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US-CHINA TRADE DISPUTES: RISING TIDE, RISING STAKES

Gary Clyde Hufbauer, Yee Wong, and Ketki Sheth

INSTITUTE FOR INTERNATIONAL ECONOMICS

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Contents

Preface **ix**

1 Introduction **1**
Forces Larger than China 2
China in Global Trade and Investment 4
US-China Bilateral Trade Friction 4
Overview of Trade Disputes 9

2 The Revaluation Debate **11**
Section 301 Petition 13
Key Players 13
The Legal Case, Part 1: GATT Article XV (4) 16
The Legal Case, Part 2: IMF Article IV 24
Evaluation 27

3 Textiles and Clothing **29**
The Brassiere Case 29
The End of the MFA 30
Sources of China's Comparative Advantage 34
Evaluation 36

4 Intellectual Property Rights **39**
Accomplishments 42
Evaluation 44

5 The CNOOC Case **47**
CFIUS Review 48
Evaluation of the Case 50

Dubai Ports World Case 53
Conclusion 53

6 Semiconductor Chips and Automobile Parts 55
Semiconductor Chips 55
Automobile Parts 61

7 Antidumping Disputes 63
Nonmarket Economy Status 63
Furniture 70
Color Televisions 73
Conclusion 74

8 Conclusion 75
Comparison with Japan 76
Lessons from History 77
The Bottom Line 80

Appendix A Tables 83

Appendix B Safeguards and Antidumping Remedies Against Textile and Clothing Imports 95

Appendix C Short History of US-Japan Trade Frictions 97

References 101

Index 107

Tables

Table 1.1 US trade with the world and current account balance, 1999–2005 5
Table 1.2 US-China trade, 1999–2005 6
Table 1.3 China's merchandise trade balance with selected partners, 2004 7
Table 1.4 Comparison of China's export growth with other Asian economies 8
Table 1.5 Summary of US-China trade disputes, 2005 9
Table 2.1 Current and prospective US bilateral trade with Asian partners, 2005 28
Table 3.1 US-China textile and clothing trade, 2000–2005 35
Table 6.1 US electronics and information industry trade with China and Japan, 1997–2005 58
Table 8.1 Comparison between US-Japan and US-China trade, 1986 and 2005 77
Table A.1 Statistical relations between US manufacturing employment, output, and trade 83

Table A.2 Significant US congressional bills and resolutions concerning Chinese trade and currency practices 84
Table A.3 Official and unofficial proposals for renminbi revaluation 91
Table A.4 Selected international treaties signed by China dealing with intellectual property 94

Boxes

Box 1.1 US manufacturing and the US trade deficit 3
Box 3.1 Limits to textile and clothing liberalization: The MFA quota phaseout 31

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Preface

Since its accession to the World Trade Organization (WTO), China has emerged as a major force in global production and trade. In 2005 China became the world's sixth largest economy at market exchange rates, ahead of Italy and just behind France. China is also the third largest trading partner for the United States. As China continues to rise as a great power, its bilateral merchandise trade surplus with the United States has exploded—to $201 billion in 2005—while its global current account surplus has widened to $160 billion in 2005, more than 7 percent of GDP. With China accounting for more than one-fourth of the total US trade deficit, and with Chinese foreign exchange reserves approaching $1 trillion, US-China economic relations have become the focus of intense political debate.

These issues are analyzed in the context of China's overall economic prospects, along with US-China security and foreign policy issues, in *China, The Balance Sheet: What the World Needs to Know Now about the Emerging Superpower,* a recent book by the Institute and the Center for Strategic and International Studies published by Public Affairs Press. This new study addresses the trade policy disputes between China and the United Sates. It attempts to present a comprehensive view of the challenges facing the United States and China in their commercial relations and to suggest policies for managing disagreements over the next few years.

Overshadowing all trade disputes is the renminbi exchange rate. This issue has already been addressed in a number of Institute studies, primarily by Senior Fellows Morris Goldstein and Nicholas Lardy, and this new analysis focuses on the prospects for using trade policy instruments

(mainly via the WTO) to promote currency adjustment. Authors Gary Clyde Hufbauer, Yee Wong, and Ketki Sheth also offer an outside estimate that a revaluation of the renminbi and other Asian currencies by 20 percent, together with a sharp reduction in the US savings deficit, might reduce the US global current account deficit by as much as $120 billion per year. Alternative estimates developed by other economists at the Institute, on the basis of more in-depth study of the currency misalignments, suggest a possible improvement in the US trade balance of $60 billion to $80 billion per year from such alterations in Asian exchange rates.

While the renminbi is the biggest lightning rod at the moment, it is by no means the only commercial dispute between China and other major countries. After the termination, in January 2005, of import quotas imposed under the Multi-Fiber Arrangement, followed by the rapid expansion of Chinese textile and clothing exports, both the United States and the European Union negotiated a fresh set of bilateral quotas with China. While the new quotas are set to expire in 2008, textile and clothing trade disputes are virtually certain to continue for a decade or longer. Disagreements over Chinese tax incentives, the violation of intellectual property rights, antidumping duties, and China's nonmarket economy status add to the litany of commercial disputes. The recent US decision to block CNOOC's bid to acquire Unocal and other investment issues compounded trade frictions.

This study is an expanded version of the Institute's Policy Brief, *China Bashing 2004,* authored by Gary Clyde Hufbauer and Yee Wong. This new publication is intended to reach a broader audience and provide an updated analysis of US-China commercial frictions, in response to requests from congressional staff and other interested readers. In their report, the authors offer specific proposals for both countries to jointly manage their foreseeable trade disputes in the years ahead.

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The Institute is funded by a highly diversified group of philanthropic foundations, private corporations, and interested individuals. Major institutional grants are now being received from the William M. Keck, Jr. Foundation and the Starr Foundation. About 33 percent of the Institute's resources in our latest fiscal year were provided by contributors outside the United States, including about 16 percent from Japan.

The Institute's Board of Directors bears overall responsibilities for the Institute and gives general guidance and approval to its research program, including the identification of topics that are likely to become important over the medium run (one to three years) and that should be addressed by the Institute. The director, working closely with the staff

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The Institute hopes that its studies and other activities will contribute to building a stronger foundation for international economic policy around the world. We invite readers of these publications to let us know how they think we can best accomplish this objective.

C. Fred Bergsten
Director
June 2006

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Introduction

Ever since President Richard Nixon's celebrated trip to Beijing in 1972, the party out of power has chastised the White House for being "soft on China"—in security terms, economic terms, or both. In turn, the administration insists that it is both tough and diplomatic. In recent times, the backdrop of a growing bilateral trade deficit ($201 billion in 2005), declining numbers of US manufacturing jobs (down from 17.3 million in 2000 to 14.3 million in 2005), and increased concerns about national security have made the familiar drama more acute. The nature of the relationship between the United States and China may be decades old, but the urgency of the disputes that arise between them is new.

As China continues its rise as a great power, Congress and the administration wrestle with one another over the proper tactics and strategies to shape US-China economic relations. Recent congressional legislative proposals have called for renminbi revaluation, import tariffs, and a larger congressional role in reviewing foreign takeovers. One of the recent bills (HR 4733) calls for the creation of a congressional "trade enforcer" to launch dispute resolution cases in the World Trade Organization (WTO)—a proposal clearly aimed at China.[1]

The momentum in Congress in proposing bills regarding US-China relations has spurred the administration to offer its own proposals to head off unwelcome legislation. In February 2006 the United States Trade Representative (USTR 2006) released its *Top-to-Bottom Review of*

1. See "Democrats Offer Legislation with Eye Toward Trade Deficit Report," *Inside U.S. Trade,* February 10, 2006. Under this bill, the USTR could object to the case, but Congress could override the USTR.

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US-China Trade Relations, which included a call to "strengthen the Executive-Congressional Partnership on China Trade." The USTR promised regular briefings for congressional members and staff and emphasized opening a new phase of US-China relations, since China had implemented most (but not all) of its WTO obligations. The USTR review calls for additional personnel to create an internal China enforcement task force within the USTR (USTR 2006). While the review attempts to assuage Congress, it portrays the administration and USTR as the leaders in shaping US-China trade relations. In this sense, the USTR review in 2006 echoed the Treasury's initiatives in 2005 on the renminbi exchange rate.

Forces Larger than China

The US bilateral deficit with China is only part of the US external imbalance with the rest of the world. The US global trade deficit in goods and services widened from $375 billion in 2000 to $725 billion in 2005.[2] In macroeconomic terms, when a country spends beyond its income—as the United States has done on a large scale for several years—imports must exceed exports to absorb the difference between national spending and national income. The widening US trade deficit between 2000 and 2005 thus reflects lower household savings and higher federal budget deficits. The rest of the world willingly provides the dollars to finance US spending habits because the United States is an attractive place to invest (see box 1.1)—so attractive that the dollar actually strengthened in foreign exchange markets for much of the time that the trade deficit grew. If the United States did not have a growing bilateral trade deficit with China, it would have experienced larger trade deficits with other countries.

Job losses in the manufacturing sector are part of an even longer trend as the United States increasingly becomes a services economy. Since 1950, the proportion of US jobs in the manufacturing sector has dropped from about 31 to 12 percent. But the absolute decline between 2000 (17.3 million workers) and 2005 (14.3 million workers) was particularly brutal, and many firms and workers laid the blame squarely on China.[3]

2. The US current account deficit in 2005 was wider still, at $805 billion, since it includes unilateral transfers as well as commercial trade in goods and services.

3. For examples of US concern over China's role as a manufacturing hub, see Shenkar (2004) and Morici (2006); see also Ernest H. Preeg, The Emerging Chinese Advanced Technology Superstate, Statement before the US-China Economic and Security Review Commission, Washington, April 21, 2005.

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Box 1.1 US manufacturing and the US trade deficit

The main causes of the US trade deficit—or more precisely, the US current account deficit ($411 billion in 2000, rising to $760 billion in 2005)—are low national savings and a strong dollar. US household savings remain modest: 2.3 percent of disposable personal income in 2000 and −0.4 percent in 2005. Moreover, the federal budget surplus of $230 billion in 2000 turned into a deficit of $318 billion in 2005. When the United States has a trade deficit, it is concentrated in manufactured goods, mainly because manufactures are the most readily traded sector of the economy and account for about 80 percent of US exports and imports. In 2005 the US trade deficit in manufactures was $541 billion.

The trade deficit is not the main reason for job losses in the manufacturing industries. The main reasons between 2000 and 2003 were recession (a drop in quarterly US purchases of manufactured goods from $479 billion to $462 billion between 2000Q4 and 2003Q2) and rising manufacturing productivity (accelerating from 3.4 percent annually in 1990–95 to 4.1 percent annually in 1995–2000 to 4.9 percent annually in 2000–2005). Net US manufactured imports increased from $396 billion in 2000 to $541 billion in 2005. If one assumes that each additional $1 billion of domestic manufacturing output creates 2,620 jobs and that each $1 billion increase in net imports corresponds with a $1 billion destruction of domestic manufacturing output, then the increase in the annual manufactures trade deficit (of $145 billion) might be blamed for almost 400,000 manufacturing job losses between 2000 and 2005 (see appendix table A.1). Using a less mechanical methodology, Martin Baily and Robert Lawrence (2004) estimate that about 256,000 US manufacturing jobs (15 percent of the total) were lost due to rising net imports during 2000–2003.

Both estimates assume that a US manufacturing trade deficit causes a decline in US manufacturing output. However, this assumption is not validated empirically. In fact, our estimates, based on 1990 and 2005 quarterly data, reject the hypothesis that a deterioration of the trade balance is correlated with a contraction of manufacturing output at the 5 percent significance level. In fact, the negative coefficient reported in equation 2 in appendix table A.1 indicates that a larger US manufacturing trade deficit generally corresponds with higher, not lower, US manufacturing output. This can be readily explained by the dominant force of rising and falling national income in driving both US imports of manufactures and US output of manufactures. To summarize, the political arithmetic that equates trade deficits with job losses is either exaggerated or plain wrong (see appendix table A.1).

Source: Baily and Lawrence (2004).

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China in Global Trade and Investment

China's role in global trade is often overlooked. In 2005 China surpassed Japan as the world's third-largest importer and became the world's sixth-largest economy, ahead of Italy and behind France.[4] Also in 2005 China became the world's third-largest exporter, and two-way trade with China accounted for at least 13 percent of world trade expansion that year. The emergence of China as an economic power has been a boon for commodity producers. China is currently the world's second-largest consumer and importer of oil, after the United States and ahead of Japan, and its demand for crude oil is projected to grow by 4 percent annually over the next decade.[5]

Also not often appreciated is the openness of the Chinese economy, measured by the trade-to-GDP ratio, or imports plus exports divided by GDP. The current trade-to-GDP ratio for China is about 70 percent. By comparison, Japanese and US trade openness ratios were about 20 percent each in 2004.[6] Another indication of Chinese openness is the ratio of foreign direct investment (FDI) stock to GDP.[7] The figure for China in 2004 was 42 percent, for Japan, 2 percent, and for the United States, 20 percent.

US-China Bilateral Trade Friction

Since its accession to the WTO, China has become the United States' third-largest trading partner and the sixth-largest market for US exports. Between 2000 and 2005, US imports from China rose from $100 billion to

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4. In December 2005 the Chinese government revised its GDP growth estimates to better measure its rapidly growing services sector. According to its measures, the Chinese economy reached about $1.98 trillion in 2004 at the market exchange rate. Andy Xie, a Morgan Stanley economist, believes that China's GDP could reach $10 trillion and be as large as that of the United States by 2020. See Lardy (2005); James Areddy, "China Boosts GDP Rates to Reflect Services Gains," *The Wall Street Journal*, January 10, 2006; and Xie (2003a).

5. In 2005 China accounted for half of global consumption of cement and 27 percent of steel. China alone accounted for 30 percent of the growth in world oil demand in 2004. See "The Commodities Bonanza from China," *Asiamoney*, February 1, 2004; and "Asia's Oil Equation: Managing Demand Is As Important As Securing Supply," *Financial Times*, June 28, 2005.

6. Based on IMF's *International Financial Statistics* database, January 2006. See Yasheng Huang, Is China Playing by the Rules? Free Trade, Fair Trade, and WTO Compliance, Testimony before the Congressional-Executive Commission on China, Washington, September 24, 2003.

7. Based on GDP at current exchange rates from the IMF's *World Economic Outlook* database (April 2005) and UNCTAD's *World Investment Report* (2003). Yasheng Huang argues that the inefficiencies of the Chinese economy make China unusually open to foreign trade and FDI. See Yasheng Huang, Is China Playing by the Rules? Testimony before the Congressional-Executive Commission on China.

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Table 1.1 US trade with the world and current account balance, 1999–2005 (billions of dollars)

Year	Total merchandise trade: US imports[a]	Total merchandise trade: US exports[b]	Total services trade: US imports	Total services trade: US exports	Goods and services trade balance	Current account balance[d]
1999	1,017	642	184	266	–293	–300
2000	1,205	712	209	285	–417	–416
2001	1,133	666	206	275	–398	–389
2002	1,155	630	212	282	–455	–475
2003	1,250	651	228	296	–531	–520
2004	1,460	727	263	328	–668	–668
2005[c]	1,662	804	322	378	–802	–725

a. Imports for consumption.
b. Domestic exports.
c. According to Bureau of Economic Analysis statistics, which differ from US International Trade Commission statistics, US merchandise imports for 2005 were $1,675 billion and exports were $896 billion.
d. The current account balance differs from the goods and services trade balance mainly because of unrecorded flows of goods and services.

Sources: Merchandise trade: USITC Dataweb, 2006; services trade: Bureau of Economic Analysis, 2006.

$243 billion, while US exports to China climbed from $16 billion to $42 billion.[8] The steady reduction of Chinese trade barriers over the last two decades facilitated the growth of Chinese exports as well as imports.[9] The expansion of US-China commerce delivers lower prices to American consumers and producers and enables both countries to use their resources more efficiently. Despite the benefits on both sides of the trade equation, most US politicians view the bilateral deficit in purely negative terms.

Several caveats apply to evaluating the size and balance of US-China trade. Even though China runs a large bilateral trade surplus with the United States—about $201 billion in 2005—according to US statistics it runs a trade deficit with the rest of the world, most notably about

8. US merchandise exports to the rest of the world rose from $697 billion in 2000 to $765 billion in 2005 (USITC Dataweb, March 2006).

9. In unweighted average terms, Chinese tariffs declined from 55.6 percent in 1982 to 12.3 percent in 2002 (IMF, *World Economic Outlook,* 2004). In accordance with Lerner's (1936) teaching that import tariffs act as export taxes, the progressive reduction of Chinese import duties facilitated the rapid growth of Chinese processing industries using imported inputs.

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Table 1.2 US-China trade, 1999–2005 (US statistics, millions of dollars)

Year	Merchandise trade		Services trade		Goods and services trade balance
	US imports[a]	US exports[b]	US imports	US exports	
1999	82	13	3	4	–68
2000	100	15	3	5	–82
2001	102	18	4	6	–82
2002	125	21	4	6	–102
2003	152	27	4	6	–123
2004	196	33	6	7	–162
2005[c]	243	39	7	7	–201

a. Imports for consumption.
b. Domestic exports.
c. Services trade estimated using 2000–2004 growth trend.

Sources: USITC Dataweb, 2006; Bureau of Economic Analysis, summary data for private services trade by area and country, 1992–2004.

$48 billion in 2005 with its Asian partners (tables 1.1, 1.2, and 1.3).[10] China's deficit with its Asian partners reflects its growing role as a final assembler in Asian production networks, one direct consequence of which is that the US bilateral trade imbalance with China rises as its trade imbalance falls with other Asian countries, especially Hong Kong, Taiwan, Korea, and Japan. Goods assembled from imported parts and components account for about 55 percent of China's total exports and 65 percent of Chinese exports to the United States.[11] In 2005, according to its own official data, China's trade surplus represented only 2 percent of China's GDP. However, US observers are skeptical of official Chinese trade statistics; unofficial US sources put China's trade surplus at 6 to 7 percent of GDP (Goldstein and Lardy 2005, Bergsten et al. 2006).

Another common explanation for the rising US bilateral trade deficit with China is that China limits market access. Although China's tariffs are higher than those of its peers in the Organization for Economic Cooperation and Development, its tariffs remain among the lowest of any developing country. In 2004 the average level of tariffs was about 10.4 percent, but the effective tariff ratio was only 2.2 percent (Bergsten et al. 2006).

The comparison between China and Japan is instructive. Since 1981, Japan has run global current account surpluses, often very large. Begin-

10. The rise in Chinese imports from the surrounding region reflects its growing importance as a manufacturing hub for reexports (IMF, *World Economic Outlook,* 2004).

11. C. Fred Bergsten, "Clash of the Titans," *Newsweek,* international edition, April 24, 2006.

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Table 1.3 China's merchandise trade balance with selected partners, 2004 (Chinese statistics, unadjusted, billions of dollars)

Region/country	Exports	Imports	Trade balance
Hong Kong	100.9	11.8	89.1
United States	125.0	44.7	80.3
European Union	107.2	70.1	37.0
Australia	8.8	11.6	–2.7
Russia	9.1	12.1	–3.0
Association of Southeast Asian Nations	42.9	63.0	–20.1
Japan	73.5	94.4	–20.9
Korea	27.8	62.3	–34.4
Taiwan	13.6	64.8	–51.2
Total	593.4	561.4	32.0

Source: China Ministry of Commerce 2005 data.

ning in 1993 China ran modest global current account surpluses, though they have soared recently.[12] Much of China's accumulation of foreign exchange reserves corresponds to inward flows of portfolio capital and FDI, not trade surpluses.[13] While Chinese exports accounted for nearly 7 percent of total world exports in 2004, they are still less than Japan's record of 10 percent in 1986 (see table 1.4 for a comparison of China's export growth with that of other Asian economies).[14]

However, the US bilateral deficit with China is now greater than it was at its 2000 peak with Japan. In 2000 the US bilateral trade deficit with

12. While China has a trade surplus with the United States ($201 billion in 2005) and runs a huge trade deficit with the rest of the world ($82 billion in 2004), Japan has a large trade surplus with both the United States ($83 billion in 2005) and the rest of the world ($45 billion in 2004). See Lawrence Lau, Is China Playing by the Rules? Free Trade, Fair Trade, and WTO Compliance, Testimony before the Congressional-Executive Commission on China, Washington, September 24, 2003.

13. Chinese "hot money" capital inflows dropped in the second half of 2005 after the small appreciation, but as of mid-2006, they are again flowing at a brisk rate in anticipation of another, larger revaluation. Flows could exceed $10 billion a month. For the 2003–05 story, see "Portfolio Investment in China: Cooling Down," *The Economist,* January 28, 2006.

14. See "Is The Wakening Giant A Monster?" *The Economist,* February 13, 2003. Chinese exports are based on the China Ministry of Commerce statistics database, 2005, and world exports on IMF, *World Economic Outlook,* 2005.

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Table 1.4 Comparison of China's export growth with other Asian economies

Country/group	Period[a]	Number of years	Average annual real export growth rate (percent)
Korea	1960–95	35	21.5
Japan	1954–81	27	14.2
China	**1978–2004**	**26**	**13.7**
Newly industrialized economies[b]	1966–97	31	13.1
Malaysia	1968–96	28	10.2

a. Periods of sustained export expansion, ending when the three-year moving average export rate declined below 10 percent.
b. Hong Kong, Korea, Singapore, and Taiwan.

Sources: IMF's *Direction of Trade Statistics,* 2005; Prasad and Rumbaugh (2003).

Japan was $85 billion, about 0.9 percent of US GDP. In 2005 the US bilateral trade deficit with China was $201 billion, about 1.6 percent of US GDP. At its highest point in 1986, the ratio between US imports from Japan and US exports to Japan was 3.0. The comparable ratio for US trade with China in 2005 was 5.8, implying that US exports to China must grow nearly six times as fast as US imports from China to narrow the gap in dollar terms. Between 2000 and 2005, US exports to China increased by 163 percent, while US imports from China grew by 143 percent.[15] US exports grew faster than imports but not nearly fast enough to narrow the dollar gap.

After China joined the WTO in December 2001, trade complaints were temporarily put on hold. The grace period is now over as US manufacturers and labor unions scramble to file complaints. Congress has joined the fray, introducing more than 15 new bills against Chinese practices since January 2005 (appendix table A.2). The complaints range from the undervalued renminbi, China's slow progress in meeting WTO commitments, and standards for assessing countervailing duties to concerns about national security. This book catalogues and evaluates the main complaints now on the table.

15. It should be mentioned that, during 2000–2005, US exports to the rest of world increased by only 10 percent.

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Table 1.5 Summary of US-China trade disputes, 2005

Dispute	Share of US imports from China (percent)	Share of US exports to China (percent)	US-China trade balance (billions of dollars)	Potential reduction in US-China bilateral trade deficit (billions of dollars)
Renminbi revaluation (20 percent)[a]	100[e]	100[e]	–185.3	36.1
Textiles and clothing[b]	15[e]	1	–19.3	5.1
Furniture[c]	40[e]	1	–15.4	3.7
Semiconductors[d]	3	5[e]	1.0	0.3
Color television sets[c]	9[e]	0	–2.0	0.5
Total imports (billions of dollars)			222.9	189.6
Total exports (billions of dollars)			37.6	50.1
Total trade balance (billions of dollars)			–185.3	–139.5

a. See text for explanation. This is a high-end estimate and assumes a $24 billion reduction in imports and a $12.2 billion increase in exports.
b. Assuming that the November 2005 bilateral textiles and clothing agreement exerts five times the effect of limits imposed earlier on brassiere imports. This may be a low estimate of future restraints.
c. Assuming that the highest penalty duties (24 percent) apply to all imports.
d. The 13 percent value-added tax preference for domestic semiconductors was eliminated in April 2005.
e. Whether the dispute is over US imports, US exports, or both.

Sources: Office of Textiles and Apparel, US Department of Commerce, 2004; USITC Dataweb, 2004.

Overview of Trade Disputes

Table 1.5 summarizes, in a very rough way, the major trade frictions now preoccupying authorities in Washington and Beijing. The first two columns show the relevant trade coverage, expressed as a share of bilateral trade using US trade statistics.

Within specific sectors, ongoing disputes loom over textiles and clothing. After the Multi-Fiber Arrangement expired on January 1, 2005, and all quotas were lifted, China faced mounting opposition from US industry lobbies that sought to curb the potential flood of cheap Chinese textiles and clothing. Bilateral textiles and clothing disputes quickly expanded

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from brassieres to include quotas on socks, woollen pants, cotton shirts, sweaters, and knit fabric, to name the most important. To compromise, a new US-China textile trade agreement was hammered out, which came into force on January 1, 2006. Under the new bilateral agreement, Chinese exports of 21 categories of textile and clothing are capped, but the new quotas progressively expand through 2008, when they expire. As a very rough guess, the new agreement might reduce US imports by $5 billion annually.

A corollary to the textile and clothing dispute is persistent concern about Chinese labor practices. At the time this policy analysis was going to press, the AFL-CIO re-filed a petition with the Bush administration asking for retaliation against allegedly unfair Chinese labor practices. While the original 2004 petition gained little ground, the AFL-CIO lodged similar allegations in its new petition filed in June 2006. According to the latest petition, China encourages minimal labor standards and violates workers' rights by suppressing strikes and prohibiting independent unions. As a consequence of the alleged practices, the AFL-CIO calculates that Chinese companies can reduce their labor costs by an estimated 47 percent, which in turn enables Chinese exporters to enjoy higher profit margins at the expense of their US competitors. The petition assumes that appropriate Chinese government enforcement of workers' rights will raise manufacturing and labor costs and thus export prices of goods shipped to the United States. The petition ignores the benefits accruing to US consumers from access to cheaper Chinese imports and the spur that competition from China provides to American companies to boost their own productivity.[16]

Other key disputes include antidumping duties on wooden bedroom furniture and color television sets, which together may discourage up to $4 billion of US imports from China, although this is probably a high estimate. If China ends its tax discrimination against semiconductors as promised, US exports might increase by $0.3 billion. Finally, a solution to the new auto parts dispute might add another $300 million to US exports.

The largest and most important dispute, however, is over the renminbi exchange rate. It affects all US imports from China and all US exports to China and has repercussions throughout Asia. As a crude and probably high estimate, resolving the dispute along the lines advocated by US officials might reduce the bilateral trade deficit by $60 billion to $80 billion—a figure that, even if somewhat exaggerated, dwarfs all other trade disputes combined. The exchange rate clearly dominates other disputes in its quantitative impact, and that is where a discussion of current US-China economic relations must begin.

