

## **SECTION 2: U.S.-CHINA BILATERAL TRADE AND ECONOMIC CHALLENGES**

### **Introduction**

The U.S.-China trade and economic relationship grows larger—and more unbalanced—with each passing year. China became the world's largest trading nation in 2013, overtaking the United States to register a record \$4.16 trillion in total exports and imports.<sup>1</sup> Like a mirror image of the United States, China's trade ledger was heavily weighted toward exports over imports. China enjoyed a global surplus of \$260 billion and a surplus with the United States of \$318.4 billion. As of the end of August, the U.S. trade deficit with China already stood at \$216 billion, about \$8.5 billion more than that time last year.<sup>2</sup> At this pace, the 2014 deficit will reach a historic high.

U.S. exports to China have grown—fourfold in the last decade—and China has become America's third largest export market, behind neighbors Canada and Mexico.<sup>3</sup> The United States shipped \$120 billion worth of goods to China in 2013, a 7 percent increase over 2012.<sup>4</sup> In 2014, U.S. exports to China also increased, totaling \$68 billion through the end of July, a 7 percent increase over the same period in 2013.<sup>5</sup> But the value of imports from China still dwarfs the value of our exports to China.<sup>6</sup> Americans turn to China to purchase computer and communications equipment, and apparel. China's main purchases from the United States are oil seeds, aircraft and parts, as well as waste and scrap. China thus has the benefit of selling more value-added goods, which tend to employ more workers at higher pay in the production process than does the marketing of commodities or lower value-added goods. Consequently, a growing percentage of the U.S. trade deficit also involves high-tech merchandise. The United States ran a \$116.8 billion deficit in advanced technology trade with China in 2013.<sup>7</sup> In short, Chinese exports to the United States are contributing to an increasingly sophisticated labor market while U.S. exports to China are falling short both in volume and in labor market value. Table 1 and Table 2 show top U.S. imports from China and exports to China between 2009 and 2013.

**Table 1: Total and Top U.S. Imports from China, 2009–2013**  
(US\$ millions)

Year	2009	2010	2011	2012	2013	Percent Change 2009–2013	Percent Change 2012–2013
Total Imports from China	296,402	364,944	399,335	425,644	440,434	48.5%	3.50%
Computer Equipment	44,818	59,800	68,276	68,815	68,123	51.9%	–0.10%
Communications Equipment	26,362	33,464	39,806	51,857	58,839	123%	13.50%
Miscellaneous Manufactured Commodities	30,668	34,168	32,672	32,644	32,440	5.7%	–0.60%
Apparel	22,669	26,603	27,554	26,926	27,410	21%	1.80%
Semiconductors and Other Electronic Components	12,363	18,263	19,835	19,012	19,363	56.7%	1.80%

Source: U.S. International Trade Commission DataWeb and Wayne M. Morrison, *China-U.S. Trade Issues* (Congressional Research Service, February 10, 2014).

**Table 2: Total and Top U.S. Exports to China, 2009–2013**  
(US\$ millions)

Year	2009	2010	2011	2012	2013	Percent Change 2009–2013	Percent Change 2012–2013
Total Exports to China	69,576	91,878	103,879	110,590	122,016	75.4%	10.30%
Oilseeds and Grains	9,376	11,208	11,500	16,546	16,092	76.4%	–2.70%
Aerospace Products and Parts	5,344	5,766	6,392	8,367	12,620	36.4%	50.80%
Waste and Scrap	7,142	8,561	11,540	9,526	8,765	22.7%	–8.00%
Motor Vehicles	1,134	3,515	5,369	5,788	8,614	660%	48.80%
Navigational, Measuring, Electromedical, and Controlling Instruments	2,917	3,782	4,275	5,153	5,732	96.5%	11.20%

Source: U.S. International Trade Commission DataWeb and Wayne M. Morrison, *China-U.S. Trade Issues* (Congressional Research Service, February 10, 2014).

Meanwhile, a rapidly growing stream of Chinese direct investment is flowing into the United States, which currently totals \$35.9 billion. More than \$14 billion of this amount was contributed in 2013 alone, and \$8 billion in the first quarter of 2014.<sup>8</sup> In 2014, the relationship between the two countries reached a milestone as

Chinese direct investment into the United States began to surpass U.S. direct investment into China.<sup>9</sup> Despite this recent change, China is not among the top sources of foreign direct investment in the United States. The top nine sources—the United Kingdom, Japan, the Netherlands, Canada, France, Switzerland, Luxembourg, Germany, and Belgium—collectively account for more than 80 percent of the total stock of foreign direct investment in the United States, while China, with less than 1 percent, is just one of 150 other countries that collectively account for the remainder.<sup>10</sup> However, China is the fastest growing source of foreign direct investment (FDI) globally, and in the United States, and its global outbound investment is expected to continue to grow exponentially in the years to come.<sup>11</sup>

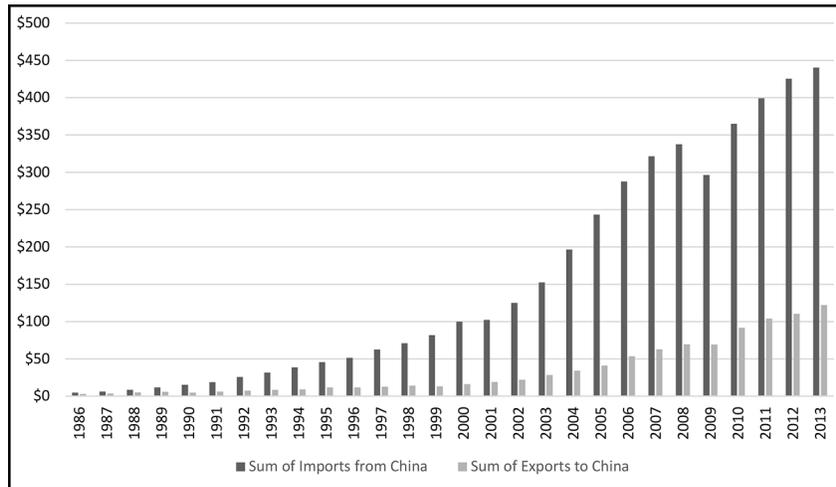
This section draws on the Commission’s February 21, 2014, public hearing on U.S.-China economic challenges. It advances the Commission’s continuing assessment of the impact of U.S.-China trade on U.S. employment and investment. It examines the effectiveness of U.S. diplomacy and the sufficiency of enforcement efforts in attempting to bring greater balance to the trading relationship. Finally, it assesses the motives and incentives driving Chinese investment in the United States and forecasts the potential impacts of this investment flow on U.S. labor markets.

## **The Impact of Bilateral Trade on U.S. Employment**

### ***Sizing up the Deficit***

U.S.-China bilateral trade reached a new peak of \$562 billion in 2013, but China shipped nearly four dollars’ worth of goods to the United States for every dollar’s worth of imports it purchased from the United States.<sup>12</sup> The resulting U.S. trade deficit with China set a record for the fourth straight year.<sup>13</sup> This deficit, non-existent three decades ago, is now the largest bilateral deficit in the world and three times the size of the second largest deficit, with Japan.<sup>14</sup> Figure 1 illustrates the rise in the U.S.-China trade deficit between 1986 and 2013.

**Figure 1: U.S. Trade Deficit with China: Annual 1986–2013**  
(US\$ billions)



Source: United States Census Bureau. <http://www.census.gov/foreign-trade/balance/c5700.html#2006>.

China's trade surplus in goods with the United States last year represented 41 percent of America's total global deficit in goods of \$703 billion.<sup>15</sup> The size of the overall trade deficit—and the bilateral trade deficit with China in particular—is a perennial source of concern in the U.S. about “declining competitiveness, job losses, and unfair trade practices by Chinese companies.”<sup>16</sup> In a February 2014 press release, Alliance for American Manufacturing President Scott Paul blamed the U.S. trade deficit with China for “a shrinking middle class” and “fewer good job opportunities,” and described the deficit as “further proof that our economic policies—including a lack of enforcement of existing trade laws—contribute to outsourcing.”<sup>17</sup> A 2012 Gallup poll found that a majority of Americans (66 percent) believe the trade deficit with China is a major barrier in the bilateral relationship, and 52 percent of Americans see China's economy as a critical threat to U.S. vital interests in the future.<sup>18</sup>

Yet some economic theories support the opposite conclusion: that trade creates jobs overall when nations specialize in producing goods in categories where they enjoy an advantage due, perhaps, to an abundance of natural resources or transportation routes. Even where no actual advantage exists in any particular good, according to David Ricardo's classic economic theory a “comparative advantage” falls to the nation that is able to specialize in production.<sup>19</sup> The Organization for Economic Cooperation and Development (OECD), for example, argues that “liberalized trade is an engine for job creation in all countries.”<sup>20</sup> The United States International Trade Administration (ITA) cites statistical evidence that exports supported the creation of 1.6 million jobs between 2009 and 2013. This perspective on trade, however, assumes that nations follow generally accepted international trade rules, are market ori-

ented and not dominated by state-owned enterprises, and that commercial ventures are not provided lavish government subsidies or government protection from imports. Such is not the case with China, whose longstanding industrial policies call for running large trade surpluses by discriminating against imports in favor of domestically produced goods.\* China hurts the U.S. economy “by undermining our comparative advantage,” notes Derek Scissors, an economist at the American Enterprise Institute. He notes that China protects its domestic industries by blocking some U.S. exports. The Chinese government also “reserves large parts of its market for state-owned enterprises” which compete unfairly. Finally, as the world’s “biggest thief” of American intellectual property, China “undermines our biggest advantage in trade,” says Dr. Scissors.<sup>21</sup>

Economic Policy Institute economist Robert Scott told the Commission at its February 21 hearing that while exports support U.S. jobs, imports undermine jobs in import-sensitive industries and in related industries. Thus, Scott contends, while trade can create jobs, it is “the trade balances—the net of exports and imports—that determine the number of jobs created or displaced by trade agreements.” Dr. Scott argues that if liberalized trade relations do not raise exports more than imports, there will not be a net job gain.<sup>22</sup> Although the extent to which growing bilateral trade deficits have shifted jobs from the United States to China is unclear, Dr. Scott believes as many as 2.4 million American jobs have been lost or displaced as a result of China joining the World Trade Organization (WTO) in 2001.<sup>23</sup> This would represent a significant portion of the 3.6 million reduction in manufacturing jobs in the United States since December 2001.<sup>24</sup>

