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HEARING ON
"CHINA'S EMERGENT MILITARY AEROSPACE AND COMMERCIAL AVIATION CAPABILITIES"

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Chairman Slane, Vice Chairwoman Bartholomew, and distinguished members of the Commission, thank you for inviting me here today to discuss the relationship between the United States and China in commercial aerospace manufacturing. I am Principal Deputy Assistant Secretary for the Office of Manufacturing and Services in the International Trade Administration. Manufacturing and Services provides specialized industry expertise and economic analysis to foster America's economic competitiveness and job growth.

The aerospace industry has long been one of America's most competitive manufacturing industries. In 2009, U.S. aerospace exports were over $81 billion, giving aerospace the largest positive trade balance of any sector. Maintaining the long-term competitiveness of this industry—which employs more than 478,000 Americans—is therefore a priority for us.

China is an important market for U.S. aerospace exporters, and it presents a number of opportunities to expand U.S. exports and U.S. jobs. However, U.S. aerospace companies also face a number of challenges, many of which are shared by firms in other sectors. My testimony today will highlight some of these opportunities and challenges and also serve to answer the questions posed by the Commission. I will focus mostly on the market for commercial aircraft.

Outlook for American Sales

China is widely expected to be one of the largest markets for commercial passenger aircraft in the next 20 years. Growth in the Chinese fleet is being driven by annual double-digit growth in both passenger and cargo volume. Both Boeing and Airbus are predicting that approximately 3,800 more aircraft will be delivered to Chinese airlines by 2030. Based on list prices, the value for these aircraft would total over $400 billion. A majority of those aircraft will be in the narrow body market, including aircraft such as the Boeing 737 and the Chinese C919, currently in development. Today, the Chinese large civil aircraft market is roughly divided between Boeing and Airbus. ITA does not engage in forecasting but, in the near term, we do not anticipate any radical changes in that distribution, though we note that Airbus has been gaining market share in recent years. In the longer term, the entry into the market of new competitors, including the C919, makes it more difficult to predict. Since the U.S. is the only current producer of large civil aircraft outside of Europe, U.S. companies throughout the aerospace supply chain are well-positioned to capitalize on this growth, expanding U.S. exports and jobs.

The growth in passenger and cargo service demand also creates opportunities for U.S. exports in related industries. China is currently building 42 new airports, which will bring opportunities in construction, equipment sales, and airport retail. More planes also means more pilots to be trained by U.S. flight schools and more opportunities to sell parts and maintenance services. In addition, improving transportation throughout China will provide greater physical access to the Chinese market for the broad spectrum of American exporters.

Procurement from Chinese Suppliers

China is also a growing contributor to the global supply chain for aircraft and parts. Many U.S. and foreign aerospace firms have significant relationships with Chinese aerospace manufacturers, particularly in metal components. These relationships are not a recent development—U.S. companies have worked with Chinese suppliers for many years. While most of the interaction is on the component side, some western firms—Airbus and Embraer—have set up aircraft assembly facilities in China to provide commercial aircraft to the Chinese market. China also manufactures fuselage sections for Bombardier's Q-400 turboprops and is investing in the development of the C-Series passenger jet.

It is important to put the Chinese role in the U.S. aerospace supply chain into perspective. Historically, the U.S. has run a positive trade balance with China in aircraft and parts amounting to about $5.3 billion in exports in 2009. A significant portion of this figure is associated with new aircraft sales. On the supply side, in 2009, China shipped approximately $470 million worth of aircraft parts and equipment to the United States, representing just 2.12 percent of U.S. aerospace parts imports by value and trailing far behind countries such as France (20.2 percent), UK (16.9 percent), Japan (15.1 percent), and Canada (12.6 percent). We therefore conclude that the development of China's aviation sector has had a minimal effect on the U.S. commercial aviation industrial base, and has been limited mostly to component manufacturing.

For national security reasons, the U.S. has been unwilling to significantly advance China's state-of-the art aircraft design, materials, and production technologies since such technologies could be applied directly to their military aircraft developments. As a result, subcontracted work has

been limited to sheet metal fabrication, some hand lay-up of composite material, and some low-tech aero gas turbine engine component manufacture.

Participation in Chinese Aircraft Manufacturing Programs

U.S. companies are actively pursuing opportunities to become part of China's supply chain as Chinese aerospace manufacturers develop their own commercial aircraft. China's aircraft manufacturing industry is decades old, but it has mostly been concentrated in military applications. Since 1995, China has only exported $2 billion worth of aircraft. China has only one small passenger aircraft certified in the United States. The Chinese have been clear about their desire to gain western certification of the ARJ21 regional jet and the C919 narrow body so that it may be exported to western markets. China has actively sought participation of western firms in the development of these aircraft, particularly in the development of major subsystems such as engines or avionics. These programs represent significant commercial opportunities for U.S. firms.

Challenges

The growth of the Chinese aerospace sector also presents inevitable challenges for U.S. companies and U.S. policy makers. These include concerns regarding the relationship between civil and military production; the direction of Chinese industrial policy in the aerospace sector; and the extent to which government funding in this sector could unfairly subsidize Chinese producers in violation of China’s WTO obligations.