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16. See Steven Greenhouse, "A.F.L.-C.I.O. Files a Trade Complaint Against China's Labor Practices," *The New York Times*, C1.

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The Revaluation Debate

Between 1995 and 2005, China fixed the renminbi at about 8.28 to the dollar.[1] In July 2005, under considerable foreign pressure, China ended the peg by moving toward a managed exchange rate with a "central parity" based on a currency basket,[2] allowing the renminbi to move up or down within a narrow band of 2.1 percent. The basket effectively revalued the renminbi to a rate of 8.20 to the dollar. Within the prescribed band, daily fluctuations against the dollar are limited to 0.3 percent.[3] Under this system, the renminbi gradually appreciated to around 8.10 to the dollar toward the end of 2005. In May 2006 the Chinese authorities changed the

1. Small variations were allowed on both sides of the official rate of 8.28 renminbi to the dollar.

2. China looked to Singapore in designing its own currency reform. Since 1981, Singapore has used a managed float exchange rate regime: The Singapore dollar is pegged to a basket of currencies with a heavy (but unknown) dollar weighting. Like the People's Bank of China, the Singapore Monetary Authority reveals little information about the exact mix of its currency basket, which can be changed from time to time depending on trade flows and other considerations. See Mary Kissel, "China Studies Currency Basket," *Asian Wall Street Journal*, May 23, 2005.

3. While the exact composition of the currency basket remains a matter of speculation, the governor of the People's Bank of China, Zhou Xiaochun, mentioned that the currency basket reflects a combination of China's trade patterns and sources of foreign direct investment (FDI). Zhou said the basket is dominated by the dollar, yen, and euro but also includes currencies of Singapore, the United Kingdom, Malaysia, Russia, Australia, Thailand, and Canada. In September 2005 China made marginal changes to allow the renminbi to fluctuate by 3 percent against nondollar currencies compared with 1.5 percent previously. See "Patching the Basket—The Yuan," *The Economist*, October 1, 2005.

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"central parity"—a figure that is announced daily—to 7.99 to the dollar. This change allowed the renminbi to appreciate above the psychologically important level of 8.00 to the dollar.

However, both the old renminbi rate of 8.28 to the dollar and the new rate of around 8.00 are widely seen as undervalued for three reasons: China has sharply increased its current account surplus, which topped $100 billion in 2005;[4] it has accumulated huge foreign exchange reserves, reaching $819 billion in December 2005; and for several years foreign direct investment (FDI) has poured into China, totaling some $60 billion in 2004,[5] augmented by a tide of hot money. A strong argument can be made that the Chinese economy was overheating in 2004, 2005, and the first half of 2006, with an annual growth rate of over 9 percent and a boom in real estate prices. According to this argument, significant revaluation could usefully complement China's domestic policy measures to slow the economy by dampening exports and encouraging imports. Experts disagree considerably about the extent to which the renminbi should be revalued, but whether it is undervalued by 10, 25, or 40 percent, in 2005 the renminbi exchange rate became the lightning rod for US-China trade relations.[6]

Meanwhile, both inside and outside China, views are converging that future demand growth should concentrate on consumption rather than investment or net exports (Bergsten et al. 2006; supplement charts from Nicholas Lardy). Investment, including that in new houses and apartments, now accounts for—remarkably—around 50 percent of GDP. Net exports are around 7 percent of GDP, also a very high level. Household consumption is around 40 percent of GDP, a very low figure, especially compared with the very high figure of 70 percent for the United States. Alongside other policy tools, such as expanded consumer credit, higher interest rates, lower personal taxes, and larger public expenditures, revaluation could help shift the composition of Chinese demand growth toward public and private household consumption.

4. Based on unofficial figures, China's current account surplus increased from 3 percent of GDP in 2003, to 4 percent of GDP in 2004, to 7 percent in 2005. See Morris Goldstein and Nicholas Lardy, "China's Revaluation Shows Size Really Matters," *Financial Times*, July 22, 2005. For another critical view, see Morici (2006).

5. FDI in China is far greater than investment in other developing countries, such as India with $4 billion and Russia with $1 billion. See UNCTAD's *World Investment Report* 2005 and OECD, *Trends and Recent Developments in Foreign Direct Investment*, June 2004. Also see Michael R. Sesit, "China Overtakes US as Magnet for Foreign Direct Investment," *Wall Street Journal*, June 28, 2004, A2.

6. See appendix table A.3 for an outline of the numerous proposals to revalue the renminbi exchange rate.

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Section 301 Petition

Early in 2004 the National Association of Manufacturers (NAM) and other members of the Fair Currency Alliance (FCA) mounted a campaign to force the revaluation of the renminbi. On January 21, 2004, President George W. Bush reiterated that "countries like China have got to deal with their currency." Eight days later, the FCA hired a Washington law firm (Collier Shannon Scott) to prepare a draft Section 301 petition to challenge the Chinese exchange rate.[7]

While privately pressuring China to revalue throughout 2004, in April 2004 the Bush administration dismissed the substance of the draft Section 301 petition even before it was filed.[8] Subsequently, the FCA mobilized support for congressional bills that echo the original 301 petition.[9] Pressure from Capitol Hill in the run-up to congressional elections in November 2006 could persuade the Bush administration to take sterner measures.

Key Players

In its May 2005 report to Congress, the Treasury openly criticized China. Treasury Secretary John Snow argued that China's "rigid currency regime has become highly distortionary."[10] In November 2005, however, the Treasury's official semiannual report to Congress backed away from branding China a "currency manipulator," a legal label that—if invoked—would essentially invite Congress to enact punitive legislation against China. In the report Snow conceded that the Chinese "rigid exchange rate" creates

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7. Section 301 of the Trade Act of 1974 enables the president to take measures against "unjustified and unreasonable" foreign barriers. Following the Marrakesh Agreement that established the WTO, the USTR has channeled meritorious Section 301 petitions into the WTO dispute settlement mechanism.

8. At the time, US Treasury Secretary John Snow contended that "persistent engagement" would be more effective than a trade petition. See US Treasury, press release, "US-China Trade Relationship," April 28, 2004.

9. The FCA has since been renamed the China Currency Coalition (CCC) and claims the support of about 35 senators and congressmen. In April 2005 the CCC endorsed the congressional bill known as the Chinese Currency Act of 2005 (HR 1498). See China Currency Coalition, press release, "Legislation Clarifying U.S. Trade Laws Targets Injury Caused By China's Exchange-Rate Manipulation," April 7, 2005, available at www.chinacurrencycoalition.org (accessed November 2005).

10. The Chinese central bank uses renminbi to purchase US dollars in the currency market and then sterilizes part of the addition to renminbi base money by selling renminbi bonds. See "US Treasury Chief Presses China on Currency, Financial Reforms," Agence France Presse, October 12, 2005.

"distortions and risks," but he endorsed the "initial steps by China to increase exchange rate flexibility."[11] To underline the administration's decision that financial diplomacy would prove more effective than punitive sanctions in persuading China to revalue the renminbi, in May and October 2005 Snow made two appointments to Beijing: Ambassador Olin Wethington as US currency emissary and David Loevinger as financial attaché. Their continuing mission is to advocate a flexible rate and liberalized capital flows.[12] The Treasury's efforts have produced modest results. In January 2006 China launched over-the-counter trading of the renminbi, which allows the market to play a role in determining the exchange rate.[13] In April 2006, prior to President Hu Jintao's visit to the United States, the Chinese government announced that individuals could invest as much as $20,000 in foreign assets and that Chinese companies could have a freer hand in making overseas investment. Such moves on the capital account would not normally strengthen the renminbi, but they do give greater play to market forces, the Treasury's stated goal. Moreover, as mentioned earlier, in May 2006 the People's Bank changed the "central parity" to just under 8.00 to dollar, another slight appreciation and a psychologically important level.

At the beginning of the currency campaign, Federal Reserve Chairman Alan Greenspan advised against a floating exchange rate or ending capital controls.[14] Greenspan emphasized the precarious nature of the Chinese banking system, which carries a huge volume of nonperforming loans

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11. See US Treasury, press release, "Statement of Treasury Secretary John W. Snow on the Report to Congress on International Economic and Exchange Rate Policies," November 28, 2005.

12. See US Treasury, press release, "Treasury Secretary Snow Appoints Olin L. Wethington as Special Envoy on China," May 19, 2005. In the run-up to President Bush's meeting, Snow claimed that negotiations between the Treasury and the Chinese government resulted in modest but significant financial-sector reforms. Specifically, the establishment of Chinese foreign exchange trading systems created platforms for a meaningful foreign exchange trading system under a system of floating rates. As Snow pointed out, "to conduct foreign exchange trading … we forget that if you're pegged, you've got to learn how to trade." With the help of US financial experts, Shanghai firms in particular took initiatives to establish forward, derivative, and hedge markets. See "John Snow: Full Transcript," *Financial Times,* November 4, 2005.

13. The new method for determining the renminbi exchange rate announces the "central parity" rate against the US dollar on a daily basis using some sort of weighted average price of market-maker quotes. As a result, the trading band will allow the market to play a more substantial role in determining the renminbi rate, although the People's Bank still calls the shots. See Wang, Wang, and Goodman (2006).

14. See Alan Greenspan, State of the Banking Industry, Testimony before the Senate Committee on Banking, Housing, and Urban Affairs, Washington, April 20, 2004.

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(NPLs) on its collective balance sheet.[15] Ending capital controls, Greenspan argued, could trigger an outward flood of capital to more secure foreign banks. This in turn might destabilize the Chinese economy and drag down world growth. However, by June 2005 Greenspan aligned his position with Snow's statements, conceding that China's large purchases of dollars "pose threats to China's financial stability."[16] In effect, Greenspan acknowledged the primacy of the Treasury in setting US exchange rate policy. The new Federal Reserve Board chairman, Ben Bernanke, will likely support the administration's currency campaign in 2006.

Meanwhile, Capitol Hill added to executive branch voices calling for Chinese currency revaluation. Some 20 out of 25 China bills introduced between 2003 and 2005 alleged an unfair Chinese trade advantage from the undervalued renminbi (appendix table A.2). In February 2005 Senators Charles Schumer (D-NY) and Lindsey Graham (R-SC) introduced a bill to impose a "temporary across the board tariff" of 27.5 percent on all Chinese exports to the United States.[17] After Schumer and Graham visited China in March 2006, they were impressed by Chinese government efforts and agreed to postpone a vote on the bill, but no later than September 2006. Another prominent bill to pressure the Chinese government to revalue the renminbi surfaced in March 2006, when Senators Charles Grassley (R-IA) and Max Baucus (D-MT) proposed milder measures against countries identified as having "currency misalignments." Sanctions included denial of market economy status (relevant to antidumping cases) and mandatory US opposition to a larger voice in the International Monetary Fund (IMF) and the World Bank.

By April 2006, when President Hu Jintao visited the United States, administration and congressional measures had fostered a slightly more

15. According to some estimates, 40 percent of the recent increase in Chinese bank loans, some $259 billion, are nonperforming. See Nicholas Lardy's estimates in Goldstein and Lardy (2005). In May 2006 Ernst & Young published a report saying that nonperforming loans (NPLs) amount to an astounding $911 billion, but the report was quickly retracted under pressure from the Chinese government. Most nonofficial commentators put the NPL range at $300 billion to $500 billion in 2006, whereas the government has published an estimate of $164 billion. See "A Muffled Report," *The Economist,* May 20, 2006, 78.

16. Greenspan recognized that a flexible Chinese exchange rate, determined by the market rather than by "administrative edict," would take many years before it reached a "satisfactory degree of soundness and flexibility." See Alan Greenspan, China, Testimony before the Senate Committee on Finance, June 23, 2005.

17. Under the Schumer-Graham bill, the tariff can be averted by a presidential certification that China is not amassing foreign exchange reserves to prevent exchange rate appreciation. Moreover, if the president determines that China has acted in "good faith" toward revaluing the currency, he can delay imposing the tariff for 180 days.

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flexible renminbi regime but not a substantial appreciation of the currency. It might be worth recalling a previous intersection between trade policy and currency values. In August 1971 President Richard Nixon met with his top advisers at Camp David and agreed on a four-part plan to address the worsening US balance of payments, which had swung from a surplus of 2.2 percent of GDP in 1970 to a deficit of 1.2 percent in 1971. The plan proposed a 90-day freeze on wages and prices, an investment tax credit of 10 percent, an import surcharge of 10 percent, and "closing the gold window."[18] The result of this package was the Smithsonian Agreement of December 1971, which initially realigned the fixed exchange rates of Bretton Woods vintage and ultimately led to a system of floating rates (Solomon 1982). Circumstances in that era were vastly different from those today, but the episode suggests that by breaking enough crockery in the arena of trade, the United States can force other countries to alter their exchange rate systems.[19]

The Legal Case, Part I: GATT Article XV(4)

If the United States gives up on financial diplomacy and resorts to legal action, the FCA draft Section 301 petition prepared in 2004 previews the claims that might be advanced in the WTO. In April 2006 the China Currency Coalition (CCC), the successor to the FCA, issued a statement that supplements the earlier petition.

The core of the case is that China's exchange rate policy, which allegedly undervalues the renminbi by 40 percent, allows Chinese firms to export goods to the United States at artificially low prices, resulting in US job losses.[20] The FCA and the CCC contend that the undervalued Chinese renminbi violates Article XV(4) of the General Agreement on Tariffs and Trade (GATT), which states, "Contracting parties shall not, by exchange action, frustrate the intent of the provisions of the Agreement."[21] The lob-

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18. This phrase meant that the US Treasury would no longer sell gold to foreign central banks, in exchange for dollars, at the rate fixed by President Franklin Roosevelt in the 1930s, namely $35 per troy ounce.

19. In the 1980s, as the dollar became more overvalued, the Reagan administration used selective import protection to quell demands from the US industrial community and then engineered a large decline in the dollar via the Plaza Accord. See Hufbauer and Elliott (1994) and Solomon (1999).

20. See Collier Shannon Scott, press release, "Former USTR Official to Lead China FX Challenge," January 29, 2004; Fair Currency Alliance, press release, "China's Erroneous Numbers: First Report from FCA," June 10, 2004; China Currency Coalition, press release, "China's Record Foreign Currency Reserves No Surprise to U.S. Coalition," January 18, 2006.

21. The text of GATT is available at www.wto.org.

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bies also contend that the undervalued renminbi amounts to a prohibited export subsidy that violates Articles 1, 2, and 3 of the WTO Agreement on Subsidies and Countervailing Measures (the SCM agreement), along with parallel articles in the WTO Agreement on Agriculture.

These claims raise two questions. First, are the claims sufficiently strong that, at least for tactical purposes, the United States Trade Representative (USTR) and the Treasury could bring a plausible case to the WTO? Second, if a case is launched and pursued through decisions by a WTO panel and the WTO Appellate Body—probably a two-year process—what are the chances of a US legal victory?

In our view, the Article XV(4) case, if brought, would have no traction. By contrast, an SCM case passes the plausibility test. Both cases might advance the US goal of giving market forces a greater role in determining the Chinese exchange rate, but if either case were pursued to the bitter end, entailing hundreds of hours of legal argument and thousands of pages of legal briefs, we think the claims advanced by the FCA and CCC would be rejected by the WTO Dispute Settlement Body. We first consider GATT Article XV(4), then the SCM agreement.

Article XV(4)

Neither a fixed exchange rate (the Chinese system prior to July 2005) nor a tightly managed float (the Chinese system since then) can be deemed a per se violation of GATT Article XV(4). Both systems are widely used and condoned by the IMF Articles.[22] GATT Article XV(9)(a) states that "nothing in this Agreement shall preclude . . . the use by a contracting party of exchange controls or exchange restrictions in accordance with the Articles of Agreement of the [IMF]." Insofar as GATT and the WTO are concerned, this language appears to scream "keep out of the exchange rate sandbox."

However, the legal case with respect to Article XV(4) hinges on the argument that in practice, China's exchange rate regime "frustrates the intent of the provisions" of GATT. Uninformed observers may ascribe to GATT and the WTO the intent to ensure bilateral trade balances, and current China bashers often cite as an "offense" the huge bilateral imbalance between the United States and China, now exceeding $200 billion annually according to US statistics.[23] The history of GATT, however, is replete

22. Former USTR Robert Zoellick admitted that there was no WTO obligation against a fixed exchange rate, pointing out that "the United States had a fixed exchange rate until 1971." See Edward Alden, "Zoellick Snubs Calls for WTO Criticism," *Financial Times*, February 26, 2004.

23. Even President Bush, a devout free trader, gave comfort to the bilateral balance argument when he commented that the $200 billion imbalance leaves many Americans "wondering where's the equity in trade" (*Financial Times*, April 11, 2006, 1).

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with evidence that its goal is not to ensure bilateral trade balances. Among economists, triangular trade is a virtue, not a vice, because it enables each country in the multilateral system to specialize in what it produces best. Triangular trade flourishes when bilateral imbalances are condoned. When GATT was formed, the United States worked to limit discriminatory quota and tariff schemes, instituted for balance of payments reasons, that confined trade to bilateral channels.[24]

A better claim, at least on economic grounds, is that the WTO *should* seek balanced trade among its members on a *multilateral* basis. But even this claim runs into objections. First, the preamble to GATT-1947 (adopted *in toto* by GATT-1994) states that

> relations in the field of trade and economic endeavour should be conducted with a view to raising standards of living, ensuring full employment and a large and steadily growing volume of real income and effective demand, developing the full use of the resources of the world and expanding the production and exchange of goods. (WTO 1999)

It can certainly be argued that balanced multilateral trade promotes "rising standards of living," "full employment," the "full use of resources," and helps expand "the production and exchange of goods." But the language does not explicitly commend balanced trade on a multilateral basis. Perhaps that was an omission, but if so, it is repeated in the preamble to the Marrakesh Agreement Establishing the World Trade Organization, which states that

> relations in the field of trade and economic development should be conducted with a view to raising standards of living, ensuring full employment and a large and steadily growing volume of real income and effective demand, and expanding the production of and trade in goods and services, while allowing the optimal use of the world's resources in accordance with the objective of sustainable development, seeking both to protect and preserve the environment and to enhance the means for doing so in a manner consistent with their respective needs and concerns at different levels of economic development. (WTO 1999)

As a general rule, interpretations of trade obligations by GATT panels prior to the WTO, and by the WTO Appellate Body since 1994, have not extended member obligations beyond the explicit requirements of the text. It seems unlikely to us that the Appellate Body would read an obligation of balanced multilateral trade into the WTO preamble.

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24. The exceptions to multilateralism in Article I, *General Most-Favoured-Nation Treatment;* Article XII, *Restrictions to Safeguard the Balance of Payments;* and Article XIV, *Exceptions to the Rule of Non-discrimination* were all tightly drafted, at US insistence, to minimize bilateral preferences. See Jackson (1969).

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A second objection, more technical but perhaps more fatal, is that the General Agreement on Trade in Services (GATS) has no language on exchange rates parallel to Article XV(4). So, from a legal standpoint, proponents cannot consider GATT and GATS together to argue for a general objective to achieve multilateral balance in *goods and services.* As an economic proposition, multilateral balance in merchandise trade alone makes no sense; multilateral balance only makes sense if the balance includes both goods and services. Some countries, including China, are large net importers of services and large net exporters of merchandise. Other countries, such as the United States, are the reverse, large net exporters of services and large net importers of merchandise. Yet Article XV(4) of GATT-1947 applies only to frustration of the Agreement's provisions *with respect to trade in goods.* With this limitation, Article XV(4) cannot be read as a GATT prescription for multilateral balance in *goods and services.* The only basis for such a prescription is the WTO preamble, cited above, which does not explicitly commend multilateral balance.

Still more technical but equally fatal is the textual language and addenda to Article XV(4). The language of Article XV(4) commits contracting parties not to use exchange rate action to "frustrate* the intent of the *provisions* of this Agreement" (emphasis added). The asterisk refers to the addenda to Article XV(4), which state that another *specific* GATT article needs to be frustrated in an important way before the strictures of Article XV(4) can be invoked. Try as they may, proponents of multilateral balance will find no GATT article that states such an objective.

In fact, as Jackson's (1969) definitive text reveals, insofar as payments disequilibria are concerned, GATT articles are confined to situations in which a country experiences balance of payments difficulties, not situations in which a country has a large balance of payments surplus. GATT-1947 Article XVIII authorizes a contracting party that "can only support low standards of living and is in an early stage of development" to override its trade obligations with temporary balance of payments measures. Other contracting parties, such as countries in the Organization for Economic Cooperation and Development (OECD), including the United States, must apply for a prior dispensation from the contracting parties as a whole before imposing balance of payments restrictions.[25] Under GATT-1947, trade measures to

25. The limitations on balance of payments measures reflect that, when GATT was drafted after World War II, the United States itself had every prospect of large balance of payments surpluses with war-wracked Europe and Japan. Because of the textual limitations, the Nixon tariff surcharge of 1971 was inconsistent with GATT, though never tested. However, in defense of the Schumer-Graham legislation, the United States might claim balance of payments difficulties if the bill imposed a tariff surcharge on *all* imports, not only imports from China. But the claim would need the prior concurrence of other WTO members, an unlikely prospect. The claim would break new legal ground, since prior experience with the balance of payments exception has involved countries that, unlike the United States, were unable to attract vast amounts of capital to purchase assets denominated in their own currencies.

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restore equilibrium to a country's balance of payments were textually confined to quotas, though tariff surcharges were sometimes used, and surcharges were explicitly authorized by the Understanding on the Balance of Payments Provisions of the General Agreement on Tariffs and Trade 1994.

From a WTO legal standpoint, therefore, China's multilateral trade balances are irrelevant to its obligations under Article XV(4). However, as part of its defense, China would surely argue that it has not *run* an exceptionally large surplus in traded goods and business services—the subject matter of the WTO. Considerable statistical dispute surrounds the size of China's current account surplus. In a dispute proceeding, we think that the WTO would place the greatest weight on IMF figures. Between 2000 and 2004, according to the IMF, China's current account surplus for goods and services totaled $180 billion. Over the same period, Japan's current account surplus was $313 billion, and Germany's was $363 billion. China does not particularly stand out among these economic peers. Moreover, if the policy argument drifts into the realm of current account surplus relative to GDP, China's 6 or 7 percent surplus looks positively innocent compared with those of Japan, Singapore, Hong Kong, the Gulf States, and other WTO members that run persistent double-digit current account surpluses as a percent of GDP.

If critics make an issue of the rapid rise in China's foreign exchange reserves—from $169 billion at the end of 2000 to $819 billion at the end of 2005 (IMF's *International Financial Statistics* 2005)—China can retort that the reserves have been bolstered by substantial inward flows of FDI and portfolio capital.[26] Such financial flows are simply outside the purview of the WTO. An excursion into China's motives for acquiring large foreign exchange reserves, which may reach $1 trillion by the end of 2006 (Bergsten et al. 2006), would take the WTO even further from its institutional purview.

To summarize these various objections, we think the WTO Appellate Body would be most unlikely to condemn China's exchange rate policy under Article XV(4). The question is not whether the United States would lose, but whether its arguments would be summarily dismissed.

SCM Agreement

The FCA draft petition and the CCC statement offer another legal leg for the WTO case. They argue that the undervalued renminbi acts as a "prohibited export subsidy" that violates Articles 1, 2, and 3 of the WTO's SCM agreement. Under the WTO, a "prohibited export subsidy" must sat-

26. Morgan Stanley economist Andy Xie (2005a) estimates that hot money inflows total as much as $350 billion. According to IMF economists Eswar Prasad and Shang-Jin Wei (2005), more than 87 percent of the increase in China's foreign exchange reserves from 1988–2000 to 2001–04 was explained by hot money. Prasad and Wei reject the mercantilist explanation that China uses a mercantilist policy—a deliberately undervalued currency—to accumulate foreign exchange reserves.

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isfy three criteria: The subsidy must be "contingent . . . upon export performance," it must entail governmental "financial contribution," and it must provide "benefit" to the recipient (see WTO Article 3 in WTO 1999; see also Benitah 2003).

Taking these tests in reverse order, an undervalued exchange rate, if it exists, surely benefits exporting firms. While "benefit" is not precisely defined, the context of the WTO SCM Agreement, along with decided cases, establishes that a prohibited subsidy must provide value to the recipient, whatever it may cost the government.[27] An undervalued exchange rate definitely provides value to exporting firms. The difficulty is proving that the Chinese renminbi is "undervalued." The USTR and Treasury can recruit distinguished scholars to supply expert testimony that the renminbi is seriously undervalued. But the battle of economic expertise is not one-sided: China can draw on its own stable of distinguished scholars, including two Nobel laureates (Robert Mundell and Joseph Stiglitz), a recognized Stanford professor (Ronald McKinnon), and several Wall Street financial experts, to supply opposing expert testimony. Our guess is that the WTO Dispute Settlement Body would turn to the International Monetary Fund (IMF) for an authoritative statement, given the historical division of labor between the IMF and GATT. If the IMF is not willing to declare definitively that the renminbi is undervalued by a certain amount, we think that would be the end of the case. If the IMF is willing to make such a declaration, the WTO dispute proceeding could turn to other issues.

The next issue is whether an undervalued exchange rate entails a "financial contribution" by the Chinese government. In previous WTO cases, policies deemed to provide a "financial contribution" have included giving grants, making loans at below-market rates, providing tax breaks, concessionary terms for exploiting natural resources, and providing transport at especially cheap rates for exported goods (see WTO Article 1 in WTO 1999). A similar budget cost or targeted concession cannot be easily associated with an undervalued exchange rate. To be sure, the United States can argue that importers are paying too much renminbi for their purchases—in other words, that the undervalued rate takes money from importers and gives it to exporters, so that the policy operates like a tax on imports and a subsidy on exports.[28] The United States can also

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27. Decided cases (especially in the export credit field) look at the benefit to the recipient firm rather than the cost to the government.

28. John Magnus argues that a financial contribution exists because the Chinese central bank performs the service of converting dollars to renminbi. See his testimony on Chinese Subsidies and US Responses before the US-China Economic and Security Review Commission, Hearing on China's World Trade Organization Compliance, Washington, April 5, 2006. We think this interpretation would not be accepted by the WTO Appellate Body, if only because it would lead to the conclusion that all central banks that operate in the foreign exchange market are thereby providing a financial contribution to their exporters. Such a bold conclusion would, in our opinion, need support from verbatim SCM language to prevail.

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argue that the Chinese central bank will lose money on its dollar assets when the exchange rate is "inevitably" revalued.