Other economists disagree as to the extent to which trade with China is responsible for U.S. job losses. According to the Chicago Council’s Philip Levy, equating a given value of trade with a given number of jobs is a “popular—and deeply flawed—shortcut.” He points out that Dr. Scott’s analysis assumes any imports that did not come from China would be replaced with U.S. production even though there is much reason to believe that production would simply shift to other countries where it could be done more cheaply than it can be done here at home.<sup>25</sup> But Dr. Scott is not an outlier in his conclusion that the economic relationship has cost American jobs, especially in the manufacturing sector. Yale economist and Commission witness Peter Schott published a National Bureau of Economic Research study in 2013 demonstrating that closer trade relations with China have depressed American manufacturing job growth.<sup>26</sup> Dr. Schott’s findings are corroborated by an earlier study led by Massachusetts Institute of Technology economist David Autor, which found that “increased exposure to low-income-country imports [such as those from China] is associated with rising unemployment, decreased labor-force participation, and increased use of disability and other benefits, as well as with lower wages.”<sup>27</sup> Yet even as some critics decry the costs of U.S.-China trade, proponents counter that China is a source of affordable goods for American

\*For further descriptions of China’s industrial policies, see the U.S.-China Economic and Security Review Commission’s *2012 Annual Report to Congress*, Chapter 1, Section 3, “The Evolving U.S.-China Trade and Investment Relationship,” p. 82.

consumers, which raises their buying power. Proponents of trade agreements with China also note China's growing significance as an export market for U.S. goods, and the opportunities for U.S.-based companies to invest in the Chinese market. In 2013 alone, U.S. companies invested \$3.4 billion in China.\*

### ***Gross vs. Value-Added Measurements of Trade***

One view is that different stories are borne out by different calculations. The WTO and the OECD argue that traditional trade data distorts our understanding of bilateral trade balances.<sup>28</sup> They advocate the use of value-added measurements of trade, which have the effect of reducing the U.S. trade deficit with China. This accounting methodology was highlighted in the February 21 hearing discussion of value added, a topic that has garnered growing attention in recent years and was taken up in depth by the Commission in 2012.† Whereas traditional measurements of trade attribute the entire value of a good to the country in which it last underwent processing, value-added measurements account specifically for the value contributed to the good while in that country. Although China is the final assembly place for many goods exported to the United States, it often adds comparatively little value to those goods. Applying value-added measurements to the bilateral trade relationship could reduce the perceived deficit with China by approximately 25 percent, according to the WTO and the OECD.<sup>29</sup> These measurements particularly impact perceptions where high-tech goods are concerned, because technology goods tend to be high-value, but China may add only marginal labor-assembly value to the high-tech goods it exports.<sup>30</sup>

Because value-added measurements of the deficit portray the trade imbalance as much smaller than is suggested by traditional measurements, it might be assumed that the damage sustained by the U.S. labor market has been overstated as well. But value-added measurements of trade do not alter the overall trade deficit. They merely reapportion responsibility among the surplus countries. Regardless of how the bilateral trade balance is measured, U.S. employment in some sectors has clearly declined as trade with China has increased. The negative impact the trade relationship has had on employment in those sectors is not diminished by the lower deficit estimates that value-added measurements produce. In fact, as Dr. Schott noted, in the U.S. manufacturing sector, value added has increased even as employment has declined. This means the percentage of total value a country adds to its goods is not necessarily a reflection of the health of its labor market.<sup>31</sup> U.S. manufacturers appear in some instances to have increased value added by applying more efficient technologies and simultaneously cutting workers—reducing jobs while increasing their share of the total production process precisely to improve their ability to compete

\* See "China 2013 Foreign Investment Inflows Hit Record High," Reuters, January 16, 2014. <http://www.reuters.com/article/2014/01/16/us-china-economy-fdi-idUSBREA0F0E120140116>; Derek Scissors, *The U.S. and China: Jobs, Trade, and More* (Heritage Foundation, October 11, 2012). <http://www.heritage.org/research/reports/2012/10/the-us-and-china-jobs-trade-and-more>; and "Shades of Grey: Ten Years of China in the WTO," *The Economist*, December 10, 2011. <http://www.economist.com/node/21541408>.

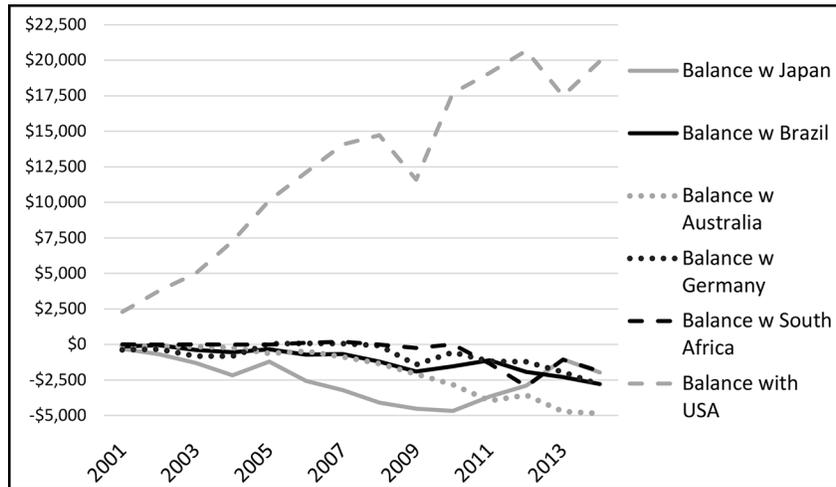
† See the U.S.-China Economic and Security Review Commission's *2012 Annual Report to Congress*, Chapter 1, Section 3.

with China.<sup>32</sup> Furthermore, increased value added is often achieved by more skilled and more highly paid workers, so these developments have been a boon to some American workers, but they have nevertheless translated to fewer American jobs overall.

### ***Permanent Normal Trade Relations (PNTR) and China's WTO Accession***

Some analysts maintain that a contributing factor in the development of the trade imbalance was the decision to allow China to join the WTO in 2001 without making it first fully commit to removing all barriers to imports.\* While U.S. manufacturing employment has long been in decline, and has dropped 34 percent from its peak in the 1970s, China's WTO entry and initial membership years coincided with a particularly precipitous dip.<sup>33</sup> Dr. Schott noted in his testimony that there was an 18 percent drop in U.S. manufacturing employment from March 2001 to March 2007. Dr. Scott calculates that "since China entered the WTO in 2001, job losses have increased to an average of 353,000 per year."<sup>34</sup> China currently holds bilateral trade deficits with Australia, Germany, and Japan.<sup>35</sup> The European Union's trade deficit with China declined from \$236 billion in 2008 to \$182 billion in 2013.<sup>36</sup> Yet, China's trade surplus with the United States continues to grow. Figure 2 illustrates the growth of the U.S. trade deficit with China over time, as compared to surpluses with China maintained by developed nations on each of the other continents.

**Figure 2: China's Monthly June Bilateral Trade Balance with the United States vs. Other Developed Nations, 2001-2014**  
(US\$ millions)



Dr. Schott's research indicates that the U.S. decision to grant permanent normal trade relations (PNTR), which paved the way for China to join the WTO and receive most-favored nation status

\* See for example David Shambaugh, *China Goes Global: The Partial Power* (New York, NY: Oxford University Press, 2013).

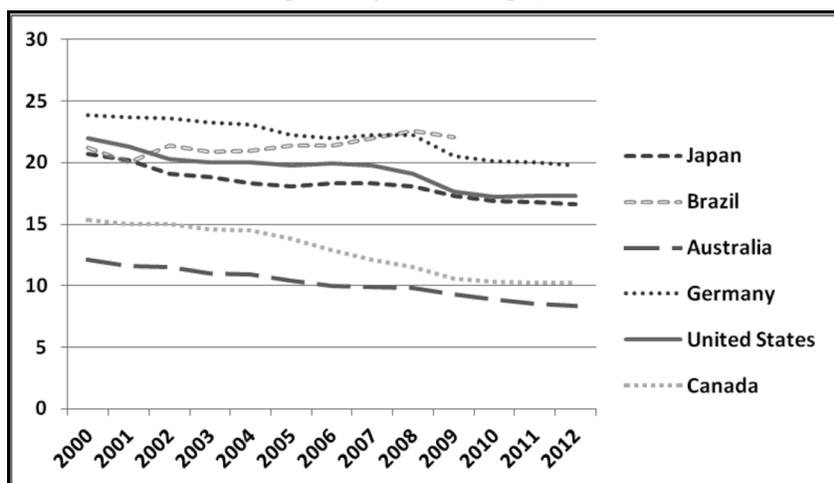
(MFN),\* led to the 18 percent U.S. employment drop in the ensuing years. According to Dr. Schott, a clear correlation exists between the jobs dip and the U.S. granting PNTR to China, which preceded China's entry into the WTO.<sup>37</sup> Once China had permanent MFN status and WTO membership, the yearly voting requirement ended, and U.S.-based corporations could invest in China with confidence that Congress would not revoke China's MFN status, which would have raised tariffs on Chinese exports to the United States. With the uncertainty removed, foreign investment in China climbed dramatically, funding foreign-invested factories and jobs producing exports bound for the United States and Europe. In 2012, China surpassed the United States to become the world's top destination for FDI.<sup>38</sup> FDI into China rose from \$40 billion per year in 1999<sup>39</sup> to \$95 billion in 2009 and \$117.59 billion in 2013.<sup>40</sup> Since China joined the WTO, foreign-invested enterprises have accounted for between 45 and 60 percent of Chinese exports annually.<sup>41</sup> In recent years, the United States has consistently ranked as China's fifth-largest source of FDI, behind Hong Kong, Taiwan, Singapore, and Japan. China's Ministry of Commerce reported U.S. FDI into China of \$3.35 billion in 2013.<sup>42</sup> In 2013, an estimated 55 percent of all exports from China to the United States were from foreign-invested enterprises—80 percent in the case of advanced technology products.<sup>43</sup>

As Chinese imports rose, U.S. employment fell across a range of manufacturing sectors, but this impact was most dramatic in those U.S. industries where tariffs had previously stood to rise most significantly if Congress did not renew annual MFN rates. According to Dr. Schott, it was this "ending of the possibility of sudden spikes in Chinese import tariffs that likely strengthened import competition and suppressed U.S. employment growth."<sup>44</sup> Dr. Schott notes that the "very large" decline in U.S. manufacturing was more precipitous in the 2001 to 2007 period than in response to the 2008 international economic crisis.<sup>45</sup> "In absolute levels, manufacturing employment is kind of sideways until you get to about (2001) and then it falls off a cliff," he testified. Figure 3 indicates the declines in the percentage of manufacturing employment since 2000 in several of China's major trading partner countries.