Military Manufacturing

Chinese aerospace firms are state-owned enterprises that have historically undertaken commercial and military manufacturing. U.S. export control regulations strictly restrict transactions of certain items that would directly and significantly contribute to China's military capabilities.

In 2008, China established the Commercial Aircraft Corporation of China Ltd. (COMAC) to focus on the commercial aircraft market. Other Chinese companies are involved in the commercial aircraft market, too. The extent to which the creation of COMAC, and other efforts to separate commercial from military work, are effective remains to be seen. It is clear, however, that China intends to develop new capabilities through its commercial programs, some of which could be then be used to support its military programs.

Industrial Policy

China has placed a high priority on developing a domestic capability in large aircraft manufacturing. Large passenger aircrafts are listed as one of 16 key science & technology major special projects established by the *"National Medium- and Long-Term Science and Technology Development Plan (2006-2020)."* The plan also identifies enhancing indigenous innovation capability in aircraft as a major science and technology development path for the transportation sector. Developing a large passenger airplane (C919) is a priority project in China's *11th Five-Year Plan (2006-2010)*. Civil aircraft is one of 18 categories of major technology equipment in

China's December 2009 "*Catalog Guiding Indigenous Innovation in Major Technology Equipment*", which encourages domestic development of specified industrial equipment.

Since the establishment of COMAC in 2008, China has announced new programs in aircraft engines and civil helicopters. In April, 2010, China invested in Epic Aircraft, a bankrupt U.S. manufacturer of experimental general aviation aircraft, in a bid to enter that market. While China encourages western partners in its aircraft manufacturing programs, foreign companies may not own Chinese aircraft manufacturers outright but must rather form joint ventures in which the majority share is retained by the Chinese partner. In addition, China has increasingly required that joint ventures be established as a condition for awarding manufacturing contracts. These joint ventures typically involve some element of technology transfer by the U.S. partner. The intention seems to be for China to develop domestic capabilities in subsystems in addition to airframes. In addition, while China does not have an official offset policy, and made a specific commitment not to impose aircraft offsets as part of its WTO accession, a company's "commitment" to building a relationship with China is a factor in purchasing decisions.

U.S. export control regulations identify the items that require a license for export to China. When a license is required, the U.S. government evaluates the license application to assure there are no national security risks associated with the transaction described in the application. Beyond that, U.S. firms must carefully weigh their competitiveness interests when determining how much proprietary technology they are prepared to share with prospective Chinese partners on these projects.

China's indigenous innovation practices for all industries are being scrutinized by ITA staff and the U.S. Government. We have raised concerns about China's innovation policies through numerous meetings, letters, and multilateral fora. During his trade mission this week and at next week's Strategic & Economic Dialogue Secretary Locke has and will continue to reiterate the concerns we have with these policies. Under Secretary Sanchez will also note our misgivings about these programs during next Wednesday's six month review of the progress of the Joint Commission on Commerce and Trade. While these discussions are aimed at eliminating specific problematic aspects of China's indigenous innovation policies, it is clear that, as a matter of industrial policy, China will continue to pursue the development of a domestically produced aircraft industry capable of supplying internal demand and some foreign customers as well.

Government Funding

The C919 is primarily a government funded project run by, COMAC, a state-owned enterprise (SOE) jointly owned by the Chinese central government, the Shanghai municipal government and several large SOEs.

The Department of Commerce is clearly concerned with ensuring that government support for Chinese aerospace producers does not unfairly disadvantage U.S. companies and is fully consistent with China's WTO obligations. The structure of Chinese government financing and the relationship to State Owned Enterprises make it difficult to make a clear determination regarding the nature of government support. To better understand the nature and terms of government funding in China's aerospace and civil aircraft industry, the Department of Commerce is closely monitoring Chinese government involvement in the industry. Staff from

the Subsidy Enforcement Office and the Beijing Office of the Import Administration are actively studying the issue. In addition, as part of China's WTO Transitional Review Mechanism in 2009, the United States requested that China provide further details on its support policies in the aerospace sector. We have also followed up on the issue with questions in the WTO's China Trade Policy Review currently being conducted. If necessary, after sufficient information has been gathered and subject to interagency and domestic industry review, the United States can request additional information regarding China's subsidies to the aerospace and civil aircraft industry under Article 25.8 of the WTO Subsidies Agreement through the WTO Subsidies Committee.

Global Competitiveness

It is our expectation that U.S. companies will be well-positioned to sell aircraft and parts in China over the short- to mid-term. The United States has been the largest supplier to the Chinese aerospace market almost every year since 1995, and China has been a top 10 market for U.S. aerospace exports since 1992.

Over the longer term, the global competitive landscape becomes more complicated. In addition to China's C919, new aircraft programs that would compete with U.S. manufactured products have been launched or rumored in Canada, Brazil, and Russia. The potential for success in any of these programs is uncertain. At the International Trade Administration, we will continue to ensure that U.S. companies have the opportunity to compete on a level playing field, so that the success of any program is based on the technical merits of the product rather than government intervention.