China can offer responses to these arguments. First, for WTO purposes, it does not suffice to use an on-budget subsidy analogy to condemn an off-budget public policy such as an undervalued exchange rate. Citing WTO precedents, China can claim that a "financial contribution" equates to an observable budget cost or targeted concession as traditionally measured. Nowhere in the history of public accounts has a budget cost been ascribed to an undervalued exchange rate. In a real sense, of course, an undervalued exchange rate is "targeted" at all exports, but China can argue that if the drafters of the SCM Agreement had meant to encompass an undervalued exchange rate, they would have said so in as many words.

A second Chinese response is that WTO Panel or Appellate Body acceptance of the US argument would project the WTO squarely into turf historically occupied by the IMF. In the future, if a WTO member country were to become unhappy with the exchange rate of another member, it could launch a WTO case. Finance ministers would vigorously object to this intrusion into their policy domain. Equally important, WTO adjudication of exchange rate values would breach the historic division between the IMF and GATT. In our view, the Chinese arguments would persuade the WTO Dispute Settlement Body to rule against the claim of "financial contribution."[29]

Even if we are wrong, the US case faces yet another hurdle: demonstrating that the benefits conferred by the "financial contribution" of an undervalued exchange rate are "contingent, in law or in fact,* whether solely or as one of several other conditions, upon export performance, including those illustrated in Annex I." To a casual reader, it might seem obvious that the benefits of an undervalued exchange rate are "contingent upon export performance." A firm does not benefit from an undervalued exchange rate if it does not export anything. However, a closer reading throws considerable doubt on the assumed "contingency." The asterisk in the quoted text refers to footnote 4 in the SCM Agreement, which states, among other points, "The mere fact that a subsidy is granted to enterprises that export shall not for that reason alone be considered to be an export subsidy with the meaning of this provision." This footnote can be interpreted to mean that a favorable exchange rate with no other strings attached is no more a prohibited export subsidy than any other beneficial economic "climate," such as a concessionary tax rate that applies to all new plant and equipment investment by foreign firms.

29. Alternatively, as John Magnus has contended in correspondence with the authors, these hypothetical Chinese arguments would persuade the WTO Dispute Settlement Body to find that the undervalued exchange rate does not confer a "benefit" in the sense of the SCM Agreement.

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Moreover, the Illustrative List of Export Subsidies, which appears as Annex I to the SCM Agreement, does not support the contingency argument. The genesis of this list was a 1960 GATT Working Party Report (GATT Secretariat 1961), and the list itself was codified in the Tokyo Round Code on Subsidies and Countervailing Duties (Hufbauer and Erb 1984). The SCM Agreement repeats, almost verbatim, the illustrative list in the Tokyo Round Code. It only mentions exchange rate practices by stating that, among prohibited export subsidies are "currency retention schemes or any similar practices that involve a bonus on exports." However, currency retention schemes are a feature of *overvalued,* not undervalued, exchange rate regimes; they permit exporters to retain a certain amount of foreign exchange earned, either to purchase imported inputs or to sell at a premium to other importers.[30] Other than that single reference, all other practices enumerated in the illustrative list refer to tax, expenditure, transport concessions, and credit practices that are specifically tied to export performance. While the list is "illustrative" and not exhaustive, China can argue, as above, that if GATT and WTO members had intended to cover such an important subject as allegedly undervalued exchange rates, they would have written an explicit statement in the text of the SCM agreement or in its illustrative list.[31]

Perhaps recognizing the weakness of its legal case, the CCC has promoted a piece of legislation, the Ryan-Hunter bill (HR 1498), which would *unilaterally* declare that an undervalued currency—the renminbi or any other—amounts to a prohibited export subsidy, subject to countervailing duties. This proposal has shades of the infamous Byrd Amendment,[32] which refunded antidumping and countervailing duties to petitioning US firms and which President Clinton reluctantly signed into law in 2000. Even at the time of enactment, trade experts widely recognized that the Byrd Amendment conflicted with WTO provisions (Ikenson 2004b). However, it took three years of legal wrangling for the WTO to declare the amendment illegal, and only in 2005 did Congress repeal it, effective in October 2007.

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30. Currency retention schemes and multiple exchange rate regimes have been questioned for their subsidy implications by the US Department of Commerce and in GATT (see Hufbauer and Erb 1984). But China maintains a unified exchange rate, and there is no precedent for a GATT or WTO export subsidy case against an allegedly undervalued, but unified, exchange rate.

31. In his testimony to Congress, John Magnus argues that the export contingency test could be met despite the absence of specificity, based on the expansive holding in the extraterritorial income exclusion case (WTO 2002). However, faced with the prospect of extending that holding to exchange rates, the WTO Appellate Body might well "discover" a limiting principle.

32. Formally known as the Continued Dumping and Subsidy Offset Act of 2000.

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We conclude that the chances of a US legal victory in the WTO are at best modest. But we also recognize that litigation can, in certain circumstances, promote productive negotiation, even though the litigation rests on a novel legal theory. This may be one of those circumstances.

The Legal Case, Part 2: IMF Article IV

A second pillar in the FCA's draft petition is that China violated Article IV of the IMF. Article IV Section 1 (iii) states that each IMF member should "avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members."

To enforce this prescription against competitive undervaluation, IMF Article IV Section 3 states that the IMF should "exercise firm surveillance over the exchange rate policies of members, and shall adopt specific principles for the guidance of all members with respect to those policies." A 1977 Fund Executive Board paper lists indicators for questioning exchange rate policies, including "protracted, large-scale intervention in one direction in the exchange market" (Goldstein 2004). Under the principles of IMF Article IV and the 1977 paper, it can be argued that China violated IMF conditions by maintaining fixed exchange rates for a long period of time, intervening on a large scale and in "one direction in the exchange market."[33] Citing these provisions, Goldstein contends that the IMF should either publicize that China "engaged in currency manipulation or that the renminbi is undervalued" (Goldstein 2005a, 9).

Other economists, such as Nobel laureate Robert Mundell (2004), point out that the IMF has never required a major country with an inconvertible currency to revalue.[34] China expert and former Treasury official Albert Keidel argues that official IMF guidelines, which permit China to intervene in exchange markets "to counter disorderly conditions," provide cover for China's exchange rate policies. Keidel, along with Ronald McKinnon and some Wall Street observers, contends that China's primary interest is to ensure domestic stability rather than to advance a mercantilist trade strategy (Keidel 2005).

Mundell also questions whether a revaluation could run counter to IMF Article IV Section 1. Under Article IV Section 1 (ii), member countries should "seek to promote stability by fostering orderly underlying eco-

33. Goldstein (2005a) observes that the reticence of the Fund and the United States to question Japan when it requested authorization to intervene in exchange markets weakens the case against China. For further analysis of China and its IMF obligations, see Goldstein (2005a).

34. Mundell (2004) contends that a revaluation would delay convertibility indefinitely.

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nomic and financial conditions and a monetary system that does not tend to produce erratic disruptions." Mundell contends that a currency appreciation would increase Chinese unemployment by raising the dollar cost of wages.[35] With existing underemployment in China estimated at 200 million persons, he believes that a revaluation could create economic and financial instability, which violates Article IV Section 1 (iii).[36]

Morris Goldstein's counterassertion to Mundell (and others) has several parts (Goldstein 2005a, 2005b). First, under alternative definitions of equilibrium exchange rates—what he calls the *underlying balance approach* and the *global payments approach*—Goldstein finds that the renminbi is undervalued by 15 to 40 percent. Second, he contends that renminbi revaluation would help put China on a path to sustainable growth, with a larger component of domestic consumption in GDP. Revaluation would also improve China's financial stability, lowering inflows of hot money, and decreasing speculative investment in real estate projects. Finally, Goldstein argues that if the IMF fails to chastise China for currency manipulation, other IMF member countries can and will rationalize their own currency policies, however manipulative, on the basis of seeking full employment.

A related IMF issue is whether China's renminbi policy meets the requirements of IMF Article IV Section 4, which states that member-country exchange rate policies should be evaluated in the context of "the underlying stability of the world economy." Specifically, the IMF "should take into account price movements and rates of expansion in the economies of members." Again, Section 4 provides a peg for criticizing China, but a peg without much prior use.

Yet as the chorus of voices calling for IMF action on renminbi revaluation has grown, the IMF leadership has taken only a few small steps. In the context of Article IV consultations with China in April 2005, the IMF concluded that China needed to undertake "greater exchange rate flexibility," presumably beyond the 2.1 percent revaluation orchestrated in July 2005. For the IMF the rising Chinese current account surplus indicated that the renminbi was undervalued. In November 2005 the IMF

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35. Economist Richard Cooper agrees with Mundell's view that a large renminbi revaluation remains a high-risk strategy for China. Cooper believes that the Chinese government's prime concern is to dampen investment in specific economic sectors without raising unemployment in urban areas. Urban unemployment could threaten to incite political unrest, which has already erupted sporadically in rural areas. See Cooper (2005).

36. Stephen Roach of Morgan Stanley underscores another of Mundell's concerns: the fear that dismantling the renminbi peg could destabilize world financial markets. Andy Xie of Morgan Stanley contends that China cannot "tolerate substantial currency volatility," given his estimate of 300 million surplus workers. See Mundell (2004); Stephen S. Roach, Getting China Right, Statement before the US-China Economic and Security Review Commission, Washington, September 25, 2003; and Xie (2005b).

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underscored its earlier support for a flexible exchange rate by noting that Chinese banking liquidity remains too high and investment rates are unsustainable.[37]

Although top IMF leaders, such as the managing director and the first deputy director Anne Krueger, have voiced mild frustration over China's exchange rate policies, without strong leadership from the managing director, the likelihood remains very small that the IMF's Executive Board will chastise China for breaching its IMF obligations. In its more than 50-year history, the IMF has never criticized or suspended a member country for breaching Article IV. To publish a formal criticism of a member country's exchange rate policies over the opposition of that member, a 70 percent majority of the IMF's Executive Board must approve. To suspend a member country for violating Article IV requires a supermajority of 85 percent.[38] Neither formal criticism nor suspension appears to be a meaningful threat in the China case.

Instead soft rhetoric is the IMF's tool of choice: In the most recent IMF Article IV consultations with China, the IMF directors "recommended that the authorities allow the exchange rate to move more quickly toward a level that better reflects underlying market forces."[39] Soft rhetoric continues to be Treasury's tool of choice as well. In its May 2006 report to Congress on international currencies, Treasury merely stressed its "strong disappointment" that China has not allowed the renminbi to rise faster and further against the dollar.[40]

Deliberations in the IMF's boardroom and the Treasury's semiannual report, however, comprise only part of larger negotiations over the renminbi. Additional pressure will emanate from bilateral talks between the United States, the European Union, Japan, and China, from G-8 finance minister meetings; and of course from debates in Congress.

37. The IMF listed reasons why a renminbi revaluation would be useful for China's own long-term interests, helping to reduce speculative and distorted investment and to raise domestic consumption. See IMF Article IV Consultations with the People's Republic of China, July 8, 2005.

38. IMF Article XXVI enumerates reasons for the IMF to impose "compulsory withdrawal" of any member country. In a small number of cases, usually with political overtones, Article XXVI has been invoked for violations of Article VIII (the requirement to provide economic information). Articles XXVI and VIII have no application to current Chinese circumstances.

39. See IMF Article IV Consultations with the People's Republic of China, September 12, 2005. At the IMF's meeting of 184 members in April 2006, the managing director and his staff were assigned a larger role in "multilateral surveillance" of exchange rates. How the new powers are used remains to be seen, but IMF leadership is nervous about offending China, lest it provoke Beijing into accelerating the creation of a rival Asian monetary facility.

40. See the *Wall Street Journal*, May 11, 2006.

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Evaluation

Over the last few years, the pegged renminbi has helped to boost Chinese exports to the US market and contributed to a growing US trade deficit on a multilateral basis. A revalued renminbi, especially if coordinated with the appreciation of other Asian currencies against the dollar (Cline 2005b), will help stabilize and may even reverse the growing US deficit. An optimistic estimate of Asian currency appreciation (including China) over the next two years is around 20 percent, about the same amount that the euro, the yen, and a few other floating currencies appreciated between November 2002 and October 2004. Assuming that the revaluation is accompanied by an improved balance between saving and investment in the United States,[41] an outside estimate of the induced improvement in the US trade balance is around $120 billion (table 2.1). A more realistic estimate may be between $60 billion to $80 billion per year (Bergsten et al. 2006).[42]

Even the more realistic figure is a step in the right direction, but the White House and Congress will need to take other steps as well. The federal budget deficit needs to be slashed by raising taxes and cutting spending. As part of a larger package, in 2006 and 2007, the Treasury needs to raise the pressure on China to revalue the renminbi, using the language and tools of financial diplomacy. The merits of a high-profile WTO case are questionable; the better tactic is to press for renminbi revaluation in the IMF's boardroom.[43] A reasonable target for the renminbi would be an appreciation of 10 percent in central parity by the end of 2006, coupled with greater flexibility in the renminbi band. By the end of 2007, the target should be an appreciation of 20 percent.

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41. Lawrence Summers, among many other commentators, emphasized that larger US national savings, both at the household and government levels, as well as exchange rate adjustments, are necessary to reduce the US current account deficit. See Lawrence Summers, The United States and the Global Adjustment Process, Third Annual Stavros S. Nierchos Lecture, Institute for International Economics, Washington, March 23.

42. According to US Federal Reserve economists, Jaime Marquez and John Schindler, a 10 percent appreciation lowers China's export share of world trade by one-half of a percentage point in the long run ($52 billion in 2005 trade value terms). The same appreciation is estimated to lower China's import share of world trade by a tenth of a percentage point ($11 billion in 2005 trade value terms). The reason China's imports decrease, rather than increase, with an appreciated renminbi is that about half of China's imports are used as inputs for assembled exports. The Marquez and Schindler coefficients imply that China's bilateral trade surplus with the United States would drop by about $14 billion with a 10 percent appreciation of the renminbi. See Marquez and Schindler (2006).

43. In her confirmation testimony on May 22, 2006, USTR Susan Schwab commented, "In our view, initiating a WTO case on [the renminbi value] would put China in the position of defending, rather than reforming, its currency regime," The Ttalk Quote Book, Global Business Dialogue, Inc., May 23, 2006, available at www.ttalk.biz.

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Table 2.1 Current and prospective US bilateral trade with Asian partners, 2005

Country	Current merchandise trade (billions of dollars)			Hypothetical currency appreciation versus dollar[a] (percent)
	US exports	US imports	Trade balance	
China	38	223	–185	22
Hong Kong	15	8	7	36
Korea	25	40	–15	7
Malaysia	10	31	–21	30
Philippines	6	8	–2	22
Singapore	19	14	5	40
Taiwan	20	32	–12	19
Thailand	7	18	–11	17
Total	139	374	–235	22
Calculated change in US trade balance with listed Asian countries combined[b]				117

a. The hypothetical appreciation against the US dollar is one-half the figure shown in Cline (2005a, table 6.2) as "Remaining real appreciation to reach optimal amount." The figure in the total row is the trade-weighted average.

b. The calculated change in the US trade balance is based on Cline (2005a, table 3.5). According to Cline's calculation, after five years, a 10 percent average trade-weighted appreciation of *all* foreign currencies against the dollar will improve the US current account balance by 1.57 percent of US GDP. The listed Asian countries account for about 22 percent of US merchandise trade (imports plus exports). Hence, a 10 percent average appreciation in just the Asian currencies is estimated to cause (after five years) a 0.35 percent improvement in the US current account balance expressed as a percent of GDP (1.57 percent * 0.22 = 0.35 percent). By extension, a 22 percent average appreciation would be estimated to cause an improvement equal to 0.77 percent of GDP (0.35 percent * 2.2 = 0.77 percent). In 2004 US GDP was $11.7 trillion. Assuming 5 percent annual nominal growth, in 2010 US GDP may reach $15.2 trillion. A current account improvement equal to 0.77 percent of GDP would therefore equal $117 billion in 2010, some five years after the hypothetical average Asian appreciation of 22 percent.

Sources: USITC Dataweb, 2006; Cline (2005a).

Even if the renminbi were revalued, however, several trade issues would still create friction between the United States and China. One of the more bitter arenas of contention is the textile and clothing sector, as China finds itself to be quite competitive while the United States experiences painful job losses. The situation has become more acute with the expiration of the Multi-Fiber Arrangement, which has broader implications for both countries regarding their trade strategies in the years to come.

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3

Textiles and Clothing

Textile and clothing (T&C) products are the most contentious of all Chinese exports, both because China has enormous competitive strength in this sector and because the Multi-Fiber Arrangement (MFA), which severely restricted the natural flow of trade, expired on January 1, 2005. While the January 2006 bilateral US-China T&C agreement resolved disputes over brassieres, socks, and other items, more T&C disputes are practically certain. Thus a sketch of the celebrated brassiere case remains relevant. After summarizing the brassiere case, this chapter turns to the wider implication of the end of the MFA.

The Brassiere Case

In November 2003 the US Department of Commerce imposed a 7.5 percent quota growth limit on Chinese brassieres, knit fabrics, dressing gowns, and robe imports above the levels reached between September 2002 and September 2003.[1] The Department of Commerce and Committee

1. In July 2003, after three leading US textile lobbying groups requested consultations with the Committee for the Implementation of the Textile Agreements (CITA), the Department of Commerce invoked special safeguard provisions to limit brassieres and kindred imports from China. Draft paragraph 238 of China's WTO accession agreement established the China-Specific Textile Safeguard Mechanism, in effect until December 31, 2008. (Paragraph 238 became paragraph 242 in the final protocol for China's accession.) WTO members can request consultations with China if rising Chinese T&C imports cause "market disruption." Unless both parties reach a different agreement, the quota limit will terminate one year after the consultation request. However, the United States could then invoke a new quota limit. See WTO (1995).

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for the Implementation of the Textile Agreements (CITA) based their decision on rapidly rising imports of Chinese brassieres; while US production declined, China advanced from being the sixth-largest exporter in 2001 to the largest exporter in 2003. Brassiere imports from China increased by 294 percent, from $120 million in 2001 to $474 million in 2005, when they accounted for 31 percent of total US brassiere imports from the world.[2] The brassiere situation is typical of many T&C imports from China and was seen to validate an overriding fear of a potential flood of Chinese T&C exports after the MFA quotas expired in January 2005. From 2000 to 2005, US imports of T&C products from China, mainly clothing, increased from about $8 billion to $19 billion. In the same years, China's share of US T&C imports from the world grew steadily from 11 to 25 percent.

Under the terms of China's accession to the WTO (paragraph 241 of China's draft protocol of accession),[3] a WTO member can apply safeguard tariffs and quotas against any Chinese product without applying comparable safeguards against imports from other countries (see appendix B for further details). After an evidentiary hearing and a finding of "material injury," WTO members can impose these product-specific safeguards against any Chinese export until December 2013.[4] In the special case of T&C (paragraph 238 of the draft protocol), safeguards can be applied almost automatically until 2008, whenever imports create "market disruption" (a lower standard than "material injury"). Both provisions (paragraphs 238 and 241) are contrary to the WTO's principle of nondiscrimination, which China agreed to waive as a condition of accession.

The End of the MFA

The Agreement on Textiles and Clothing (ATC) negotiated in the Uruguay Round (1986–95) called for the phaseout of quota restraints imposed under the auspices of the MFA. The phaseout was to be spaced over 10 years, with all T&C quotas to be eliminated by January 1, 2005 (box 3.1). The

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2. US producers only sell synthetic fabric rather than cotton brassieres and have long since shifted brassiere assembly to Mexico and Central America.

3. Paragraph 241 of China's draft protocol of accession (the safeguard clause applicable to any product) became article 16 in the final protocol; paragraph 238 in the draft protocol (the T&C specific safeguard) appears as paragraph 242 in the final protocol. Richard Seldin, Comments on China Bashing 2005–06, personal e-mail correspondence, March 7, 2006, on file with authors.

4. In 2004 the European textile-lobbying group, the International Association of Users of Artificial and Synthetic Filament Yarns and Natural Silk (AIUFFAS), petitioned the European Union to impose this WTO safeguard mechanism (paragraph 241) against Chinese fabric and fiber imports. See "European Group to Submit First China Textile Safeguard Petition," *Inside US Trade,* January 28, 2004. Also see Knappe (2003).

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Box 3.1 Limits to textile and clothing liberalization: The MFA quota phaseout

US textile and clothing quotas are not a new phenomenon. Since the US Agricultural Act of 1956, the US government has used quotas to limit textile and clothing imports. In the 1960s industrialized countries, led by the United States and Europe, imposed short- and long-term agreements to protect their own markets from cheaper foreign textile and clothing competitors. These were later consolidated in 1974, under GATT, as the Multi-Fiber Arrangement (MFA), which in turn was revised and extended three times. As an outcome of the Uruguay Round of multilateral trade negotiations, the WTO Agreement on Textiles and Clothing (ATC) established a staged and back-loaded liberalization of MFA textile and clothing quotas. In 2005 all quotas were supposed to have been eliminated and the MFA abolished. The stages are summarized below. However, in 2005 the European Union and the United States both reinstated quota limits on their imports of Chinese textile and clothing. The limits were imposed consistent with the terms of China's protocol of accession to the WTO.

Year	Quota relaxation
1994	WTO members required to permit quota-free volume of textile and clothing imports to grow at 6 percent annually.
1995–97	WTO members required to remove quotas on 16 percent of the total volume of each WTO member's 1990 textile and clothing imports.
1998–2001	WTO members required to remove quotas on an additional 17 percent of the total volume of each WTO member's 1990 textile and clothing imports.
2002–04	WTO members required to remove quotas on an additional 18 percent of the total volume of each WTO member's 1990 textile and clothing imports.
2005	WTO members required to remove all remaining quotas, usually the remaining 49 percent of the total volume of each WTO member's 1990 textile and clothing imports.
2005–07	In June 2005 the European Union signed an agreement to restrict the growth level (between 8 and 12.5 percent annually) of 10 categories of Chinese textile and clothing imports. The agreement will hold until the end of 2007.
2006–08	In November 2005 the United States and China agreed to a memorandum of understanding that places quotas on 34 categories of Chinese textile and clothing imports beginning January 1, 2006. The quotas are increased annually: 8 to 10 percent in 2006, 10 to 16 percent in 2007, and 15 to 17 percent in 2008.

Sources: Gereffi and Memedovic (2003); "EU, China Reach a Deal on Textile Imports," Associated Press/MSNBC, September 5, 2005; USTR, press release, Media Availability of USTR Portman and Minister Bo Xilai on the US-China Textile Agreement, November 8, 2005.

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ATC outlined the stages of liberalization over the 10-year period, requiring a minimum level of annual quota expansion. Most importing countries stuck to the bare minimum called for at each stage, leaving about half of the required quota elimination until the eve of 2005.

With the end of the MFA, Chinese T&C exports to the United States grew rapidly. The US textile industry claimed that the surges were harming the domestic industry and beseeched the Bush administration to impose import restraints. To support its case, the US industry cited cheap labor in China, the massive loss of jobs in the United States, and a further deterioration of the US trade balance. The textile industry claimed that 19 textile plants had closed and 26,000 jobs had been lost since the end of the MFA, assigning the chief blame to China.[5] For its part, China argued that its exports are mainly displacing other US T&C imports, not enlarging US imports of T&C goods as a whole.

From 2002 to 2004, China's T&C exports to the United States grew on average by 22 percent annually. However, in 2005, after the MFA expired, Chinese T&C exports to the US market grew by 50 percent. Simply noting the superfast growth in Chinese exports, however, does not answer the question of which suppliers are being displaced. Total US T&C imports grew 6.8 percent in 2005, which is actually less than the 2004 growth rate of 7.8 percent.[6] In broad terms, these figures appear to support China's claim that its exports to the US market mainly displace third-country suppliers. The end of the MFA regime apparently allowed China to realize its comparative advantage over alternative foreign suppliers.

Whatever the facts, US T&C producers are convinced that their competitive problems originate in China. Hence the impending end of the MFA regime at the end of 2004 caused many textile lobbyists to call for action against Chinese T&C exports. Facing pressure from abroad, China took preliminary measures to ward off complaints. Early in 2005 China voluntarily placed a tax on its T&C exports.[7] However, US firms criticized the tax as being too small to be effective.

As already described, under China's accession agreement to the WTO (paragraph 238), special safeguard measures can be applied to Chinese T&C exports until 2008.[8] If a WTO member country believes imports from

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5. See Martin Crutsinger, "US Renews Limitations of Clothing from China," *Washington Post,* September 2, 2005.

6. The lower 2005 growth rate may partly reflect the new quotas against Chinese T&C imports in the second half of 2005. Based on January to September comparisons, total US T&C imports grew 9.5 percent in 2005, similar to the growth rate for 2004 (9.4 percent).

7. See "Sharp Rise of China's Textile Exports to EU, US Curbed," *People's Daily Online,* May 13, 2005, available at english.people.com.cn (accessed June 1, 2005).

8. Another category of special safeguards—so-called paragraph 241—can be applied with more demanding conditions against any Chinese export, including T&C items, until 2013.

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China are causing “market disruption,” the member is allowed to limit Chinese imports to a maximum of a 7.5 percent annual growth for specific and identified T&C categories. Between October 2004 and December 2004, CITA received petitions to review over 20 T&C categories with a view to invoking special safeguard measures under the WTO provisions.[9] In May 2005 CITA began putting quota limits on individual items, and by the end of that year, nine T&C quotas were in place: five in May, two in September, and one in early November. These safeguards, invoked under WTO provisions, were scheduled to end on December 31, 2005, but were extended with somewhat more liberal terms under the January 2006 memorandum of understanding (MoU) between China and the United States, discussed shortly.[10]

European firms were also distressed by rapidly rising T&C imports from China. In 2004 and 2005 the European Commission held extensive negotiations with Chinese officials to reach an agreement that would satisfy both regions. On June 10, 2005, an agreement was signed that placed prospective limits on 10 categories of Chinese T&C imports. However, the one-month grace period before the EU-Sino textile agreement was to be enforced caused many European retailers to place extensive orders for Chinese garments. As a result, 77 million garments were held at customs, requiring a further round of negotiations to deal with the sudden flood.[11]

Following the EU-Sino textile agreement and the US safeguards, China enforced a quota system to limit its exports. The system, similar to that in place under the MFA, was introduced on July 20, 2005.[12] Some commentators feared that reintroducing a quota system akin to the MFA will favor larger Chinese companies at the expense of small and medium-sized T&C exporters. Thus, for example, in early 2006 only 76 of the 6,200 textile companies in Foshan, China, had received their export quotas.[13]

When the EU-Sino pact was announced, CITA called for US consultations with Chinese officials. The broad goal was to establish a comprehensive agreement as an alternative to the annual product-by-product system contemplated in the special WTO safeguards (paragraph 238).

