to have some 65 percent of its $2.27 trillion in foreign currency reserves in dollar-denominated investments, or a total of some $1.5 trillion.

The United States derives several advantages from the world's acceptance of the dollar as the reserve currency. The United States can issue bonds denominated in dollars, allowing it to borrow without fear that a fall in the dollar's value will increase its debt. Conversely, the United States can choose to inflate its currency and reduce the burden of its debt—a practice known as monetizing the debt. Also, U.S. currency held by foreigners constitutes an interest-free loan to the U.S. government, known as seigniorage. (There is $870 billion in currency outstanding. Of that, $646 billion is in $100 bills, most of which are thought to be held by foreigners).[39]

China's growing focus on the special drawing rights has coincided with China's reconciliation with the IMF. For the past three years, China has blocked IMF reviews of its economy, called an Article IV

Consultation, because it objected to public criticism of its controlled exchange-rate regime.[40] In the latest report issued in July 2009, the IMF board concluded that the RMB "remains substantially undervalued." This change is a step-down from previous statements and reports labeling China's exchange rate as "fundamentally misaligned."[41] Speaking at the opening of the World Bank and IMF annual meetings in October 2009, Dominique Strauss-Kahn, the head of the IMF, reiterated his criticism of the Chinese currency, saying that the IMF "view still is the [RMB] is undervalued."[42]

As its activism on the special drawing rights issue shows, China is becoming more engaged with the IMF and other international organizations as it tries to boost its global influence. China is the world's third largest economy and wants greater recognition but has fewer IMF votes in proportion to the size of its economy (its share is roughly the same as Belgium and the Netherlands combined).[43] Instead of making a direct contribution, China signed an agreement to purchase $50 billion in special drawing rights-denominated bonds issued by the IMF.[44] China is hoping that buying bonds from the IMF will help increase China's say in the organization's governance, even though IMF allocations are determined by each country's financial contribution to the IMF—not the country's economic size or population.[45]

During the Commission's May 2009 Asia trip, the Commissioners met with Zhu Guangyao, China's assistant minister of Finance, who said that as the IMF is undergoing changes as a consequence of the global crisis, China's role in the IMF is changing, too. Echoing comments made by other prominent Chinese policymakers and scholars, he called for a more balanced representation in the IMF, with a bigger role for other developing countries. (China claims that it is a developing country.) Mr. Zhu said the goal was not to overthrow the system but rather to bring it into accordance with the global economy—for example, since the United States accounts for more than 15 percent of the global economy, its quota should reflect a similar allocation. (The United States currently holds 16.77 percent).[46] Mr. Zhu has also said that China would like to see the voting shares split equally between the developed and the developing countries.[47] In the joint communiqué from the G–20 Summit in Pittsburgh in September 2009, the leaders called for a shift in IMF voting by at least 5 percentage points from developed to underrepresented developing countries, which is certain to affect China's voting power.[48] In a statement to the IMF's steering committee in October 2009, Yi Gang, vice governor of the People's Bank of China, said Beijing wanted the IMF to "establish a system to automatically adjust [voting] quotas and to reflect changes in countries' economic status."[49]

Lending weight to its call for an alternative to the U.S. dollar, Beijing is trying to diversify its investments by investing in commodities and overseas companies and gradually atttempting to internationalize the RMB by allowing it to be used for some regional trade transactions.[50] For example, in the 10 months after Lehman Brothers collapsed in September 2008, Chinese bidders announced 50 outbound offers worth over $50 billion, with more than two-thirds of the offers in buying mining or energy assets.[51] Chinese Premier Wen Jiabao announced in July 2009 that Beijing will use its massive foreign exchange reserves to "hasten the implementation of [the] 'going out' strategy," which translates into supporting the overseas expansion of and acquisitions by Chinese companies.[52] Taking advantage of falling commodity prices, China's State Reserve Bureau and other importers went on a buying spree to replenish China's strategic reserves, to insulate domestic producers of these goods from falling global prices, and to reallocate a portion of its foreign exchange reserves away from the dollar.[53] China has been stockpiling oil, iron, copper, and other metals, and canola and soybeans since the end of last year.[54] Despite its spending on such initiatives, China's reserves continue to accumulate.[55]

