

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 2011

Introduction

In the ten years since China joined the World Trade Organization (WTO), China has maintained a steep growth trajectory, outpacing both Germany and Japan to become the second largest economy in the world. China’s gross domestic product (GDP) has grown from \$1.32 trillion in 2001 to a projected \$5.87 trillion in 2011. This represents an increase of more than 400 percent. In certain industries, such as automobiles, mobile handsets, and personal computers, China’s market already exceeds that of America’s. Concurrently, China has lifted 400 million of its citizens out of poverty and has experienced the largest rural-to-urban migration in history.¹

At the same time, the concerns that originally surrounded China’s accession to the WTO—that China’s blend of capitalism and state-directed economic control conflict with the organization’s free market principles—have proven to be prophetic. Although China did not meet all of the traditional requirements for accession, the WTO took a calculated gamble that China could effectuate the reforms necessary to conform to those requirements within a reasonable period of time. The U.S.-China Economic and Security Review Commission was established by the United States Congress in part to monitor the outcome of that gamble. Ten years later, China’s state-directed financial system and industrial policy continue to contribute to trade imbalances, asset bubbles, misallocation of capital, and dangerous inflationary pressures. Meanwhile, China’s legal reforms are in jeopardy from a bureaucratic backlash.² China’s adherence to WTO commitments remains spotty despite the decade that the country’s rulers were given to adjust. These circumstances create an uneven playing field for China’s trading partners and threaten to deprive other WTO signatories of the benefit of their bargain.

Each of these issues will be analyzed in detail in this section, beginning with an examination of U.S.-China trading relations, followed by U.S.-China financial relations and, finally, an evaluation of China’s role in the WTO. The fact that a decade has now passed since China’s controversial admission to the WTO means that

China is now relieved of its burden of facing an annual review by the WTO of China's compliance. This section will examine the implications of this change.

U.S.-China Trading Relations

For the first eight months of 2011, China's goods exports to the United States were \$255.4 billion, while U.S. goods exports to China were \$66.1 billion, yielding a U.S. deficit of \$189.3 billion. This represents an increase of 9 percent over the same period in 2010 (\$119.4 billion). During this period China exported four dollars' worth of goods to the United States for each dollar in imports China accepted from the United States. In 2010, the United States shipped just 7 percent of its total exports of goods to China; China shipped 23 percent of its total goods exports to the United States. In the ten years since China joined the WTO, the U.S. trade deficit with China has grown by 330 percent (see table 1, below).

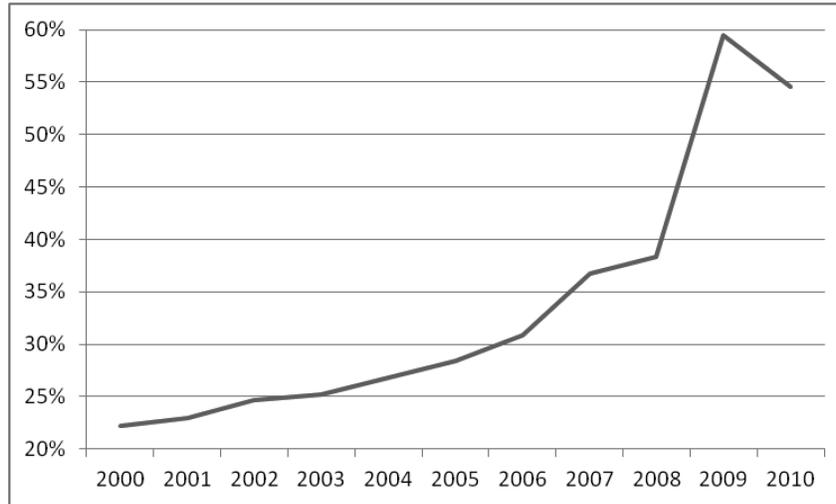
Table 1: U.S.-China Trade in Goods (\$ billions), 2000–2011 YTD

	00	01	02	03	04	05	06	07	08	09	10	11 (YTD)
U.S. Exports	16	19	22	28	34	41	55	65	69	69	91 ³	66
U.S. Imports	100	102	125	152	196	243	287	321	337	296	364	255
Balance	-83	-83	-103	-124	-162	-201	-232	-256	-268	-226	-273	-189

Source: U.S. Census Bureau, *U.S. Trade in Goods and Services* (Washington, DC: U.S. Department of Commerce, August 15, 2011).

At first glance, this trade deficit may appear to be explained by a broader trend of American dependence on imports, but this is not the case. In the first eight months of 2011, Chinese goods accounted for 20 percent of U.S. imports, while U.S. goods accounted for only 5 percent of Chinese imports.⁴ China's portion of America's trade deficit has increased considerably. While the overall U.S. trade deficit with the world has grown from \$376.7 billion in 2000 to \$500 billion in 2010, China's share of this deficit has nearly tripled during the period, from 22 percent in 2000 to 60 percent in 2009 and 55 percent in 2010 (see figure 1, below).

Figure 1: China's Share of the U.S. Global Trade Deficit (by percentage), 2000–2010



Source: U.S. Bureau of the Census, *U.S. Trade in Goods and Services* (Washington, DC: U.S. Department of Commerce, August 15, 2011).

