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Discussion Paper on the Question of:

Do China's violations of international commercial norms, including exchange rate manipulation, IPR violations and non-tariff barriers, require immediate forceful steps by its trading partners to make it play by the rules?

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Overview

The U.S.-China trade relationship has been and continues to be governed, on the part of China, by its drive to assume its rightful place alongside the United States on the global political and economic stage and by the struggles inherent in merging market principles based on the global rules of the World Trade Organization into a largely state-controlled economy. The trade relationship, on the part of the United States, is driven by its leadership position on the global stage, upon which all other countries depend, in engaging China to open its growing economy to world trade.

China has pursued an export led growth strategy that aims not just at job creation but at creating a global economic powerhouse. The centerpiece of this strategy is an undervalued currency, initiated in 1992 when China unified and depreciated its currency, that encourages foreign direct investment flows into China and that propels export growth. As a result, China has amassed foreign exchange reserves that exceed that of Japan and has reached over $1 trillion; the lions share of these reserves are used to purchase U.S. securities thus helping to keep interest rates low in the United States. The increase in foreign exchange reserves in turn increases the money supply in China by 18-20% annually, resulting in increased bank lending (mostly to state-owned enterprises) that increases industrial overcapacity which, in turn, fuels the industrial economy – now growing at 10-12 percent annually.

This export-led growth strategy has created a U.S-China trade relationship of extremes. While U.S. exports are growing faster to China than to any other single market, imports, at much higher levels, from China continue to grow creating the largest bilateral trade deficit in the world. At current trends, the bilateral trade deficit, of over $200 billion, will more than double in five years. Companies that are producing in China are benefiting by lowering costs for their exports, keeping prices low in the United States; companies that produce mainly in the U.S. domestic market face severe competition from Chinese products and in diminishing downstream domestic markets for their products.

The remnants of China's state-controlled economy still prevail, accounting for many of the trade disputes that China has with the United States and with other WTO members. Disputes over semiconductors, auto-parts, intellectual property protection, and subsidies stem from entrenched government interference in a marketplace still in its infancy and the failure of a judiciary to be independent with decisions based on the rule of law. China's drive for equal status with the United States coupled with the ongoing Chinese internal conflicts between the still-powerful remnants of state control mean that trade frictions between the United States and China will continue to increase and become more acrimonious. Equally important, China's undervalued exchange rate and its overheated

Major Trade Disputes

China's transitional economy and its legal system need to be brought into conformity with WTO principles. The underlying principle of the WTO and the global trading system is that markets will function in a transparent manner to distribute the benefits of trade to the participants. The role of markets is critical; otherwise trading partners will not receive the benefits of concessions granted in trade negotiations. Because China's economy is still in transition, markets have neither worked efficiently nor have they been transparent. While there are many countries with economies still in transition, the size of China's economy coupled with its dominance in trade, require that China conform to WTO principles in order for the entire trading system to work as envisioned. Failure to do so will mean that current disputes will continue to spin out of control. The situation in the following three areas is critical:

- Currency Manipulation: China's undervalued exchange rate is subsidizing its exports, taxing imports and encouraging foreign direct investment to flow to China, at the expense of investment to other countries in the region. As a result, increases in foreign exchange reserves generate global overcapacity which threatens the global financial system when the first downturn occurs. To a large degree, China's undervalued exchange rate has encouraged manufacturing to move to China displacing U.S. jobs. That manufacturing jobs have not increased is owed in no small measure to this effect.
- Intellectual Property Rights: China's unwillingness or inability to address IPR protections hits directly at the competitive industries in the United States. While the Central government has periodically closed manufacturing pirates of DVDs and CDs, the government has virtually ignored the equally serious issue of counterfeiting which Chinese pirates produce imitation goods that are hazardous, such as drugs without active ingredients, disc brakes made of sawdust, children's clothing that is not flame retardant. China applies administrative penalties equivalent to "slaps on the wrist," but not measures that would curtail counterfeit production. China rarely applies criminal penalties to IPR piracy.
- Industrial Policy: China is increasingly relying on industrial policy measures to prevent foreign suppliers from entering or increasing access to China's market. China is establishing standards that are unique to China but which give Chinese producers a competitive advantage. These policies are expanding into all fields, not just automotive, telecommunications, and electrical equipment.