9. Petitions were filed by several US textile organizations: American Manufacturing Trade Action Coalition, National Council of Textile Organization, National Textile Association, and UNITE HERE!

10. The MoU is available at the Web site of the Office of Textiles and Apparel, www.otexa.ita.doc.gov.

11. See “EU, China Reach a Deal on Textile Imports,” Associated Press/MSNBC, September 5, 2005, available at www.msnbc.msn.com (accessed November 15, 2005).

12. See Mei Fong, “China Will limit Textile Exports Amid Trade Rift,” *Wall Street Journal,* June 21, 2005, A14–A15.

13. See “Textile Producers Cut Jobs on Fall in Export Orders,” *Sina English,* January 14, 2006, available at english.sina.com (accessed May 31, 2006).

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Because China employs 1.9 million workers directly in the T&C industry and the United States employs about 700,000, the talks were a trade priority for both countries. After five months and seven rounds of negotiations, on November 8, 2005, the above-mentioned MoU between China and the United States was finally signed. The MoU was implemented starting January 1, 2006, and will be enforced through December 31, 2008. It covers 34 categories and calls for an annual increase in the quota for each category: 8 to 10 percent growth in 2006, 10 to 16 percent growth in 2007, and 15 to 17 percent growth in 2008. When the MoU was signed, 19 categories were already covered by safeguards and 15 were not.[14]

After the MFA ended in 2005 the common perception was that China would dominate global T&C production, displace exports from other developing countries, and cause further job loss in industrialized countries (Nordas 2004). World Bank analysts estimated that roughly $200 billion in clothing production for export markets would shift to China over the next few years, with the main losers being non-Asian developing countries.[15] We think that the wave of Chinese clothing exports may be smaller and slower. Chinese T&C exports have actually been declining as a share of total Chinese merchandise exports. As the Chinese economy continues to mature and shifts toward technology exports, Chinese T&C exports should continue their decline as a share of total Chinese merchandise trade (see table 3.1). This process should lessen the much-feared flood of low-cost clothing from China into the United States. Moreover, WTO members other than the United States and the European Union are likely to impose special safeguards on Chinese T&C exports.

Sources of China's Comparative Advantage

China's trade advantage in clothing goes well beyond an undervalued exchange rate and public subsidies. China has a huge domestic market that enables economies of vast scale and scope. In addition to abundant cheap labor (more on this later), China is well positioned for raw textile materials. Using advanced technology, China is now the world's largest producer of manmade fibers.[16] China has large domestic supplies of

14. USTR, press release, Media Availability of USTR Portman and Minister Bo Xilai on the US-China Textile Agreement, November 8, 2005.

15. See Krantz, Di Natale, and Krolik (2004); and *World Bank Press Review,* April 29, 2004. US industrial production of textiles contracted in real terms each year from 2000 to 2003, while US clothing production declined each year from 1997 to 2003. See also Gereffi (1999) and Nathan Associates (2002).

16. See USITC (2004a). In terms of quality, China is fast approaching the level of Korea and Taiwan.

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Table 3.1 US-China textile and clothing trade, 2000–2005
(billions of dollars and percent of total merchandise trade)

	United States		China	
Year	**Billions of dollars**	**Percent**	**Billions of dollars**	**Percent**
2000				
Exports	.2	.0	49.4	20.0
Imports	8.0	.7	16.6	7.0
2001				
Exports	.3	.0	49.8	18.7
Imports	8.2	.7	16.3	6.7
2002				
Exports	.5	.1	57.8	18.1
Imports	9.6	.8	17.0	6.8
2003				
Exports	1.1	.2	73.3	16.7
Imports	12.0	1.0	19.3	4.7
2004				
Exports	1.9	.3	88.8	15.0
Imports	20.8	1.4	23.0	4.1
2005				
Exports	1.8	.2	n.a.	n.a.
Imports	19.1	1.3		

n.a. = not available

Source: China Statistical Yearbook, 2003 and 2005.

ramie, silk, and angora rabbit hair and imports large volumes of cotton and wool.

Unlike other competitive T&C exporters such as India, the Chinese government invests heavily in infrastructure. Major highways link impoverished western provinces with industrialized coastal cities. With deep-water ports, shipping times from China to the western coast of the United States are faster than those of neighboring southeast Asian countries and India.[17] The government has encouraged higher-quality production of high-value fabrics by organizing the 600 best mills into

17. Shipping times from China to the western coast of the United States average 12 to 18 days, while shipping times from Southeast Asian countries to the United States average about 45 days. See USITC (2004a).

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24 groups as part of its Fabrics China campaign and has taken other steps to strengthen the Chinese T&C industries.[18]

Above all, political and economic attention focuses on labor cost differences as a source of Chinese comparative advantage. In the clothing industry, the US hourly wage averages $9.70 per hour including fringe benefits, while the Chinese hourly wage averages $0.88 per hour including fringe benefits.[19] If all other costs were equal, workers in the US clothing industry would need to be roughly 11 times more productive than China to offset the labor cost advantage. US clothing workers are substantially more productive than Chinese workers, thanks to better capital equipment, technology, and training, but they are not 11 times more productive.[20] Other factors, such as proximity to markets—especially for "replenishment" items—and access to raw materials, favor US production. However, for decades to come, the Chinese clothing industry will have a dramatic labor cost advantage over the US industry.[21]

Evaluation

The basic facts of comparative advantage pose the stark question of whether the US T&C industry will downsize to niches in which it can compete with Chinese and other low-wage producers. Downsizing is a matter of both adjustment speed and ultimate industry size. More policy measures like the current MoU between the United States and China will almost certainly be enacted to slow the feared Chinese rush into world

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18. Since 1998, the Chinese government has provided about $5.6 billion in grants and loans to restructure the domestic T&C industry. The government opened large garment manufacturing parks, and closed inefficient T&C state-owned enterprises. As a result, the T&C industry collectively shed about 1.5 million jobs, even as many small-scale clothing companies were launched and began to thrive. In addition, the Chinese T&C industry benefits from FDI, roughly 80 percent from Taiwan and Hong Kong. Foreign T&C companies generated $30 billion in sales and $1.3 billion in profit in 2000. See CITA (2003).

19. Including fringe benefits, the average US clothing hourly wage is $9.70, the average US textile hourly wage is $10.08, and the combined average hourly wage for US textile and clothing is $9.89.

20. Using annual sales divided by the workforce as a very rough measure of productivity, the US T&C industry generates about $237,250 in sales for each employee. By comparison, at the mid-2006 exchange rate of 8.00 renminbi to the dollar, the Chinese T&C industry generates about $26,759 in sales for each employee. On these figures, US T&C workers are about 8.9 times more productive than Chinese workers.

21. See Abernathy (2004). As long as Chinese clothing factories can draw on the vast rural labor pool, they will easily remain competitive with plants in India, Bangladesh, Pakistan, and similar countries. Chinese factories have the advantage of better infrastructure and faster delivery.

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T&C markets. It seems likely that import pressures from China will be moderated on an ad hoc basis, through the various safeguard and antidumping measures summarized in appendix B. Moderated, however, does not mean stopped. Meanwhile, over the next decade, the T&C industries in the United States, the European Union, and other industrialized countries will need to shed a substantial number of workers, as China, India, and other emerging countries enlarge their market share.

In searching for niches in which they can match Chinese competition, US clothing manufacturers will need to respond by emphasizing several factors: offering ultra-fast delivery of "replenishment" items,[22] using the latest high-quality fabrics and stitching methods, making fashion items that are not price sensitive, entering high value-added product markets that are less labor intensive, and bypassing traditional retailers through direct e-commerce sales to consumers. Looking at the entire chain of clothing production and distribution, the US industry will need to migrate to the distribution end of the spectrum. Indeed, well-known US clothing producers, such as the Sara Lee Corporation, Nike, Levi Strauss, and Disney, have already deemphasized production activities in favor of better marketing of their brand names and retail outlets (Gereffi 1999).[23]

The US government should not rely solely on safeguard measures and antidumping duties to protect US jobs. Instead it should speed up the adjustment process with an improved trade adjustment assistance (TAA) program that makes wage insurance and portable health insurance its centerpiece (Kletzer and Litan 2001). Unlike traditional unemployment insurance and TAA programs, wage insurance benefits, including portable health insurance, take effect once a person finds a new job, thereby encouraging displaced workers to find a new job as soon as possible.[24] When a worker is unemployed, the government should provide minimal income support and basic health insurance. Another useful idea, advocated by Kletzer and Rosen (2005), is broad-brush certification of

22. In this spirit, Central American clothing producers are taking advantage of their geographical proximity to the United States, betting that speed will sometimes win over price. See "As US Quotas Fall, Latin Pants Makers Seek Leg Up on Asia," *Wall Street Journal,* June 16, 2004.

23. See also US Department of Commerce, US-China Joint Commission on Commerce and Trade Working Group on Structural Issues Hearing, Washington, June 3, 2004.

24. To be eligible, a worker must prove job displacement, earnings loss, and a minimum time of employment in his previous job (e.g., two years). Average annual payments would be capped (e.g., $10,000 annually plus health benefits for up to two years). Kletzer and Litan (2001) estimate that a wage insurance program for the entire economy (not just trade) at current levels of worker displacement would cost about $5 billion per year. See also Steve Lohr, "Debate Over Exporting Jobs Raises Questions on Policies," *New York Times,* February 23, 2004.

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wide swaths of the T&C industry for adjustment assistance.[25] This approach would bypass the slow process of plant-by-plant certification when large numbers of workers are dislocated by import competition. By using such approaches to create a much better safety net, the US government can alleviate some of the opposition to trade liberalization that is deeply embedded among T&C workers and encourage them instead to seek on-the-job training in new positions.

Concerns about trade with China do not end with questions of comparative advantage, however. The strength of China's legal mechanisms has also been called into question, particularly in the area of intellectual property rights (IPRs). Copyright and other IPR infringements, a sore point in US-China relations, are taken up in the next chapter.

25. This idea is now reflected in legislation offered by Senator Max Baucus (D-MT).

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Intellectual Property Rights

Infringements on intellectual property rights (IPRs) have been steadily increasing, according to US business firms, and China is the leading violator. According to Bergsten et al. (2006, 95), "China's failure to protect intellectual property . . . is probably the second most important source of friction in the bilateral U.S.-China economic relationship." Annual US losses on a global basis for copyright violations alone have been estimated at between $2.5 billion and $3.8 billion.[1] In the last five years there has been an 80 percent increase in US International Trade Commission proceedings involving IPR violations from foreign countries (USTR 2006). In 2004 China accounted for 63 percent of the total value of infringing products seized by US Customs. The next highest source was Hong Kong, accounting for 6 percent; India and Russia accounted for 4 percent combined.[2]

IPR violations were a clear priority and emphasized throughout the Top-to-Bottom Review on China published by the USTR in February 2006. Indeed, the IPR problem with China was mentioned in five of the six "key

1. See USTR's Out of Cycle Review Results, available at www.ustr.gov.

2. See US Customs statistics on Top IPR Seizures 2004, available at http://cbp.gov. The total value of seizures was only $87 million in 2004; however, the great bulk of counterfeit products are sold outside the United States.

3. The six objectives are participation, implementation and compliance, enforcement of US trade laws, further market access and reform, export promotion, proactive identification, and resolution of trade problems. Participation was the only category where IPRs were not mentioned.

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China trade objectives and priority goals."[3] The steps outlined in the "key actions" were meant to address IPR violations through additional personnel, consultations with US companies, improved mechanisms for US IPR holders to bring cases to the Chinese authorities, and technical exchanges between the United States and China regarding detection and enforcement.

IPRs are slowly becoming a domestic priority within China as well. During President Hu Jintao's visit to Microsoft on April 18, 2006, he assured Microsoft Chairman Bill Gates that China would "earnestly protect intellectual property rights. We will honor the pledges we made. The Chinese side has already stepped up our legislative efforts and law enforcement to protect intellectual property rights." The visit and pledge underscored the growing role private firms play in providing incentives and pressure for increased IPR protection.[4] Yet while the Chinese government has taken steps to curtail infringements, many contentious differences separate China and the United States. For any country to meet international norms, it must have an adequate institutional system to support IPR protection. Enforcement requires a legal framework, inclusive of processes for registration, disputes, and appeals, complemented by good police work and a competent judicial system (Lian 2006).

Few of the conditions for protecting IPRs are met within China. There are many IPR agencies, but they work with little coordination. The agencies may decree conflicting regulations, which are ignored in any event. Government incentives may even favor violating IPRs because public officials are evaluated on the economic performance of their constituencies, and some local firms may be IPR violators (Bender 2006). China has become a party to numerous IPR treaties (appendix table A.4), but it still lacks a domestic institutional system that can effectively protect IPRs.

A major shortcoming is weak enforcement by Chinese provincial authorities. According to Article 61 of the WTO's Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS), IPR laws should be enforced to deter wrongdoers.[5] Raids and seizures have increased in China, but their deterrent effect seems slight owing to inconsequential penalties. Infringing products color 90 percent of the market in almost every copyright sector in China (IIPA 2005a). Slow investigations, weak prosecution, and low fines all undermine the enforcement effort. To launch a criminal investigation, high monetary proof-of-sale thresholds must be satisfied, calculated on the value of the infringed product rather than the original good ($24,100 for enterprises; Bender 2006). Though the Chinese government reported a 25 percent increase in IPR-related criminal prosecutions for the first half of 2005 (to 1,549 cases), sufficient infor-

4. See "US: We Mean Business on Piracy, Hu tells Gates," *South China Morning Post,* April 20, 2006.

5. For the text of the TRIPS agreement, see www.wto.org.

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mation is not available to assess the scope or impact of these cases. Trademark prosecutions are on the rise, but copyright prosecutions are rare. Moreover, there has been a steady reduction in the number of cases that administrative authorities forward to the Ministry of Public Security for Criminal Investigation: 86 in 2001, 59 in 2002, 45 in 2003, and 14 in the first half of 2004 (IIPA 2005b). Regardless of weak IPR protection in China, from 1995 to 2002, US royalty and fee receipts from Chinese enterprises increased by 300 percent, suggesting that US companies are increasingly comfortable with China as a production location. However, since 1994 there has been a decrease in royalty receipts from nonaffiliated firms compared with receipts from affiliated firms.[6] US firms evidently prefer to transfer intellectual property to Chinese firms that they control, as it allows a greater degree of protection against leakage and IPR infringement (Lian 2006).

The weakness of official criminal enforcement has spurred private initiatives. In one case, David Benner of Pfizer reported a man he suspected of producing fake Viagra. The ensuing investigation resulted in 12 arrests and seizure of almost half a million pills. Though the Chinese authorities assisted in the case, much of the investigation and progress was due to Pfizer's initiative.[7] In another case, brought by GM Daewoo, enforcement was complicated by the fact that a local government was implicated in the IPR infringement. In January 2005 GM Daewoo sued Cherry Automobile Company, owned partly by the local Chinese government, for producing the QQ, a car virtually identical to GM Daewoo's Spark.[8] As in other private actions, GM Daewoo will be fortunate to recoup its litigation costs alone. Another concern with civil litigation is the inability to enforce judicial decisions: It is estimated that only 40 to 60 percent of final verdicts are carried out, and perhaps only 10 percent when officials in other jurisdictions are needed to execute the judgment (Bender 2006).

Another impediment to IPR protection is that China's industrial policies often abet infringement by delaying the release of legitimate goods. This delay allows counterfeit goods to dominate the market for a considerable period (IIPA 2005b). Aware of these problems and complaints, in April 2004, at the fifteenth annual meeting of the Joint Commission on Commerce and Trade (JCCT), China committed to ensure a significant reduction in IPR infringements; pursue a greater range of criminal investigations and stiffer penalties, applying criminal sanctions to persons with

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6. Affiliate and nonaffiliate transactions are differentiated by a threshold of 10 percent equity shareholding.

7. See Nicholas Zamiska and Heather Won Tesoriero, "Drug Headache: As Battles Fakes in China, Nation's Police are Uneasy Allies," *Wall Street Journal,* January 24, 2006.

8. See "China Pressed to Forcefully Attack Intellectual Property Theft," US Department of State, International Information Programs, January 1, 2005, available at www.usinfo.state.gov (accessed May 22, 2006).

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secondary involvement in pirated and counterfeit products; bring nationwide enforcement actions and increase customs enforcement; ratify and implement the World Intellectual Property Organization (WIPO) Internet treaties as soon as possible and extend the ban on pirated software to local governments; launch a national IPR education campaign;[9] and establish a working group under the JCCT to work with the United States on IPR issues.

Two years later infringement continued to be high, and IPRs were therefore a key discussion topic at the seventeenth annual JCCT on April 11, 2006. China made further pledges at that meeting, including a special campaign focusing on pirated optical disks and legislation requiring legal software to be preloaded on all computers produced and imported into China. To ensure that the public sector did not use infringed products, the Chinese team also discussed US proposals regarding government and state enterprise procedures for managing software assets. China agreed to pursue individual IPR cases raised by the US government and adopted a broad plan to improve overall IPR enforcement.[10] Although the campaign against pirated optical disks and the legislation requiring preloaded software are promising, the JCCT meeting was longer on rhetoric than substance. New Chinese commitments appear minimal, given the very large scale of IPR infringement.

Accomplishments

In August 2004 the State Council proclaimed a concentrated effort to decrease IPR infringements in sectors where they were common. The campaign lasted until the end of 2005. Though there have been more raids and seizures, fines remain low, and it is still profitable to manufacture pirated goods and pay the fine if caught. It is also not known what happens to the seized materials; some reportedly reenter the market. Only some provinces and municipalities have taken measures to comply with the ban on illegal software.[11]

In November 2004 China's Ministry of Public Security for Criminal Investigation began Operation Mountain Hawk, which outlines procedures for cooperation between national and local police when investigating cases.

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9. As promised, in 2004 an educational awareness campaign was launched. An example of the program includes the broadcasting of a television program called "Intellectual Fortune" in 20 provinces. It is too early to tell what effects the campaign will have. See USTR's Out of Cycle Review Results, available at www.ustr.gov.

10. See US Department of Commerce, press release, "The US-China Joint Commission on Commerce and Trade (JCCT) Outcomes on US Requests," April 11, 2006.

11. See USTR's Out of Cycle Review Results, available at www.ustr.gov.

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In December 2004 China announced new judicial interpretations that lowered the minimum threshold required for a criminal conviction for IPR violators.[12] In line with its commitments at the 2004 JCCT meeting, the new interpretation held accomplices liable to prosecution but also deleted the stiffer penalties on repeat offenders and made violations criminal only if done "for profit." The "for profit" qualification will presumably insulate from criminal prosecution those individuals who download computer software and entertainment and music files for their personal use.

China and the United States increased their cooperation on enforcement matters starting in late 2004. August 2004 marked the first US-China joint investigation effort, Operation Spring, in which a counterfeit DVD export ring was closed down and six people arrested. In November 2004 US and Chinese commerce agencies produced guidelines for case reviews. When US companies report violations, Chinese authorities undertake an interagency review, and with enough evidence, the case is brought to the Ministry of Commerce.[13] The first case brought through this mechanism was launched by the National Basketball Association (NBA): 12,000 slippers were confiscated and an administrative penalty applied.[14]

In early 2005 the USTR conducted an Out of Cycle Review to determine China's progress in meeting the commitments it made in 2004. The report found that China's IPR infringements had not been reduced, and therefore the USTR took several actions. In April 2005 USTR elevated China onto its Priority Watch List, meaning more intense surveillance. In October 2005, in accordance with Article 63 of the WTO TRIPS agreement, the United States requested a first round of information on China's enforcement mechanisms and proceedings.[15] This step was widely seen as a precursor to a US WTO case against China for violating the TRIPS agreement.

Regarding the commitments made by China during the seventeenth JCCT meeting held in April 2006, it is too early to determine whether the government will effectively implement its action plan and deliver on other promises. China has already closed a number of factories producing pirated optical disks; according to Chinese Vice Premier Wu Yi, as of March 2006, 224 production lines had been closed.[16] To implement recent

12. See USTR, Positive List Of Developments: May 2004–April 2005, available at www.ustr.gov.

13. See USTR, Positive List of Developments: May 2004–April 2005, available at www.ustr.gov.

14. See Clearance Case of Commodities Infringing "NBA" Trademark in Fuzhou, China's State Office of Intellectual Property Protection of the People's Republic of China, available at http://ipr2.mofcom.gov.cn/column/representativecases.shtml (accessed July 11, 2006).

15. See USTR's Out of Cycle Review Results, available at www.ustr.gov.

16. See press conference at the Annual Meeting of the US-China Joint Commission on Commerce and Trade, available at www.ustr.gov.

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legislation requiring preloaded software, several Chinese computer manufacturers have agreed to purchase US operating systems. Most notably, in April 2006, Microsoft signed four new agreements with Chinese manufacturers to preinstall Windows.[17] The largest of these agreements was made with the Lenovo Group, China's top computer maker and owner of IBM's former PC division; the agreement has an estimated value of $1.2 billion over the next year. The chairman of Lenovo claims that the new legislation has an impressive impact, estimating that 70 percent of Chinese customers are now purchasing computers with Windows XP installed, compared with 10 percent in November 2005.[18] While these initial steps seem promising, it remains too early to judge the outcome of the 2006 JCCT agreements.

Evaluation

IPR protection is a problem for every country, including advanced nations. While China's rhetoric has improved, infringements continue to be rampant. Though infringements may decline in the long run, major improvements seem unlikely in the near future, unless China steps up its enforcement effort substantially. WTO cases brought under TRIPS are likely to be drawn out, and successful results may well cover only a single sector or a single province. The United States can nudge the process forward by targeted countermeasures, especially in the wake of a successful WTO case, but ultimately IPR protection depends on China, and unfortunately, economic incentives in China continue to favor violations.

The central government has launched initiatives to reduce the number of IPR infringements, but the provincial and municipal governments often view infringement more as a commercial opportunity than a civil or criminal offense. Without the support of local officials, IPR enforcement will continue to be difficult, even with the central government's lead. Possible solutions include insisting on better funding for enforcement bureaucracies and creating a system of incentives to engage broader support for IPRs. Bounties might be paid to private citizens and public officials who report or apprehend violators. China should also welcome corporate measures and self-help in the broader campaign to protect IPRs. In this respect, the recent initiatives on preloaded software could provide a model for wider application.

17. See Joseph Kahn, "Chinese Leader Focuses on Business as 4-Day US Visit Begins in Washington State," *New York Times,* April 19, 2006.

18. See Richard McGregor, "Ho Trip to Seattle Lifts Hopes of Sea Change in Piracy Policy," *Financial Times,* April 19, 2006.

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The concerns about the relationship between Chinese government and business that run through IPR issues also have national security implications, which came to a head in the summer of 2005 over a bid by the China National Offshore Oil Corporation (CNOOC) to acquire US oil company Unocal. The attention paid to CNOOC in 2005 was surpassed by the US public outcry in early 2006 over the Dubai Ports World acquisition of terminal operations in six US ports. However, the upshot of these two cases is a strong congressional push for greater scrutiny of foreign acquisitions of US companies and assets, which means that national security issues are likely to affect US-China commercial relations in the future, as the next chapter discusses.

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5

The CNOOC Case

In mid-2005 competing takeover bids for the Unocal Corporation, a US oil producer, spiraled into a political controversy that swept through Congress. The entire debate and the subsequent controversy over Dubai Ports World in early 2006 are examined at length in Graham and Marchick (2006). Here we summarize the battles, focusing on the China National Offshore Oil Corporation (CNOOC) case.

The American-owned Chevron Corporation and CNOOC both sought to acquire Unocal, hiring lobbyists to sway public opinion and political leaders. The Chinese company's opening bid for Unocal was $18.5 billion, all cash; Chevron's initial bid was $16.6 billion in cash and stock. However, the hurdles thrown up by a politically opposed Congress slowly eliminated CNOOC's advantage. In the end, Chevron prevailed, acquiring Unocal for its increased offer of $17.8 billion, proposed on July 19, 2005 (Dorn 2005).

Just two days after the Chinese company made its opening proposal, on June 24, 2005, Representative William J. Jefferson (D-LA) circulated a letter through the House of Representatives demanding that President Bush and senior officials review the CNOOC bid. Throughout July 2005 Congress pushed bills that called for the bid to be reviewed and stopped, based on claims that the takeover would threaten both US national security and economic interests.

The claims stemmed from three central facts: CNOOC is a foreign company; the Chinese government controls it; and it has the unfair advantage of financial support from the Chinese government. In the end, congressional opposition created a high likelihood that CNOOC's bid would be delayed and possibly blocked altogether. On June 30, 2005, the

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House passed nonbinding HR 344, sponsored by Representative Richard W. Pombo (R-CA), by a vote of 398 to 15, demanding that if Unocal entered into an agreement with CNOOC, "the President should initiate immediately a thorough review of the proposed acquisition, merger, or takeover." With the administration declining to review CNOOC's possible takeover until Unocal's board accepted the bid, it became very difficult for CNOOC to ensure a smooth and quick takeover.

Faced with the administration's inaction, Congress continued to assert its power by amending the Energy Policy Act of 2005 (HR 6) to include a provision calling for a one-time study "of the growing energy requirements of the People's Republic of China and the implications of such growth on the political, strategic, economic, or national security interests of the United States." The legislation allowed for 120 days for the report to be completed and presented to the president and Congress. Not until 21 days after the report was presented could a US organization that reviews investment in a domestic corporation "conclude a national security review related to an investment in the energy assets of a United States domestic corporation by an entity owned or controlled by the government of the People's Republic of China," thereby immobilizing the review process under way in the Committee on Foreign Investment in the United States (CFIUS) with respect to the proposed CNOOC-Unocal deal for a potential 141 additional days.[1] In response to the new law, CNOOC released a press release citing "unprecedented political opposition . . . creating a level of uncertainty that present[ed] an unacceptable risk to our ability to secure this transaction," and on August 2, 2005, just eight days before the Unocal board was to vote on Chevron's bid, CNOOC withdrew its offer, ensuring Chevron's success.[2]

CFIUS Review

According to US law—the so-called Exon-Florio Amendment of 1988 to the Defense Production Act of 1950—if a foreign acquisition poses a possible threat to US national security, CFIUS is to review it.[3] CFIUS is a Treasury-led committee with representatives from 11 other federal departments, including the Departments of Homeland Security, State, Commerce, and Defense. If CFIUS finds the perceived national security threat to have a factual basis, it conducts an investigation and can ultimately recommend that

1. Legislation is available at thomas.loc.gov.

2. See CNOOC, press release, "CNOOC Limited to Withdraw UNOCAL Bid," August 2, 2005, available at www.cnoocltd.com.

3. CFIUS was first created by executive order in 1975 but was given statutory powers by the Exon-Florio Amendment of 1988.