In its annual report on financial stability, issued in June 2009, the People's Bank of China formalized the call for a new reserve currency, saying that China will push reform of the international currency system to make it more diversified and will aim to reduce reliance on the current reserve currencies.[56] Though the report does not explicitly mention the U.S. dollar, the dollar is the dominant reserve currency in the world. The People's Bank of China said in the report that under the proposal, the IMF "should manage part of the reserves of its members" and be reformed to increase the rights of emerging markets and developing countries.[57] That would be a significant change, since China currently does not even disclose to the IMF the composition of its reserves, let alone allow the IMF to manage them.[58] China also urged stronger monitoring of countries that issue reserve currencies.[59]

Many economists in China believe that the economic crisis has laid bare defects in the dollar-led global economy, and developments this year indicate that China is laying the groundwork for a long-term strategy to increase the international role for the RMB, perhaps even as a reserve currency. For example, Li Lianzhong, an academic at a key think tank under the Communist Party, said China's RMB should become the fifth currency in the special drawing rights basket, with an equal weighting of 20 percent according to each currency.[60]

But as Swaminathan Aiyar of the Cato Institute and Arvind Subramanian of the Peterson Institute for International Economics argue, political considerations may be as important as economic self-interest in the formulation of China's strategy. By calling for a greater role for special drawing rights, China may be seeking to reduce the political and financial power of the United States: China's move has been backed by Russia, Brazil, India, and other developing countries that "have long chafed at the de facto dollar standard."[61]

RMB Swaps and Cross-border Trade Settlement Agreements

In addition to calling for special drawing rights to replace the dollar as the world's reserve currency, China has signed currency swap agreements totaling 650 billion RMB (or about $95 billion) with Hong Kong, Argentina, Indonesia, South Korea, Malaysia, and Belarus, which would allow those partners to settle accounts with China using the RMB rather than the dollar in order to facilitate bilateral trade and investment.[62]

Limited use of the RMB has been allowed since 2003 in border trade with Vietnam and Laos to the south and Mongolia and Russia in the north, according to a book published by the State Administration of Foreign Exchange.[63] But now trade settlement is moving from border zones to China's largest financial centers, including Shanghai, Guangzhou, and Hong Kong. Starting in July 2009, the central bank extended settlement by offering companies in Shanghai and four southern cities—Shenzhen, Guangzhou, Dongguan, and Zhuhai—tax breaks to start conducting trade in the currency with Hong Kong and Macao and allowing certain banks in Hong Kong to issue bonds denominated in RMB.[64] (See chap. 3, sec. 3, for more details on China's currency swap and trade settlement agreements with Hong Kong.) The State Council has also specified that the pilot program will apply to cross-border trade transactions with the 10 members of the Association of Southeast Asian Nations countries on a tentative basis, though details remain forthcoming.[65] There have also been some indications that trade-settlement deals are in the works with other countries, including reports that Brazilian President Luiz Inácio Lula da Silva and his Chinese counterpart Hu Jintao discussed the plan to settle trade in local currency during Lula's three-day state visit to China in May 2009.[66]

The Chinese government has ambitions to give its currency a wider regional and international presence, though the currency now is almost impossible to use outside of China's borders. Chinese firms are unlikely to convince their foreign business partners to settle transactions in RMB—not least because there are very limited opportunities for using the RMB.

HSBC, one of the world's largest banks, suggested that China's plans to internationalize the RMB, if successful, could lead to nearly $2 trillion in annual trade flows (as much as 50 percent of China's total) being settled in RMB as early as 2012. Many analysts, however, remain very skeptical.[67] Philip Bowring, Asia columnist for the *International Herald Tribune* and former editor of the *Far Eastern Economic Review*, wrote on the obstacles to internationalizing the RMB:

> *China's expressions of desire to reduce the role of the dollar are . . . contradicted by its actual policy of maintaining a de facto peg to the U.S. currency, meanwhile continuing to accumulate dollars in reserves now totaling $2 trillion. The modest [RMB] appreciation after 2005 came to a halt more than a year ago as China has sought to sustain exports in the face of the global slump. There is conflict between macro-economic stabilization goals and pressures from industries and employment creation not to put more pressure on exporters. China is still wedded to high growth and a cheap currency. . . . Nor has there been any significant move towards full convertibility as the financial crisis has, with good reason, made the authorities nervous of liberalization.*[68]

While Arthur Kroeber, managing director of Dragonomics Research & Advisory, an independent research firm based in Beijing, wrote that for the RMB to become a reserve currency, *foreigners must be able to invest freely in onshore [RMB] financial assets (stocks, bonds, and bank deposits) and freely repatriate both their earnings and their capital. For foreign investors to want to hold [RMB] assets on a large scale, they must be convinced that China's financial markets are trustworthy and not rigged.*

For the [RMB] to become even a secondary reserve currency, it must therefore fully liberalize its capital account and set up reliable financial markets that are reasonably free of government interference. Technical difficulties aside, this will require a significant retreat from the current state-dominated model of credit allocation—and this cannot happen quickly.[69]

Even Chinese officials seem to have equivocated on the idea of moving to the special drawing rights. China's Vice Foreign Minister He Yafei said that the creation of a supranational reserve currency has been discussed "among academic circles" but that any proposal outlined "is not the position of the Chinese government," according to China's state-run Xinhua news agency.[70] Li Yang, a former adviser to the People's Bank of China and a prominent academic, said at the July 2009 Global Think Tank Summit in Beijing that the transition to a multireserve currency system could take 20–30 years or longer.[71] Making the RMB a reserve currency would also carry some dangers. Chancellor Lawrence Lau of the Chinese University of Hong Kong said that if the RMB becomes "a reserve currency held by multiple countries," then shifts in confidence in the RMB could destabilize the exchange rate, which in turn "may trigger an economic crisis in China."[72]

Still, China's proposals for changes in the international financial architecture have to be taken seriously. China's leaders plan ahead. For example, China's recently announced goal to turn Shanghai into an international financial center by 2020 may suggest that China wants a fully convertible RMB by then.[73] Chinese regulators have taken steps to broaden the international appeal of China's capital markets and establish an offshore bond market for the RMB. Plans have been announced to allow qualified foreign-invested firms to list on the Shanghai exchange next year, to approve foreign banks' issuance of RMB-denominated corporate bonds, and to raise individual quotas for foreign investment in stocks from $800 million to $1 billion.[74] The Ministry of Finance also announced in September that in order to "improve the international status of the [RMB] [and] promote development of the [RMB] bond market," 6 billion RMB ($879 million) of government bonds will be sold in Hong Kong to foreign and retail investors—the first time RMB sovereign debt will be sold outside mainland China.[75] According to a report in the official *China Securities Journal*, in July 2009 China's State Council put Hu Xiaolian, the current head of the State Administration of Foreign Exchange, which administers China's foreign exchange reserves, in charge of a soon-to-be-formed special monetary policy office under the People's Bank of China to promote internationalization of the RMB.[76] This new office will be responsible for drafting RMB exchange rate policy and execution, monitoring foreign currency supply and demand, and developing an RMB offshore market.[77]

U.S.-China Bilateral Dialogues

In 2009, the Obama Administration adopted the basics of the Bush Administration's bi-annual Strategic Economic Dialogue and gave it a slightly new name: the Strategic and Economic Dialogue. Instead of twice a year, the group will meet once a year. Leadership on the U.S. side is now shared by Treasury Secretary Timothy Geithner and Secretary of State Hillary Clinton. The new Strategic and Economic Dialogue's broader agenda will include broader foreign policy issues such as climate change and North Korea. Assistant Minister of Finance Zhu Guangyao, with whom the Commission met during its May 2009 trip to China, said the Strategic Economic Dialogue process was particularly helpful in cultivating strategic trust. While both sides hailed the importance of consulting with each other, the July 27–28 Strategic and Economic Dialogue failed to produce any new agreements. In fact, much of the final communiqué was repeated verbatim from the previous Strategic Economic Dialogue statements, including China's commitment to open its financial services market to foreign investors and to treat foreign investment the same as domestic investment when granting government contracts.[78] The latter item has long been a point of contention between the two countries, since China is not a signatory to the World Trade Organization's Government Procurement Agreement despite a 2001 promise by Beijing to do so "as soon as possible." Instead, the two sides compromised by agreeing that by October 2009 China will submit a report to the Government Procurement Committee "that sets out the improvements that China will make in its revised offer."[79] In October 2009, China submitted to WTO members a promise to deliver an improved offer for joining the Government Procurement Agreement sometime in 2010 but indicated that the new offer may exempt state-owned enterprises and subcentral government entities.[80]