These data suggest that the growth in the U.S. global trade deficit reflects growth in the U.S. trade deficit with China and that other emerging economies are being replaced by China as a final supplier of finished exports to the United States. Indeed, numerous international trade scholars have asserted a causal link between increases in China's trade surplus with the United States and decreases in the bilateral balance of trade of other nations of South and South East Asia with the United States.⁵

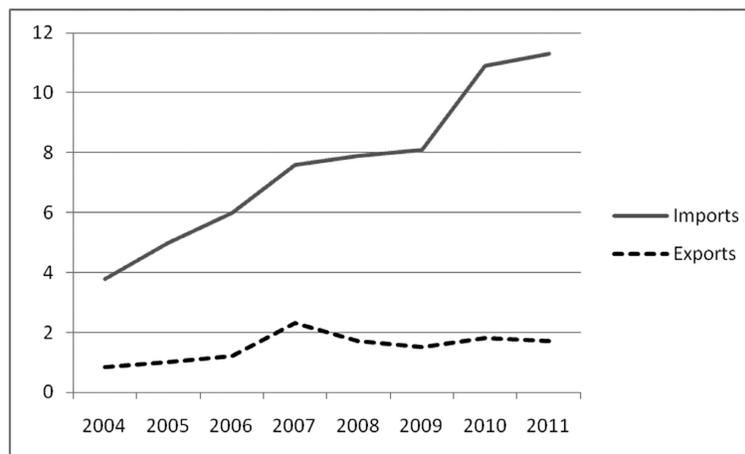
The more significant trend, however, is not the magnitude of the U.S. trade deficit with China but the composition of goods. Over the last ten years, Chinese manufacturing has undergone a dramatic restructuring away from labor-intensive goods toward investment-intensive goods. Production is driven increasingly less by low-cost labor and increasingly more by low-cost capital, which is used to build next-generation manufacturing facilities and to produce advanced technology products for export. This can be seen most clearly by examining Chinese exports of labor-intensive products, such as clothing and footwear, as a percentage of total exports. In 2000, exports of labor-intensive products constituted 37 percent of all Chinese exports. By 2010, this percentage fell by more than half had fallen to just 14 percent (see table 2, below).

Table 2: Chinese Labor-intensive Exports (as a percentage of total exports), 2000–2010

	2000	2005	2010
Apparel and clothing	24	10	9
Footwear	7	3	2
Furniture	3	2	2
Travel goods	3	1	1
Total	37	16	14

Source: Manufacturers Alliance, “U.S. and Chinese Trade Imbalances in Manufactures Surge” (Maple Grove, MN: Manufacturers Alliance Economic Report, ER-728, August 2011).

This shift has serious implications for the U.S. economy. As China joined the WTO, the United States had already lost production of low-value-added, low-wage-producing commodities such as umbrellas and coffee cups. But America’s export strength lay in such complex capital goods as aircraft, electrical machinery, generators, and medical and scientific equipment. China’s exports to the United States are increasingly from its capital-intensive industries, particularly advanced technology products. From 2004 to 2011, U.S. imports of Chinese advanced technology products grew by 16.5 percent on an annualized basis, while U.S. exports of those products to China grew by only 11 percent.⁶ In August 2011, U.S. exports of advanced technology products to China stood at \$1.9 billion, while Chinese exports of advanced technology products to the United States reached \$10.9 billion, setting a record one-month deficit of more than \$9 billion. On a monthly basis, the United States now imports more than 560 percent more advanced technology products from China than it exports to that country (see figure 2, below).⁷

Figure 2: U.S. Exports to and Imports from China of Advanced Technology Products in the Month of June (\$ billion), 2004–2011

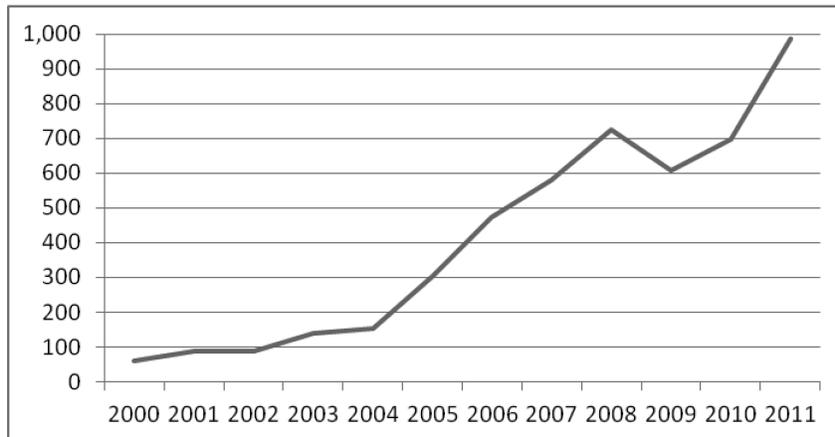
Source: U.S. Bureau of the Census, *U.S. Trade in Goods and Services* (Washington, DC: U.S. Department of Commerce, August 15, 2011).

The weakness in U.S. exports of advanced technology products to China is explained in part by barriers to market access experienced by U.S. companies attempting to sell into the Chinese market.⁸ According to a recent survey conducted by the American Chamber of Commerce in China, 71 percent of American businesses operating in China believe that foreign businesses are subject to more onerous licensing procedures than Chinese businesses.⁹ Additionally, twice as many respondents report that Chinese licensing strictures have grown more onerous over the last year than those who believe that licensing requirements have eased. Finally, four times as many respondents report that they have been harmed by national treatment as those who report that they were aided. Encountering market access barriers, however, is not unique to American business. A similar 2011 study by the European Chamber of Commerce in China found that inconsistencies in the procurement process employed by the Chinese central government resulted in a lost opportunity for European businesses that is equal in size to the entire economy of South Korea, or one trillion dollars.¹⁰

Import barriers are part of China's policy of switching from imports to domestically produced goods. In particular, part of China's "indigenous innovation" policy protects domestically produced goods by discriminating against imports in the government procurement process, particularly at the provincial and local levels of government.¹¹ (For a more complete discussion of the indigenous innovation policy, please see chap. 1, sec. 3, of this Report.)