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\* MFN or PNTR, as it came to be known. China was provided permanent most-favored nation status by Congress as part of its successful efforts to negotiate the terms of its entry into WTO membership. Previously, the administration could grant temporary MFN status each year under the terms of the Jackson-Vanik Amendment (Section 401, Title IV of the Trade Act of 1974, P.L. 93-618) that governed U.S. trade relations with communist countries that restrict freedom of emigration and other human rights. While successive administrations granted China annual waivers from the Jackson-Vanik Amendment, Congress each year debated rescinding the waiver, as provided for in the Amendment. The debate in Congress became particularly heated after the 1989 massacre of students and prodemocracy protestors at Tiananmen Square. But Congress never succeeded in revoking the administration's yearly grant of temporary MFN status to China. After a debate in which supporters championed the benefits of China's WTO accession, the House approved PNTR for China on May 24, 2000. The Senate gave its approval in September 2000.

**Figure 3: Comparative Declines in Manufacturing Jobs in Countries Trading with China, 2000–2012**  
(as percentage of total employment)



Source: "Brazil: Distribution of Employment by Economic Sector from 1999 to 2011," Statista. <http://www.statista.com/statistics/271042/employment-by-economic-sector-in-brazil/>; Federal Reserve Bank of St. Louis.

The granting of permanent MFN status also had three other effects which drove down employment in the United States, according to Dr. Schott. China's new MFN status encouraged more U.S. businesses to outsource their manufacturing to Chinese subcontractors. This trend was already underway in low value-added manufacturing, such as clothing and shoes, but it accelerated, particularly in the field of electronics. In addition, Chinese manufacturers were also reassured by the granting of permanent MFN status that they could count on the United States as a more reliable market. With the advantage of lower labor costs, lower costs of capital due to below-market rate loans from state-owned banks, and with other government tax inducements to export, Chinese manufacturers responded to the call to increase exports.<sup>46</sup>

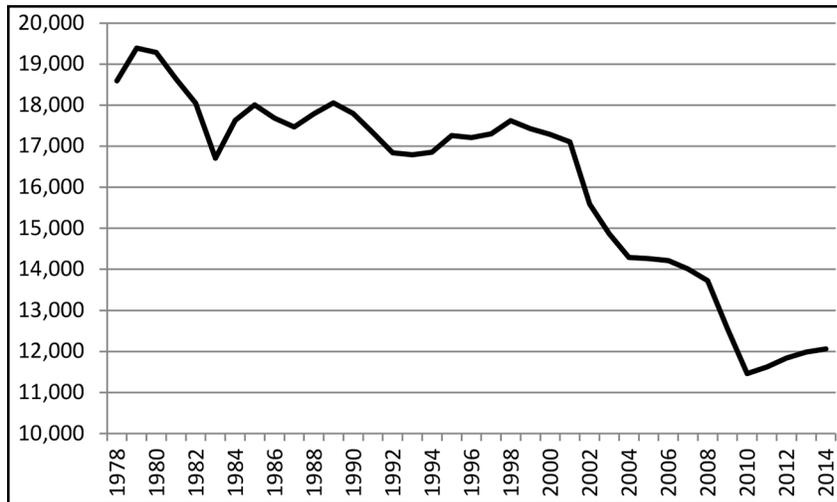
Finally, U.S.-based manufacturers who elected to maintain production in the United States felt comfortable doing so if they were able to cut production costs in domestic plants—often by automating to reduce labor costs. "U.S. manufacturers both used technology that substituted away from workers to make the things that they were making before, but they also substituted out of labor intensive manufacturing and into the higher-value-added [sectors] that you think the U.S. has a comparative advantage in, as is completely predicted by most views of trade," said Dr. Schott.<sup>47</sup>

Among other indirect causes of declining employment in U.S. manufacturing brought on by China's WTO membership were the provisions for limiting foreign investment in certain manufacturing operations in China, according to the testimony of Oded Shenkar, an Ohio State University economist who has studied the effects on the U.S. automobile industry of trade with China. Dr. Shenkar pointed to a Chinese prohibition on majority ownership of auto

plants in China as one cause for U.S. job losses. The prohibition facilitated Chinese efforts to obtain process technology in vehicle manufacturing because foreign firms interested in participating in the Chinese auto industry were forced to bid on the chance to become minority shareholders in joint ventures with Chinese companies, often with contractual obligations to share their technology with the Chinese partner and to assist the partner in developing a Chinese car brand. “The Chinese have done a remarkable job of absorbing this technology ... and they are now ready to take it to the next level,” he said. “We are entering an imitation age, meaning that it is easier to imitate, it is more beneficial to imitate.”<sup>48</sup> As a result, China has quickly developed a sophisticated vehicle manufacturing capability that could supply most of the Chinese market without imports from North America or Europe.

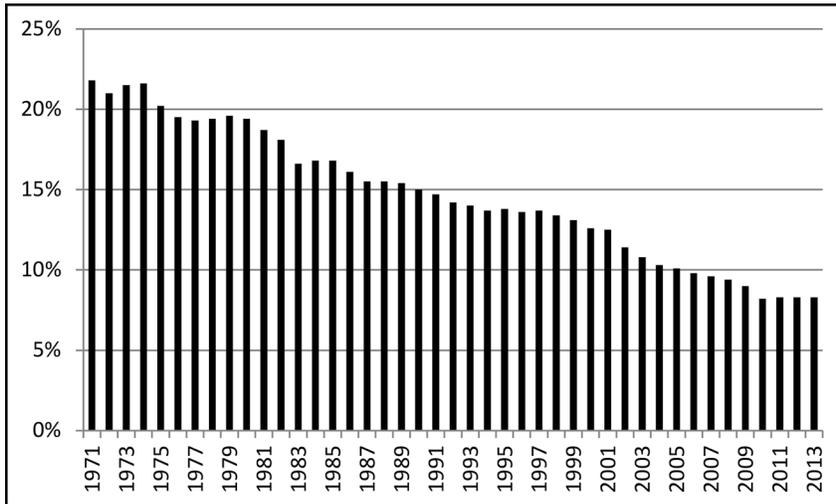
Figure 4 and Figure 5 show the decline of U.S. manufacturing jobs and the growth of the U.S. trade deficit with China since the late 1970s. As a percentage of total U.S. employment, manufacturing jobs have dropped from 21.8 percent in 1971 to 8.3 percent in 2013.<sup>49</sup> Figure 6 shows how the U.S. trade deficit with China has grown over time.

**Figure 4: U.S. Manufacturing Jobs in Thousands, January 1978–January 2014**



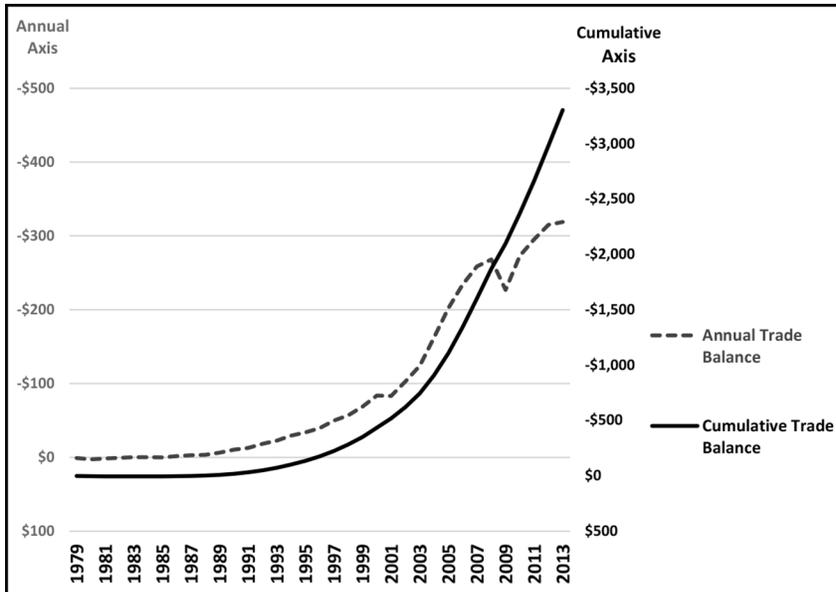
Source: U.S. Bureau of Labor Statistics.

**Figure 5: Manufacturing as a Percentage of Total U.S. Employment, 1971–2013**



Source: U.S. Bureau of Labor Statistics.

**Figure 6: U.S. Trade Balance with China, 1979–2013**  
(US\$ billions)



Source: 1979–1984 numbers from International Monetary Fund, via China Business Review, March–April 1985; 1985–2013 (through November) numbers from U.S. Census Bureau.

### Managing the Bilateral Trade Relationship

When China joined the WTO in 2001, Beijing committed to sweeping reforms, which required “changes to hundreds of laws, regulations, and other measures affecting trade and investment,” according to the office of the U.S. Trade Representative (USTR).<sup>50</sup> China’s very motivation for joining the WTO was “rooted in the realization that it needed an external impetus to overcome domestic obstacles to further reforms . . . if it was to sustain the rapid economic growth of the 1980s and 1990s,” according to supporters of China’s WTO entry.<sup>51</sup> But in 2003, the Hu Jintao leadership came to power and began emphasizing increased state involvement in the economy, leading to institutionalized preferences for state-owned enterprises and other state interferences that conflicted with the market reforms envisioned by the United States as well as other trading partners, and promised by China itself. The report from the Third Plenum calls for the market to play a “decisive role” in the allocation of resources in the economy, rather than the “fundamental role” it has previously been allocated. But thanks to the policies of the Hu Jintao era, China has already solidified its role as the workshop to the world, according to David Shambaugh, director of the China policy program at the George Washington University. Says Dr. Shambaugh:

*Currently, it is the world’s largest producer of household and office furniture sets, machine tools, lubricant oils, lithium ion batteries, Christmas ornaments, footwear, cameras, computers, televisions, tape recorders, instrumentation, cloth and nylon fibers, textiles, plastics, stainless steel, washing machines, watches, mobile phones, and other consumer durables. In 2014 China is projected to overtake Australia as the world’s largest wine producer by volume.*<sup>52</sup>

According to a 2012 report from the Information Technology and Innovation Foundation, “While virtually all governments have crafted economic development policies to boost competitive advantages, China has developed the most comprehensive set of policies, with most of them violating the spirit, if not the letter of the law of the WTO.”<sup>53</sup> Currency manipulation, subsidies, tariffs, forced technology transfers, export restrictions, manipulative standard setting and other policies have been used to “gain an absolute advantage” for Chinese companies across a wide array of industries, to the detriment of competitors in the United States and globally.<sup>54</sup> While the WTO membership committed China to adopt free market policies, its divergence from WTO rules and principles benefited China at the expense of its rule-following trading partners.