U.S. Leadership Needed

The global trading community is depending on the United States to take the leadership role with China, as demonstrated by the fact that the United States is the only country to have initiated dispute settlement against China. This is not a new role for the United States. For example, U.S. leadership in the global economic arena is credited with the establishment of the General Agreement on Tariff and Trade (GATT), with the consecutive rounds of trade negotiations under the GATT/WTO and with resolving the trade disputes with Japan in the 1980s.

Dialogue vs…

While the United States, in exercising that leadership role, has an arsenal of tools, dialogue has been the principal method used to resolve disputes with China, increasing both in numbers and in levels of representation. When China joined the WTO, the principle forum of dialogue was the Joint Commission on Commerce and (JCCT) jointly chaired by the U.S. Secretary of Commerce and the China's Minister of Trade. In addition, the secretary of the Treasury and China's Ministry of Finance held their own dialogue, the Joint Economic Commission, on monetary issues. Since that time, that JCCT forum has been elevated, to be represented by China's then-State Councilor, and now Vice Premier, Wu Yi and jointly on the U.S. side by the Secretary of Commerce and the USTR. In 2006, with the appointment of Secretary Paulson as Secretary of the Treasury, the "enhanced" JCCT along with the JEC have been combined under the Strategic Economic Dialogue (SED), represented by Vice Premier Wu Yi and by Secretary Paulson along with other cabinet officers. The SEC encompasses more than the JCCT since it also includes issues that fall within the monetary sphere, such as exchange rate manipulation. Since China joined the WTO, dialogue has been the preferred vehicle for raising and resolving issues with China by the United States. That the United States has continually raised the level of representation in these dialogues underscores the desperation to which the United States is driven to achieve success. Unfortunately, last year's pilgrimage to Beijing by Secretary Paulson and a bevy of Cabinet officers was simply viewed by the Chinese as the American's kowtowing to China.

Unfortunately, the record of success for these dialogues is, at best, weak. While those dialogues have been the opportunity for the United States to publicize agreements reached with China, little, if any, actual results have been achieved when measured by impact on trade. The achievements of the April 2006 JCCT meetings demonstrate the ineffectiveness of dialogue in resolving disputes with China:

- China committed to open the market for U.S. beef. One year later, U.S. beef exporters were unable to gain access to China's market. According to USTR's National Trade Estimate (NTE) report, there has been no bilateral beef exports from cows aged 30 months or less. China released a list of 22 conditions that the United States would have to meet before it would accept any beef; some conditions were unrelated to bovine spongiform. According to *Inside U.S. Trade*, the beef industry has asked that this issue be included on the agenda for the May SED meeting.

- China agreed to lower its registered capital requirement for foreign telecom service providers. China has not done so by late last year and probably has not done so this year given that the NTE report was silent on any positive results.
- China also committed to issue technology-neutral telecom standards. However, it does not appear that China has abandoned those standards and the non-transparency of China's regulatory regime makes it difficult to ascertain that technology-neutral standards exist.
- In addition to not meeting those obligations, China has taken steps backward in the telecom area. China's Ministry of Information Industry and China Telecom may adopt policies aimed at discouraging the use of imported components or equipment and that China has failed to eliminate redundant testing requirements in the telecommunications industry.
- China agreed in 2006 to eliminate duplicative testing requirements on medical devices. However, China only eliminated redundant testing and testing fees but did not eliminate redundant application fees, certification processes and inspection teams for inspecting the manufacturing facilities of medical device makers in the United States.
- China also "reiterated" its commitment that the Postal Law will not harm foreign express delivery companies. Nevertheless, the current draft law continues to include provision which according to the NTE report to "generate serious concerns," since it would exclude foreign service providers from the domestic market.

In summary, China has not met its commitments under the 2006 "enhanced" JCCT meeting, despite the higher level representation on both the Chinese and U.S. sides. While dialogue frequently results in agreements or understandings, they rarely result in meaningful resolution of the dispute and greater trade flow as the outcomes of the 2006 JCCT meeting demonstrate. Mostly, the forums for dialogue beget more dialogue. [For further information on the results of the JCCT, see: China's 2004, 2005, and 2006 JCCT Commitments, the US-China Business Council, Washington, DC, 2006]

Aggressive Action

Aggressive measures have had a better record of success, although the United States has undertaken such steps reluctantly and sparingly. For example:

- The dispute over semi-conductors in 2004 was the subject of a numerous bilateral discussions, including within the Joint Commission on Commerce and Trade (JCCT). China refused to amend its practices until the United State exercised its rights under the WTO and filed a case in March. China quickly revised its policies and practices after a dispute was filed. In addition, the threatened use of WTO dispute settlement became the basis for then USTR, Robert Zoellick, to reach agreement on another nettlesome issue, China's threatened use of regulations governing proprietary security technology for wireless networking chips.