By contrast, the monthly U.S. trade surplus in scrap and waste reached a record high of \$1.1 billion in August 2011. The annual U.S. trade surplus in scrap and waste grew from \$715 million in 2000 to \$8.4 billion in 2010, representing an increase of 1,187 percent, or 28 percent per year on an annualized basis (see figure 3, below). Unfortunately, however, the gains to the U.S. economy from this trend are limited, as the value-added component of scrap and waste is almost nothing.

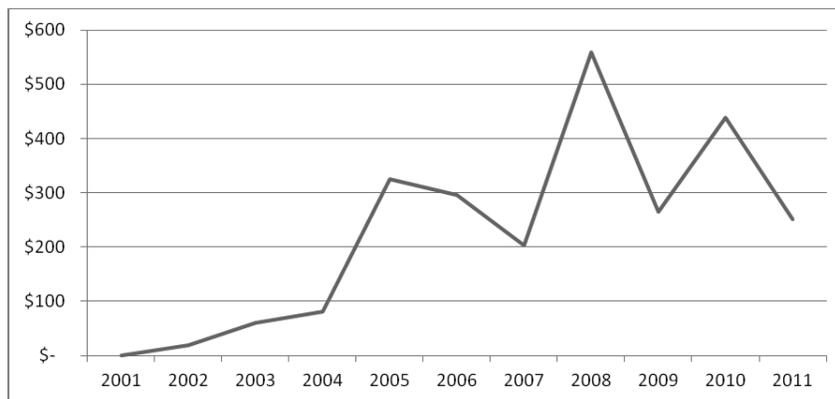
Figure 3: U.S. Trade Surplus in Scrap and Waste with China in the Month of June (\$ million), 2000–2011



Source: U.S. Bureau of the Census, *U.S. Trade in Goods and Services* (Washington, DC: U.S. Department of Commerce, August 15, 2011).

Similarly, the U.S. trade surplus in agricultural products with China has experienced dramatic growth (see figure 4, below). This trend has been fueled by higher grain prices in the Chinese market, greater demand for animal feed from Chinese farmers, and a series of water shortages that have left China more or less dependent on foreign sources of food. The inflationary antecedents to these trends are discussed in greater depth below.

Figure 4: July U.S. Surplus of Trade in Agricultural Products with China (\$ million), 2001-2011



Source: U.S. Bureau of the Census, *U.S. Trade in Goods and Services* (Washington, DC: U.S. Department of Commerce, August 15, 2011).

U.S.-China Financial Relations

U.S.-China financial relations are largely determined by two bedrock monetary policies of the Chinese government: a closed capital account and a closely managed exchange rate. Since 1994, the Chinese government has used a variety of methods to insulate the value of its currency from market forces that would otherwise have caused the renminbi (RMB) to appreciate against the dollar. In various policy statements and in its 12th Five-Year Plan (2011–2015), the Chinese Communist Party has once again identified gradual liberalization of the capital account as one of its priorities.¹²

Consequently, movement toward a more market-based currency has been slow and halting.¹³ Chinese merchants who export to foreign parties are still left with little choice other than to relinquish their foreign currency earnings to the state-owned banks in exchange for renminbi. Thus, when China runs a trade surplus, the supply of RMB in circulation grows.¹⁴ To counteract the inflation that would naturally spring from a rapidly expanding money supply, the Chinese government issues special bonds in an attempt to attract investors and thereby soak up the extra money.¹⁵ Thus, the government is left holding both foreign currency and RMB, and the Chinese public is left holding sterilization bonds denominated in RMB. The Chinese government must then reinvest the foreign currency if it is to avoid losing value to inflation. The Chinese government could pursue any investment strategy, but in order to satisfy

the second of its two primary monetary policies, namely, a managed exchange rate, it chooses to invest its foreign currency in bonds, primarily U.S. Treasury bonds.

This activity helps maintain the price of dollars relative to the RMB.¹⁶ To avoid a black market in foreign currency, the government requires that most Chinese businesses and citizens exchange their dollars at a bank, the large majority of which are state owned. Each day the central bank declares the price at which the state-owned banks will exchange dollars for RMB. Finally, in order to keep this maneuver affordable, the government must maintain an abnormally low domestic rate of interest. For if the prevailing interest rate at Chinese banks were to increase, then the government would be forced to increase the interest rate on sterilization bonds in order to maintain their attractiveness in the market, which would significantly increase the cost associated with the exchange rate policy. These conditions create a perfect setting for inflation, as the following data will illustrate.

In June 2011, China's foreign exchange reserves surged on strong trade surpluses to \$3.2 trillion, up nearly one trillion from \$2.4 trillion in June 2010, or roughly 30 percent year-on-year growth.¹⁷ China's foreign exchange reserves are now roughly three times greater than that of Japan, which has the second-highest foreign exchange reserves in the world. Roughly two-thirds of China's foreign exchange reserves are generally thought to be denominated in U.S. dollars, although the exact makeup of the reserves is unknown, because the Chinese government considers it to be a state secret.

Somewhat better known is the volume of China's foreign exchange reserves that are made up of U.S. Treasury securities. As of July 2011, the official estimate by the U.S. Treasury Department stood at \$1.2 trillion, up slightly from the same period one year before.¹⁸ The real amount is considerably higher, since the \$1.2 trillion does not take into account any purchases made on the secondary market nor does it factor in purchases made by intermediaries or made through tax havens, such as the Cayman Islands. (For a more thorough examination of this issue, see the Commission's *2010 Annual Report to Congress*, chap. 1, sec. 2, "The Implications and Repercussions of China's Holdings of U.S. Debt.")