The United States has relied on a combination of dialogue and enforcement efforts to try to address the range of problems arising from Chinese state capitalism and to encourage China to uphold its WTO accession commitments. Washington has pressed 15 of the 31 WTO cases brought against Beijing to date, more than twice as many as any other WTO member.<sup>55</sup> (For a detailed list of pending cases before the WTO involving the United States and China, see Chapter 1, Section 1, “Year in Review: Economics and Trade.”) In addition to these enforcement efforts, high-level diplomatic engage-

ments are scheduled throughout each year in the form of the biannual meetings of the Joint Commission on Commerce and Trade (JCCT), the annual meetings of the Strategic and Economic Dialogue (S&ED), and a host of related meetings. In many respects, however, these efforts have been ineffective, as underscored by the annual reports to Congress on China’s WTO compliance, in which the Office of the United States Trade Representative highlights many of the same issues year after year.\*

**Dialogues—All Talk, Little Action**

The JCCT was established in 1983 to focus on bilateral economic issues, and the S&ED was launched in 2006 (originally as the Strategic Economic Dialogue), to serve as a bilateral framework for managing a wide array of political, economic, and security issues. These dialogues are intended to act as information-sharing forums and to facilitate reciprocity and collaboration.<sup>56</sup> They provide structure to the bilateral relationship, offering “a degree of assurance that diplomatic relations will not be allowed to regress beyond a certain point.”<sup>57</sup> Face-to-face meetings are supposed to grease the wheels for collaborative action, and in the last decade, the number of meetings has proliferated as both sides have identified more and more issues in need of attention. The JCCT includes at least 13 trade-related dialogues and working groups, four devoted to intellectual property rights, and seven that are sector specific, while the S&ED has at least 30 working groups and dialogues of its own.<sup>58</sup> Figure 7 and Figure 8 show the range of trade and economic working groups and dialogues associated with the JCCT and S&ED, respectively.

**Figure 7: Working Groups and Dialogues of the Joint Commission on Commerce and Trade**

<b>Working Groups that Meet Throughout the Year</b>	
Agriculture	Pharmaceuticals and Medical Devices
Commercial Law	Sanitary and Phytosanitary
Environment	Statistics
High Technology and Strategic Trade	Steel
Industries and Competitiveness	Structural Issues
Information Industry	Trade and Investment
Insurance	Trade Remedies
Intellectual Property	Travel and Tourism
<b>Additional Known JCCT Working Groups and Dialogues that Meet or Have Met Irregularly</b>	
<i>Trade</i>	<i>Intellectual Property Rights</i>
Transparency Dialogue	Intellectual Property Rights Law Enforcement Group
Trade Remedies Working Group	Intellectual Property Rights Criminal Enforcement Working Group
Antimonopoly Dialogue	
Commercial Law Working Group	

\*Prepared pursuant to section 421 of the U.S.-China Relations Act of 2000 (P.L. 106-286), 22 U.S.C. §6951, which requires USTR to report annually to Congress on China’s compliance with commitments made as part of its 2001 accession to the WTO, including multilateral commitments and bilateral commitments made to the United States.

**Figure 7: Working Groups and Dialogues of the Joint Commission on Commerce and Trade—Continued**

<b>Additional Known JCCT Working Groups and Dialogues that Meet or Have Met Irregularly</b>	
<i>Trade</i>	<i>Intellectual Property Rights</i>
Structural Issues Working Group Business Development and Industrial Cooperation Working Group Telecommunications Dialogue Insurance Dialogue Industries and Competitiveness Dialogue Broadband Wireless Internet Protocol Standard Group Statistics Working Group High Technology and Strategic Trade Working Group Statistics Working Group Industrial and Innovation Policies Dialogue	Government SOE Procurement Group Intellectual Property Rights Working Group on Software Legalization
	<b>Sectors</b> Agricultural Trade Working Group Textiles Consultative Group  Travel and Tourism Working Group Information Industry Working Group  Steel Dialogue Joint Liaison Group on Law Enforcement

**Figure 8: Economic Track Working Groups and Dialogues Under the Strategic and Economic Dialogue**

<b>S&amp;ED Economic Track Pillars</b>	
Macroeconomic Cooperation Global Economic Governance Trade and Investment Financial Markets	
<b>Additional Known S&amp;ED Economic Track Working Groups and Dialogues that Meet or Have Met Irregularly</b>	
<i>Energy</i>	<i>Other</i>
Climate Change Policy Dialogue Energy Policy Dialogue Ten-Year Framework Joint Working Group U.S.-China Energy Efficiency Forum Renewable Energy Forum Advanced Biofuels Forum	Anticorruption Group Investment Forum Policy Planning Dialogue Initiative on City-level Economic Cooperation U.S.-China Governors Forum to Promote Sub-national Cooperation
<i>Regional</i>	<i>Quasi-independent</i>
Africa Dialogue  Central Asia Dialogue Latin America Dialogue  South Asia Dialogue	Joint Experts Dialogue on Rules of Origin Annual Labor Dialogue High-level Consultation on People-to-People Exchange Healthcare Forum Joint Financial Committee

Sources: Derek Scissors, *Tools to Build the U.S.-China Economic Relationship*, Backgrounder No. 2590 (Heritage Foundation, August 8, 2011); *United States has Secured Commitments in Key Bilateral Dialogues, but U.S. Agency Reporting on Status Should be Improved*, Report to Congressional Requestors, United States Government Accountability Office, February 2014. <http://www.gao.gov/assets/670/660824.pdf>.

Critics argue the meetings have become “glorified talk-shops” that do not produce real progress. Dr. Scissors has criticized the S&ED and its subordinate institutional arrangements as ineffective tools that seem to have evolved “haphazardly over time” rather than having been consciously designed.<sup>59</sup> He notes an “incoherent proliferation of groups and discussions,” which “appear to have no logical relationship whatsoever.”<sup>60</sup> As these sub-level engagements continue to multiply, Dr. Scissors says that they “have become the cover story for the failure to act on fundamental matters—that is, nothing was accomplished but the two sides agreed to create several more working groups.”<sup>61</sup> A February 2014 study by the U.S. Government Accountability Office (GAO) lends credence to his critique. The GAO identified 298 trade and investment commitments made by China through the various JCCT and S&ED dialogues since 2004, but was unable to determine the extent to which any of them had been fulfilled due to poor tracking by U.S. government agencies.<sup>62</sup> The report concluded that “more comprehensive reporting would give Congress and other policy makers a clearer understanding of progress and the role of the dialogues as they continue to assess challenges in the U.S.-China relationship.”<sup>63</sup>

### ***Enforcement Efforts***

In all, the Obama Administration has brought more than twice as many trade enforcement cases against China as did the previous Bush Administration, stepping up efforts to enforce China’s agreements.<sup>64</sup> The current Administration has filed eight requests for WTO consultations\* with China to date, and has alerted the WTO to the existence of 200 Chinese subsidy programs that Beijing failed to disclose to the WTO as required by Article 25 of the WTO Agreement.<sup>65</sup> It is the first administration to enforce the Section 421 China-specific safeguard, an import relief mechanism aimed at protecting U.S. industries and workers in the event of import surges from China.†<sup>66</sup> It also accepted a Section 301 petition on China’s funding and protection of its clean energy industries, resurrecting a trade enforcement tool that has largely lain dormant in recent years.‡<sup>67</sup>

Despite these efforts “violations continue and our trade relationship grows more lopsided each year,” according to Elizabeth Drake an expert on international trade at the Washington law firm Stewart and Stewart. Ms. Drake cited “problems such as WTO-illegal and trade-distorting subsidies, discrimination against U.S. goods, services, and technologies, localization requirements, inadequate protections for intellectual property and more.”<sup>68</sup> One particularly acute problem, according to Ms. Drake, is that when issues are politically sensitive, the United States too often chooses dialogue

\*A consultation request is the first step in filing a formal complaint in the WTO.

†Section 421 of the Trade Act of 1974 as amended allowed the United States to apply safeguard measures targeted exclusively at Chinese products, an exception to WTO rules that was available to counter Chinese import surges until it expired on December 11, 2013 in accordance with provisions of the U.S.-China WTO agreement.