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the president block the takeover. The process is supposed to be completed within 90 days.

Since 1988, more than 1,500 cases have been forwarded to CFIUS, about 10 percent of all foreign acquisitions. Of these, 25 have been investigated, with 12 sent to the president and 13 voluntarily withdrawn. Only one of those 12 cases sent to the president was blocked: In 1990 China National Aero Technology Import and Export Corporation was required to sell its aircraft component interest in Mamco Manufacturing, Inc.[4]

While the number of rejected takeovers seems small, many more deals have been blocked indirectly as potential purchasers voluntarily withdrew, believing that CFIUS would not approve the acquisition. CNOOC submitted its offer to CFIUS, but the administration indicated that a review would not commence until Unocal accepted the offer. By this ploy, along with the amended Energy Act, CFIUS and the administration were able to immobilize the proceedings: CNOOC needed CFIUS approval to make its offer viable and assuage the legitimate fears of Unocal shareholders and directors that a takeover might be blocked, but CFIUS initially refused to review the offer until it was accepted by Unocal.

Meanwhile, voices in Congress began calling for new standards and greater openness in the CFIUS review process. The amendment to the Energy Act illustrates not only Congress's political opposition to CNOOC but also its dissatisfaction with the CFIUS review process. Criticisms of the closed-door character of the CFIUS process, the narrow mandate of the national security test, and the exclusion of congressional views were key points in the debate. Among the proposed "reforms" are expanding the national security test to cover critical infrastructure; prohibiting foreign acquisition of critical infrastructure;[5] requiring an additional 45-day review (after the initial 30-day review) if a foreign government is involved in the acquisition of a US firm; and notifying select members of Congress of CFIUS decisions before they are issued in final form.[6] Defenders of the existing CFIUS mandate claim that putting "critical infrastructure" off limits to foreign investment would insulate wide sectors of the US economy from beneficial competition, that foreign governments often have a stake in competitive foreign firms, and that notifying CFIUS cases broadly to Congress will invite intense political lobbying in contested takeovers (see Graham and Marchick 2006). At this writing (May

4. See Bruce Stokes, "Tighter Control of Foreign Investment?" *National Journal*, July 23, 2005.

5. See "Oxley Says Hunter Likely to Seek Tough CFIUS Language Changes," *Inside US Trade* 24, no. 20, May 19, 2006, 1; "Blunt Bill Includes Less Onerous Notification Requirements," *Inside US Trade* 24, no. 19, May 12, 2006, 3.

6. In 2005, during the CNOOC debate, some Congressmen proposed that CFIUS should apply a "national economic interest" test, as well as a national security test, for foreign takeovers. This idea was dropped in 2006, during the course of legislative drafting.

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2006), it is too early to tell how the congressional debate will turn out. The contest is between mild changes proposed by Congressman Roy Blunt (R-MO) and endorsed by Congressman Mike Oxley (R-OH); stronger measures (especially notification to a larger number of congressmen) pushed by Senator Richard Shelby (R-AL); and radical reforms (the critical infrastructure provisions) advocated by Congressman Duncan Hunter (R-CA).

While there was no definitive review of CNOOC's proposed takeover of Unocal, it appears there was little substance to the national security concerns that were publicly raised in 2005. A study undertaken by the US Department of Energy to analyze China's increasing energy demands, released in February 2006, found that foreign investments by China's national oil companies were not an economic threat to the United States (Evans and Downs 2006). Concern over subsidized finance was the best-reasoned objection, though at the time of the CNOOC bid, subsidized finance was not a legal ground for rejecting a foreign acquisition. Moreover, in the 2006 congressional review of the CFIUS mandate, the leading proposals relegate subsidized finance at most to a factor in evaluating a takeover bid that involves the participation of a foreign government

The thrust of the national security and national economic interest objections voiced in 2005 was that CNOOC would dispose of energy production according to directions from the Chinese government, not market forces. While the People's Republic of China owns 70 percent of CNOOC,[7] the extent of government control and influence was never determined. CNOOC repeatedly affirmed that its purchase of Unocal was based on "purely commercial objectives." To allay concerns, Fu Chengyu, the chairman and chief executive officer of CNOOC, promised that substantially all of the oil and gas produced in the United States would continue to be sold in the United States and that CNOOC planned to retain virtually all of Unocal's employees.[8]

Evaluation of the Case

Ignoring these statements, it is worth considering a worst-case scenario: suppose that CNOOC preferentially directed all of Unocal's production to China, selling none of it on the world market. Economists widely regard the oil market as the most fungible commodity market that operates on a global scale. Fungibility means that if certain oil supplies are artificially

7. See Jerry Taylor, "CNOOC Bid for UNOCAL No Threat to Energy Security," *Free Trade Bulletin* no. 19, Cato Institute, July 19, 2005.

8. See CNOOC, press releases, "Statement by Fu Chengyu, Chairman and CEO of CNOOC Limited," June 24, 2005, and "CNOOC Limited to Withdraw UNOCAL Bid," August 2, 2005. Available at www.cnoocltd.com.

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channeled to one destination, other oil supplies will be redirected, filling any market that previously relied on the channeled supplies. If the oil market is indeed fungible, then Unocal production hypothetically directed to China under CNOOC's management would simply replace other imports that would have gone to China otherwise. Since overall global supply would remain the same, the price of oil would not be affected. CNOOC might absorb a financial loss by selling below world price to Chinese customers, but there would be little impact on the rest of the world. The fungibility assumption might be questionable if Unocal was a major supplier like BP or Exxon-Mobil, but Unocal accounts for only 0.2 percent of global oil production,[9] seemingly far too small a share to significantly affect the world oil market.

Furthermore, 70 percent of Unocal's reserves are located in Asia and are largely committed under long-term contracts to serve the Asian region.[10] Unocal's production in the United States accounts for less than 1 percent of US domestic consumption and is most profitable when sold in the United States.[11] For CNOOC to artificially channel much of Unocal's production to China, it would need to invest in new infrastructure, break contracts, receive permission from other governments, and incur revenue losses. Even if CNOOC pursued this course, the amount of energy produced from Unocal's reserves would not be large enough to affect global prices or supply conditions. Even in a worst-case scenario, the global supply available for the United States would not be materially affected. In short, there does not appear to have been a national security or economic interest case against CNOOC's proposed takeover of Unocal.

Arguments were also made that CNOOC's acquisition of Unocal may have relinquished technology vital to US national security. There is no indication that Unocal possessed any proprietary technology that was not already available to CNOOC through private vendors, contractors, and other sources. While Unocal's knowledge of deep water drilling off the Gulf of Mexico is of great value, spreading such expertise could result in greater oil production worldwide, benefiting all consumers. Furthermore CNOOC was willing to relinquish the Gulf of Mexico assets if that step would secure US approval of the transaction.[12]

Finally, Chevron also claimed that since CNOOC's offer was financed by low-interest loans from the government, it had an unfair nonmarket

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9. See Taylor, in *Free Trade Bulletin* no. 19, Cato Institute, July 19, 2005.

10. Quote of Fu Chengyu in *People's Daily Online*, July 26, 2005. Also see Patrick Barta and Matt Pottinger, "Why CNOOC May Not Be Such A Big Threat," *Wall Street Journal*, June 30, 2005.

11. See Taylor, in *Free Trade Bulletin* no. 19, Cato Institute, July 19, 2005.

12. See Russel Gold, "China Still Has to Prove It Can Close Deal," *Wall Street Journal*, July 21, 2005.

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advantage. Since the existence or extent of this advantage was never investigated, it cannot be quantitatively evaluated. As noted, under the current Exon-Florio Amendment, subsidized finance is not a reason to block a takeover. In prior cases evaluated by CFIUS, the cost of capital, whether debt or equity, was never considered in evaluating whether a takeover should be blocked. However, the Unocal episode clearly raises the question of whether subsidized finance should be a reason to block future takeovers.[13] A closely related question is whether foreign government control should be a reason to block future takeovers. As the legislative debate has evolved in 2006, subsidized finance may eventually be listed as a factor that CFIUS should consider but only when evaluating a takeover that involves a foreign government. Subsidized finance does not, at this writing, appear to be a concern in purely private takeover bids. Both Senator Richard Shelby (R-AL) and Congressman Roy Blunt (R-MO), the congressional leaders in the CFIUS debate, agree that foreign government takeovers merit extra consideration—an additional 45-day review (beyond the normal 30-day CFIUS review). They differ, however, on the size of the foreign government stake that, as a threshold, triggers the extra review. Whatever the outcome of this debate, it appears that a new process will be mandated before the next hotly disputed case arises.

Returning to the Unocal drama, at the end of the day Chevron was more successful at lobbying Congress and marshalling public opinion than was CNOOC. In part this was because Chevron had the "home court advantage" of a political environment that was already irritated with China over a variety of issues ranging from the renminbi exchange rate to textile imports. By effectively building on a platform of tense relations, Chevron was able to win the takeover battle in the arena of congressional and public opinion. Unocal shareholders and the board of directors turned out to be secondary players.

Who really benefited from the Unocal showdown? The potential consequences are not ideal. For Chevron and the US business community, the precedent of blocking foreign investment is not favorable to promoting free trade and investment on a global basis in all sectors, including oil. Unocal shareholders were forced to accept a lower bid. Will other shareholders here and abroad face the same fate? Regarding US energy policy generally, it may not be the best strategy to block Chinese investment in US energy supplies as the United States simultaneously urges other countries to open their oil reserves to US exploration (e.g., Mexico). As for China's energy demands, stopping the CNOOC bid did not quell the core

13. As China continues to subsidize international investments, other countries, such as India, are likely to follow suit in order to successfully compete, potentially undermining the current open world oil market system. One possible solution is to encourage China to participate in international agreements that attempt to monitor and control such predatory financial practices (Evans and Downs 2006).

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issue of China's growing demand for energy. If the US government does not allow China to invest in the United States, there will be one less reason for China to heed US objections against doing business with rogue states, such as Iran and Sudan.

Dubai Ports World Case

Shortly after the CNOOC case faded from the headlines, Dubai Ports World, based in Dubai (part of the United Arab Emirates), sought to acquire the Peninsular and Oriental Steam Navigation Company (P&O), a British firm, for $6.8 billion. P&O's main assets were terminal facilities owned or leased in various ports around the world, including facilities at six US ports. The senior civil servants sitting on CFIUS approved the sale in November 2005, and it was set to close in March 2006. The civil servants regarded the transaction as sufficiently routine that they briefed neither political officials nor Congress. However, another company, Eller, which was battling convoluted civil litigation in London against P&O, alerted several congressmen in early 2006, and by February 2006, full-throated opposition erupted from Capitol Hill. President Bush and his cabinet members tried to quell the protest without success.

Three charges were mounted against the Dubai Ports World takeover: first, that Dubai had served as an organizational locale for some of the terrorists involved in the attacks of September 11, 2001; second, that Dubai Ports World is largely owned by the government of Dubai, and specifically the emir; and third, that, as a matter of principle, neither US port facilities nor other critical infrastructure should be owned by foreign persons, public or private.[14] Faced with overwhelming opposition in Congress, including an adverse 62 to 2 vote in the House Appropriations Committee, Dubai Ports World conceded on March 9, 2006, stating that it would sell the US port facilities acquired from P&O to a US-controlled firm.

Conclusion

In the aftermath of the CNOOC and Dubai Ports World cases, in 2006, Congress began to review the authorizing legislation for CFIUS. The major changes under discussion were summarized earlier. While it is too

14. Many US port and airport facilities as well as other establishments that might be deemed "critical infrastructure" are already owned or controlled by foreign firms—some, such as Citgo, with government participation. This fact was not widely known in Congress or the public at large before the Dubai Ports World case.

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early to tell how the congressional debate will play out, it seems certain that US policy toward international investment will henceforth be examined through a tightly focused lens of national security. In the process, the historic US orientation toward open borders, for investment as well as trade, may well be redefined. Any changes are likely to put an extra spotlight on investments in the United States by Chinese as well as Middle Eastern firms.

Rightly or wrongly, the US emphasis on national security is seen abroad as a protectionist detour; after all, in both the CNOOC and Dubai Ports World cases, the acquired company eventually was bought by a US rather than a foreign firm. For its part, however, the United States has accused China of preferential treatment of its own firms, lodging complaints with the WTO regarding China's semiconductor and automobile industries, among others. The next chapter takes up this issue.

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6

Semiconductor Chips and Automobile Parts

Starting in the presidency of George H. W. Bush and continuing through the presidency of Bill Clinton, the United States has used economic diplomacy to open Chinese markets—for telecommunications, agriculture, financial services, and other products. Throughout the 1990s, a major US diplomatic tool was to condition US approval for Chinese entry into the WTO on China's internal reforms. After China was granted permanent normal trade relations by the United States in 2000 and was admitted to the WTO in 2001, a period of relative calm ensued. Since many US firms are not satisfied that China is living up to its WTO obligations, it was only a matter of time before the United States launched complaints under the WTO's dispute settlement mechanism. Two cases involving access to Chinese merchandise markets have now been initiated: semiconductor chips and automobile parts.

Semiconductor Chips

On March 18, 2004, the George W. Bush administration filed the first US complaint against China in the WTO. The US government alleged that China provided preferential tax treatment for domestic semiconductor producers and that the preferences violated China's national treatment obligations.[1] China imposes a 17 percent value-added tax (VAT)

1. Foreign concerns about the Chinese internal tax system were expressed in the October 2001 WTO Working Party Report on China's WTO Accession; see paragraphs 19 to 21 and 167.

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on semiconductors, both imported and domestic.[2] Both foreign and domestic firms are eligible for various export tax rebates, and these rebates do not appear to discriminate between locally owned and foreign-owned manufacturers.

But China did appear to discriminate against imported semiconductors destined for use in the domestic market. Discrimination would violate the national treatment principle embodied in Article III of the General Agreement on Tariffs and Trade (GATT).[3] According to the United States Trade Representative (USTR), domestic producers were refunded as much as 14 percent of the 17 percent VAT.[4]

After the United States filed its WTO case, the European Union, Japan, Mexico, and Taiwan asked to join the WTO consultations, the first stage under the WTO dispute settlement mechanism. The dispute was resolved in July 2004, a few days before the United States was prepared to initiate a WTO panel. Through bilateral negotiations, China agreed to eliminate VAT refunds for any new semiconductor products or manufacturers and to phase out semiconductor tax rebates in April 2005.[5] While the immediate dispute was resolved, similar disputes could well arise in the future as China seeks to strengthen its role as an information technology leader. An understanding of key issues in the semiconductor case is therefore important.

Role of the Semiconductor Industry Association

The US Semiconductor Industry Association (SIA), representing about 85 percent of the US semiconductor industry, was the driving force behind the WTO case (Howell et al. 2003). Investment in the Chinese domestic in-

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2. According to the USTR, the VAT payments on imported chips cost US chip makers about $344 million in 2003. See Neil King Jr., "US Fights China's Tax on Imported Chips," *Asian Wall Street Journal,* March 19, 2004, A4.

3. GATT Article III states that each WTO member must provide foreign producers the same treatment given to domestic firms with respect to internal taxation and regulation. See WTO Analytical Index: General Agreement on Tariffs and Trade 1994, available at www.wto.org (accessed April 2004).

4. See USTR, press release, "US Files WTO Case Against China," March 18, 2004.

5. China also agreed to repeal, by October 2004, the VAT rebate eligible for integrated circuits designed in China but manufactured abroad. Semiconductor Manufacturing International Company (SMIC), China's largest semiconductor manufacturer, estimated that eliminating VAT rebates would lead to a decline in the company's profit margins by about $204 million annually. See USTR, press release, "US and China Resolve WTO Dispute Regarding China's Tax on Semiconductors," July 8, 2004; Sean Maloney, US-China Economic Relations, Testimony before the Senate Committee on Finance, US Senate, Washington, June 23, 2005; and "Elimination of Rebates Not Death Blow," *China Business Weekly,* July 27, 2004.

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tegrated circuit industry totaled $3.6 billion from 2000 to 2002; the SIA attributed a substantial part of this to the discriminatory VAT policy.[6] The SIA claimed that the Chinese government used low-interest loans and cheap land to nurture its domestic semiconductor industry. The SIA feared that excessive investment would not only make China a serious rival in high-technology circuits but also create overcapacity and depress world semiconductor prices.[7]

China's Role in World Semiconductor Trade

China already has the world's third-largest domestic semiconductor market, closely following the United States and Japan (table 6.1 compares US electronics and information industry trade with China versus Japan).[8] Within China, domestic semiconductor purchases are expected to rise by 16 percent per year, exceeding Japan by 2010. Taken as a region, northeast Asia has already become the largest semiconductor market in the world, having surpassed the United States in 2001.[9]

Booming domestic computer and telecommunications sectors underpin the Chinese semiconductor market.[10] The Chinese share of the world integrated circuit sales jumped from under 3 percent in 1997 to 15 percent

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6. Integrated circuits are an advanced version of semiconductors. The Chinese integrated circuit industry is expected to realize about $12 billion in sales annually by 2013.

7. See Anne Craib, Statement before the US-China Economic and Security Review Commission, US House of Representatives, Washington, February 5, 2004.

8. According to George Scalise, president of SIA, a cost differential of more than $1 billion separates the construction and operation of semiconductor plants in China versus the greater expense in the United States. Scalise estimates that 70 percent of the cost difference is due to Chinese tax benefits (such as the VAT rebate), 20 percent due to capital grants, and only 10 percent due to lower labor costs. He argues that since semiconductor plants are capital and technology intensive, even an 80 percent differential in wage rates translates into just a 10 percent difference in final costs. See George Scalise, China's High-Technology Development, Testimony before the US-China Economic and Security Review Commission, US Senate, Washington, April 21, 2005.

9. In 1997 the US semiconductor industry represented 33 percent of the world market, and the western Asia-Pacific region represented 22 percent. By 2001 northeast Asian countries, including China, represented close to 30 percent of the world market, while the United States dropped to about 25 percent. See Hatano (2003).

10. China already has the world's largest mobile phone market and second-largest personal computer market. China produces over 7 percent of global electronics equipment, and production is forecast to rise 11 percent annually. The SIA estimates the Chinese market for computer chips will grow at a rate of 21.5 percent each year until 2008. The US market has grown by 7.3 percent per year. See Chao and Sussman (2003) and Bruce Stokes, "China's High-Tech Challenge," *National Journal*, July 30, 2005.

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Table 6.1 US electronics and information industry trade with China and Japan, 1997–2005 (billions of dollars)

	US imports[a]			US imports from China as share of total imports	US imports from Japan as share of total imports	US exports[b]			US exports to China as share of total exports	US exports to Japan as share of total exports
Year	China	Japan	World	(percent)	(percent)	China	Japan	World	(percent)	(percent)
1997	16.4	54.6	261.3	6	21	3.9	17.0	219.8	2	8
1998	20.2	52.4	275.7	7	19	4.3	14.7	226.1	2	7
1999	25.1	56.7	308.2	8	18	4.2	15.2	229.8	2	7
2000	32.7	65.6	364.4	9	18	5.5	18.7	265.5	2	7
2001	33.3	49.8	313.7	11	16	6.7	15.6	229.5	3	7
2002	44.5	44.2	311.7	14	14	7.0	12.2	204.5	3	6
2003	58.3	44.2	325.5	18	14	8.2	11.4	202.2	4	6
2004	83.8	50.4	382.8	22	13	10.7	11.8	223.3	5	5
2005	95.6	48.6	462.8	21	10	9.8	10.4	240.2	4	4

a. Imports for consumption.
b. Domestic exports.

Note: Semiconductors account for a significant share of electronics and information industry trade.

Source: USITC Dataweb, 2006.

in 2002.[11] Chinese joint venture partnerships with foreign companies contribute a significant share of Chinese semiconductor revenues.[12] However, domestic Chinese production is still concentrated on low-end technology. To satisfy domestic demand, China currently imports at least 80 percent of the semiconductors used in electronics production. The Chinese government is trying to reduce its net import position and upgrade its domestic mix toward more sophisticated integrated circuit products, over a time horizon between 2005 and 2010.[13] As part of its plan, the Chinese government offers incentives to domestic and foreign companies through about 500 special investment zones.[14] The results are noteworthy. The US-based Agilent Technology, the world's largest testing gear maker, plans to invest $100 million in China.[15]

Chinese Tax Incentives

Among the many tax and trade incentives the Chinese government offers, some particularly benefit foreign firms. Most foreign firms are exempt from import quotas. A foreign-owned firm with advanced technology production techniques and equipment may qualify for technologically advanced enterprise status, the benefits of which include an initial five-year exemption from taxes, then a further five-year 50 percent reduction in

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11. Correspondingly, Chinese integrated circuit exports to the United States increased by 628 percent, from $59 million in 1995 to $431 million in 2002, while US exports to China increased by 880 percent, from $165 million in 1995 to $1.6 billion in 2002. Based on data from the US Department of Commerce, International Trade Administration, Trade Compliance Center.

12. Most Chinese foundries (semiconductor plants that produce chips according to designs developed by specialized companies) have technology licensing agreements with leading semiconductor companies in Taiwan, the United States, Japan, and Europe. In 2004 the SIA estimated that foreign companies accounted for about 80 percent of the revenue of Chinese foundries. The SIA predicts that local Chinese companies will soon be designing semiconductors and driving world demand for advanced manufacturing capabilities. See testimony of George Scalise.

13. Currently China adds only about 5 percent of the value of chips sold. For example, Intel's plant in Shanghai does not make chips but rather tests and assembles chips from silicon wafers made in US plants. See Andres Higgins, "Power and Peril: America's Supremacy and Its Limits," *Wall Street Journal*, January 30, 2004.

14. Special investment zones include five special economic zones, 32 economic and technological development zones, 52 high-technology zones, 260 coastal open-city zones, and various technology zones in major cities (e.g., Shanghai Pudong New Area and Beijing Zhongguancun Science and Technology Zone).

15. See Godwin Chellam, "Agilent Tests China's Surging Electronics Demand," Reuters, January 26, 2005.

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corporate income taxes (to a minimum 7.5 percent rate), and then an additional three-year one-third reduction, to a minimum 10 percent rate.[16]

Another incentive is the research and development (R&D) tax deduction. If a foreign company establishes an R&D center and increases its R&D outlays by 10 percent or more in two consecutive years, it may deduct 150 percent of its R&D expenses for corporate tax purposes. Local incentives are also available.[17] The Pudong New Area in Shanghai refunds land use fees and land grant fees for preapproved R&D centers and subsidizes property taxes under the Pudong Technology Development Fund.

Soon after the WTO dispute was resolved in April 2005, China focused on improving technology through increased R&D spending, announcing the creation of a new integrated circuit development fund starting in April 2005. While the exact size of the fund is unknown, the Chinese government expects R&D investment eventually to reach at least $1.3 billion annually.[18]

Evaluation

The United States has won the battle to end discriminatory VAT rates but could still lose the war over industrial subsidies: China could shift to other forms of public support, particularly for high-end integrated circuit production. Because the domestic Chinese semiconductor market is booming, and because many foreign firms are participating in the boom, the SIA might have a hard time both marshalling its members to oppose second-generation subsidies and demonstrating trade injury. However, if the time comes—say, five years hence—when Chinese semiconductor and other IT firms sell large quantities on world markets and depress prices,

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16. Chinese tax benefits can be extended even longer by rolling the profits from an established company into a new company and starting the relief cycle anew.

17. See Chao and Sussman (2003). Similar tax incentives are given in the domestic car industry. See Richard McGregor, "China Acts to Shut Out Car Entrants," *Financial Times,* June 2, 2004.

18. The Chinese Ministry of Finance, Ministry of Information Industry, and the National Development and Reform Commission will jointly sponsor the integrated circuit fund. All semiconductor companies registered in China will be eligible to apply for funds up to 50 percent of the costs associated with the approved R&D projects. The new integrated circuit fund covers investments in the domestic chip industry at a level of about $120 million annually, personnel training of about $1.2 billion annually, income tax breaks, and a 1 percentage point discount on loans for new investments. See "Elimination of Rebates Not Death Blow," *China Business Weekly,* July 27, 2004; "China Industry: New Fund for Semiconductor Research," Economist Intelligence Unit, April 22, 2005; and SIA (2004).

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it seems likely that safeguard and antidumping remedies will be invoked to slow the Chinese export push.[19]

Automobile Parts

On March 30, 2006, the Bush administration filed the second US complaint against China in the WTO, demanding better access to the booming Chinese automobile parts market. This time the European Union joined the United States. The Chinese auto parts market is already worth about $19 billion annually, according to Department of Commerce estimates, and US and EU firms obviously want to participate. In 2005 US auto parts exports to China were under $700 million.

In their submissions to the WTO, the United States and the European Union claimed that China's tariffs on auto parts not only exceeded the bound rates China agreed to in its WTO accession agreement but also violated the national treatment principle enunciated in Article III of the GATT.[20] The United States and the European Union cited two other provisions as well: Article 2 of the Trade-Related Investment Measures (TRIMs) agreement, which states that WTO members cannot impose an investment measure that violates the national treatment principle, and Article 3(1)(b) of the Agreement on Subsidies and Countervailing Measures (SCM agreement), which prohibits "subsidies contingent, whether solely or as one of several other conditions, upon the use of domestic over imported goods."

At issue is China's policy, implemented in 2005, that imposes higher tariffs on imported auto parts when the value of these parts amounts to 60 percent or more of the cost of a car made in China. This policy effectively increased tariffs on some auto parts from the prior range of 10 to 15 percent to a new level of 28 percent, the bound rate imposed on imported vehicles.[21] This increase arguably violates the national treatment provisions in GATT Article III and TRIMs. Also, by favoring domestic parts, it arguably violates the SCM agreement.

The United States further complained that China treats auto kits—either completely knocked down (CKD) or semi-knocked down (SKD)—as

19. Despite eliminating the VAT rebates, concerns about China's tax policies persist. According to the National Association of Manufacturers, US companies still complain of "export-based tax incentives and the discriminatory application of tax rates and rebates." See USTR (2005); and US State Department, press release, "China's Industrial Policies Conflict with WTO Rules," June 2, 2005.

20. Article III of the GATT requires WTO members to apply the same tax treatment to imports as they do to domestic products.

21. The 28 percent rate is imposed unless the finished vehicle meets China's local-content requirements.

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finished autos for tariff purposes.[22] This treatment arguably violates the WTO Protocol on the Accession of the People's Republic of China, in which China committed to lower tariffs on knocked down kits.[23]

China has defended its current tariff system as a way of preventing domestic auto producers from avoiding the higher tariffs on fully constructed vehicles by importing whole cars piecemeal as parts. In our view, the Chinese defense will not prevail in the WTO. Indeed, it seems likely that, as with semiconductors, China will settle the auto parts case prior to full-blown litigation in the Dispute Settlement Body.