China's decision to purchase U.S. government securities is not born out of any diplomatic beneficence but, rather, the economic self-interest of China, seeking to fix the exchange rate of the RMB to the dollar. In 2011, China's resolve was tested when a major rating agency reduced the credit rating of U.S. Treasury bonds. As the party with the largest holdings of U.S. government debt, China stands to lose the most from any drop in value of U.S. Treasury securities.

Beijing remained silent during the summer debt ceiling impasse in Washington.¹⁹ However, following Standard & Poor's downgrading of U.S. Treasury bonds, Guo Shuqing, the chairman of the China Construction Bank and former head of the State Administration of Foreign Exchange, opined that "[h]olding U.S. Treasuries contains certain risks, but at a time when the global economy is volatile and the euro zone is in deep difficulties, U.S. Treasuries, among all the not-so-ideal products, remain as the best product in

terms of safety and returns.”²⁰ Mr. Guo’s comment reflects the fact that China is committed to the outsized ownership of U.S. Treasuries by its choice of methodology in controlling the price of the RMB. In addition, as U.S. interest rates have declined, the market value of China’s Treasury holdings has increased. Standard & Poor’s downgrade of U.S. Treasuries did not affect this trend.

As a result of growth in foreign exchange reserves, China’s domestic money supply has skyrocketed, which has added to inflationary pressures. In May and June 2011, China’s M2 money supply, which includes checking, savings, and money market accounts, grew by more than 15 percent.²¹ From 2000 to 2010, aggregate M2 growth amounted to 434 percent, totaling more than \$10 trillion in U.S. dollars.²² By way of comparison, from 1996 to 2008, the U.S. money supply grew at an average annual rate of 3.5 percent and currently stands at \$1.005 trillion.²³ Considering that the U.S. gross domestic product (GDP) is still roughly three times greater than the Chinese GDP, this means that the Chinese money supply has grown to be roughly 30 times greater than the U.S. money supply when normalized to scale (see figure 5, below). Figure 5 depicts the growth over time of U.S. and Chinese M1 money supplies, which is equivalent to M2 minus savings deposits and time deposits.

Figure 5: Chinese M1 Money Supply by Year (100 Million RMB) 2004–2010



Source: Economics Junkie, November 18, 2010. <http://www.economicjunkie.com/inflation-money-supply-in-china/>.

Derek Scissors, an expert in the Chinese economy at The Heritage Foundation, characterized growth in the Chinese money supply in the following terms: “There are occasional, loud claims in China that the current bout of inflation was caused by quantitative easing in the United States. This is like blaming your brother-in-law’s binge eating for your weight gain. China’s 2008 stimulus package led to a 30-percent increase in the money supply in 2009. The

PRC's (People's Republic of China) monetary base is bigger than America's, even though its economy is less than half the size. Chinese inflation is home-made, and the recipe is simple."²⁴

Citing the danger that such money growth can pose, the Chinese government has pronounced the curtailment of inflation as one of its top economic priorities. But because the Chinese government relies upon issuing debt in order to carry out its managed exchange rate policy, it has limited options. Raising interest rates would require the government to pay higher interest on the sterilization bonds. Consequently, the only inflation-fighting weapon fully available to the government is raising the reserve requirement for banks in order to remove money from circulation, which it has done several times over the last year.²⁵ Beijing also initiated a campaign to rein in off balance sheet lending, a hallmark practice of Chinese banks.²⁶

In June 2011, Chinese Premier Wen Jiabao published an op-ed in the *Financial Times* claiming that these measures had succeeded in taming inflation.²⁷ Despite Premier Wen's assurances, inflation continued to rise. In September 2011, China's consumer price index hovered at 6.1 percent.²⁸ Food prices, the single largest driver of inflation, were up 13.4 percent. In the same period, housing prices went up 5.9 percent year on year, indicating the formation of a real estate bubble.

Not all of this inflationary activity is attributable to growth in money supply. Other factors play a role as well. For example, as rural-to-urban migration tapers off, manufacturers are finding it more difficult to keep their factories staffed. As labor shortages mounted, wages were increased in order to attract workers.²⁹ Consequently, households can afford to spend more on meat and grain, which drives up the price of agricultural commodities. China is also facing growing shortages of water, which further exacerbates inflation in farm goods. For a country that is increasingly reliant upon hydroelectric power, water shortages place upward pressure on the price of electricity.³⁰ This, in turn, drives up the cost of production in secondary industries.

Until recently, the greatest inflationary threat facing the Chinese government was rapid increases in the price of fixed assets, particularly real estate. In response to popular discontent, the Chinese government placed a priority on taming real estate prices, with some success.³¹ According to data released in mid-August, prices for newly built homes stayed level or decreased in 31 out of China's top 70 cities, including Shanghai, Beijing, Shenzhen, and Guangzhou.³² At the same time, the liabilities of China's property developers increased by 43 percent year on year, and the Guggenheim China Real Estate Fund, a popular exchange traded fund that tracks the performance of the Chinese property development industry, fell 28 percent from a year-long high of \$30.37 per share in November 2010 to \$21.96 in October 2011.³³