- In the dispute over Kraft linerboard paper, where China was improperly applying antidumping duties, China agreed to eliminate those measures in January 2006 after USTR indicated that it would file a WTO case against China.
- The lack of enforcement of IPR in disputes with China over IPR in the 1995-96 resulted in sanctions being identified and threatened. As a result, according to Chinese Government statistics, China seized some 35 million illegal audio-visual products from 1994 to year-end 1998. It shut down or fined 74 assembly operations for pirated VCDS and seized over 20 million smuggled VCDs during the same period.

While the examples of more aggressive trade strategies with China are rare, the results have generally been more favorable. In the other cases involving dispute settlement in the WTO brought by the United States, China is continuing to litigate those disputes within the WTO. The major advantage in those disputes is that other countries including the EU, Japan, and Canada, among others, have joined in some of those disputes.

That China responds to more aggressive strategies while not making serious progress through dialogue is not surprising. The results of dialogue demonstrate that China does not believe it needs to change it practices or, if pressured to act, it does so in small increments and over very long periods of time. For example, China reluctantly agreed to adopt a "flexible" exchange rate (following threats to pass the Schumer/Graham tariff bill) but only appreciated its currency by 2.1 percent (estimates of undervaluation range from 15%-75%).

Tools for Action

On the other hand, sanctions and/or the threat of sanctions are recognized as the best way of balancing the interests of both countries when one country's practices are not fully compliant with WTO rules or international practice. The WTO system itself recognizes that the fundamental rationale for countries to effect policy changes is the threat of sanctions, a basic component of the WTO dispute resolution system.

While sanctions under WTO dispute resolution are not common, other, more aggressive, tools are available to the United States. China's WTO accession agreement recognized and accommodated some of the special characteristics of China's economy as a means of helping the international trading system adjust to China's transition to a market economy.

- First, China recognized that it was still a non-market economy country and included a provision to allow companies filing anti-dumping complaints to treat China as a non-market economy country by using third country pricing where appropriate (15 years from date of accession).
- Second, China recognized that in the area of subsidies, other WTO members would be able to use other, non-market, methodologies to calculate subsidies. (no time limit). This provision has never been used since the Department of Commerce has only recently accepted a countervailing duty case involving paper products.

- Third, China agreed to permit other countries to apply safeguard actions solely against China when Chinese imports were creating market disruption and when injury was occurring. (12 years from date of accession). The United States has not agreed to apply sanctions in the five cases where the ITC found injury.
- Fourth, China agreed to annual special review mechanisms of China's implementation of its WTO commitments. (8 years from date of access and one special review on the 10^{th} year)

While the United States has used (prior to accession) and continues to use the non-market methodology for antidumping cases, that provision has been undermined by a Department of Commerce rule that benefits China in allowing new shippers a zero anti-dumping duty. Thus Chinese manufacturers change their names and avoid paying antidumping duties

With respect to the application of non-market methodology for countervailing duties against illegal subsidies, the Department of Commerce has only recently accepted its first case. This case is an opportunity for the United States to demonstrate that it will treat illegal subsidies by China seriously and not provide a simple "slap on the wrist." Most important, it provides a remedy for industries facing injury from unfair subsidies for China's industries.

With respect to the special WTO reviews, those discussions have become non-events with China not responding effectively to any of the recommendations of other countries. The United States and other countries have continued to allow China to diminish the role of the review so that it is non-substantive with no results – not too dissimilar from other forms of dialogue.

Most important, the United States has never implemented any of the USITC recommendations on section 421. This domestic provision, based on China's WTO Accession Agreement, allows countries to apply restrictions to imports from China, over a three-year period when market disruption occurs and when a domestic industry is being injured. In the five cases where the ITC found market disruption and injury, remedies, including those recommended by the ITC, were denied by the Administration. Implementation of these remedies would have signaled to China that the United States was prepared to defend its trade interests. While China frequently shouted protectionism, U.S. officials refused to note that China's non-market practices were in themselves protectionist.