Evaluation

We predict that the resolution of the automobile parts case, like the semiconductors case, will convey the lesson that China will alter its trade policies when they demonstrably conflict with WTO obligations. However, the legal case will need to be persuasively articulated before China budges. We also predict that Chinese trade officials will prove highly creative in seeking out loopholes in the WTO framework, when those loopholes can be exploited to further China's industrial policies. If this forecast is correct, it suggests a continuing cat-and-mouse game between the United States and China, as China targets additional industries for rapid development using varied forms of public assistance.

22. A CKD kit contains all the individual parts required to assemble an auto. In an SKD kit, the main elements of an auto—for example, the chassis, transmission, engine, and body—are assembled to a greater degree, and thus the finished auto requires less work in the importing country.

23. See "U.S., EU Request WTO Consultations with China over Auto Tariffs," *Inside US Trade,* March 31, 2006.

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7

Antidumping Disputes

Since 1995, China has become the primary antidumping (AD) target worldwide. Between 1995 and 2005, China was subject to 434 AD cases, accounting for about 16 percent of all WTO AD cases (WTO 2006).[1] On a worldwide basis, several billion dollars of Chinese exports are now the subject of AD orders and fresh investigations. Import coverage of US AD cases initiated against China in 2004–05 alone exceeded $1 billion; since 2003, about half of all US AD cases have targeted China, and the rate is now running at about one new case each month. Meanwhile China is aggressively pursuing its own AD cases against foreign companies—some 59 launched since 2001.[2]

Nonmarket Economy Status

China is designated as a nonmarket economy (NME) in US AD law. This designation was carried into China's accession agreement with the WTO,

1. During 1995–2001, 27 percent of AD investigations involving China were initiated by the European Union and the United States; 36 percent were initiated collectively by India, South Africa, Argentina, and Brazil. Other countries accounted for the remainder. China has supplanted Japan, South Korea, and Taiwan as the most frequent target of AD investigations, according to the WTO. See Mao Yingchun, op-ed, "Status Problem Hampers Trade," *China Daily,* June 11, 2004; also see Charles Hutzler, "China: Trade-Status Battle Heats Up," *Asian Wall Street Journal,* June 24, 2004, A5; and Yin (2003).

2. Chemical products are the most frequent target of Chinese AD actions. See "China Accuses Corning of 'Dumping,'" *Wall Street Journal,* June 17, 2004; also see "China Starts Antidumping Probe on Nonyl Phenol from India, Taiwan," *BBC Monitoring Asia Pacific,*

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and WTO members widely use the label to justify somewhat arbitrary calculations in AD cases against China. The NME designation implies that state intervention severely distorts Chinese costs and prices. Consequently, an importing country can calculate AD margins using the costs and prices of "surrogate" countries to guesstimate the "true" costs and prices that would prevail if China had a market economy. Under its WTO accession agreement, at US insistence, China agreed that WTO members could continue to apply the NME methodology in Chinese AD cases until December 11, 2016.

China as an NME under US Trade Law

More than 60 countries now have AD laws. As trade experts (e.g., Finger 1993; Messerlin 1996) have long argued, AD laws have become the easy road to imposing trade safeguards, with the further advantage, from the petitioner's standpoint, that the respondent bears the stigma of unfair trade practices. US AD law originated with the US Revenue Act of 1916, as extended by the US Antidumping Act of 1921. The chances of winning an AD action were made substantially better for petitioners in the 1979 legislation that implemented the Tokyo Round of multilateral trade negotiations (Finger 1993, Laroski 1999). In brief, under the NME methodology codified in the 1979 legislation, the US Department of Commerce estimates the costs of production in any given NME country based on "surrogate country" prices.[3] India and Singapore are sometimes used as surrogates to estimate production costs in China.[4] The only favorable aspect of an NME designation, from the respondent

December 29, 2005; Mankiw and Swagel (2005); and USTR, press release, "National Trade Estimate Report: China," March 30, 2005.

3. For further analysis of US Department of Commerce methodology and US AD laws, see Lindsey and Ikenson (2002). On average, the NME duties that the United States imposes against China are over 20 percentage points higher than those applied to market economies. See GAO (2006).

4. In the recent furniture AD case (discussed below), none of the Chinese firms persuaded the Department of Commerce that they were operating on a market economy basis. Under US law, individual firms must present evidence to show that they are market-oriented to receive a separate AD rate, rather than be assigned the countrywide AD rate calculated under the NME methodology. As with furniture, the Department of Commerce used the NME designation to impose duties of between 49 and 112 percent on more than $1 billion of shrimp imports from China. See Edward Alden, "US Puts Tariffs on China Shrimps," *Financial Times*, July 6, 2004; also see "Shrimp Wars," *The Economist*, July 8, 2004. See Charles Hutzler, "China: Trade-Status Battle Heats Up," *Asian Wall Street Journal*, June 24, 2004, A5.

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country's standpoint, is that NMEs are not currently subject to countervailing duties (CVDs).[5]

As amended in 1979, chapter 4 of the US Tariff Act of 1930 enumerates six criteria for determining whether a country merits NME status:[6] currency convertibility, wage rates determined by free bargaining between labor and management, joint ventures for foreign investments, government control over means of production, government control over allocation of resources and prices, and "such other factors as administering authority considers appropriate."[7]

The alternative to NME status is market economy status (MES). Poland and Russia successfully moved from NME to MES in 1993 and 2000 respectively.[8] The transition reflects a mix of political and economic criteria. For China, graduation from NME status will be heavily

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5. Since 1984, the Department of Commerce has excluded NMEs from CVD investigations, on the theory, affirmed in *Georgetown Steel v. United States,* 801 F.2d 1308 (Fed. Cir. 1986), that subsidies cannot be determined in a nonmarket economy. In plain language, the rationale is that subsidies are part of a state-run economy. However, in March 2005 Senators Susan Collins (R-ME) and Evan Bayh (D-IN) introduced the Stopping Overseas Subsidies (SOS) bill. The SOS bill would revise current trade laws to allow the US Department of Commerce to hear CVD cases against all trade partners, including NMEs. See "An Examination of Commerce's Policy of Not Applying US Countervailing Duty Laws to NMEs, Particularly China: Time for Change," Stewart & Stewart Submission to the US-China Economic and Security Review Commission (USCC), February 26, 2004. Also see Senator Collins' press release "Senators Collins and Bayh Introduce Legislation to Help US Companies Fight Unfair Trade Practice," March 10, 2005; USCC (2004); and US Department of Commerce, US-China Joint Commission on Commerce and Trade (JCCT) Working Group on Structural Issues Hearing, June 3, 2004.

John Magnus points out that the *Georgetown Steel* case (2003) *permitted* the Department of Commerce to exclude NMEs from CVD investigations but did not *mandate* the exclusion. Hence, as a matter of administrative law, Magnus contends that the Department of Commerce could change its practice without an explicit congressional directive. See John R. Magnus, Chinese Subsidies and US Responses, Testimony Before the US-China Economic and Security Review Commission, Hearing on China's World Trade Organization Compliance, Washington, April 5, 2006.

6. US Department of Commerce determination of NME status is not subject to judicial review. See Laroski (1999).

7. The statute defines an NME country as "any foreign country that...does not operate on market principles of cost or pricing structures, so that sales of merchandise in such country do not reflect the fair value of the merchandise." See US Tariff Act of 1930, Title 19, Chapter 4 (18) (b), available at frwebgate.access.gpo.gov (accessed June 2004).

8. After the European Union granted Ukraine MES in December 2005, the United States was widely expected to award Ukraine the same coveted MES label early in 2006. See "United States to Decide on Market Economy Status," *Interfax Ukrainian News,* December 5, 2005.

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influenced both by the fears of AD petitioners and by China's concessions on other trade issues.[9]

Issues Blocking MES for China

In April 2004 then USTR Robert B. Zoellick suggested that the US government would "leverage" China's interest in MES with US interests on "labor, currency, subsidy, and other issues." US Commerce Secretary Donald Evans opined that China will "fail to meet market economy status until market forces set labor and currency rates."[10] Both the Zoellick and Evans statements were based on a mixture of politics and economics: the six criteria outlined in the statute, plus sentiments in Congress as expressed by the US-China Economic and Security Review Commission (USCC) and others. Out of this mix, the two primary hurdles are renminbi revaluation and labor standards.

MES and Revaluation

Although the June 2004 US Department of Commerce hearing did not succeed in listing concrete steps that China needs to take to reach MES, the hearing was useful in underlining US concerns. Besides the prevailing sentiment that the renminbi is severely undervalued, speakers stressed restrictions on obtaining foreign currency from Chinese banks and the accumulation of official foreign exchange reserves.

The political question is not the extent of renminbi convertibility, however, but the degree of revaluation. Since December 1996, China has met its obligations to the International Monetary Fund (IMF) for current account convertibility.[11] China is gradually moving toward capital account convertibility by allowing foreign banks to issue renminbi securities, allowing foreign investors to receive financing from Chinese banks,

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9. According to a recent US GAO report, granting China MES would reduce countrywide NME duties, which averaged about 98 percent. The lower rates could, however, be offset by rising rates assigned to individual Chinese companies that do not comply with Department of Commerce determinations. See GAO (2006).

10. See USTR, press releases, "Statement of USTR Robert B. Zoellick on US-China Relations," April 28, 2004, available at www.ustr.gov (accessed May 2004), and "Statement from Commerce Secretary Donald L. Evans on America's Economic Relationship with China," April 28, 2004, available at usinfo.state.gov (accessed June 2004). During the April 21, 2004, US-China JCCT meeting between Chinese Vice Premier Wu Yi and senior US trade officials, a tentative agreement was reached to consider China for MES for future AD investigations.

11. IMF Article 8 stipulates that "no member shall . . . impose restrictions on the making of payments and transfers for current international transactions." See IMF Article 8—General Obligations of Members, available at www.imf.org (accessed June 2004).

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and permitting individual Chinese to invest up to $20,000 abroad. While full convertibility in both the current and capital accounts may be desirable, it is a goal that many developing countries have yet to meet.[12] In any event, US business and trade union leaders as well as congressmen are more concerned about revaluing the renminbi than they are about capital account convertibility.

MES and Labor

The USTR (2005) contends that China violates core labor standards as defined by the International Labor Organization. By contrast, according to China's Ministry of Commerce, the Chinese government regulates minimum wages and social security requirements but otherwise "promotes collective bargaining through fair negotiation between labor and management."[13] Obviously a wide gap separates US and Chinese perceptions of China's labor practices and whether the government hand is heavy or light. From the standpoint of many US observers, Chinese wages of $1.00 an hour and less, together with long working hours and cramped, noisy, and dirty factory conditions, are proof that China flagrantly violates core labor standards. From the standpoint of Chinese officials, the dramatic rise over the past 25 years in urban wages, particularly along the coastal provinces, abundantly demonstrates China's ability to improve working conditions—far better than Bangladesh and Egypt, for example. Given China's strength as an export powerhouse, unlike Bangladesh or Egypt, the perception gap is likely to persist for many years. However, on a case-by-case, company-by-company basis, Chinese firms will increasingly demonstrate that they can meet core labor standards.

Significance of MES for China

To prevent future AD cases from following the ad hoc and often discriminatory NME methodology used by the Department of Commerce and other foreign trade ministries, China is actively courting key trade partners to obtain MES ahead of the 2016 WTO deadline. MES obviously makes a difference when AD cases are litigated; it is also important to China to be judged on an equal footing with Western industrialized countries. In April

12. David Loevinger, former US deputy assistant treasury secretary for Africa, Middle East, and Asia, noted that even the United States has restrictions on FDI that prevent it from fully meeting the IMF's capital account convertibility standards. See his remarks at the US Department of Commerce JCCT Working Group on Structural Issues Hearing, June 3, 2004.

13. Chinese academic studies estimate that in 2001, 85 percent of Chinese companies based wages paid to workers on "voluntary negotiations." Zhang Jin, "Report Supports Market Status," *China Daily*, June 9, 2004.

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2004 China made the granting of MES a precondition for concluding a free trade agreement (FTA) with New Zealand and Australia. After New Zealand granted MES, China received the label from 43 other nations.[14] It has yet to receive MES from Canada, the European Union, Japan, or the United States, and though China is courting its key trade partners for MES, it has not yet formally requested MES from the United States.[15]

China's ability to receive MES from the European Union remains in doubt.[16] A preliminary report issued by the European Commission stated that the European Union "is committed to granting MES to China" but found that China has fulfilled only one of its five criteria, the criterion of "absence of barter trade" and "absence of State-induced distortions in the operations of enterprises linked to privatization."[17] China did not meet the European Union's four other requirements: degree of government influence, including through tax discrimination; adequate corporate governance, especially regarding accounting standards; transparent rule of law to ensure property rights and operation of a bankruptcy regime; and a financial sector that operates independently of the state. However, Chinese efforts to lobby individual EU member countries for MES might pay off. Austria, which will hold the rotating EU presidency in 2006, indicated that granting China MES would be inevitable.[18]

On the other hand, China might want to reconsider its campaign for the MES label. As China's economy develops, more voices on Capitol Hill urge a change in US legislation so that US companies can file both CVD

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14. China has received the MES designation from Australia, Brazil, Egypt, India, Malaysia, Pakistan, South Africa, South Korea, Thailand, and Ukraine, to name some of the most important countries. See Yin (2003); also see New Zealand government, press release, "New Zealand and China to Work Towards FTA," April 14, 2004; and Australian government, Department of Foreign Affairs and Trade backgrounder, "Australia-China FTA: Market Economy Status," 2005.

15. Personal e-mail communication with Richard Seldin, March 7, 2006.

16. While the European Union does not exactly follow the NME methodology used by the United States, the European Union does apply a third-country market (TCM) designation in Chinese AD cases, which amounts to about the same thing. During July 2003–December 2003, the average EU antidumping duty (about 46 percent), based on the TCM methodology, was lower than the average US antidumping duty (about 94 percent). See WTO (2004a, 2004b) and EU Council (1994).

17. See Tobias Buck and Mure Dickie, "Europe to Snub China on Status of Economy," *Financial Times,* June 27, 2004.

18. Martin Bartenstein, Austrian minister of economics and labor, acknowledged that MES is "one of the important topics on the table between the EU and China" and suggested the possibility that EU will "grant China market economy status...during Austria's presidency of the EU." Spain and Portugal also support MES. See Toh Han Shih, "EU Ready to Grant China Key Economic Status," *South China Morning Post,* December 18, 2005.

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and AD complaints against Chinese exports of the same product. Moreover, the proposed legislation would label a wider range of practices as unfair subsidies. Currently, as an NME, China is immune from CVD actions: According to established practice in the Department of Commerce, which was upheld by the Court of International Trade in the in *Georgetown Steel* case (2003), subsidies cannot be determined in an NME, simply because all prices and costs are distorted.[19] Once China is declared a market economy, new CVD actions based on novel subsidy definitions will very likely follow.[20]

Evaluation

For the purposes of the MES designation, China's most important trading partner is clearly the United States. If achieving MES is important to China, the Chinese government will need to revalue the renminbi significantly. However, once China revalues, MES could still remain a bargaining chip for other trade concessions that the United States seeks.

Even though give-and-take is the essence of trade negotiations, we think that the MES issue should not be determined solely by backroom bargaining. Instead, as a first step, the US government should clarify the measures required for meeting MES. If core labor standards are an essential criterion, the same requirement should be applied equally to all countries. More broadly, all six statutory criteria should be evaluated through a public hearing process that enables a fair comparison between China and other countries that already have MES status, such as Russia, India, and Pakistan.[21]

Finally, in our view, the administration should resist congressional efforts, such as the Collins-Bayh SOS bill, to unilaterally broaden the definition of actionable subsidies beyond practices that are currently identified in the WTO Agreement on Subsidies and Countervailing Measures. If a broader definition is necessary to close troublesome loopholes, the changes should be negotiated multilaterally in the Doha Development Round, not legislated unilaterally by Congress.

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19. Personal e-mail communication with Richard Seldin, March 7, 2006.

20. The Collins-Bayh SOS bill would allow American firms to seek CVDs to offset a wide spectrum of Chinese practices: an undervalued exchange rate, state bank loans to state-owned enterprises, free or low-cost rent in government-owned facilities, and free or low-cost raw materials and energy supplies.

21. Based on several risk indicators, including legal, regulatory, and financial risk, the Economist Intelligence Unit concluded that China was at least as deserving of MES as Ukraine or Russia. See "Ukraine/China Risk: Ukraine Leapfrogs China to Gain EU Market Economy Status," Economist Intelligence Unit, December 1, 2005.

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Furniture

In October 2003 the American Furniture Manufacturers Committee for Legal Trade (hereafter, the committee) led 31 furniture makers and five unions to file a petition with the US Department of Commerce against Chinese furniture imports (US Federal Register 2003). The committee asked for AD tariffs ranging from 150 to 440 percent on over $1 billion worth of Chinese wooden bedroom furniture imports sold by 135 Chinese furniture companies. The committee claimed that Chinese wooden bedroom furniture exports were sold at "less than fair value," leading to "material injury" in the domestic US furniture industry.[22] According to the petition, Chinese imports accounted for 23 percent of the value of US domestic consumption in 2002, while sales from petitioner firms declined by 23 percent between 2000 and 2002. The committee argued that lower Chinese prices and abundant labor were leading to job losses in the domestic furniture industry.[23] Citing US Bureau of Labor Statistics data, the petition argued that 34,700 jobs had been lost since 2000, representing 28 percent of the furniture industry workforce.

In January 2004 the US International Trade Commission (USITC) determined that the US domestic industry suffered material injury from Chinese wooden bedroom furniture imports. In December 2004 the Department of Commerce made a final determination to impose relatively moderate duties of between 2 and 16 percent on Chinese firms that accounted for the majority of US furniture imports. For all other Chinese furniture-producing firms, duties stood at 198 percent.[24]

Unlike the brassiere case, in which the US government applied WTO safeguard remedies with no prior hearing, the furniture dispute is a generic AD investigation. Since China is considered an NME, the Department of Commerce used prices and costs from supposedly comparable

22. "Less than fair value" and "material injury" are legal terms. Their precise meaning is adjudicated, on a case-by-case basis, by the US Department of Commerce and the USITC respectively.

23. US furniture producers' share of the US market declined from 60 percent in 2000 to 49 percent in 2002, while the Chinese share of the US market increased from 19 percent in 2002 to 28 percent in 2003. These figures illustrate the period under review for the material injury finding by the USITC (2004b). See also "Chinese Furniture Faces US Tariffs," *Wall Street Journal,* June 17, 2004, A2.

24. For details, see US Department of Commerce, press release, "Amended Final Determination in the Antidumping Duty Investigation on Imports of Wooden Bedroom Furniture from the People's Republic of China," December 28, 2004. The reason other furniture-producing firms ended up with extremely high duties is that they did not respond to the Department of Commerce's questionnaires or otherwise contest the case.

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market economies—India and Russia—to guesstimate the cost of production in China.[25]

The trend in the US furniture industry is away from manufacturing and toward distribution and marketing. Among the 20 remaining petitioners, imports from China accounted for 35 percent of their total imports in 2002 (USITC 2004b). Many furniture retailers, including the largest furniture store chains, such as Bombay Company and Crate and Barrel, also import from China. They retaliated against the petition by creating a lobbying group, the Furniture Retailers of America (FRA), which objected that even a 20 percent Department of Commerce dumping margin would, under the Byrd Amendment, lead to average annual payouts of $6.6 million per company to the domestic furniture industry.[26] The FRA further argued that high AD duties would prompt furniture companies to source from countries such as Indonesia, Philippines, Malaysia, and Vietnam, rather than US manufacturers.

China's Role in World Furniture Trade

The Chinese furniture industry relies both on economies of scale and cheap labor to capture a growing share of the world furniture market.[27] According to the Chinese National Furniture Association, Chinese furniture production grew from $13 billion in 1999 to $20 billion in 2002, while Chinese furniture exports increased from about $2 billion in 1999 to $5 billion in 2002.[28]

The Chinese furniture industry consists of about 30,000 firms employing five million workers; 1,000 of these firms are joint ventures with foreign investors. Government policies that encourage foreign investment

25. See the previous section on NME status. In the wooden bedroom furniture case, Indian import prices of wood were reportedly unavailable, and Russian wood prices were used instead. The US Department of Commerce used Indian statistics to estimate all other average costs to Chinese furniture producers. See Ikenson (2005).

26. The Continued Dumping and Subsidy Offset Act, widely known as the Byrd Amendment, mandates distribution of AD duties and CVD to companies that support the relevant petitions. To date, the US government has paid more than $700 million to US companies. In January 2003 the WTO Appellate Body determined that the Byrd Amendment violated WTO rules and distorted trade. In March 2004 the US Congressional Budget Office (CBO 2004) reported that the Byrd Amendment harms the US economy. In 2006 Congress enacted legislation that phases out the Byrd Amendment in October 2007.

27. Overall, Chinese furniture costs are about 10 to 40 percent less than US costs. See Cao, Hansen, and Xu (2002).

28. According to the USITC (2004b), Chinese production increased from 1.8 million pieces of furniture and related products in 2000 to 4.5 million pieces in 2002.

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support the export-oriented success of Chinese firms. Furniture production for export is concentrated in special economic zones.[29] Within these zones, China has developed specialized industrial parks called "furniture towns," which dominate furniture sales along the prosperous east coast. As a result, China is the fourth-largest furniture exporter in the world, and the United States is the top destination for its exports.[30] Chinese furniture exports to the United States increased from $359 million in 2000 to $1.2 billion in 2003. Often overlooked is that demand from US producers drives Chinese imports. From 2000 to the first half of 2003 Chinese furniture imports as a share of US domestic producer shipments increased from 6 percent to nearly 27 percent (Ikenson 2004). By 2003 nearly one-half of US furniture imports were from China, and Chinese furniture exports to the United States accounted for about half of total Chinese furniture exports.[31]

Evaluation

Restricting imports of Chinese furniture through AD duties or other means will not bring back US jobs. Instead, the main effect will be to curtail US household purchases of furniture and to shift sources of supply to Southeast Asia. The reality is that US furniture producers and retailers will source basic furniture from either China or other low-cost developing countries. Since the first quarter of 2004, Southeast Asian countries have increased their exports of furniture to the United States by at least 35 percent.[32] The United States is a net importer in every furniture category, including office furniture.[33]

As in the clothing industry, to tackle job losses in the domestic furniture industry, the US government should improve its existing trade adjustment assistance (TAA) program, emphasizing wage insurance and

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29. See CSIL Milano (2003) and *Research Report on Furniture Industry and Market of China,* All China Marketing Research Co. Ltd., 2001.

30. See USITC (2004b). The value of Chinese wooden bedroom furniture exports to the United States accounted for 95 percent of total Chinese wooden bedroom furniture exports.

31. Hong Kong purchased 13 percent and the European Union purchased 12 percent of Chinese furniture exports. While US imports from Canada (second-largest US furniture supplier) and Mexico (fourth-largest US furniture supplier) fell by $91 million during 2000–2003, US imports from China increased by $804 million in the same period. Meanwhile, total US furniture exports declined from $105 million in 2000 to $78 million in 2003. See *China National Furniture Association Annual Report* 2003.

32. See J. D. Piland, "China Shows Ill Effects from the Antidumping Duties While its Competitors Boost Their Shipments," *Wood and Wood Products,* June 1, 2005.

33. In 2003 the United States exported about $395 million of office furniture and imported about $2.3 billion. Based on US Department of Commerce data on household and office furniture exports and imports, available at www.ita.doc.gov (accessed May 2004).

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health benefit provisions (Kletzer and Litan 2001). Meanwhile, several US furniture makers will survive by distributing imported furniture or by producing high-value crafted furniture. Ethan Allen, for example, has established a strong brand identified with elegance and high quality.[34]

Color Televisions

In May 2003 one US firm and two labor unions filed an AD petition with the Department of Commerce and USITC against imports of Chinese color televisions (CTVs). After determining that China is an NME, the Department of Commerce used India as a surrogate country to impose preliminary AD duties ranging from 5.2 to 26.4 percent on 13 Chinese CTV companies.[35]

After its hearing, the USITC found "material injury" based on the adverse impact that the rising volume of Chinese CTV imports exerts on US prices and producers (USITC 2003). The USITC claims that Chinese CTVs, sold at prices between 10 and 30 percent lower than average US prices, contributed to the decline in US production of CTVs, from 5.6 million units in 2000 to 1.1 million units in 2002, and the loss of 7,068 industry jobs during the same period. However, China accounts for only 9 percent of US imports of CTVs (USITC Dataweb 2004).

On May 14, 2004, the USITC commissioners voted unanimously in favor of AD duties on US imports of Chinese CTVs. The largest four Chinese CTV makers—Prima, Konka, TCL, and Changhong—which account for 90 percent of all Chinese CTV exports to the United States, face AD duties ranging from 5 to 26 percent.[36] All other Chinese CTV makers face duties of 78 percent.[37] The US Department of Commerce and USITC rulings will effectively block some Chinese CTVs from the US market, but it

34. See Elizabeth Wine, "US Furniture Makers To Risk Lifting Prices," *Financial Times,* May 10, 2004.

35. See the Department of Commerce's ruling in US Federal Register (2004). In response to the preliminary Department of Commerce ruling, the Chinese economic counselor, Tian Jun, noted that the Chinese government had not intervened in the Chinese CTV market since 1984. See his speech, US-China Trade Relations and the WTO, delivered at the Center for Strategic and International Studies and *The Economist* event, Washington, January 14, 2004.

36. Changhong faces the highest AD duties, at 26.37 percent. In November 2003, TCL merged with French company Thomson, maker of the RCA brand TVs, creating the world's largest TV manufacturer, with $3.5 billion in annual sales. See "US Places Duties on TVs from China," *Los Angeles Times,* home edition, May 15, 2004, C3; and US Department of Commerce, International Trade Administration, Notice of Amended Final Determination of Sales at Less Than Fair Value: Certain Color Television Receivers from China, May 19, 2004.

37. The other producers did not submit cost information to the Department of Commerce, so AD duties were based on "best information available."

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seems likely that CTV imports from Chinese firms facing lower AD duties will flourish. Moreover, CTV imports from alternative suppliers, such as Mexico and Korea, may quickly replace Chinese CTVs on the shelves of Wal-Mart and Best Buy. As in the clothing and furniture cases, the main result will not be to revive manufacturing activity in the United States but to shuffle the mix of foreign suppliers.