China's response to its inflation problem has drawn criticism because it failed to deal with China's capital controls as a cause of inflation. Economist Nigel Chalk of the International Monetary Fund likened China's Pyrrhic victory over property prices and subsequent surge in the consumer price index to an economic game of *Whack-a-Mole*.³⁴ Benjamin Simfendorfer, former chief China econo-

mist at the Royal Bank of Scotland, predicted that China's consumer price index will remain between 5 percent and 10 percent for the next decade.³⁵ And Nouriel Roubini, professor of economics at New York University, decried China's dependence on fixed asset investment as the principal driver of China's GDP growth and a factor in its inflation.³⁶ All noted that the Chinese government is merely treating the symptom, rather than the cause, of the inflation problem. Until the Chinese government fully liberalizes its capital account, and ceases manipulating its currency, China's trade surpluses will continue to inflate the supply of RMB in circulation. Until the Chinese government eliminates its reliance on sterilization bonds, Chinese savers will prefer the volatile real estate market as an investment vehicle over the negative real returns from bank deposits and bonds. Finally, until the Chinese government fully subjects the RMB to the dictates of market forces, the consumption share of China's GDP will remain stunted at around 35 percent—half the rate in the United States, according to many commentators.³⁷

On the positive side, the Chinese government allowed the RMB to rise by roughly 6 percent in nominal terms over the last year, from 6.775 RMB per dollar on July 16, 2010, to 6.370 RMB per dollar on October 17, 2011.³⁸ This is the second-fastest rate of appreciation since the Chinese government eliminated its hard peg to the dollar in 2005. Nonetheless, the US Treasury Department reports that the RMB remains “substantially undervalued.”³⁹ There is also nascent acknowledgement by Chinese academics that Beijing's intervention in the foreign exchange market has a measurable effect on the balance of trade, at least in certain sectors. For example, in a scholarly article published in the Chinese journal *Advances in Informational Sciences and Service Sciences*, researchers from Huazhang Agricultural University found that every 1 percent increase in the exchange rate between the RMB and the U.S. dollar leads to a 0.498 percent decrease in Chinese exports of citrus fruits.⁴⁰ Moreover, there is growing support among the engineers of China's monetary policy to expanding the range of the daily trading band beyond the current 0.5 percent, potentially accelerating the rate of appreciation.⁴¹

Meanwhile, the Chinese government is increasing its efforts to reduce its reliance on the dollar and nudge international debt markets toward the RMB.⁴² Last year, McDonald's became the first major multinational to issue an RMB-denominated corporate bond in Hong Kong, referred to by the financial community as *dim sum bonds*, which brought in RMB 200 million at a 3 percent yield.⁴³ Caterpillar followed with a much larger issue of RMB 1 billion at 2 percent.⁴⁴ In March 2011, Unilever paid an even lower yield of 1.15 percent in an issuance of RMB 300 million.⁴⁵ Morgan Stanley issued its own RMB 500 million round at 1.625 percent (see table 3, below).⁴⁶ Finally, the Chinese Ministry of Finance issued RMB 20 billion of sovereign debt, the largest RMB-denominated bond in history.⁴⁷

Table 3: RMB Bond Issuances by Multinational Companies, 2010-2011

	Issuer	Round	Yield
Aug-10	McDonald's	¥ 0.2 bn	3.000%
Nov-10	Caterpillar	¥ 1.0 bn	2.000%
Mar-11	Unilever	¥ 0.3 bn	1.150%
May-11	Morgan Stanley	¥ 0.5 bn	1.625%
May-11	Volkswagen	¥ 1.5 bn	2.000%
Total		¥ 3.5 bn	

Source: Fiona Law et al., "Caterpillar Yuan Bond Issue Draws Strong Demand," *Wall Street Journal*, November 24, 2010. <http://online.wsj.com/article/SB10001424052748703572404575634532182318468.html>.

¥ = yuan or renminbi

The low yields reflect the lack of alternatives available to Chinese retail investors. Some Chinese commentators have dismissed such corporate bond sales as publicity stunts by multinationals designed to appease the Chinese government. One financial analyst described McDonald's RMB bond as a "McGesture."⁴⁸ Others believe that these issuances are neither about fundraising nor politics but, rather, a method of benefitting from the appreciation of the RMB.⁴⁹

Still, others point out that the fledgling RMB debt market, despite having been in existence for only one year, has already achieved greater liquidity than the well-established debt markets of the Philippines, Indonesia, and Malaysia, with daily trading volume in excess of \$2 billion.⁵⁰ To put these numbers into perspective, during the first two quarters of 2011, the U.S. corporate bond market saw \$630 billion of new issuances (RMB 4 trillion), and the average daily trading volume was \$17.3 billion.⁵¹ Thus, the United States maintains an overwhelming lead in the issuance of new corporate bonds but only a modest lead in daily trading volume (see table 4, below).

Table 4: US and Chinese Corporate Bond Market Activity (\$ billion) 2011 Q1-Q2

	New Issuances	Daily Trading Volume
US	\$ 630.90	\$ 17.30
China	\$ 0.50	\$ 2.00

Source: Securities Industry and Financial Markets Association (New York, NY).

Meanwhile, a greater share of China's foreign trade is settled in RMB. In the first four months of 2011, cross-border, RMB-denominated trade exceeded the total amount of RMB-denominated trade conducted in all of 2010, 500 billion.⁵² Put in relative terms, RMB-denominated trade in the first quarter of 2011 represented 7 percent of China's overall foreign trade.⁵³ However, according to Yin Jianfeng, a financial researcher with the Chinese Academy of Social Sciences, as of the close of 2010, 80 percent of RMB-denominated trade concerned foreign companies importing into China.⁵⁴

Whereas using RMB to settle export trade helps to alleviate China's problems with foreign exchange, exchange rates, and inflation, using RMB to settle import trade actually aggravates those problems.⁵⁵ For example, if IBM uses RMB to settle import trade, it implies that at some time prior to the import transaction, IBM used dollars to buy RMB. It also implies that following the import transaction, the Chinese economy is left with more U.S. dollars and more RMB than before. The increased volume of RMB leads to further inflationary pressure for China, and the increased volume of U.S. dollars has the same effect as purchasing Treasury securities: It artificially decreases the supply of dollars in circulation in the United States, creates greater dollar scarcity, and promotes a low exchange rate with the RMB.