The discussion of the Strategic and Economic Dialogue focused on the 2008–09 economic crisis and U.S.-China trade in the global economy. As the biggest holder of U.S. Treasury bonds, China expressed concern over the U.S. budget deficit and the safety of China's investment in billions of dollars. China expressed fears that the accumulating American budget deficit could weaken the dollar and put at risk China's vast holdings of Treasury securities and other dollar-denominated assets. (A fall in the value of the dollar relative to the RMB also would make China's exports more expensive.) China holds an estimated $1.5 trillion such securities, making it the U.S.'s largest foreign creditor.[81] China's Finance Minister Xie Xuren said the delegation wished to "express the view that credible steps should be taken to prevent fiscal risks and to ensure sustainability" and that "high attention should be given to fiscal deficits."[82]

Many commentators saw the exchange of rebukes on the Chinese side and assurances on the American side as a sign of a power shift between the two countries, in which an assertive China seeks to protect its investment while the United States mutes its criticism because it depends on China's purchases of the Treasuries to finance the economic recovery.[83] And indeed, during the Strategic and Economic Dialogue, the U.S. side was "quiet on human rights and muted on the [RMB]," according to news accounts.[84]

Now that the Strategic and Economic Dialogue will convene only once a year, discussion of sectoral U.S.-China trade issues will depend on the U.S.-China Joint Commission on Commerce and Trade, which will hold its next meeting on October 28–29, 2009, in Hangzhou, China. The United States promised to "earnestly consider China's concerns" and work through the joint commission "toward China's Market Economy Status in an expeditious manner" (the United States made similar pronouncements in the past, but there has been no change in China's status as a nonmarket economy).[85]

This issue has long been a sore point for China: 97 members of the WTO officially recognize China as a market economy, but its biggest trading partners—the United States, the European Union, and India—do not.[86] Under its WTO accession agreement, China will automatically attain market economy status by 2016, but for now, the U.S. Department of Commerce treats China as a nonmarket economy when determining antidumping penalties, which can frequently result in higher fees. The United States has a statutory test for determining whether an economy can be classified as a market economy.[87] The factors to be considered under U.S. law in granting market economy status include the extent to which the country's currency is convertible, the extent to which wage rates are freely determined by negotiations between labor and management, and the extent to which the government owns or controls the means and decisions of production.[88]

In what could prove to be a significant development in the imposition of trade remedies on Chinese imports, in September 2009 the U.S. Court of International Trade ordered the U.S. Department of Commerce to develop methodologies to prevent double-counting of subsidies if it applies antidumping and countervailing duties simultaneously on imports of the same product from nonmarket economies. If the Commerce Department cannot develop such methodologies, then it must refrain from imposing simultaneous antidumping and countervailing duties.[89] China initiated a WTO case against the United States on its concurrent use of antidumping and countervailing measures against certain Chinese-made products, which is currently pending.

The WTO Cases

Cases Brought by the United States against China

Export Restrictions

The United States and the European Union have cited China's export restrictions (such as export quotas and taxes) on raw materials (bauxite, coke, fluorspar, magnesium, manganese, silicon metal, silicon carbide, yellow phosphorus, and zinc) in their June 2009 request to convene a dispute settlement panel. The United States charged that such policies are intended to discriminate against foreign firms by lowering prices for Chinese companies in the steel, aluminum, and chemical sectors. China ranks as either the top or a dominant producer of all the restricted materials. U.S.