Evaluation

Our comments on the furniture case are equally applicable to the television case. At most, AD duties provide short-term relief, felt to a greater extent by firms in their income statements than by workers in finding new careers. We recommend that US safeguard measures, including the AD system, should be revamped to focus on wage insurance, health benefits, and meaningful training programs for dislocated workers rather than import protection.

Conclusion

Imposing AD measures on Chinese imports provide at best a small, temporary, and inefficient measure of relief to the larger problem of accommodating China's growth as an exporting power. As Chinese exports—augmented by exports from India, Brazil, Indonesia, and other emerging countries—reach a larger range of industries and markets, both in the United States and abroad, US firms will need to adjust their own mix of products and markets. Adjustment is often painful, but at the same time it is essential to the dynamic process of economic growth. The US government needs to enact far larger and more robust programs for dislocated workers. At the same time, customary safeguard measures will be needed to give select US industries more time to adjust than market forces alone might permit. To be both effective and nondiscriminatory, the United States should apply safeguards to nearly all imports (usually excluding imports from Canada, Mexico, and other free trade agreement partners), and not pick just on China. When AD measures simply limit Chinese imports, the predictable result is import diversion to other suppliers—such as India and Korea. The consequence is far less effective relief for the US industry and a significant efficiency loss for the world economy.

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Conclusion

Complaints against China in 2006 largely reflect the accusation that the renminbi is undervalued, though several other disputes dance just offstage. Conflicts over textiles and clothing, intellectual property rights (IPRs), semiconductor chips, automobile parts, antidumping measures, and Chinese acquisitions of US companies threaten to counteract the positive effect of US-China relations even if China revalues its currency. The individual industry disputes are also harbingers of future disputes as Chinese firms begin to compete in new industries and expand their world market share in established lines of trade. Trade disputes will likely become even more intense when the US economy slows down from its brisk growth and unemployment creeps above 5 percent. Geopolitical disagreements—punctuated by China's rapidly expanding military arsenal—have every prospect of sharpening economic tensions.[1] In short, however difficult 2006 may seem in US-China commercial relations, looking back from the vantage of 2008, the current era may seem placid. For the foreseeable future, trade disputes cannot be avoided—but they can be managed.

From the US perspective, complaints against China add up to widespread concern about the loss of manufacturing jobs and the pace of adjustment. But China has more than an export stake in settling disputes. More than a decade ago, under Chairman Deng Xiaoping, China decided to use membership in the WTO, and globalization more broadly, as levers to transform its economy from state-run to market-driven. Enormous

1. The Pentagon's 2006 Quadrennial Defense Review emphasized China's acquisition of precision missiles and conventional and nuclear submarines. See Dan Blumenthal, "Get Serious about China's Rising Military," *The Washington Post*, May 25, 2006, A29.

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progress has been made, but the task is far from complete. The Chinese leadership has a major political investment in avoiding trade clashes with the United States, since acrimonious disputes could call into question China's larger commitment to domestic reform.

Comparison with Japan

The history of US trade frictions with Japan (summarized in appendix C) may foreshadow the rocky path ahead with China. Postwar limits on textile and clothing imports started in 1957 when President Dwight Eisenhower negotiated a "voluntary" restraint agreement (VRA) with Japan. The next large Japanese trade dispute was over steel: In 1968 President Lyndon Johnson negotiated another VRA. During the Tokyo Round of multilateral trade negotiations (1974–79), Ambassador Robert Strauss held heated talks with his Japanese counterparts over access to Japanese beef and other agriculture markets. In the 1980s, under President Ronald Reagan, the United States imposed VRAs on semiconductors, steel, and automobiles and also initiated a round of market access negotiations. The intensity of US trade disputes with Japan abated only in the mid-1990s, as the US economy boomed and the Japanese economy slumped.[2]

In comparing current US-China frictions and past US-Japan frictions, four key political and economic factors should be considered. One factor that does not augur well for managing future disputes is the absence of a security alliance. The US-Japan postwar security alliance, cemented in the Treaty of Mutual Cooperation and Security (1960), lowered the decibel level of US trade complaints. Obviously no such alliance exists with China; in fact, future security tensions could inflame trade disputes (Bergsten et al. 2006).

Another factor not in China's favor is the import-to-export ratio. As table 8.1 shows, the bilateral ratio between US imports and US exports is significantly higher for China today than for Japan at its peak in 1986—a ratio of six versus a ratio of three. To close the absolute dollar size of the bilateral trade gap, US exports to China must grow more than six times as fast as imports, whereas the comparable benchmark for Japan was more than three times as fast. The implication is that the absolute size of the US-China bilateral trade deficit will very likely expand for a considerable period.

The openness of the Chinese economy compared with Japan, however, is a key plus. The ratio of external trade (imports plus exports) to GDP provides a broad measure of openness. As shown in table 8.1,

2. In 1988 Clyde Prestowitz published the classic book on the Japanese "threat," titled *Trading Places.* In 2001 C. Fred Bergsten, Takatoshi Ito, and Marcus Noland (2001) explained why US-Japanese relations turned around so decisively.

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Table 8.1 Comparison between US-Japan and US-China trade, 1986 and 2005

Country	US imports from (billions of dollars)	US exports to (billions of dollars)	US import to export ratio	Trade to GDP ratio[a]	Inward stock of FDI (billions of dollars)[a,b]	FDI to GDP ratio[a]	Share of world merchandise exports (percent)[a]
China							
1986	4	4	1.0	.22	37	0	1.4
2005	243	42	5.8	.67	702	.42	6.6
Japan							
1986	82	27	3.0	.10	7	0	9.9
2005	138	51	2.7	.21	97	.02	6.0

FDI = foreign direct investment

a. 2005 figures are for 2004.

b. Includes inward FDI from Hong Kong.

Sources: USITC Dataweb Version 2.7.1 for US imports and exports; UNCTAD's *World Investment Report,* 2005, for inward stock of FDI; IMF's *World Economic Outlook,* April 2005, for GDP in current prices; WTO statistics database, 2005, for Japanese, Chinese, and world exports.

China's trade to GDP ratio increased from 22 percent in 1986 to 67 percent in 2004. By comparison, Japan's trade to GDP ratio increased from 10 to 21 percent over the same period. Another measure of China's openness is the ratio of foreign direct investment (FDI) stock to GDP. The figure for China increased from less than 1 percent in 1986 to 42 percent in 2004. By comparison, the Japanese figure increased from less than 1 percent in 1986 to only 2 percent in 2004. A third measure is the size and persistence of global trade surpluses. Japan has run large surpluses for more than 30 years; China began to run large trade surpluses only in the past four years.

A final factor is the size of Japan and China as players in global trade. In 2004 the Chinese share was nearly 7 percent of world exports; at the height of export-led growth, Japan reached 10 percent in 1986. China may surpass Japan's erstwhile share of world exports, but for now, China is not shaking world markets to the same degree that Japan did in the mid-to-late 1980s.

Lessons from History

Based on the history of US-Japan trade friction, modulated by the four factors just discussed, we foresee decades of US-China trade friction. The intensity could be sharp when the US economy experiences a downturn and unemployment rises, especially if a difficult economy coincides with

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geopolitical tension (Bergsten et al. 2006). China will continue its export push into foreign markets, adding higher-technology products to the familiar mix of textiles, clothing, toys, and furniture. This push will ensure a long string of trade cases. At the same time, China's openness and rapid growth will ensure that China remains an exceedingly attractive market for financiers, direct investment, commodity exports, and a wide range of manufactured and service exports. Security alliances will not shelter China, but commercial considerations will dampen the excesses of trade protection. Against that background, we offer a few recommendations for managing disputes over the next few years.

Chinese Policies

Based on its huge domestic market, its high saving rate, its entrepreneurial skills, and its pool of cheap and often skilled labor, China has enormous competitive advantages. To realize the full value of its competitive strengths, however, China needs an open world trading system that can not only absorb a growing volume of Chinese exports but also supply raw materials, such as oil, copper, and soybeans, and manufactured goods, such as electrical equipment, aircraft parts, and medical instruments, that China does not produce at competitive costs.

In its best long-term interests, China should take several measures to foster an open world trading system in the years ahead. It should

- revalue the renminbi and eventually adopt a floating exchange rate, so that the Chinese "basic balance," including inward direct investment, is approximately zero over China's business cycle.[3]
- not wait for lengthy WTO negotiations to liberalize access to its own markets. Instead it should take the lead and launch its own program of unilateral liberalization, thereby challenging other WTO members to invigorate the Doha Development Round. Industrial tariffs capped at 5 percent sharply reduced agricultural barriers, and an open market for financial services akin to what now prevails in Hong Kong would be an excellent place for China to start.
- announce the progressive phaseout of domestic subsidies and incentives for infant industries, such as that for semiconductors, and eliminate them altogether in industries that have demonstrated their prowess in export markets, such as textiles and clothing.

3. As long as FDI enters China, a zero "basic balance" means that China will incur a trade deficit.

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- strengthen and streamline its system for protection of IPRs. Among other measures, China should devise a system of incentives that encourage private citizens and public officials to report IPR violations and enforce IPRs.

US Policies

For their part, US leaders should publicly declare that expanding trade relations between the United States and China serves US economic interests, even when China has a bilateral trade surplus. Economic criticism leveled at Chinese policies should focus on China's trade balance with the world, exchange rate equilibrium, market access barriers, and unwarranted subsidies—not China's bilateral surplus with the United States.

- In industries where Chinese imports are rising rapidly and genuinely injure domestic US firms, the United States should apply time-limited safeguards. WTO paragraph 241 safeguards are preferable to paragraph 238 safeguards. Both safeguards violate the WTO nondiscrimination principle in that they can be imposed solely against Chinese exports. However, unlike the automatic process of paragraph 238, paragraph 241 safeguards require an initial investigation to determine whether Chinese exports inflict some degree of injury on domestic firms.
- Ahead of the 2013 date for the expiration of WTO paragraph 241 safeguard actions, the United States should shift to normal safeguards when domestic industries face injury. Unlike paragraph 241 safeguards, normal safeguards apply to all imports except those of free trade agreement partners; they cannot single out China for discriminatory trade restrictions.
- Ahead of the 2016 expiration of the nonmarket economy designation, the United States and other WTO members should phase out the application of this discriminatory status against Chinese exports.
- To effectively address the impact of Chinese imports on US manufacturing jobs, the US government should reshape its trade adjustment assistance (TAA) program, focusing on wage insurance and health benefit initiatives. Safeguard measures, including antidumping duties that are imposed against Chinese and other imports, should be accompanied by TAA relief. The emphasis of US measures should shift from product to job markets.

Joint China-US Policies

President Hu Jintao's visit in April 2006 underscored China's preference for *ad hoc* meetings with friendly US firms and "shopping bag

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diplomacy" rather than formal obligations on IPR or market access issues.[4] Rather than negotiating concrete IPR agreements with the US government, President Hu promised Microsoft Chairman Bill Gates that the Chinese government would enforce its policies against software piracy.

Although President Hu may prefer such government-to-business contacts, to deal with trade tensions systematically, the United States and China also need to build upon the framework of the Joint Commission on Commerce and Trade (JCCT). The April 2006 JCCT meeting was constructive, if limited. China agreed to improve market access, notably by joining the WTO Government Procurement Agreement, albeit at an uncertain date, and to improve its IPR enforcement efforts. In a similar fashion, future semiannual meetings can address the rolling agenda of commercial disputes that will remain a core feature of US-China relations.

The Bottom Line

The United States and China cannot duck the prospect of multiple commercial disputes in the years ahead, ranging from the renminbi-to-dollar exchange rate to export restrictions and import liberalization. The challenge facing both Beijing and Washington is to resolve these disputes, case by case as they arise, in a manner that strengthens open markets and the multilateral trading system. Whatever their geopolitical differences, both countries share an enormous stake in fostering open trade and investment. Both countries risk losses running to hundreds of billions of dollars of GDP annually if their commercial relations are engulfed by a wave of protection and recrimination. By the same token, however, both China and the United States can share gains in the hundreds of billions of dollars if their joint policies ensure the continued expansion of world trade and investment.

4. Leading up to President Hu's visit, China signed 106 purchase contracts with US firms totaling $16 billion, including a deal to purchase 80 aircraft from the Boeing Company, valued at $4.6 billion. However, it is hard to know whether these purchases will represent additional US exports or simply accelerated US exports of sales that would have occurred anyway. See "Growing Expectations for Hu Jintao's Visit to the United States," *Asia News,* April 10, 2006, available at www.asianews.it.

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APPENDICES

Appendix A

Table A.1 Statistical relations between US manufacturing employment, output, and trade

Equation 1
Dependent variable = number of manufacturing workers (thousands)[a]

Explanatory variables	Coefficient	t-value
Manufacturing output (billions of 2000 dollars)	7.51	10.31
Manufacturing workers' productivity index (2000 = 100)[b]	–66.45	3.98
Time trend (per quarter)	–91.53	–1.97
Constant	16,129.00	5.33

Adjusted R-squared = 0.99
Number of observations = 63

Equation 2
Dependent variable = quarterly changes in manufacturing output (all variables measured in billions of current dollars)[c]

Explanatory variables	Coefficient	t-value
Change in manufacturing trade deficit	0.80	1.76
Change in nonmanufacturing GDP	0.11	1.73
Constant	–4.33	–0.63

Adjusted R-squared = 0.065
Number of observations = 61

a. Equation 1 is corrected for serial correlation using the Cochrane-Orcutt method.
b. Measured as output per hour of all persons.
c. Data for equation 2 is based on national income accounts with capital consumption adjustment.

Note: The statistical equations follow the method reported in Hufbauer and Rosen (2000), updated to cover the period 1990–2005.

Sources: US Department of Commerce, Bureau of Economic Analysis, 2006; US Department of Labor, Bureau of Labor Statistics, 2006; USITC Dataweb; and Hufbauer and Rosen (2000).

Table A.2 Significant US congressional bills and resolutions concerning Chinese trade and currency practices

This table lists most if not all the bills and resolutions relating to China's trade and currency practices introduced between 2003 and 2006. Many of the later bills essentially repeat bills introduced earlier. Other than S Res. 219 and H Res. 414, none of the bills or resolutions have been enacted; however, the three leading contenders in mid-2006 are Schumer-Graham (S 295), Grassley-Baucus (S 2467), and Collins-Burr (S 1421).

Bill number	Month introduced	Issues addressed	Description
2003			
HR 851 Rep. Louise Slaughter (D-NY)	February	Job loss, environment, workers' rights	No comment on revaluation. Proposes a "Trade Impact Review Commission" to assess the impact of China's accession to WTO on US jobs.
S 1586 Sen. Charles Schumer (D-NY)	September	Currency, trade deficit, job loss	States renminbi is undervalued by 15 to 40 percent. Authorizes tariff of 27.5 percent on US imports from China if negotiations to revalue are unsuccessful.
S Res. 219 Sen. Lindsey Graham (R-SC)	September	Currency, trade deficit, job loss	Recommends a floating, market-based exchange rate. Asks China to stop manipulating its currency and instead fulfill its commitments to the WTO and IMF. Passed in the Senate.
HR 3058 Rep. Phil English (R-PA)	September	Currency, trade deficit	Requires US treasury secretary to analyze Chinese exchange rate policies and impose tariffs on Chinese products to offset the effect of "currency manipulation."
S 1592 Sen. Joseph Lieberman (D-CT)	September	Currency, trade deficit, job loss	States renminbi undervalued by 15 to 40 percent. Requires US International Trade Commission to determine the scope of currency manipulation and trade barriers (e.g., value-added tax practices). If US and Chinese governments cannot reach an agreement, then recommends safeguards under sections 301 and 406 of the Trade Act of 1974.

(table continues next page)

Table A.2 *(continued)*

Bill number	Month introduced	Issues addressed	Description
H Con Res. 285 Rep. Donald Manzullo (R-IL)	September	Currency, trade deficit, job loss	States undervalued renminbi is responsible for 40 percent of the decline in US manufacturing jobs and production. Cites IMF recommendation that China adopt a floating exchange rate. Recommends Section 301 case against China.
HR 3228 Rep. Bernie Sanders (I-VT)	October	Trade	No comment on revaluation. Recommends withdrawal of normal trade relations (i.e., most favored nation treatment) for imports from China.
HR 3269 Rep. John Dingell (D-MI)	October	Currency	Asks the US secretary of commerce to assess whether currency manipulation affects the US manufacturing sector and evaluate whether reduced Chinese accumulation of US dollars would affect US monetary policy.
S 1758 Sen. George Voinovich (R-OH)	October	Currency, trade deficit	States renminbi is undervalued by 40 percent. Requires US treasury secretary to analyze Chinese exchange rate policies and impose additional tariffs on Chinese products to offset "currency manipulation." Recommends retaliatory action under sections 301 through 309 of the Trade Act of 1974.
HR 3364 Rep. Sue Myrick (R-NC)	October	Currency, job loss	States exchange rate is undervalued by 15 to 40 percent. If the United States cannot negotiate a revalued renminbi, proposes 27.5 percent tariff on some or all Chinese products.

(table continues next page)

Table A.2 Significant US congressional bills and resolutions concerning Chinese trade and currency practices *(continued)*

Bill number	Month introduced	Issues addressed	Description
H Res 414 Rep. Phil English (R-PA)	October	Currency, job loss	Recommends a floating exchange rate "determined by the market." Asks China to fulfill its international trade agreements, support the US manufacturing sector, and adopt free-market financial-sector reforms. Passed in the House.
S Res. 262 Sen. Olympia Snowe (R-ME)	November	Currency, job loss	Recommends a floating, market-based renminbi exchange rate. Asks US Treasury to expedite negotiations for market-based currency reform in China.
2004			
HR 3716 Rep. Phil English (R-PA)	January	Nonmarket economies	Recommends an amendment to allow the Department of Commerce to hear countervailing duty cases against "nonmarket" economies such as China.
2005			
HR 33 Rep. Tim Ryan (D-OH)	January	Currency, trade deficit	Recommends a revaluation of renminbi based on trade-weighted basket of currencies. Asks the US president to adopt recommendations outlined in the USCC 2004 report to Congress.
S 295 Sen. Charles Schumer (D-NY) Sen. Lindsey Graham (R-SC)	February	Currency	States renminbi is undervalued by 15 to 40 percent. Authorizes tariff of 27.5 percent on US imports from China if negotiations to revalue are unsuccessful.
HR 728 Rep. Bernie Sanders (I-VT)	February	Trade	No comment on revaluation. Recommends withdrawal of normal trade relations (i.e., most favored nation treatment) for imports from China.

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Table A.2 *(continued)*

Bill number	Date introduced	Issues addressed	Description
S 377 Sen. Joseph Lieberman (D-CT)	February	Trade	States renminbi is undervalued by 15 to 40 percent. Asks US Treasury to confirm that China is manipulating its currency. Recommends retaliatory action under sections 301 and 406 of the Trade Act of 1974.
S 593 Sen. Susan Collins (R-ME)	March	Nonmarket economies, trade	Amends Title VII of the Tariff Act of 1930 to allow countervailing duties to apply to nonmarket economies. Related to HR 1216.
HR 1216 Rep. Phil English (R-PA)	March	Nonmarket economies, trade	Amends Title VII of the Tariff Act of 1930 to allow countervailing duties to apply to nonmarket economies. Related to S 593.
HR 1498 Rep. Tim Ryan (D-OH)	April	Currency	No comment on revaluation. Proposes the US Tariff Act of 1930 revise its definition of countervailable subsidy to include "exchange rate manipulation."
HR 1575 Rep. Sue Myrick (R-NC)	April	Currency	States renminbi is undervalued by 15 to 40 percent. Authorizes tariff of 27.5 percent on US imports from China if negotiations to revalue are unsuccessful.
S 984 Sen. Olympia Snowe (R-ME)	May	Currency	No comment on revaluation. Recommends revised definition of currency manipulation under the US Exchange Rates and International Economic Policy Coordination Act of 1988. Requires US Treasury to analyze the discrepancy in China's trade surplus data with the United States and other countries.

(table continues next page)

Table A.2 Significant US congressional bills and resolutions concerning Chinese trade and currency practices *(continued)*

Bill number	Date introduced	Issues addressed	Description
HR 2208 Rep. Donald Manzullo (R-IL)	May	Currency	No comment on revaluation. Recommends revised definition of currency manipulation under the US Exchange Rates and International Economic Policy Coordination Act of 1988. Requires US Treasury to analyze the discrepancy in China's trade surplus data with the United States and other countries.
HR 2414 Rep. Mike Rogers (R-MI)	May	Currency, trade deficit	Recommends renminbi revaluation. Requires US Treasury to analyze Chinese exchange rate policies and take measures consistent with the obligations of the United States under the WTO to offset any disadvantage to US producers resulting from China's exchange rate policies.
HR 3004 Rep. Phil English (R-PA)	June	Currency, trade deficit	Recommends renminbi revaluation. Requires US treasury secretary to analyze Chinese exchange rate policies and impose tariffs on Chinese products to offset the effect of "currency manipulation."
S 1421 Sen. Susan Collins (R-ME) Sen. Richard Burr (R-NC)	July	Nonmarket economies, trade	Amends Tariff Act of 1930 to allow countervailing duties to apply to nonmarket economies. Further amends the act so that the Department of Commerce can use novel sub methodologies to calculate subsidies on Chinese exports.
HR 3306 Rep. Charles Rangel (D-NY)	July	Nonmarket economies, currency, trade	States renminbi is undervalued by 40 percent. Recommends an amendment to allow the Department of Commerce to hear countervailing duties against

(table continues next page)

Table A.2 *(continued)*

Bill number	Date introduced	Issues addressed	Description
			"nonmarket" economies such as China. Recommends retaliatory action under sections 401 through 305 of the Trade Act of 1974.
S Res. 270 Sen. Evan Bayh (D-IN)	October	Currency	Calls for the president to instruct the US executive director to the IMF to bring complaint against China for noncompliance with Article IV and manipulation of the exchange rate.
2006			
S 2267 Sen. Byron Dorgan (D-ND)	February	Trade	Withdraws normal trade relations treatment from Chinese products. Normal trade relations would be extended only after Chinese products were in accordance with the provisions of sections 401 to 409 of the Trade Act of 1974.
HR 4733 Rep. Charles Rangel (D-NY)	February	Currency	Establishes an Office of the Congressional Trade Enforcer to ensure compliance of US trading partners with international agreements. Calls for the trade enforcer to identify and report to Congress priority foreign trade practices of China and for the report to consider WTO violations by China regarding currency manipulation.
HR 4808 Rep. Walter Jones (R-NC)	February	Trade	Prohibits importation of motor vehicles from China until the tariff rates imposed by China on US motor vehicles are equal to the rates of duty applicable to motor vehicles of China under the Harmonized Tariff Schedule of the United States.

(table continues next page)

Table A.2 Significant US congressional bills and resolutions concerning Chinese trade and currency practices *(continued)*

Bill number	Date introduced	Issues addressed	Description
HR 5043 Rep. Benjamin Cardin (D-MD)	March	Trade, currency	Establishes a National Commission on International Economic Policy, which would be required to write a report that included the impact of China on global trade flows, the impact of unfair trade practices (including currency manipulation and subsidies) by China, and the adequacy of existing international trade rules.
S 2467 Sen. Charles Grassley (R-IA) Sen. Max Baucus (D-MT)	March	Currency	Replaces the 1988 Exchange Rates and International Policy Coordination Act by defining and labeling a fundamental misalignment in currency a form of exchange rate manipulation and in violation of IMF Articles of Agreement. The act requires negotiations with a country found to have a fundamental misalignment. If negotiations fail, the act provides for concrete measures to be taken, including denial of market economy status, opposition to multilateral financing, disapproval of loans from the Overseas Private Investment Corporation, and rejection of a quota increase at the IMF. The act also creates a Senate-confirmed official in the Office of the US Trade Representative to assist with trade enforcement cases. While making no specific mention to China, this act is aimed at China and a direct response to the growing concern and desire for action with regard to the Chinese exchange rate.

Source: Thomas Legislative Information, Library of Congress, available at thomas.loc.gov/home/thomas.html (accessed May 2006).

Table A.3 Official and unofficial proposals for renminbi revaluation

Official/prominent economist	Extent of revaluation	Reason and date
John Snow, former US treasury secretary	Floating exchange rate, liberalize capital controls. No target specified for renminbi.	Urges a floating renminbi to boost US exports to China and reduce global macroeconomic imbalances (March 2004). Emphasizes US Treasury is not calling for an immediate full float with fully liberalized capital markets in China and that such actions alone would not solve current global imbalances (May 2005). However, urges greater flexibility for the renminbi and stronger Chinese domestic demand through financial-sector reform. Report to Congress declined to label China as a currency manipulator (November 2005).
Alan Greenspan, former chairman of the Federal Reserve	Revaluation. No target specified for renminbi.	Currency intervention causes inflation and creates internal and external imbalances. China needs to resolve nonperforming loans problem before renminbi appreciation. To restore internal balance, China will revalue renminbi (April 2004).
Kenneth Rogoff and Horst Köhler, International Monetary Fund	"Flexible" rather than floating exchange rate; maintain capital controls. Former IMF Chief Economist Kenneth Rogoff cautions against a large appreciation.	Given the weak Chinese banking system, IMF recommends a "flexible" but not a floating exchange rate. Does not specify the degree or timing for revaluation (September 2003)
US-China Economic and Security Review Commission	Substantial appreciation of renminbi between 15 and 40 percent based on trade-weighted basket of currencies.	Manipulation of renminbi exacerbates US trade deficit with China and hurts the US manufacturing sector in particular (March 2004).
Ernest H. Preeg, Manufacturers Alliance (MAPI)	Immediate 20 percent revaluation, a new peg with a wide band, and liberalized capital controls.	Chinese "currency manipulation" violates IMF and WTO commitments, increases the US trade deficit, and harms manufacturing and defense sectors (September 2003).