China has also made significant progress toward opening the door to RMB-denominated foreign direct investment (FDI).⁵⁶ Chinese policymakers are concerned about the magnitude of RMB deposits in Hong Kong, which stood at RMB 548 billion as of May 2011.⁵⁷ In relative terms, this represents 5 percent of the total volume of all RMB in circulation. Liberalizing RMB-denominated FDI on the mainland raises the prospect that some significant percentage of this money would be repatriated into the mainland, where it might go into speculative investments in real estate, thereby creating a bigger bubble.

China's Role in the WTO

The United States has brought three new, China-related disputes to the WTO since the date of the Commission's last Report. On December 22, 2010, the United States requested consultations with China over its subsidies for domestic manufacturers of wind power equipment (DS419). The European Union (EU) and Japan joined the consultations in January. The case has not yet advanced to the hearing stage. In the second pending case initiated this year, the United States on September 20 requested consultations with China regarding its imposition of antidumping duties on chickens imported from the United States. In addition, on October 6, 2011, the U.S. Trade Representative submitted information to the WTO identifying nearly 200 subsidies that China, in contravention of WTO rules, failed to notify to the WTO.⁵⁸

Three previous WTO cases involving U.S.-China trade are both open and active. The *Raw Materials* case, which resulted in a decision favorable to the United States, is under appeal as of August 31, 2011. The *Flat-rolled Electrical Steel* case and the *Electronic Payments* case have both advanced to formal dispute settlement, though no decision has been reached (see table 5, below).

Table 5: Open and Active WTO Cases Between the United States and China

Date Brought	Number	Title	Status
15-Sep-10	DS413	Electronic Payments	Panel established
15-Sep-10	DS414	Flat-rolled Electrical Steel	Panel established
23-Jun-09	DS394	Raw Materials	Under Appeal

Source: World Trade Organization Dispute Settlement Gateway. www.wto.org.

The United States has brought a total of seven cases against China at the WTO concerning subsidies or grants. Of the seven, four were settled through consultation, two were decided in favor of the United States, and one remains undecided (see table 6, below).

Table 6: WTO Subsidies Cases Brought by the United States Against China

Date Brought	Dispute	Short Title	Resolution	Date Resolved
18-Mar-04	DS309	Integrated Circuits	Settled	6-Oct-05
30-Mar-06	DS340	Auto Parts	Holding for US sustained on appeal	15-Dec-08
2-Feb-07	DS358	Taxes	Settled	19-Dec-07
10-Apr-07	DS362	Intellectual Property Rights	Held for US	26-Jan-09
3-Mar-08	DS373	Financial Services	Settled	4-Dec-08
19-Dec-08	DS387	Grants and Loans	No resolution	N/A
22-Dec-10	DS419	Wind Power	Settled	N/A

Source: World Trade Organization Dispute Settlement Gateway. www.wto.org.

China's WTO Probationary Period Ends This Year

During the negotiations leading up to China's accession, the United States and the European Union expressed concern about potential negative consequences that might befall the WTO due to China's sheer size and lack of a market-based economy.⁵⁹ Thus, they insisted on a series of China-specific admission requirements. The centerpiece of this "WTO-Plus" admission package was the Transitional Review Mechanism, which required China to submit to an annual review for the first eight years of its membership in the organization as well as a final review in the tenth year.⁶⁰ The Transitional Review Mechanism is in addition to, rather than in lieu of, the normal review procedure, known as the Trade Policy Review Mechanism, which all WTO members must undergo every few years in perpetuity.⁶¹

On paper, the temporary Transitional Review Mechanism appeared to be more stringent than the Trade Policy Review Mechanism. However, the procedural aspects of the Transitional Review Mechanism rendered it a paper tiger.⁶² Reports produced by the Transitional Review Mechanism require the unanimous consensus of all members involved, including China.⁶³ This puts China in the position of acting as judge in its own trial. According to trade scholars such as William Steinberg, the result consistently has been "light and generally unspecific criticism."⁶⁴

Nevertheless, the Transitional Review Mechanism has provided the United States with a somewhat useful tool for fact-finding and casting attention on controversies within the U.S.-China trade relationship. This is the tenth year of China's membership in the WTO and, therefore, the final year of the Transitional Review Mechanism. The consequences of this are twofold. First, the tools available to the United States to carry out fact-finding related to China's compliance with WTO obligations will now be limited to the

Trade Policy Review Mechanism and the various review channels of individual subsidiary bodies.⁶⁵ Second, China's membership in the WTO has reached a point of chronological maturity at which China was expected to be in full compliance with its WTO obligations.

When China initially acceded to the WTO, it accepted the China-specific rules contained in the protocol of accession, avoided litigation within the WTO, and was quick to comply with all demands of the WTO's dispute resolution process. Trade law scholars such as Henry Gao of Singapore Management University have characterized the first several years of China's membership in the WTO as a *rule taker*.⁶⁶ But after ten years of observing and learning the subtleties of WTO procedural law, Beijing's behavior has transformed into a *rule shaper*. Beijing has become much more aggressive about bringing claims against trading partners, appealing decisions that are rendered against its favor, and pushing the envelope of noncompliance. Additionally, China has grown very savvy about using the dispute settlement process and bilateral free trade agreements to undermine the effectiveness of China-specific rules.