Trade Representative (USTR) Ron Kirk called China's export restraints a "conscious policy to create unfair advantages."[90]

This problem had been first raised six years ago as part of China's WTO transition review, and the formal complaint came after more than two years of unsuccessful talks between China and the United States to resolve this issue.[91] Beijing responded that its export restrictions are legitimate under WTO regulations and insisted that the "main purpose of certain export measures is to protect the environment and precious resources . . . .in line with WTO rules."[92] Perhaps not coincidentally, on the same day the United States filed its complaint, China asked the WTO to investigate a U.S. ban on imports of Chinese poultry (see below for more details on the poultry case).

Export Subsidies

In December 2008, the U.S. Trade Representative requested WTO dispute settlement consultations with China over China's support for "Famous Brands" programs, charging that such programs use export subsidies (including cash grant rewards, preferential loans, research and development funding to develop new products, and payments to lower the cost of export credit insurance) at the central and local government level to promote the recognition and sale of Chinese brand products overseas, unfairly disadvantaging foreign competition as part of a "protectionist industrial policy."[93] China's use of preferential policies and standards to promote domestic industries over foreign competitors has a long history. The "Famous Brands" program is just one of the many ways in which China tries to give its indigenous businesses a leg up in domestic and international markets.[94] (For China's use of technological standards as a tool for supporting domestic producers, see chap. 1, sec. 3, of this Report.)

Resolved U.S. Cases against China

China's government has long tolerated rampant violations of intellectual property rights. China also has imposed stringent censorship and performance and distribution restrictions on imported movies, books, and other intellectual content, often arguing that its regulation of such materials was intended to foster "a high level of protection of public morals."[95] In April 2007, the USTR filed two related cases against China: The first case charged that China failed to comply with the WTO agreement on intellectual property protection, and the second case charged that China failed to provide sufficient market access to intellectual property rights-related products, in terms of trading rights and distribution services. The United States initiated these cases after China failed to comply with five separate memoranda of understanding it had signed with the United States. Both of these cases have now been resolved, with the panel ruling largely in favor of the U.S. position, although China is appealing the latter case.

Intellectual Property Rights

In the first case, on "Measures Affecting the Protection and Enforcement of Intellectual Property Rights," the United States argued that the thresholds for criminal prosecutions of intellectual property rights violations in China were too high, creating a loophole for smaller producers or violators. In addition, China's copyright laws fail to protect imported works (such as movies) that are under review by Chinese censorship authorities (and must be approved before the works can be distributed in China). As a result, pirated copies of the works can be widely distributed without violating copyright law and thus do not face prosecution. Finally, the U.S. side also argued that China often allowed seized pirated goods to reenter the market rather than destroying them, after removing the infringing label or trademark. In January 2009, the WTO ruled that many of China's intellectual property rights enforcement policies did not comply with WTO obligations, finding that China failed to protect intellectual property rights works under review by the government for content and mishandled the disposal of seized, pirated products. However, the panel determined that it needed more evidence on the issue of thresholds for criminal prosecutions of intellectual property rights piracy. The USTR, while admitting disappointment on the WTO findings on thresholds, noted that, right before it filed the WTO case on China's intellectual property rights enforcement, China lowered its criminal copyright threshold from 1,000 to 500 infringing copies.[96] China said in June 2009 that it will implement the recommendations and rulings of the dispute settlement body by May 20, 2010.[97]