‡According to the International Trade Administration, Section 301 of the Trade Act of 1974 as amended is “the principal statutory authority under which the United States may impose trade sanctions on foreign countries that either violate trade agreements or engage in other unfair trade practices. When negotiations to remove the offending trade practice fail, the United States may take action to raise import duties on the foreign country’s products as a means to rebalance lost concessions.”

rather than enforcement action, and the problem festers when the dialogue fails to deliver. She cites China's undervaluation of its currency as a prime example of a problem that creates major distortions in our trade relationship and yet continues to go unresolved because of a lack of enforcement action on the part of the U.S. government.<sup>69</sup>

### ***The Currency Problem—A Case Study***

By artificially suppressing the tendency of a currency value to rise in an economy running a large trade surplus, China is able to avoid the compensatory pressures of a higher renminbi (RMB) that would otherwise make its exports more expensive and imports cheaper. By counteracting the compensatory forces that would tend to level the playing field in international trade, China has "gained a substitute for the mercantilist measures it gave up to join the WTO," according to Ms. Drake.<sup>70</sup>

China has made little effort to conceal the way it deliberately stymies market forces to keep the RMB from appreciating. As a matter of policy, China tightly pegged its currency's value to that of the dollar from 1995 to 2005, at a rate of slightly more than 8 RMB per dollar. In July 2005, the government announced a policy of allowing the RMB to trade within a narrow margin compared to an unspecified "basket of currencies." The RMB gradually appreciated 21.2 percent against the U.S. dollar even as China's bilateral trade surplus continued to climb.<sup>71</sup> From July 2008 through July 2010, the RMB was again pegged to the U.S. dollar. In July 2010, China announced a return to a "managed float" exchange rate system in which some flexibility was tolerated during the trading day, but the RMB-to-dollar ratio was reset at the start of each trading day.<sup>72</sup> Between July 2010 and October 2013, the RMB appreciated 12 percent against the U.S. dollar, and by the end of 2013, it had appreciated roughly 45 percent in inflation adjusted terms since China began its currency reform efforts in 2005.<sup>73</sup> The currency exchange rate is now at about 6.2 RMB per dollar.<sup>74</sup>

The International Monetary Fund estimates that the RMB remains "moderately undervalued" by "about 5 to 10 percent on a real effective basis, as of August 2014."<sup>75</sup> There is no universally accepted method of calculating the extent to which a currency is undervalued, and some experts argue that the RMB may still be depressed by as much as 20 percent.<sup>76</sup> In 2014, the U.S. Treasury Department reiterated its longstanding assessment that China's currency is "significantly undervalued."<sup>77</sup>

China is not alone in seeking to gain an export advantage by undervaluing its currency. Fred Bergsten and Joseph Gagnon of the Peterson Institute for International Economics note that more than 20 countries have intervened in international currency markets in a variety of ways, trading currencies at an average rate of nearly \$1 trillion annually "in order to keep their currencies undervalued and thus boost their international competitiveness and trade surpluses."<sup>78</sup> They calculate that the United States has lost between 1 million and 5 million jobs as a result of currency manipulation globally.

*The largest loser [where currency undervaluation is concerned] is the United States, whose trade and current account deficits have been \$200 billion to \$500 billion per year larger as a result. . . . Half or more of excess U.S. unemployment—the extent to which current joblessness exceeds the full employment level—is attributable to currency manipulation by foreign governments. . . . Eliminating excessive currency intervention would narrow the U.S. trade deficit by 1 to 3 percent of GDP and would thus move the U.S. economy much of the way to full employment, with an even larger effect possible once multiplier effects on domestic demand are taken into consideration.<sup>79</sup>*

Dr. Bergsten and Dr. Gagnon's data show that China is far and away the most significant currency intervener, "in terms of both economic importance and amounts of intervention."<sup>80</sup> China's lower currency valuation functions as a de facto subsidy, giving its exports a price advantage vis-à-vis domestically produced goods in the U.S. marketplace and vis-à-vis U.S. products globally. Experts, including Dr. Scott, contend that this translates to artificially high demand for Chinese manufactured exports and the movement of U.S. manufacturing jobs overseas. According to Dr. Scott, China's currency manipulation has led to the loss of 3 million U.S. jobs since China joined the WTO in December 2001, more than three-fourths of them in the manufacturing sector.<sup>81</sup> If China were to value its currency fairly, 2.3 to 5.8 million U.S. jobs would be created, he says.<sup>82</sup>

President Obama has said that China's undervaluation of its currency puts American firms at a "huge competitive disadvantage," and in 2010 he made the issue a top policy priority in dealings with China, devoting most of a two-hour meeting with Chinese Prime Minister Wen Jiabao to underscoring currency concerns.<sup>83</sup> As recently as March of 2014, the president urged his Chinese counterpart to move the RMB toward a more market-based exchange rate.<sup>84</sup> The last time the U.S. Treasury Department branded China a currency manipulator was in 1994, and successive administrations, including that of President Obama, have consistently declined to label China a currency manipulator in biennial reports to Congress. Naming China would have elevated the issue diplomatically by requiring the Treasury Department to initiate negotiations on the issue with China. (Since at least 2003, the United States has raised the issue in other annual bilateral talks such as the Security and Economic Dialogue.)<sup>85</sup> Though there would be no other direct impact, Congressional proponents believe that naming China as a currency manipulator is needed. Meanwhile, the Treasury Department has unofficially cited a variety of reasons not to, among them: (1) high pressure would make the Chinese government less likely to respond because to do so would embarrass officials; (2) China has allowed the RMB to gradually appreciate during certain periods and is therefore moving toward compliance, albeit slowly; (3) Chinese officials have secretly promised to do so once the economy is stabilized; and (4) the issue in China is simply too sensitive so officials are unable to act.<sup>86</sup>

To date, the Commerce Department has also refused to treat currency undervaluation as an indirect export subsidy, a ruling that

could lead to penalty tariffs on certain imports from China, thereby boosting the competitiveness of domestic alternatives.<sup>87</sup> A number of U.S. countervailing duty petitioners have asserted claims against China's currency policy as an actionable subsidy under U.S. law. However, the Commerce Department has not officially included undervalued currency as part of a countervailing duty investigation. There is also debate over whether such an action would be consistent with U.S. law and WTO rules. In two 2010 cases involving aluminum and coated paper producers, the Commerce Department found that currency undervaluation did not constitute a domestic subsidy specific to a particular company, industry, or group of companies or industries, as is statutorily required for Commerce to initiate an investigation. Both U.S. law and WTO regulations define subsidies as financial contributions from a government benefiting a specific industry.<sup>88</sup> Bills to address China's currency policy have been introduced during every session of Congress since 2003. While none of these bills has yet become law, during the 111th Congress, the House passed the Currency Reform for Fair Trade Act (H.R. 2378) by a vote of 348 to 79. During the 112th Congress, the Senate passed the Currency Exchange Rate Oversight Reform Act of 2011 (S. 1619) by a vote of 63 to 35.<sup>89</sup> There remains significant support in the House and Senate to require the Commerce Department to treat currency undervaluation as a subsidy. In September 2013, a bipartisan group of 60 senators signed a letter calling for action on the Chinese currency issue as part of the United States' Trans-Pacific Partnership negotiations.<sup>90</sup> Various other proposed bills would require greater action by the executive branch to address China's currency manipulation, or would define currency manipulation as an illegal subsidy and would make China and other transgressor nations subject to penalty duties.\* However, gradual appreciation of the RMB and strong opposition from the U.S. business community and the Administration have thwarted the passage of legislation. The United States has also declined to challenge China's currency valuation practices at the WTO, though that, too, is a potential enforcement tool at our disposal.<sup>91</sup>

Some insist that currency undervaluation is not as serious a problem as critics of China's policy contend. Edward Lazear, former chairman of the President's Council of Economic Advisers during the George W. Bush Administration (2006–2009), points out that Chinese exports to the United States do not track closely with currency movements, evidence he cites to claim that currency undervaluation is not a key factor in determining trade patterns. Dr. Lazear notes that between 1995 and 2005, when the dollar-RMB exchange rate was stagnant, Chinese exports to the United States increased sixfold, or 19.6 percent per year. Between 2005 and 2008, when the RMB's value relative to the dollar appreciated roughly 21

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\*Bills to address China's currency manipulation in the 113th Congress have included: H.R. 1276: The Currency Reform for Fair Trade Act, which would seek to clarify that the Commerce Department can consider a "fundamentally misaligned currency" as an actionable subsidy, and S. 1114: The Currency Exchange Rate Oversight Reform Act of 2013, which specifies criteria for identifying fundamentally misaligned currencies and would require action to correct misalignment where certain "priority" countries are concerned. Both bills are essentially identical to legislation proposed but not passed in previous Congresses. For more detailed information on these and older legislative proposals to address Chinese currency valuation, see Wayne M. Morrison, "China's Currency Policy: An Analysis of the Economic Issues." <https://www.fas.org/sgp/crs/row/RS21625.pdf>.

percent, Chinese exports to the United States should have fallen if there were a strong correlation between trade and currency valuation. Instead Chinese exports “continued to grow at about the same pace, averaging 18.2 percent per year.”<sup>92</sup> *Forbes Magazine* contributor Dan Ikenson echoes Lazear’s argument, noting that “the U.S. economy has ‘created’ more jobs in periods when the trade deficit was growing than in periods when it was shrinking.”<sup>93</sup> Dr. Scissors agrees, noting that “jobs have been lost by the millions over the past three years, while the yuan has either held steady or been rising against the dollar.”<sup>94</sup>

Even if U.S. employment rates are affected by China’s currency valuation, business community advocates generally contend that trying to force China to revalue its currency will only result in layoffs in the United States and price increases for consumer goods in the U.S. marketplace, not the return of jobs lost in prior years. Commission witness Philip Levy, senior fellow at the Chicago Council on Global Affairs, notes that U.S. companies that have moved manufacturing facilities to China would not return those operations to the United States if China’s currency were revalued, but would instead shift manufacturing to alternative cost-effective countries, such as Vietnam, Cambodia, and Malaysia.<sup>95</sup> This is because, said Dr. Levy, “there is no way a minimum-wage worker in the United States earning a meager annual income of \$13,920 can compete with someone in Asia earning between \$1,000 and \$1,500 annually.”<sup>96</sup> Groups such as the U.S.-China Business Council also oppose legislative proposals because they would impose tariffs based on “subjective estimates.”<sup>97</sup> This means that findings would inevitably be politicized, they argue, triggering a trade war that would undermine U.S. employment by stunting the growth of U.S. exports to China without delivering U.S. jobs in import-sensitive industries.<sup>98</sup>

While forcing a revaluation of China’s currency may be a key component to resolving the negative impact of bilateral trade on U.S. employment that does not guarantee it will be a panacea. In his testimony to the Commission, Dr. Shenkar of the Ohio State University recalled the 1985 Plaza Accord,\* which was supposed to rebalance the U.S. trade deficit with Japan by decreasing the U.S. dollar’s valuation vis-à-vis the Japanese yen, but even after the currency misalignment was altered in the U.S. favor, the United States never realized the expected recovery of employment in the U.S. car manufacturing industry.<sup>99</sup> But Dr. Scott contends that there is no doubt that China’s currency undervaluation contributes to the bilateral trade imbalance, and neglecting to push harder for resolution in order to protect the growth of U.S. exports to China is short sighted. “Talking about trade and only talking about the growth of exports is like keeping score in a baseball game and only counting runs scored by the home team,” he says. “It might make your team sound like it’s doing well, but it won’t tell you if they’ve won the game.”<sup>100</sup> While U.S. exports to China have grown dra-