According to a recent study by international trade law scholars at the University of Hong Kong, of the five WTO cases filed by China between September 2008 and March 2011, four of them were designed to use the dispute settlement process to change or undo rules contained in China's Accession Protocol.⁶⁷ These cases purposely turn on vague terminology found in the Accession Protocol. China has exploited this weakness by using a creative interpretation to render entire provisions inapplicable.

Since 2002, China has concluded nine free trade agreements and commenced negotiations for five more.⁶⁸ In all 14, a precondition to negotiation has been agreement by the other party to grant China market economy status. These preconditions are targeted toward eliminating certain restrictions placed upon China during accession to the WTO. In particular, when antidumping proceedings are instituted against China, the instituting party is allowed to draw price comparisons from third-party countries, in lieu of China, in order to show dumping behavior by Chinese companies.⁶⁹ Similarly, for purposes of identifying illegal subsidies and calculating countervailing measures, the instituting party may act with reference to prices and conditions prevailing in third-party countries in lieu of China.⁷⁰ Chinese trade officials view these provisions as a substantial drag on China's freedom of action within the international trading system. Under the terms of the Accession Protocol, however, China's nonmarket-economy status is set to expire in 2016, at which time these provisions will cease to have effect.⁷¹ It must be noted that the expiration in 2016 of China's status as a nonmarket economy under the Accession Protocol does not negate applicable U.S. domestic law, which will continue to have effect beyond 2016.

If enough WTO members accord market economy status prematurely to China, it will diminish support for Washington's position that China has a long way to go to merit market economy status. China has more bargaining power in bilateral negotiations with smaller nations than it does in multilateral negotiations at the WTO. It appears that by pushing for concessions from a series

of bilateral negotiations under the auspices of free trade agreements, China hopes gradually to undermine the Washington consensus, strong-arm its way into market economy status, and shake free of restrictive terms and obligations in its accession agreement.

Moreover, China is not willing to comply fully with the decisions of the WTO dispute settlement process and prioritizes the preservation of its own political system above fidelity to WTO commitments. This can be seen most clearly by examining a recent case study of China's failed compliance with WTO commitments.

Stonewalling the WTO: A Case Study in China's Intransigence

On April 10, 2007, the United States brought a complaint at the WTO alleging that China's state monopoly on imports of cultural products (such as movies, music, and magazines) was inconsistent with China's WTO obligation to permit, within three years of accession, all persons and enterprises, both foreign and domestic, to import and export all goods throughout the territory of China, except for a specific list of products reserved for monopoly by state-owned enterprises (SOEs).⁷² The cultural products at issue were not included in the list of exceptions negotiated by China and agreed to by the WTO. Thus, the United States claimed that the continued SOE monopoly over importing cultural products constitutes a violation of China's obligations. China attempted to defend itself by invoking Article XX(a) of the General Agreement on Tariffs and Trade, which allows members to adopt or enforce measures "necessary to protect public morals." China claimed that censorship of imported cultural products is critical to protecting public morals and that only SOEs could be relied upon to carry out censorship, therefore SOE monopoly on importation of cultural products should be allowed under the General Agreement on Tariffs and Trade.

The United States responded to this defense by proposing an alternative arrangement, which was to allow all persons and entities to import cultural products but require them to submit to China's Central Propaganda Department for censorship of each individual import. China rejected this proposal on the grounds of cost. Under the status quo, SOEs practice self-censorship, which leaves the workload of the Central Propaganda Department quite limited. Under the U.S. proposal, the Central Propaganda Department's workload would increase dramatically, thus requiring a significant expansion of payroll. On August 12, 2009, the dispute panel issued a ruling rejecting China's defense, finding that the U.S. proposal constituted a reasonable alternative to the status quo and mandating China to modify its policies accordingly. China appealed, and the appellate body upheld the ruling. China then announced its intention to comply with the ruling but requested a reasonable period of time to do so. In July 2010, the United States and China reached an agreement to set a deadline of March 19, 2011, for implementation.

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On March 19, 2011, the State Council of China published amendments to the *Regulations on the Management of Publications* and the *Regulations on the Management of Audiovisual Products*.⁷³ The effect of the amendments was to eliminate the requirement that importers be SOEs and, instead, create a process whereby any individual or entity, private or public, foreign or domestic, can apply to the Central Propaganda Department for a license to import cultural products. Because the government still retains unbridled discretion over which applications will be approved and which will be denied, in practical terms the amendments were empty and meaningless. The new process could just as well be used to grant licenses only to SOEs. Indeed, there is no record of any non-SOE receiving a license under the new rule. For this reason, scholars of international trade have opined that the March 2011 amendments fell far short of what would be required to constitute full compliance with the ruling in this case or the protocol commitment on which it was predicated.⁷⁴ Procedurally, the United States has the right to initiate further WTO proceedings to compel compliance or issue sanctions.

The full importance of this development becomes clearer in light of two elements. First, the issue in this case was not whether China should be allowed to practice censorship. The issue was whether China's self-professed censorship imperative is sufficient grounds to justify a state monopoly on importation of cultural products. Contrary to China's public insistence, the real reasons why China rejected the U.S. proposal have nothing to do with cost. First, China wishes to protect its domestic filmmaking industry. Second, adopting the U.S. proposal would set in motion a process that would destroy the effectiveness of China's censorship regime.⁷⁵ The reasoning behind this claim bears brief explanation.