Market Access

In the second case, on "Measures Affecting Trading Rights and Distribution Services for Certain Publications and Audiovisual Entertainment Products," the United States sought to address three significant market access concerns. The United States claimed that the measures violated China's WTO obligations. First, the WTO panel examined prohibitions on the rights of foreign companies and individuals to import products, including reading material, audiovisual home entertainment products, sound recordings, and films for theatrical release into China. Second, the WTO panel addressed prohibitions and restrictions on the rights of foreign suppliers to distribute most of these products in China. Third, the WTO panel reviewed discriminatory treatment of imports of most of these products in China's market.[98] Like the ruling on the intellectual property rights protection case, the panel's decision, handed down in August 2009, was not an unqualified success for the United States, though the panel largely backed U.S. claims. For example, the panel found that China was breaking WTO rules by forcing U.S.-made magazines and videogames and other media to be sold through government-owned monopolies but that the United States had failed to prove that China's distribution of U.S. films (which made U.S. films go through one of two designated distributors) violated China's WTO obligations. The WTO also ruled that it was illegal to give one government-owned company the monopoly to import films and books and that China must let foreign companies sell music over the Internet. China appealed the panel's decision on September 22, 2009, citing the need to protect "public morals" as a justification for restricting access for U.S. products.[99] On October 6, the United States issued a cross appeal, seeking review by the Appellate Body of the panel's conclusion that the Chinese state plan mandating the number, structure, and geographic distribution of importers could efficiently allow imports while maintaining China's stated objective of protecting public morals.[100]

It is too early to tell what effect these two rulings will have on copyright protection and piracy in China. China announced its intention to appeal the ruling in the second case. Even if the appeal is lost, it is unlikely that better distribution of copyrighted U.S. media will guarantee better treatment for U.S. businesses as long as there is money to be made in China by manufacturing and selling counterfeit movies, CDs, and videogames.[101] In what may prove to be a first promising step toward better intellectual property protection, four men were imprisoned and heavily fined by a district court in Suzhou for distributing a counterfeit version of Microsoft Windows XP and other computer programs over the Internet.[102]

Trading Rights Authorization

In March 2008, the USTR requested WTO dispute resolution consultations with China regarding its discriminatory treatment of U.S. suppliers of financial information services in China. The United States claimed that China violates global trade rules by giving the Xinhua news agency the right to issue annual licenses for overseas media organizations, barring them from directly distributing information and soliciting subscribers in China. Xinhua was given sole power in September 2006 to regulate news services that distribute financial information in China, such as Bloomberg and Reuters—while it also is a direct competitor of such services. In response to the U.S. complaint, in November 2008 the USTR announced that China had agreed to eliminate discriminatory restrictions on how U.S. and other foreign suppliers of financial information services do business in China. The two sides signed an contract in which China agreed to have the State Council Information Office serve as a regulator. However, in April 2009 China raised the possibility of renewed information controls when the government said financial information providers must not engage in news-gathering in China.[103] The State Council Information Office published the regulations that formalized the agreement but also said in Article XIX that "foreign financial information providers set up in China . . . must not undertake news-gathering activities."[104] At the time of this Report's writing, it is unclear whether there will be any follow-up or requests for clarification from the U.S. side.

Chinese WTO Cases against the United States

In July 2009, China brought a WTO case against the United States over a provision in the Omnibus Appropriations Act of 2009 that in effect prohibits the establishment or implementation of any measures that would allow poultry products to be imported from China. At the center of the case is the 2006 rule issued by U.S. Department of Agriculture (USDA) that allowed China to export cooked poultry products to the United States as long as the raw poultry meat originated in the United States or Canada. In 2007, however, the U.S. Congress stopped the USDA from implementing the rule by inserting a provision in the 2008 fiscal year spending bill that prohibited the USDA from allowing chicken processed in China to be imported.[105] The same prohibition was included in the spending bill in the next two fiscal years. The Omnibus Appropriations Act of 2009, signed into law on March 11, 2009, includes a section that bans any funding from being used to "establish or implement a rule" allowing the import of poultry products from China. China's Ministry of Commerce said that U.S. restrictions on Chinese chicken imports were "totally unfair and of a bad nature" and in violation of WTO's most-favored-nation principle.[106]

In response to China's second request, after the first had been blocked by the United States, the WTO dispute settlement body established a panel. USDA and the USTR announced on September 25 that House and Senate lawmakers have agreed to a provision in the fiscal year 2010 agriculture appropriations bill that would allow imports of processed poultry or poultry products from China if certain conditions are met. The agreement mandates U.S. inspections of Chinese facilities before any cooked chickens could be imported, and more port-of-entry reinspections. The proposal also requires the Agriculture Department to report frequently to Congress on the implementation of any rule authorizing China to export poultry products to the United States.[107] The law that created the ban lacks health or safety rationale language that might justify it. U.S. poultry and other meat industries also argue that the law prevents the United States from using science-based arguments to effectively open markets overseas for U.S. meat exports.[108]

China has one other case pending against the United States. In September 2008, China initiated a WTO case against the United States on its concurrent use of antidumping and countervailing measures against certain Chinese-made steel pipes, tires, and laminated woven sacks. As of the date of this Report, no panel has been convened for the first case, while a panel was established but no report issued for the second case.