\*The Plaza Accord, signed in September 1985, was an agreement among France, West Germany, Japan, the United States, and the United Kingdom, which allowed the depreciation of the U.S. dollar in relation to Japan’s Yen and West Germany’s Deutsche Mark. The goal of this agreement was to reduce the U.S. current account deficit and assist the U.S. economy in recovering from a serious recession by making the U.S. manufacturing industry more competitive in the global market place.

matically, our trade deficit “is still so vast that even if this great growth rate continues, it would take 38 years for America to close it,” he points out.<sup>101</sup>

### **The Interagency Trade Enforcement Center**

In February 2012, President Obama created the Interagency Trade Enforcement Center (ITEC) via executive order. The purpose was to engage in “robust monitoring and enforcement of U.S. rights under international trade agreements, and enforcement of domestic trade laws.”<sup>102</sup> The center is within the USTR and coordinates enforcement efforts among the Departments of State, Treasury, Justice, Agriculture, Commerce, Homeland Security, National Intelligence, and others. It is meant to provide “a more dedicated ‘whole-of-government’ approach to addressing unfair trade practices and barriers,” by serving as a forum for coordination between experts across agencies.<sup>103</sup> ITEC may be improving U.S. trade enforcement efforts overall, but there has been no specific news of ITEC efforts aimed at addressing China’s trade abuses since the establishment of the interagency group in February 2012, and the last U.S. request for WTO consultations to resolve a trade dispute with China came in September 2012.<sup>104</sup>

### ***Accessibility of Trade Remedies, the Need for a Private Right of Action and Other Proposals for New Enforcement Tools***

Even when U.S. industries are successful at seeking trade remedies, they do not always work. Witnesses at the February 21 hearing testified about a range of shortcomings in the United States’ trade remedy toolbox. As Ms. Drake put it, “If a trade remedy case is successful, it should actually deliver the relief that is promised.”<sup>105</sup> But circumvention of penalty tariffs, transshipment of goods through a third party, duty evasion by specific companies, a lack of transparency, access, and accountability, are among the many problems “severely hampering the ability of domestic industries to ensure the orders they have fought for are being effectively enforced.”<sup>106</sup> Ms. Drake told the Commission that we need more tools to “help our trade relationship mature into one that is more balanced and more beneficial to American industries, workers and communities.”<sup>107</sup>

U.S. trade remedy laws can be ineffective and U.S. industries can often face challenges bringing petitions for relief because of quirks in trade remedy laws. For example, when a domestic industry brings a case, it is required to demonstrate that a sufficient percentage of other domestic producers in the same industry support the petition. Specifically, petitioners must represent at least 25 percent of domestic production.<sup>108</sup> Sometimes industry interests are fragmented because of shifting trade or investment relationships of large players, so producers in need of relief cannot seek it. As the U.S. wooden furniture industry switched from manufacturing within the United States merely to retailing furniture made in China,

furniture manufacturers-turned-retailers opposed efforts to protect the remaining furniture makers in the United States.\* In addition, currently no means exist by which other parties with vested interests in fair trade enforcement, such as states and localities, can bring petitions.

Other significant challenges for U.S. industries seeking relief from anticompetitive Chinese practices are the shortcomings of the WTO's dispute resolution system, including long trial delays and appeals and weak enforcement. As Dr. Scissors points out, "WTO adjudication certainly seemed like an obvious solution to bilateral disputes at the time of the PRC's accession a decade ago. The WTO has since been revealed to be ponderous in dispute resolution, effectively permitting years of 'illegal' behavior before penalties can be imposed."<sup>109</sup>

Unfortunately, U.S. industry suffers from limited options for directly pursuing trade complaints, since neither domestic nor international trade rules provide for a private right of action. Existing rules of international trade limit dispute settlements to government-to-government actions. One 1916 law that allowed for private lawsuits against rule-breaking companies was struck down shortly before China joined the WTO. The Antidumping Act of 1916 provided a private cause of action against international companies that illegally dumped goods in the United States by selling them at prices below fair market value. It was the only law that allowed U.S. companies to file an action against competitors directly and in their home market jurisdictions, rather than seeking U.S. government assistance in pursuing dumping charges. But in 2000, a WTO dispute settlement panel ruled that the U.S. law violated Articles VI:1 and VI:2 of the General Agreement on Tariffs and Trade 1994, Articles 1, 4, and 5.5 of the Anti-Dumping Agreement, and Article XVI:4 of the WTO Agreement because the Act, as reinterpreted by U.S. courts, provides antidumping measures that do not comply with requirements of those provisions.<sup>110,111</sup> In 2004, the Act was repealed by Public Law 108-492, the Miscellaneous Trade and Technical Corrections Act.<sup>112</sup>

### ***Market Economy Status***

Even as debate focuses on how to rectify negative impacts of the bilateral trade relationship on U.S. employment, there is general agreement that granting China market economy status would exacerbate the problem. Multiple witnesses have testified to the Commission that China is not now a market economy and is not on the path to become one within the next two years. But in December 2016, the provision of China's WTO accession protocol that enables countries to treat China automatically as a non-market economy (NME) expires. China agreed to accept this temporary provision during its negotiations to join the WTO but has aggressively sought to have the designation terminated by its trading partners and will almost certainly demand that the United States treat it as a market economy after 2016.

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\*For more on the difficulty faced by U.S. furniture and textile industries in bringing unfair trade actions against overseas competitors, see the U.S.-China Economic and Security Review Commission's *2007 Annual Report to Congress*, Chapter 1, Section 4, "A Case Study of the Local Impact of Trade with China: North Carolina."

Neither NME status nor market economy status are explicitly mentioned in China's WTO Accession Protocol. However, the Protocol does specify the expiration of Article 15(a)(ii) in December 2016. At the end of 2016, the existing statutory test will be the only basis upon which the United States determines whether a country operates as a market economy is applied. Under the law, there are criteria that the Administration would have to certify that China has met before granting China market economy status. The main effect of a shift to market economy status for China would be to make it far more difficult for the United States to levy penalty tariffs on China for dumping.\* A 2005 study by GAO found that, "if Commerce grants China market economy status ... required methodological changes could well reduce antidumping duties [and] it is not clear whether CVDs [countervailing duties] would compensate for these reductions."<sup>113</sup> However, GAO also concluded that even if China is not designated as a market economy, "there is an element of uncertainty about the magnitude of the total level of protection that would be applied to Chinese products" in either scenario.<sup>114</sup> China is currently the single largest target of U.S. antidumping actions. From 2001 through 2012, the United States initiated 91 antidumping cases against China, imposing measures in 66 of those cases, and spearheaded 15 of the 31 WTO complaints brought against China.<sup>115</sup>

A market economy is an economic system in which decisions about the allocation of resources and production are made on the basis of prices generated by voluntary exchanges among producers, consumers, workers, and owners of factors of production. In China's economy, crucial economic processes are determined by the state rather than by market forces. Chinese government officials themselves describe China as a socialist market economy, in which "the government accepts and allows the use of free market forces in a number of areas to help grow the economy, but still plays a vital role in managing the country's economic development."<sup>116</sup> As of 2009, 97 nations had granted China market economy status. But because of government interventions in the Chinese marketplace, the United States and other major developed countries still recognize China as an NME.<sup>117</sup>

In situations involving imports from an NME, the WTO more readily allows for the "normal value" (the appropriate price in the market of the exporting country) of the imports to be determined using data from a surrogate country. Typically, the WTO requires the normal value of a country's export be based on a strict comparison with domestic prices or costs in that country. Since Chinese domestic prices and costs are often artificially suppressed because of government subsidies, surrogate country data is generally crucial for trading partners to demonstrate that China is engaged in dumping.<sup>118</sup>

Much attention has been focused on arguments that the expiration of Article 15(a)(ii) will not give China market economy status,

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\*Dumping is the act of introducing a product into another country's market at less than its "normal value." "Normal value" is "the comparable price, in the ordinary course of trade, for the like product when destined for consumption in the exporting country." See Christian Tietje and Karsten Nowrot, *Myth or Reality? China's Market Economy Status under WTO Anti-Dumping Law after 2016*, Policy Papers on Transnational Economic Law, No. 34 (Transnational Economic Law Research Center, December 2011).

not least because Article 15(d) of China's Accession Protocol makes clear that China's recognition as a market economy is something it must achieve bilaterally with individual members by meeting the conditions of those members' national laws. As international trade law expert Bernard O'Connor argues in his heavily cited paper, *The Myth of China and Market Economy Status in 2016*, China's WTO Accession Protocol contains "no presumption" that it will attain market economy status in 2016, and to imply that presumption "reads out of the law China's burden to prove that it is a market economy as defined by the laws of the country it seeks recognition from."<sup>119</sup> But even if market economy status is not automatic in 2016, the expiration of Article 15(a)(ii) does mean that China will no longer automatically be assumed to be an NME. In short, China's market economy status will be left to the determination of each of its trading partners, and the United States will not automatically have to grant China that status after 2016. But even if the United States opts to continue treating China as a non-market economy, the terms of the Accession Protocol will increase the evidentiary burden for justifying the use of surrogate country data in assessing duties against China after 2016.

Eileen Bradner, senior director and counsel for Nucor Corporation, told the Commission that, "part of the reason our trade laws work is because they properly treat China as a non-market, government-run economy. That should not change until China itself changes."<sup>120</sup> However, China is working under the assumption that market economy status will be conferred upon it in 2016, and any action by the United States to continue treating China as an NME is almost certain to provoke a challenge by China at the WTO. U.S. law lays out criteria for deciding whether or not a country is a market economy, but grants great flexibility to the U.S. executive branch in making the determination,\* a determination that Ms. Drake notes is not currently reviewable by U.S. courts.<sup>121</sup> This means that if the U.S. executive branch determines it is diplomatically in our best interest to treat China as a market economy beginning in 2016, negatively impacted companies will have no clear legal recourse to challenge that decision.