The Central Propaganda Department relies upon SOEs to practice self-censorship. The department frequently sends notifications to the SOEs advising them which topics are politically sensitive, which news stories to delete, etc. Those notifications are actually considered state secrets, and publication can lead to severe punishment.⁷⁶ If the notifications were available to the public, it would undermine the censorship regime by creating a demand for the forbidden fruit. Additionally, by limiting the circulation of the notifications to SOEs and party members, the Central Propaganda Department retains maximum flexibility in what is considered off limits. If the U.S. proposal were adopted, then each time the Central Propaganda Department would reject a particular import, the private party applying to import that product would have actual knowledge of the fact that the product is being censored. Given the high degree of interaction between importers and the outside world, there would be no effective way to contain the spread of this knowledge. Moreover, private importers, particularly foreign importers, would demand some degree of predictability, which would necessarily come at the expense of the flexibility of the Central Propaganda Department.

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In sum, if the Central Propaganda Department were required to liaise with private parties, as the U.S. proposal called for, the genie would be let out of the bottle, and the subversion of the censorship regime would only be a matter of time.⁷⁷ For this reason, the WTO's decision in the *Publications* case, and China's failure to honor the decision, is critically important. It suggests that in cases of conflict between internal political preferences and international trade commitments, China will choose the former over the latter.

Implications for the United States

The U.S. trade deficit with China has ballooned to account for more than half of the total U.S. trade deficit with the world and creates a drag on future growth of the U.S. economy. This problem has many causes, among which are barriers to U.S. exports and continued undervaluation of the RMB. The result is lost U.S. jobs.⁷⁸ While the exact number of U.S. jobs lost to China trade is hotly disputed—economist C. Fred Bergsten has estimated 600,000 jobs on the low end, while the Economic Policy Institute has estimated 2.4 million jobs on the high end—many parties agree that the costs are staggering.⁷⁹

Although the RMB has appreciated by roughly 6 percent over the course of the last year, there is widespread agreement among economists that it remains deeply undervalued. As a result, U.S. exports to China remain subject to a de facto tariff, Chinese exports to the United States remain artificially discounted, and Chinese household consumption remains suppressed. This contributes to a persistent pattern of massive and dangerous trade distortions, unnatural pools of capital, and dangerous inflationary pressures that threaten the stability of the global economy.

Gone are the days when Beijing was content to be the low-end factory of the world. The central planners behind China's economy are intent on moving up the value chain into the realm of advanced technology products, high-end research and development, and next-generation production. This ambition will come at the expense of America's high-technology industries.

Similarly, it no longer seems inconceivable that the RMB could mount a challenge to the dollar, perhaps within the next five to ten years. Chinese financial authorities are laying the groundwork for these ambitions via a series of bilateral arrangements with foreign companies and financial centers. While dollar-denominated financial markets retain a substantial advantage over their RMB-denominated counterparts in terms of new issuances, the RMB markets have made remarkable progress in less than one year to achieve 11 percent of the daily trading volume of dollar-denominated markets. Still, of the \$4 trillion that is traded each day in international currency markets, trade in RMB accounts for only 0.3 percent. The dollar is one side of 85 percent of all currency trades.⁸⁰

Finally, the Chinese government is growing increasingly assertive in international fora such as the WTO. The United States and the European Union went to considerable lengths to design and negotiate a system of checks and balances that would permit China to accede to the WTO without jeopardizing the smooth functioning of the organization or endangering the position of existing members in the international trading system. From start to finish, that negotiation process took 15 years. In less than ten years, China has learned the nuances of WTO law and has begun to use it systematically to undo the finely wrought balance that U.S. and EU negotiators designed. At the same time, China has shown that it will subordinate its international commitments to its domestic political preferences and deny to its trading partners the benefit of their bargain.

Conclusions

- The U.S.-China trade deficit in 2010 set a record high of \$273 billion. The U.S.-China trade deficit now accounts for more than 50 percent of the total U.S. trade deficit with the world.
- Over the last 12 months, the RMB has appreciated by 6 percent. Economists estimate, however, that it remains substantially undervalued. There is increasing grassroots pressure in China to widen the trading band of the RMB and increase the pace of appreciation.
- The Chinese economy, generally, and Chinese exports, in particular, are moving up the value chain. On a monthly basis, the United States now imports roughly 560 percent more advanced technology products from China than it exports to China. Exports of low-cost, labor-intensive manufactured goods as a share of China's total exports decreased from 37 percent in 2000 to 14 percent in 2010.
- China's foreign currency reserves are skyrocketing. A major contributor to this phenomenon is China's continued policy of maintaining closed capital accounts. China's foreign currency reserves currently exceed \$3 trillion, three times higher than the next largest holder of foreign currency reserves, Japan.
- Commensurate with growth in foreign currency reserves, China's domestic money supply is ballooning out of control. Between 2000 and 2010, China's money supply grew by 434 percent. China's money supply is now ten times greater than the U.S. money supply, despite the fact that China's GDP is only one-third as large.
- Such rapid growth in China's domestic money has created strong inflationary pressure. This has helped create a real estate bubble, which resulted in price increases of more than 100 percent in some cities within a handful of years. In September, China's consumer price index topped 6.1 percent across the board and higher in rural areas.
- China has grown more assertive and creative in using WTO procedures to alleviate, eliminate, and avoid certain restrictions in the Accession Protocol. At the same time, the WTO has ruled

that China's existing system of state monopoly over imports of cultural products is inconsistent with WTO obligations. China has not yet complied fully with the WTO ruling, and the United States has the right to initiate further proceedings to compel China to do so.