(table continues next page)

Table A.3 Official and unofficial proposals for renminbi revaluation *(continued)*

Official/prominent economist	Extent of revaluation	Reason and date
Franklin J. Vargo, National Association of Manufacturers (NAM)	Revaluation of at least 20 percent.	Undervalued renminbi enlarges US-China trade deficit and encourages neighboring Asian countries to continue pegging their currencies (October 2003).
Robert McKinnon, Stanford University	Against revaluation.	Renminbi appreciation could cause serious deflation ending with a zero interest liquidity trap (March 2004).
Robert Mundell, Columbia University	Against revaluation.	Appreciation would exacerbate non-performing loans problem, stifle economic growth, reduce foreign investment, cause deflation, and increase unemployment (May 2004).
A. Bénassy-Quéré et al., University of Paris	25 to 51 percent.	Undervalued renminbi magnifies the extent of adjustment by the euro and other currencies (May 2004).
Barry Eichengreen, University of California, Berkeley	5 to 10 percent, followed by managed float.	Countering inflationary pressure and domestic overheating requires only a modest appreciation rather than big-step revaluation (May 2004).
Albert Keidel, Carnegie Endowment for International Peace	Against immediate revaluation.	The renminbi reasonably reflects market forces. The Chinese exchange rate system does not contribute to US-China bilateral trade and does not pose a risk for global imbalances (June 2005).
Stephen Roach and Andy Xie, Morgan Stanley	Against revaluation.	China does not compete based on an undervalued currency. Renminbi did not contribute to the US-China bilateral trade deficit. Removing the renminbi peg could destabilize world financial markets (September 2003, July 2005).

(table continues next page)

Table A.3 *(continued)*

Official/prominent economist	Extent of revaluation	Reason and date
Morris Goldstein and Nicholas Lardy, Institute for International Economics	20 to 40 percent, followed by wider currency band and switch to three-currency basket peg.	China and the global economy cannot wait for liberalized capital controls before renminbi revaluation. China should not adopt a floating exchange rate because of its weak financial system. The fixed exchange rate encourages other countries to maintain a fixed exchange rate regime as well and further contributes to the growing US trade deficit (mid-2005).

Sources: US Treasury press release, "US-China Trade Relationship," April 28, 2004, Washington; John W. Snow, Statement on the State of the International Financial System before the Committee on Financial Services, March 25, 2004, US House of Representatives, Washington; US Treasury press release, "Statement of Treasury Secretary John W. Snow on the Report to Congress on International Economic and Exchange Rate Policies," November 28, 2005, Washington; US Treasury press release, "Treasury Secretary Snow Appoints Olin L. Wethington as Special Envoy on China," May 19, 2005, Washington; Alan Greenspan, Testimony on The State of the Banking Industry before the Senate Committee on Banking, Housing, and Urban Affairs, April 20, 2004, Washington; Alan Greenspan, "Current Account," speech delivered at the Economic Club of New York, March 2, 2004; Stephen S. Roach, Statement on Getting China Right before the Commission on US-China Economic and Security Review, September 25, 2003, US House of Representatives, Washington; Ernest H. Preeg, The Emerging Chinese Advanced Technology Superstate, Statement before the Commission on US-China Economic and Security Review, April 21, 2005, Washington; Franklin J. Vargo, China's Exchange Rate Regime and Its Effects on the US Economy, Statement before the Subcommittee on Domestic and International Monetary Policy, Trade, and Technology of the House Committee on Financial Services, October 1, 2003, US House of Representatives, Washington; Julie Ziegler, "IMF Backs China in Debate on Yuan Peg," *Bloomberg News*, July 23, 2003; US-China Economic and Security Review Commission Report 2004; Bergsten et al. (2006); Bénassy-Quéré et al. (2004); Eichengreen (2004); Keidel (2005); Mundell (2004); McKinnon (2004); and Xie (2003b).

Table A.4 Selected international treaties signed by China dealing with intellectual property

Convention/agreement	Year signed
Convention Establishing the World Intellectual Property Organization (WIPO) and a contracting country of WIPO	1980
Paris Convention for the Protection of Industrial Property	1985
Treaty on Intellectual Property in Respect of Integrated Circuits (signatory country)	1989
Madrid Agreement Concerning the International Registration of Marks	1989
Berne Convention for the Protection of Literary and Artistic Works	1992
Memorandum of Understanding between China and the United States concerning Intellectual Property Rights (IPRs)	1992
Universal Copyright Convention	1992
Geneva Convention for the Protection of Producers of Phonograms against Unauthorized Duplication of their Phonograms	1993
Patent Cooperation Treaty	1994
Budapest Treaty on the International Recognition of the Deposit of Micro-Organisms for the Purposes of Patent Procedure	1994
Nice Agreement (International Classification of Goods and Services)	1994
Madrid Protocol (International Regulation of Marks)	1995
Budapest Treaty (Deposit of Micro-Organisms)	1995
Extension of the IPR Memorandum of Understanding between China and the United States (concerning aspects of enforcement and market access)	1995
Locarno Agreement (International Classification for Industrial Designs)	1996
Strasbourg Agreement (International Patent Classification)	1997
Member and Signatory to Agreement on the Trade-Related Aspects of Intellectual Property Rights (TRIPS)	2001

Source: Lian (2006).

Appendix B
Safeguards and Antidumping Remedies Against Textile and Clothing Imports

Several remedies are available if the US government and other WTO members decide that rapidly rising textile and clothing imports from China are too painful for their domestic industries.

Under the WTO, the US government can apply the China-Specific Textile Safeguard (paragraph 238, which lasts until 2008) to limit the growth of Chinese textile and clothing exports to the United States to 7.5 percent of total exports during the 12-month period, terminating two months before consultation requests are made. The process of applying the textile safeguard is very easy. Once a WTO member "believes" that imports of textiles and clothing from China cause "market disruption," the growth cap is applied immediately and lasts for a maximum of one year. Optional consultations begin after the cap is applied. The relatively effortless process explains why the WTO textile safeguard was used in the brassiere case.

Under the WTO, the US government can also apply the Transitional Product Safeguard (TPS), paragraph 241, which lasts until 2013, to restrict Chinese textile and clothing imports with no time limit. Unlike the WTO textile safeguard, the TPS is not automatic; it requires a US International Trade Commission (USITC) investigation and public hearing to determine whether there is "material injury or threat of material injury to the domestic industry." This is a lengthy process compared with the textile safeguard.

Sources: Finger (1993); Ianchovichina and Martin (2003); Ikenson (2003); Lardy (2002); Lindsey and Ikenson (2002); Rumbaugh and Blancher (2004); WTO (2001).

Under special safeguard rules in domestic law, the US government can apply a quota or tariff under sections 421 and 422 of the Trade Act of 1974 to limit Chinese textile and clothing exports if such exports cause "market disruption" or "threaten to cause . . . a significant diversion of trade" into the domestic US market. Sections 421 and 422 were added to the Trade Act of 1974 in 2000 (as modifications to section 406) when Congress ratified permanent normal trade relations with China. The quota or tariff limit requires a USITC hearing and has an unlimited duration at the discretion of the US president.

Under regular safeguard rules in domestic law, the US government can apply an "escape clause" tariff under section 201 of the Trade Act of 1974 to limit Chinese textile and clothing exports, if it is found that imports caused "serious injury" to domestic producers. Unlike other safeguards, section 201 involves global safeguard investigations, except for specific countries with which the United States has free trade agreements—such as the North American Free Trade Agreement partners—provided they are excluded from injury investigations. The tariff limit lasts for up to four years, with the possibility of extension to a maximum of eight years at the discretion of the president.

Antidumping Remedies

Under China's accession protocol to the WTO, China can be considered a nonmarket economy by the United States and other WTO members, which allows the US Department of Commerce to ignore domestic Chinese prices and costs when determining antidumping duties on Chinese exports. Instead, the prices and costs of a "surrogate country" are used to calculate the dumping margin. China's nonmarket economy status expires in 2015.

Under US domestic law, the Department of Commerce's antidumping duty calculations involve several arbitrary calculations that can be slanted in favor of or against an antidumping target. The USITC determines the presence of "material injury" to the domestic industry, a low threshold of trade impact. The antidumping duty is revoked after a five-year review unless the Department of Commerce and USITC determine that revocation would lead to a recurrence of dumping and injury.

Appendix C
Short History of US-Japan Trade Frictions

US-Japan trade relations were marked by increasing friction between the late 1950s and the late 1980s, as Japan pursued an agenda of export-led growth, propelled by a highly competitive exchange rate, increasing both the volume and range of its foreign sales. The era was punctuated by a series of high-profile trade cases restricting Japan's exports and opening its import markets, coupled with persistent US pressure on Japan to appreciate the yen. The resolution of these cases, the adoption of floating exchange rates, and the dramatic appreciation of the yen, from 360 yen per dollar to under 120 yen per dollar, were cornerstones to both expanding multilateral trade and successful General Agreement on Tariffs and Trade (GATT) negotiations between the Dillon Round (1960–61) and the Uruguay Round (1986–94). For an in-depth account, see Bergsten, Ito, and Noland (2001). This appendix lists several high-profile trade cases.

Textiles and Apparel. In January 1957 President Dwight Eisenhower established a five-year "voluntary" restraint agreement (VRA) to limit Japanese cotton textile exports. In July 1961, under President John F. Kennedy, the textile VRA evolved into the Short-Term Arrangement on International Trade in Cotton Textiles (STA), signed by 19 countries. In October 1962 the STA became the Long-Term Arrangement (LTA). President Lyndon Johnson renewed the LTA in 1967, and in 1974 President Richard Nixon widened its scope to make it the Multi-Fiber Arrangement. Japanese textile and clothing exports dropped significantly after the VRA.

This appendix draws from Bergsten, Ito, and Noland (2001); Hufbauer, Berliner, and Elliott (1986); Hufbauer and Elliott (1994).

By the 1970s other emerging countries, such as Hong Kong, India, and Pakistan, replaced Japan as leading textile and clothing exporters.

Steel. As Japan shifted from textile and clothing to steel exports, the United States imposed new restrictions. From January 1969 to December 1974, the United States established VRAs with Japan and the European Community to limit carbon steel imports. The United States periodically imposed VRAs, antidumping duties, and safeguard measures (section 201) against Japanese and other steel exporters throughout the 1980s, 1990s, and 2000s.

Automobiles. As Japan strengthened its presence as a leading automobile exporter, the United States restricted Japanese automobile exports. From April 1981 to March 1985, the United States imposed auto VRAs against Japanese auto exports, followed by Japanese export restraints throughout the 1980s until the early 1990s. Bilateral negotiations resulted in a Japanese agreement to purchase US auto parts between 1990 and 1995. An important consequence of trade restrictions is that Japanese auto firms, most notably Toyota and Honda, accelerated their investment in the United States, transforming themselves into major domestic competitors of the Big Three US auto firms: General Motors, Ford, and Chrysler.

Heavyweight Motorcycles. When Japanese heavyweight motorcycle exports, mainly from Kawasaki, captured a growing share of the US market, between 1983 and 1988, the United States used the "escape clause" to impose tariff-rate quotas on Japanese motorcycle imports to protect Harley-Davidson. The tariff-rate quotas were designed to become less restrictive during the relief period and were in fact terminated early. This safeguard relief case is regarded as the most successful of the past three decades.

Color TV Receivers. To limit Japanese as well as Korean and Taiwanese exports of color TV receivers, President Jimmy Carter established an Orderly Marketing Agreement during 1977–82.

Semiconductors. From September 1986 to July 1991, Japan agreed, at US insistence, to restrict its exports of semiconductors, mainly dynamic random access memory chips. The US-Japan Semiconductor Agreement established a price floor, or "fair market value," on certain semiconductors. The agreement also committed Japan to purchase more US semiconductors, thereby opening the Japanese domestic semiconductor market.

Machine Tools. From January 1987 to December 1991, the United States limited imports of Japanese machine tool exports.

Other Trade Remedies. In 1989 the United States launched both the Super 301 process, authorized by the 1974 Trade Act (as amended by the 1988 Omnibus Trade and Competitiveness Act) and its new Structural Impediments Initiative (SII) with Japan. Super 301 allowed the US trade representative (USTR) to retaliate against Japanese practices that limited US exports and to impose trade sanctions against Japanese exports deemed to violate trade agreements (notably GATT and the WTO). The SII provided a forum for the United States and Japan to discuss structural problems in both countries that impeded trade and balance of payments adjustment.

Starting in 1984 under Ambassador Bill Brock and continuing until 1989 under Ambassador Clayton Yeutter, the USTR led the US Market Opening Sector Specific (MOSS) talks with Japan. MOSS promoted deregulation and openness in the Japanese telecommunications, pharmaceuticals, electronics, forestry, and medical equipment sectors.

Between the late 1960s and 1988, the United States and Japan had numerous citrus and beef disputes, which gradually led to expanding Japanese quota limits on citrus and beef imports. Other disputes on agricultural market access are still unresolved.

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Index

AFL-CIO, 10
Agilent Technology, 59
antidumping, 37, 75. *See also* nonmarket economy status (NME); market economy status (MES)
  Byrd Amendment on distribution of duties, 71, 71*f*
  cases against China, 63
  duties on color television imports from China, 73–74
  duties on furniture imports from China, 70–71
  duties on Chinese textiles and clothing, 96
  US law on, 64, 96
apparel. *See* textiles and clothing
Australia
  merchandise trade with China, 7*t*
  free trade agreement with China, 68, 68*f*
Austria, 68
automobiles, US-Japan dispute over, 98
automobile parts
  China's tariff policy on, 61
  China's treatment of auto kits, 61–62
  US and EU complaint against China's tariffs on, 61–62
  US exports to China, 61
  value of Chinese market for, 61

Baucus, Senator Max, 15, 38*f*, 84*t*, 90*t*
bilateral trade. *See under specific country and specific sector*
Boeing Company, China's purchase of aircraft from, 80
Bush, President George W., 13, 14, 17, 32, 47, 53, 55, 61

cement, Chinese consumption of, 4*f*
CFIUS. *See* Committee on Foreign Investment in the United States (CFIUS)
Chevron Corporation's bid for Unocal, 47–48, 51–52
China. *See also specific sector*
  accession to the World Trade Organization (WTO), 4, 29*f*, 30, 30*f*, 31*b*, 32, 55*f*, 61, 62, 64
  bilateral trade surplus with United States, 5–8, 79
  comparison with Japan, 4, 7–8, 20, 57, 58*t*, 76–78
  consumption of oil in, 4, 48, 50, 52, 78
  current account surplus of, 12, 12*f*, 20, 25
  electronics and information industry trade with United States, 58*t*
  financial-sector reforms in, 14*f*
  foreign direct investment in, 12, 20*f*, 77*t*, 78
  foreign exchange reserves of, 12, 15, 20, 20*f*, 66
  free trade agreement with New Zealand and Australia, 68, 68*f*
  GDP growth in, 4*f*

China (*cont.*)
growth as exporting power, 8*t*, 74, 78
integrated circuit development fund in, 60
investment in infrastructure, 35, 36*f*
labor standards in, 10, 67
openness of economy, 4, 76–77
merchandise trade with United States, 4–9, 6*t*, 7*t*, 9*t*, 77*t*
nonperforming loans in, 15, 15*f*
services sector in, 4*f*
services trade with United States, 6*t*
special investment zones in, 59
permanent normal trade relations for, 55
policy recommendations for, 78–79
tariffs, 5*f*, 6, 61
trade deficit with Asian partners, 6
unilateral liberalization in, 78
China Currency Coalition for renminbi revaluation, 13, 16, 17, 20, 23
China National Offshore Oil Corporation (CNOOC) bid for Unocal, 45, 47–53. *See also* Chevron Corporation's bid for Unocal
CFIUS review of, 48–49
CNOOC president's comments to allay concerns on, 50–51
objections to, 50–52
China National Aero Technology Import and Export Corporation, 49
Clinton, President Bill, 23, 55
CNOOC. *See* China National Offshore Oil Corporation (CNOOC) bid for Unocal
color televisions, 9*t*, 10
antidumping duties on Chinese, 73–74
job loss in US, 73
largest Chinese makers of, 73
petition against US imports of Chinese, 73–74
US-Japan dispute over, 98
Committee on Foreign Investment in the United States (CFIUS), 48–53
Committee for the Implementation of the Textile Agreements (US), 29*f*, 30, 33, 36*f*
congressional proposals to shape US-China economic relations, 1, 15, 84*t*–93*t*
countervailing duties, 8, 23, 87*t*
excluded from nonmarket economy status, 65
currency practices. *See* renminbi
Deng Xiaoping, 75
dollar. *See also* renminbi
appreciation of yen against, 27, 97
appreciation of other Asian currencies against, 27, 28*t*
strength of, 2, 3*b*
decline via Plaza Accord, 16*f*
purchases by People's Bank of China, 13*f*, 15
Dubai Ports World, 47
acquisition of Peninsular and Oriental Steam Navigation Company, 52–53
charges against, 53

European Union
action against rising Chinese textile and clothing imports, 30*f*, 31*b*, 33, 34
and antidumping, 63*f*, 68*f*
case against Chinese tax policy on semiconductors, 56
case against China's tariffs on auto parts, 61
granting market economy status to China, 65, 68
merchandise trade with China, 7*t*
purchase of Chinese furniture, 72*f*
Exon-Florio Amendment, 48, 51. *See also* foreign direct investment (FDI)

Fabrics China campaign, 36
Fair Currency Alliance. *See* China Currency Coalition for renminbi revaluation
FDI. *See* foreign direct investment (FDI)
foreign direct investment (FDI). *See also* China National Offshore Oil Corporation (CNOOC) bid for Unocal; Dubai Ports World
in China, 12, 12*f*, 20*f*, 77*t*, 78
China's openness to, 4, 76–77
in Japan, 77*t*
and US national security concerns, 1, 8, 45, 47–53
CFIUS review of cases, 48–50
congressional debate over CFIUS reform, 49–50, 52
in critical infrastructure, 49
Exon-Florio Amendment, 48, 51
seen as protectionist, 53
foreign exchange reserves of China, 12, 15, 20, 20*f*, 66
furniture, 9*t*, 10
antidumping duties on Chinese, 70–71

Chinese production and trade in, 71–72
EU purchase of Chinese, 72*f*
petition against US imports of Chinese, 70–71
shift to marketing and distribution in US, 71
job loss in US, 70, 72

Gates, Bill, 40, 44, 80
GATT. *See* General Agreement on Tariffs and Trade (GATT)
General Agreement on Tariffs and Trade (GATT), 23, 97, 99. *See also* World Trade Organization (WTO)
Article III, 56, 61
Article XV(4), 16–20
Article XV(9), 17
Article XVIII, 19
preamble, 18
GM Daewoo, 41
Graham, Senator Lindsey, 15, 15*f*, 19*f*, 84*t*, 86*t*
Grassley, Senator Charles, 15, 84*t*, 90*t*
Greenspan, Alan, 14–15, 91*t*, 93*t*

Hu Jintao visit to United States, 14, 15, 40, 79–80

IMF. *See* International Monetary Fund (IMF)
integrated circuit development fund (China), 60
intellectual property rights, 38, 75
Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS), 40, 43, 44, 94*t*
China's agreements with Microsoft on, 40, 44, 80
efforts to curtail infringements, 40, 42–44
fake Viagra case, 41
GM Daewoo case, 41
impediments to protection in China, 41–42
National Basketball Association trademark case, 43, 43*f*
policy recommendations for China on, 79
treaties signed by China, 94*t*
US losses from global copyright violations, 39
US royalties and fees from Chinese enterprises, 41
USTR review of China's, 43

International Monetary Fund (IMF), 15, 20, 22, 66
Articles of Agreement, 17
Article IV consultations with China, 26, 37
legal case for renminbi revaluation under Article IV of, 24–26
proposal on renminbi revaluation, 91*t*

Japan
comparison with China, 4, 7–8, 20, 57, 58*t*, 76–78
electronics and information industry trade with United States, 58*t*
history of trade frictions with United States, 76–78, 97–99
US security alliance with, 76
US trade with, 77*t*
JCCT. *See* US-China Joint Commission on Commerce and Trade (JCCT)
job loss. *See also specific sector*
and trade adjustment assistance (TAA) programs, 37–38, 79
in United States, 1, 2, 3*b*, 16, 28, 32, 70, 72, 73, 83*t*

labor standards
AFL-CIO petition against China's, 10
in China, 10, 67
significance in market economy status for China, 67
Lenovo Group, agreement with Microsoft, 44

market economy status (MES). *See also* nonmarket economy status (NME)
countries that have granted to China, 68, 68*f*
EU criteria for granting, 68
hurdles preventing United States from granting China, 66–67
significance for China, 67–69
Microsoft, 40, 44, 80
Multi-Fiber Arrangement, 9, 27, 29
end of, 30–34, 31*b*
evolution of, 97–98

national security concerns. *See* foreign direct investment (FDI); China National Offshore Oil Corporation (CNOOC) bid for Unocal; Dubai Ports World
New Zealand, free trade agreement with China, 68, 68*f*

Nixon, President Richard, 1, 19*f*, 20, 97
nonmarket economy status (NME). *See also* market economy status (MES)
calculating antidumping duties under, 64–65, 70
designation of China under US trade law, 63–66
exclusion of countervailing duties from, 65
US criteria for, 65

oil
Chinese consumption of, 4, 48, 50, 52, 78
as fungible commodity, 50–51
Unocal's share of world market, 51

permanent normal trade relations for China, 55
Pfizer, Inc., 41
policy recommendations
for China, 78–79
for United States, 79
for both, 79–80

renminbi
convertibility of, 66–67
exchange rate to dollar, 11–12, 36*f*
revaluation of, 1, 8, 9*t*, 10, 11–28
Alan Greenspan on, 14–15, 91*t*, 93*t*
China Currency Coalition (formerly Fair Currency Alliance) campaign for, 13, 16, 17, 20, 23
congressional bills related to, 15, 84*t*–90*t*
experts against, 21, 25*f*, 92*t*
improvement in US deficit from, 9*t*, 10, 27–28
John W. Snow on, 13–15, 91*t*, 93*t*
July 2005 revaluation, 11, 11*f*
legal case under GATT/WTO, 16–24, 27*f*
legal case under IMF, 24–26
and market economy status for China, 66–67
proposals for, 78, 9–93*t*
Section 301 petition (drafted by Fair Currency Alliance) for, 13, 16 (*See also* China Currency Coalition)
US Treasury and, 2, 13–15, 26, 27
US Trade Representative and, 13*f*, 16*f*, 17, 21, 27*f*
using Singapore model to reform, 11*f*

Schumer, Senator Charles, 15, 15*f*, 19*f*, 84*t*, 86*t*
semiconductors, 9*t*, 75
Chinese incentives for research and development in, 59–60
Chinese market for, 57, 59
integrated circuit development fund in China, 60
policy recommendations for China, 78
role of Semiconductor Industry Association in WTO case against China, 56–57
US-Japan dispute over, 98
WTO case against China's preferential tax treatment of, 55–57, 60
Semiconductor Industry Association (US), 56–57
Snow, John W., 13–15, 9, 93*t*
special investment zones in China, 59

TAA. *See* trade adjustment assistance (TAA) programs
textiles and clothing, 9, 9*t*, 10, 75. *See also* Multi-Fiber Arrangement
antidumping duties on Chinese, 96
Central American producers of, 37*f*
Chinese government support for, 36*f*
Committee for the Implementation of the Textile Agreements (US), 29*f*, 30, 33, 36*f*
dispute over US imports from China, 29–30
EU-Sino agreement on, 33
Fabrics China campaign, 36
job loss in United States, 28, 32
policy recommendations for China, 78
productivity of Chinese workers in, 36*f*
shift to marketing in US, 37
sources of China's comparative advantage in, 34–36
US and China hourly wages in, 36
US-China memorandum of understanding on, 10, 33, 34, 36
US-China trade in, 35*t*
US-Japan dispute over, 97–98
WTO safeguards against Chinese, 29*f*, 30, 32–33, 37, 95–96
trade adjustment assistance (TAA) programs
eligibility of workers for, 37*f*
recommendations for improving, 37–38, 79
trade disputes. *See specific sector or issue*
summary of, 9*t*, 9–10

policies to manage, 78–80
US-Japan, 76–78, 97–99
United States. *See also specific sector*
Committee on Foreign Investment in the United States (CFIUS), 48–53
Committee for the Implementation of the Textile Agreements (CITA), 29*f*, 30, 33, 36*f*
electronics and information industry trade with China and Japan, 58*t*
energy policy of, 52
granting permanent normal trade relations to China, 55
history of trade frictions with Japan, 76–78, 97–99
job loss in, 1, 2, 3*b*, 16, 28, 32, 70, 72, 73, 83*t*
merchandise trade, 3*b*, 5*t*
with Asian partners, 28*t*, 77*t*
with China, 4–9, 6*t*, 7*t*, 9*t*, 77*t*
policy recommendations for, 79
productivity in manufacturing, 3*b*
security alliance with Japan, 76
services trade, 2, 5*t*
with China, 6*t*
trade adjustment assistance (TAA) programs in, 37, 79
trade deficit
with China, 1, 2, 5–8, 9*t*, 10, 76, 84*t*–90*t*
global, 2, 3*b*, 5*t*, 16, 27
Unocal Corporation. *See* China National Offshore Oil Corporation (CNOOC) bid for Unocal; Chevron Corporation's bid for Unocal
USCC. *See* US-China Economic and Security Review Commission (USCC)
US-China Economic and Security Review Commission (USCC), 9, 21*f*, 25*f*, 57*f*, 65*f*, 66
US-China Joint Commission on Commerce and Trade (JCCT), 37*f*, 41, 43, 43*f*, 65*f*, 80
US Department of Commerce, 23*f*, 29, 61, 67, 69, 70, 71, 73
US Department of Energy's study on China's energy demand, 50
USTR. *See* US Trade Representative (USTR)
US Trade Representative (USTR)
estimate of China's value-added tax on semiconductors, 55–56
review on China's commitment to intellectual property rights, 39, 43
review of US-China trade relations, 1–2
role in WTO case for renminbi revaluation, 13*f*, 16*f*, 17, 21, 27*f*
US Treasury, renminbi revaluation and, 2, 13–15, 26, 27

WTO. *See* World Trade Organization
World Trade Organization (WTO). *See also* General Agreement on Tariffs and Trade (GATT)
agreement establishing, 13, 18
Agreement on Agriculture, 17
Agreement on Subsidies and Countervailing Measures, 17, 20–24, 61, 69
Agreement on Textiles and Clothing, 30, 31*b*, 32
Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS), 40, 43, 44, 94*t*
Agreement on Trade-Related Investment Measures (TRIMs), 61
China's accession to, 4, 29*f*, 30, 30*f*, 31*b*, 32, 55*f*, 61, 62, 64
dispute settlement mechanism, 13, 17, 21, 22, 55, 56, 62
Doha Development Round, 69, 78
General Agreement on Trade in Services (GATS), 19
Government Procurement Agreement, 80
legal case for renminbi revaluation under, 13*f*, 16–24, 27, 27*f*
safeguards against imports of Chinese textiles and clothing, 29*f*, 30, 32–33, 37, 95–96
proposal for "congressional trade enforcer" to launch cases in, 1
Uruguay Round, 30, 31*b*, 97
Wu Yi, Chinese Vice Premier, 43

yuan. *See* renminbi

Zoellick, Robert B., 17*f*, 66, 66*f*