## **The Non-Market Economics of Chinese Investments in the United States**

### ***The Primacy of the State Sector in China's Economy***

When China joined the WTO, its accession agreement indicated a gradual move towards a free market economy and a diminishing

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\*The United States' Tariff Act of 1930, as amended, provides a statutory test for determining if an economy can be classified as a market economy. The law specifies that the determination of a country's market or non-market status be made in consideration of the following factors:

- (i) the extent to which the currency of the foreign country is convertible into the currency of other countries,
- (ii) the extent to which wage rates in the foreign country are determined by free bargaining between labor and management,
- (iii) the extent to which joint ventures or other investments by firms of other foreign countries are permitted in the foreign country,
- (iv) the extent of government ownership or control of the means of production,
- (v) the extent of government control over the allocation of resources and over the price and output decisions of enterprises, and
- (vi) such other factors as the administering authority considers appropriate.

See U.S. Section 771(18) of the Tariff Act of 1930, as amended, 19 U.S.C. § 1677(18).

role for state-owned enterprises (SOEs). Although China adopted significant reforms, many of the country's largest and most influential businesses remain state-owned or state-controlled, enjoying preferential treatment and financing at the central, provincial, or local level.<sup>122</sup> By some estimates, in 2011, China had approximately 144,700 enterprises owned and operated by a branch of the central government with total assets of \$13.7 billion, revenues of \$6.3 billion, and profits of \$418.5 billion, or nearly half of the country's total industrial and business profit.<sup>123</sup> For detailed discussion of the breakdown of enterprises owned or controlled by the Chinese state, see Chapter 1, Section 2, of the Commission's 2012 Annual Report.

China's Third Plenum of the 12th National People's Congress, held in late 2013, introduced new reform initiatives for SOEs, but they are primarily aimed at restructuring and increasing the efficiency of the state sector, not reducing the state's role in the economy. The Plenum emphasized the equal importance of the state sector and the private sector, a departure from previous plenums which gave primacy to the state, but it still gave state ownership a "leading role" in the economy.<sup>124</sup> Commission witness Willy Shih, a professor at the Harvard Business School, described the reforms as a deliberate attempt to increase SOEs' exposure to the competitive forces of China's private economy while preserving their power.<sup>125</sup> The Brookings Institution's Arthur Kroeber offered a skeptical prognosis, calling it "a very safe bet that when he retires in 2022, Xi will leave behind the world's biggest collection of state-owned enterprises."<sup>126</sup> "Xi is not some Chinese version of Ronald Reagan or Margaret Thatcher," Kroeber said. "For him and his colleagues, the market is a tool, not an end in itself. The respective roles of state and market need to be clarified, but the state role will remain very large."<sup>127</sup>

A recent media campaign of the State-owned Assets Supervision and Administration Commission (SASAC), which oversees China's 121 central state-owned enterprises, appears to affirm these assessments. SASAC's advertising blitz, via articles and coverage in major state-run news outlets including *The People's Daily*, Xinhua, and CCTV, promotes the benefits of a state sector that has already been "transformed" and "streamlined into a competitive force."<sup>128</sup> As witness Adam Hersh of the Center for American Progress testified to the Commission:

*The same people with the same policy levers and the same financial incentives will continue to be in charge of China's productive resources even if the Third Plenum plans are implemented. . . . The ability to deliver subsidies to keep these state-owned enterprises operating on a non-market basis can go on for quite some time given the political structure and the ability to extract incomes from individuals in China and from firms throughout the economic system. . . . This is not a model that is going to fail in any economically meaningful timeline.<sup>129</sup>*

\*The number of enterprises owned by the central government has generally been declining each year due to consolidations and mergers rather than privatization.

### ***Characteristics of China's Outbound Investment***

Chinese investment in the United States has increased in recent years. Since FDI is generally associated with job creation and economic development, this trend has been generally applauded, particularly within state governments. The Washington, DC, based Organization for International Investment notes in its 2013 report that “foreign companies fund domestic manufacturing plants, but-tress research and development facilities, and support 5.6 million well-paying American jobs with average pay of around \$77,000 in 2011.”<sup>130</sup> The United States International Trade Administration also highlights the importance of FDI for “the creation of jobs, an increase in wealth and living standards, and [the] overall growth and innovation that drive U.S. economic competitiveness.”<sup>131</sup> But the U.S. experience with investment by state-directed corporations is limited, and the ramifications are unclear.

China's global outbound FDI exceeded \$77 billion in 2012 and is projected to reach \$2 trillion by 2020. Of this outbound investment, private firms accounted for only an estimated 9.5 percent, while SOEs accounted for the remainder.<sup>132</sup> The business motivation for Chinese companies to invest abroad is strong. Some seek to acquire advanced technology to maintain an edge in a fiercely competitive domestic market, and others are driven to expand market share outside of China to broaden their customer bases, develop recognition as global brands, and gain expertise in global marketing and supply chain management.<sup>133</sup> But the government is also a key driver for both private and SOE outbound investment activities. International investment helps the government to secure resources needed to maintain China's economic growth, serves as a form of economic diplomacy, and “provides the Chinese government with a channel to invest its vast foreign exchange reserves while boosting long-term economic growth.”<sup>134</sup>

Outbound Chinese investment is supported and encouraged by a formal government framework, the “go out” policy, which was launched in 2000.<sup>135</sup> Although the Chinese government recently announced plans to eliminate the need for government approval of outbound investments valued at less than \$1 billion, virtually all larger proposed investments by Chinese companies abroad must still be reviewed and approved by the government.<sup>136</sup> The *Guidelines for Investments in Overseas Countries' Industries* as well as the *Overseas Investment Guidance Catalogue* provide guidance such as recommended industry sectors and recommended recipient nations (of which there are currently 115).<sup>137</sup> The government involvement in Chinese outbound investment is also underscored by the entourages of businessmen Chinese officials typically bring along when traveling abroad.<sup>138</sup>

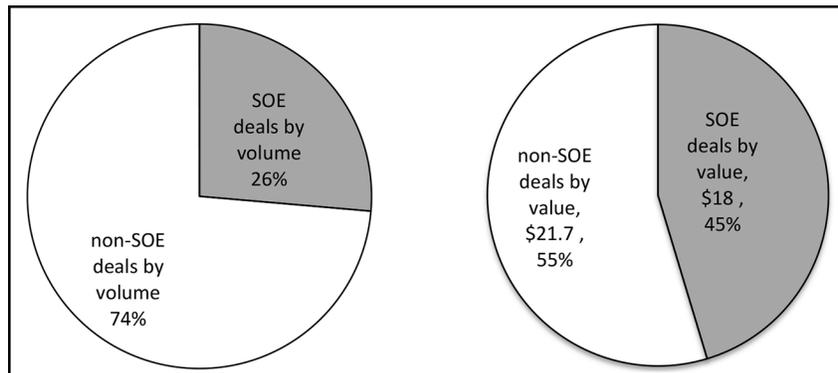
Chinese SOEs and private firms with access to state aid or state-controlled bank capital are “aggressive,” according to Timothy Brightbill, a Commission witness and partner at the law firm of Wiley Rein LLP in Washington, DC. “They think globally, and they have long investment horizons.”<sup>139</sup> In 2012 testimony before the Commission, Mr. Brightbill noted that Chinese investment abroad “represents a new and growing threat to fair competition and the ability of U.S. producers to compete here and around the globe” because “these SOEs that often do not operate based on market prin-

ciples ... [and] can introduce anti-competitive behavior and other market distortions where they invest.”<sup>140</sup> He described a situation in which U.S. companies are essentially competing directly against the Chinese government in U.S. and global markets, “creating significant imbalances that harm U.S. workers and private companies.”<sup>141</sup> Noting reluctance on the part of the United States to address this challenge proactively, Dr. Shih testified that, “we need to learn from history and not delude ourselves into thinking that in the end, fair play and justice will prevail.”<sup>142</sup>

### ***Chinese Investment in the United States***

China is the world’s fifth largest overseas direct investor.<sup>143</sup> It is not yet among the top sources of foreign investment in the United States. Official estimates are that FDI from China averaged roughly \$1 billion between 2010 and 2012, or a miniscule 0.5 percent of the United States’ total inbound FDI.<sup>144</sup> However, it is the fastest growing source of U.S.-bound FDI, registering an average annual growth rate of almost 71 percent from 2008 through 2012.<sup>145</sup> As of 2013, Chinese firms had invested in 37 U.S. states.<sup>146</sup> This trend appears to be accelerating. In June 2013, China announced its largest purchase of a U.S. asset to date—a \$4.7 billion acquisition of Virginia-based Smithfield Foods, Inc.<sup>147</sup> Research conducted by the Rhodium Group, a leading private sector consultancy tracking Chinese investments in the United States, indicates that private firms now account for the majority of U.S.-bound Chinese investments. According to their calculations, in 2013, private firms and entrepreneurs contributed 87 percent of Chinese direct investment transactions in the United States and 76 percent of the total value of inbound Chinese investment.<sup>148</sup> As of the second quarter of 2014, cumulative private Chinese investment in the United States since 2000 totaled \$21.7 billion, as compared to \$18 billion in state-owned investment. (See Figure 9.)

**Figure 9: Volume and Value of Chinese SOE and Non-SOE Investments in the United States, 2000-2014Q2**



Source: Rhodium Group.

But SOE investment in the United States remains significant, and at any rate, when it comes to Chinese enterprises, the distinc-

tion between public and private is often a false dichotomy. SOEs are frequently complex, multilayered business groups with “a myriad of subsidiary firms, some of which may be publicly listed on stock exchanges in China and overseas.”<sup>149</sup> Joel Backaler, director of the Frontier Strategy Group, testified to the Commission that government control of Chinese firms is not limited exclusively to state-owned enterprises and “it is wrong to think that state-owned enterprises are the only firms with ties to the Chinese government and recipients of financial and political support from the state.”<sup>150</sup> In addition, as Dr. Hersh testified, the extent of state ownership and subsidization “are becoming increasingly obscured as more enterprises are corporatized and registered in offshore tax havens.”<sup>151</sup>

### ***Potential Pitfalls of Chinese Investment***

Although private Chinese companies pursuing deals overseas have typically provoked fewer concerns from government regulators, the murky connections between the state and private sectors show that there may be little difference between the two in terms of their impact on U.S. competitors. Whether nominally private, Chinese companies may enjoy low-cost or free land rights and below-market interest rates on loans, and “in some cases have a monopoly on an entire industry and thus enormous pricing power.”<sup>152</sup> They may not be beholden to market forces, and access to the government’s printing press and preferential treatment can provide Chinese companies competitive advantages far beyond the reach of foreign private counterparts.<sup>153</sup> It is not the type of Chinese investment but its likely impact that should be foremost in the minds of policymakers.<sup>154</sup> Ms. Bradner summarized the potential anticompetitive challenges for Commissioners:

*We can compete with anyone if it's fair, but if you're competing with a government that does not have to cover their costs, does not have to show a profit to their shareholders or their board of directors, it's a big concern. . . . We need some kind of an enforceable mechanism [to ensure that] these entities [are operating] on commercial terms, and I think the key is that we can't be required to wait until we show injury before some kind of enforcement mechanism kicks in. . . . Some producers will be driven out of business, and it's not just the producers, but it's also the upstream and the downstream affected. And it's not at all clear that even if the foreign producer then corrects itself . . . once they get the market share, it's not at all clear that the domestic industry would be able to reconstitute itself because some of those players will be gone and won't be able to come back.*<sup>155</sup>

How does an American company or an American industry compete with a Chinese company that opens up a factory in the United States and has little or no cost of capital and innumerable subsidies? No comprehensive tracking exists of job creation by Chinese investment in the United States, but the bulk of China’s outbound investment is in the form of mergers and acquisitions, rather than

the greenfield investment that tends to be the biggest boon to local employment.<sup>156</sup> Still, some do promise significant job creation.