Even on the most egregious practice on the part of China – currency manipulation – the United States has responded weakly by promising more dialogue or, its alternative, more dialogue at cabinet level. While China did announce that it would appreciate its currency the Yuan in July, that appreciation followed a threat by the Senate on passing the Schumer/Graham legislation to apply a 27.5% rate of duty on all imports from China. Since that time, China has allowed its currency to appreciate slowly even as other factors compensate by effectively depreciating the currency. In short, China comes out ahead on currency even while it appreciates as demonstrated by the fact that in the first quarter of

2006, China's foreign exchange reserves doubled over the first quarter of the previous year. Both the WTO and the IMF prohibit currency manipulation for commercial advantage, yet the United States has refused to take concrete action in either body to eliminate this egregious practice that subsidizes China's exports and taxes U.S. exports to China. In fact, on the three section 301 cases that were filed on currency manipulation, the United States has rejected all those petitions, giving enormous comfort to China.

The United States, while continuing the current dialogue, needs to implement a more assertive and creative trade policy toward China along the following lines:

- Request the U.S. ITC to review the past section 421 petitions to see if the conditions of injury and market disruption continue to prevail in which case sanctions should be applied.
- Indicate that until China's exchange rate better reflect underlying economic fundamentals, that the Department of Commerce will include undervaluation as a prohibited export subsidy in countervailing duty investigations. Under the WTO Agreement on Subsidies and Countervailing Measures, currency manipulation to maintain an undervalued currency is a prohibited export subsidy subject to countervailing duties.
- Continue to press for resolution through the WTO on cases where China is violating its WTO commitments. If necessary, overwhelm the WTO system.
- Allocate resources to the Bureau of Customs to more aggressively monitor counterfeit goods from China. Currently, China accounts for the lion's share of seizures by Customs. Customs should apply a higher rate of inspection on imports from China and other major sources of piracy. In addition, importers and exporters found involved in piracy should experience an even higher level of inspections by Customs.
- Use mediation on disputes where there is no clear violation of WTO rules but an inconsistency with international trade practice.
- Since provincial governments are so often the cause of China not meetings its international obligations, the United States or some independent body should publish a provincial scorecard of business indicators that measure provinces implementation of WTO commitments and business indicators (similar to the World Bank's *Doing Business* Survey).

All the measures cited above are WTO consistent, either with the rules themselves or with the special provisions in China's WTO accession agreement. For the most part, the United States has failed to use all these methods since so many U.S. companies and multinational companies are invested in China and they vigorously oppose any measure that would disrupt commercial flows. The net result is that companies that produce and compete in the domestic market (but not in China) face severe competition from China, particularly by the subsidized exchange rate. Those companies not only cannot compete against imports from China, many of their customers have moved to China resulting in smaller domestic markets for their products. Were the United States simply to take action to defend domestic producers from unfair Chinese practices, e.g., section 421 measures and countervailing duty measures against exchange rate subsidies, China would recognize that the United States was prepared to take an assertive, leadership role. Furthermore, U.S. action would enable other countries to follow the U.S. lead and implement similar measures.

Conclusions for Congress

Congress has and can continue to have a significant effect in setting a more aggressive strategy and in generating more positive and significant results. First, as previously mentioned the threat of passage of the Schumer/Graham legislation was successful and resulted in China de-pegging the Yuan from the dollar and in the slight appreciation. China did what it does so well, make some minor changes that won't seriously impact its interests and, then, declare victory. But like the annual reviews of MFN in the 1990s, China can become immune that Congressional threats especially if the votes for passage are not there. China is increasingly becoming more attuned to the nuances of Congressional "action." Second, passage of effective laws can require a reluctant Administration to take the steps necessary to defend U.S. interests. For example, passage of the Fair Currency Act of 2007 would require the Department of Commerce to provide relief to U.S. companies suffering injury from China's subsidized exchange rate. Also, Congress could pass legislation requiring the President to implement ITC recommendations for relief under section 421. In short, Congress has a co-equal role on trade and can affect policy in a variety of ways, all of which are consistent with the WTO.

China will object to these measures in very vocal ways. In addition, other countries may also leap to China's side expecting that Beijing will offer a reward in the form of major infrastructure projects. While all that is happening, as it has in the past, China will recognize that the United States is serious and is prepared to fight for U.S. interests. And China will respect the United States for it leadership role in global trade.