The Chinese Tire Case

When China joined the WTO, it agreed to the so-called "China-specific safeguard" that permits China's trading partners to impose tariffs on surges of Chinese imports if these imports harm domestic producers. This provision was codified in U.S. law in Section 421 of the 1974 Trade Act. On September 11, 2009, the White House announced its decision to impose remedies under Section 421 to stop a surge of imports into the United States of Chinese tires for passenger cars and light trucks.[109] Imports of Chinese tires have grown from 4.7 percent of the U.S. market in 2004 to 16.7 percent in 2008. The International Trade Commission determined that the surge of imports of Chinese tires has disrupted the U.S. market.[110] The duty will be 35 percent in the first year, 30 percent in the second, and 25 percent in the third (the International Trade Commission recommended 55 percent in the first year, 45 percent in the second year, and 35 percent in the third year). This "safeguard" provision was made part of China's accession agreement to the WTO in 2001 and allows American companies or workers to ask the government for protection simply by demonstrating a surge of Chinese imports.

Within hours of President Obama's announcement, the Chinese Ministry of Commerce accused the United States of protectionism and violation of international trade laws. Commerce Minister Chen

Deming, for example, called the imposition of tariffs a "serious protectionist act" that has "seriously damaged" the U.S.-China economic relationship.[111] This was followed by an announcement on September 14 that China's Ministry of Commerce has launched an investigation into whether "certain imported automotive products and certain imported chicken meat products originating from the United States" were being subsidized or "dumped" in the Chinese markets, although the Chinese government made no announcements linking the investigations to U.S. tire tariffs.[112] China has also requested formal consultation at the WTO regarding U.S. tariffs, a first step toward launching a dispute settlement.[113] On September 15, the Ministry of Commerce also announced that it was drafting measures to support the tire industry and related sectors to offset the impact of U.S. tariffs.[114]

Conclusions

- China's trade surplus with the United States remains near record levels, despite the global economic slowdown that has reduced imports from other nations. While the U.S. trade deficit in goods with China through August 2009 was $143.7 billion, representing a decline of 17.6 percent over the same period in 2008, China now accounts for an increasing share of the U.S. global deficit in goods. By September 2009, China had accumulated more than $2.27 trillion in foreign currency reserves.
- China's currency has strengthened against the U.S. dollar by about 21 percent since the government announced in July 2005 it was transitioning from a hard peg to the dollar to a "managed float" against a basket of currencies. Starting in July 2008, however, the RMB's appreciation was stymied by Chinese government policy as Beijing reimposed strict controls in order to support China's export industries. China's RMB remains significantly undervalued.
- China's growing cache of dollar reserves, a consequence of a deliberate Chinese government policy, is a continuing source of tension between the two countries. Chinese leaders profess alarm that the value of their dollar cache depends on the health of the U.S. economy and the willingness of the U.S. Federal Reserve system to hold down inflation. On the other hand, the size of China's dollar reserves makes it unlikely that China could divest its dollars without reducing the value of its dollar holdings.
- The Chinese leadership has become critical of the reserve currency status of the dollar, recommending a greater role for the IMF accounting unit, special drawing rights, and perhaps even preparing the RMB for internationalization. For now, the RMB remains nonconvertible. China is also seeking more influence within the IMF.
- China continues to use trade-distorting measures in violation of its WTO commitments. The WTO found that China failed to comply with its obligations in terms of enforcement of intellectual property rights laws and to provide sufficient market access to intellectual property rights-related products.