When a major Chinese SOE investment could create hundreds or thousands of jobs but also creates a threat of unfair competition for the domestic industry in question, how should the United States balance the risks and benefits? In June 2011, the Alabama legislature passed the 2011 Alabama Tariff Subsidy Bill, attracting a \$100 million manufacturing investment from Henan Province-based Golden Dragon Precise Copper Tube Group Inc. by offering tax incentives that countered antidumping duties the U.S. government had leveled against imports of the company's products. Currently no federal law is aimed at deterring states from offering investment incentives that have the purpose or effect of undermining federal trade enforcement efforts.

Rules aimed at preventing undue foreign influence on trade petitions may also fall short where Chinese investment is concerned. Trade petitions for antidumping and countervailing duty cases must be supported by at least 25 percent of the domestic industry (as measured by production), and while U.S. companies that are related to foreign producers and importing the merchandise under investigation may be excluded from calculations of industry support,<sup>157</sup> companies that do not themselves import the merchandise under investigation cannot be excluded. This may prove to be a significant loophole for state-influenced Chinese companies investing in the United States, allowing them to influence unduly trade petitions involving merchandise from China.

Ms. Drake noted that China's WTO accession agreement did include a general requirement that it ensure its SOEs operate on a commercial basis, but this commitment has never been enforced. As for the more specific threats that Chinese investments may pose, she told Commissioners that this is part of "a very broad area where we would like for there to be rules that govern behavior, but we don't have those rules exactly right now."<sup>158</sup> The United States also lacks sufficient tracking of Chinese investments.\* The Commerce Department has tracked, on average, slightly less than \$1 billion per year in Chinese investment in the United States between 2010 and 2012, whereas the Rhodium Group, a private sector consulting firm, has tracked \$16.9 billion for that same period.<sup>159</sup> The United States does not have clear data on how much money U.S. investment bankers are raising on behalf of Chinese SOEs in initial public offerings, nor the ownership structures of these SOEs or the bases for their contracts. This is material information for U.S. shareholders in these companies and relevant to a range of other parties potentially impacted when these companies invest here.

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\*The International Trade Administration (ITA), a bureau within the U.S. Department of Commerce, stated in a 2013 report on Chinese FDI in the United States that it is "important to be aware of different estimates" of Chinese investment. ITA noted that private sector valuations employ different definitions of FDI, data gathering mechanisms, and accounting methods that lead to differences in reported value of investments. See International Trade Administration, *Report: Foreign Direct Investment (FDI) in the United States from China and Hong Kong SAR* (Washington, DC: July 17, 2013).

### ***Are Worries Overblown?***

In defense of Chinese investment in the United States, Mr. Backaler, of the Frontier Strategy Group, testified that “overall, the United States has much to gain from the global emergence of Chinese companies, including: employment generation, tax revenues, potential investors in domestic infrastructure, and new market access.”<sup>160</sup> Dr. Scissors says, “American individuals and companies voluntarily engage in transactions with Chinese companies and benefit from them.” He argues that the discussion of the Chinese investment threat is largely politically motivated and says these “exaggerations do not serve the national interest.”<sup>161</sup>

Other experts, such as Dr. Shambaugh agree, noting that worries over Chinese investment tend to credit Chinese companies with more competence than most of them have yet demonstrated. Dr. Shambaugh stresses that Chinese firms are, by and large, still navigating a steep learning curve to understand how to compete on par with leading multinational corporations from more developed countries. Most do not develop business plans and strategies before they globalize but instead are driven by “pent-up cash in search of a place to invest.”<sup>162</sup> They “often fail to do their homework to develop detailed plans for global market entry ... and demonstrate difficulties adapting to foreign legal, regulatory, tax and political environments.”<sup>163</sup> In fact, the vast majority of Chinese investments overseas are not even successful. As much as 90 percent of China’s 300 overseas mergers and acquisitions in 2008–2010 were unsuccessful for a variety of reasons, including overpaying and inability to manage the new company.<sup>164</sup>

### **Implications for the United States**

New research and analysis conducted by Dr. Schott suggests that the rapid growth of the United States’ bilateral trade relationship with China since 2001 has indirectly contributed to a sharp decline in U.S. manufacturing employment during that same period. Although China has become America’s third-largest export market and fastest-growing export destination, imports of Chinese goods to the United States still far surpass sales of U.S. goods to China. The imbalance is most pronounced in the manufactured goods sector, since the bulk of U.S. sales to China involves commodities whereas the bulk of Chinese sales to the United States is manufactured products. Direct investment in China by U.S. and other foreign corporations has increased sharply since China joined the WTO,<sup>165</sup> and 55 percent of Chinese exports to the United States are now manufactured by foreign invested enterprises. The net result is a trade relationship that clearly produces jobs for Chinese workers but costs jobs for blue collar Americans even as U.S. exports to China grow.

The negative impacts on some segments of the U.S. workforce have persisted, in part, because of inadequate U.S. management of the bilateral relationship. The United States relies heavily on dialogue to press China to uphold its international trade commitments, further open its markets, and ensure fair treatment of U.S. businesses. The number and variety of talks continue to proliferate, but they generally result in vague or narrow commitments, and no

guarantee that promises will be upheld. Under the Obama Administration, American enforcement efforts have been redoubled, but enforcement tools are limited and often ineffective.

There is some room for optimism that China's growing FDI in the United States will become an abundant source of new jobs here at home. Forbes Magazine recently projected Chinese investment in the United States could reach \$300 billion and create 1 million U.S. jobs by 2020.<sup>166</sup> But U.S. experience with Chinese investment remains limited; the bulk of this investment to date has been in the form of merger and acquisition transactions, not the greenfield investments that tend to be big job creators, and concern exists regarding the influence of the state on both state-owned and ostensibly private Chinese companies' behavior, which may pose threats to fair competition in the U.S. marketplace and hurt domestic employers.

### **Conclusions**

- The United States' trade deficit with China is by far its largest, and it has grown sharply in recent years to become the single biggest bilateral deficit in the world. In 2013, it reached \$318.4 billion, setting a record for the fourth straight year, with China exporting nearly four dollars' worth of goods to the United States for every dollar's worth of imports it purchased from the United States. Even as U.S. exports to China have grown, our deficit has grown faster. This deficit is associated with declining U.S. economic competitiveness and job losses, which helps explain why 52 percent of Americans now believe that China poses a critical threat to vital future U.S. economic interests.
- U.S. employment in some sectors, particularly the manufacturing sector, has dropped substantially as trade with China has increased. Since China joined the World Trade Organization (WTO), the United States has lost 29 percent of its manufacturing jobs, according to the U.S. Bureau of Labor Statistics, and economists have begun to establish clear correlations between this job loss and the bilateral trading relationship.
- Even as U.S. manufacturing has slumped, U.S. corporations have relocated manufacturing operations to China and imports of Chinese manufactured goods have grown exponentially. As a result, the benefits of the U.S.-China trade relationship have accrued disproportionately to U.S. corporations, while most of the drawbacks have been borne by U.S. workers.
- Unfair Chinese trade practices, including market protections, subsidization, and favoritism toward certain domestic players, as well as provisions for limiting foreign investment in certain manufacturing operations, have also contributed indirectly to the ongoing decline in U.S. manufacturing employment. Although China committed to sweeping reforms when it joined the WTO, Chinese efforts to honor these commitments have slackened in the last ten years. The Chinese economy benefits from a host of policies and practices that violate the spirit, and even the letter, of Beijing's WTO commitments and harm U.S. interests. Despite a proliferation of bilateral forums for engagement, U.S. efforts to

talk through these problems have consistently fallen short. Enforcement actions have increased, but the results of these efforts have been limited, and many issues remain unaddressed.

- The dominance of state-owned enterprises in the Chinese economy is one of the reasons the United States has not designated China as a market economy, despite China's active pursuit of such a designation for many years. The United States has a statutory test for determining whether an economy can be classified as a market economy. 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. Expert witnesses have testified to the Commission that China is not currently a market economy and is not on the path to become one in the near future.
- Because trade remedies are often inaccessible, they are effectively useless to smaller U.S. companies that cannot afford to pursue cases and to companies that cannot muster the threshold industry support. Available trade remedies remain inadequate and fail to account for the interests of other affected constituents, such as workers and communities; China's undervaluation of its currency, for example, continues to function as a de facto subsidy for its exports, and U.S. law still does not provide a sufficient remedy to this problem for private parties. The Administration has not been effective in getting China to change its policies. A number of U.S. petitioners have asserted claims against China's currency policy as an actionable subsidy, but the Commerce Department has refused to treat currency undervaluation as actionable under the law. Even when trade remedy cases are successful, they do not always deliver sufficient and timely relief.
- Growing Chinese investment in the United States could be a boon to U.S. employment, but the peculiarities of state influence on Chinese corporate behavior in the United States may also pose significant competitive challenges for domestic companies, with serious drawbacks for U.S. workers. Chinese investment in the United States could pose impediments to members of domestic industries petitioning the Federal Government for trade enforcement assistance, and anecdotal evidence demonstrates that state efforts to attract Chinese investment can also undermine federal trade enforcement efforts. The potential impact of inbound Chinese investment should be more thoroughly investigated and addressed.

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