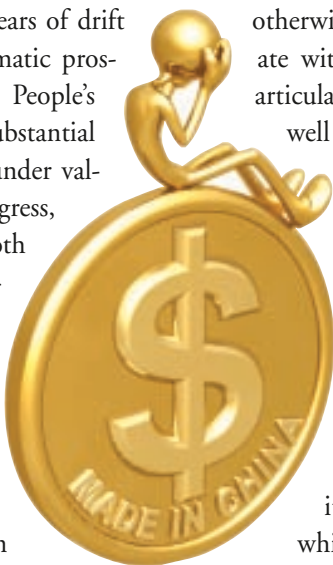


Bull in a China Shop

By Bryan Bachner*

Sino-U.S. affairs are at a crossroads. After years of drift and confrontation, commercial and diplomatic prospects between the United States and the People's Republic of China appear quite promising. A substantial trade deficit in the United States, an apparently undervalued Renminbi (RMB) and an impatient U.S. Congress, however, have precipitated a relationship where both countries, feel threatened by the deepening of connections rather than celebrating it. Recently, just prior to the Strategic Economic Dialogue — a biannual meeting among government officials designed to enhance understanding and improve bilateral trust — the U.S. government accused China of failing to meet its international obligations. In response, it initiated the implementation of trade sanctions through litigation¹ and legislation.² China reacted angrily, asserting that the United States was politicizing what should be a process of negotiation and considered severe retaliatory measures.³



otherwise authoritarian polity, that allows business to operate without extensive governmental interference. China's articulation of trade policy and enforcement of its laws falls well short of perfect; the current dramatic rattling of sabers in the U.S. trade policy arsenal, however, that emphasizes commercial differences rather than similarities demonstrates a profound disquiet of the United States with the trajectory of China's global economic strategy and the extent to which the Chinese government remains involved with its own trade policy. With the processes of globalization expanding and extending in ways that the founding fathers of the WTO could not anticipate, it is timely to take a step back from this black and white depiction of the problem and come to terms with the grays. In this paper, I will analyze as case studies the two key trade topics of the day, currency valuation and intellectual property rights, with a view toward illuminating the context and contours of the United States' trade policy with China.

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Since the end of the Second World War, the objective of U.S. trade policy has been to promote the growth of the global economy through the reduction of trade barriers between and amongst countries, as well as to gird market economies by the domestic incorporation of a rule of law. The United States' contribution to the enactment of the rules in the General Agreement of Tariffs and Trade and its institutionalization through the World Trade Organization (WTO) underlines its deep commitment to this multilateral project. In 2001, after two decades of economic reform where China had transformed a highly centralized socialist economy to one that embraced market principles, China acceded to the WTO.

The Chinese government has created a space, within its

Foreign Currency

There is a general perception that our considerable trade deficit and resultant foreign debt is a consequence of a closed Chinese governance regime manipulating an open global market. The claim is that the Chinese deliberately undervalue their currency by artificially controlling their exchange rate regime in order to encourage exports. This is achieved through the Bank of China's manipulation of the exchange rate by selecting a secret basket of currencies through which it establishes a devalued currency. The general assessment is that in the absence of a freely

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converted Chinese currency, the artificially low Chinese RMB makes it impossible for U.S. manufacturers to compete with Chinese manufacturers, which damages the U.S. economy by causing manufacturers either to close or move to China. The key issue is whether trade sanctions and legislative penalties are the most effective way to induce China to improve its valuation policy.

An indication of the depth of the concern with the undervaluation of the RMB is the decision by the United States to respond with both litigation and legislation. On March 30, 2007, the Department of Commerce Secretary Carlos Gutierrez announced that the Administration had made a preliminary decision that Chinese producers of luxury paper had obtained subsidies of between 10 to 20 percent; he thus ordered the Customs Authority to collect countervailing duties on related imports.⁴ The U.S. International Trade Commission is now deliberating whether the U.S. luxury paper goods industry has suffered any harm. The Commerce Department decision reverses a 23-year-old position that government involvement in non-market economies would not be challenged. The United States has rarely, if ever, issued sanctions for illegal subsidies against a communist or non-market economy because of the difficulty in distinguishing between subsidies and the normal operating budget of a state-owned enterprise. This transformation potentially opens up the flood gates to a variety of complaints from different industries in the United States against their competitors on the mainland. While the action is narrowly focused on a business that accounts for less than one percent of total trade between the United States and China, as it is issued simultaneous to a WTO complaint concerning intellectual property rights, it appears that the administration is signaling a shift in its institutional attitude toward Chinese trade conduct.

The Treasury Department recently announced during its biannual Treasury Report that, while China is not manipulating its currency, there has been heavy foreign exchange intervention by China's central bank.⁵ The report called China's economy unbalanced and suggested that China needs to take corrective action to allow the RMB to rise but claimed that its conduct did not reach the standard of manipulation.⁶ On one hand, Secretary of Treasury Paulson appreciates that China's valuation regime is not ideal and he has asserted that China must move to a market-based foreign exchange system; on the other hand, he has argued that excessive concern for the valuation of the Yuan suggests that the United States is using the Chinese currency as a scapegoat for its own economic ills. Further, in May of 2007, 42 members of Congress filed a petition, its third since 2004, in accordance with Section 301 of the Trade Act of 1974, to request the USTR to study whether China was illicitly undervaluing its currency.⁷

Congress, frustrated with the administration inactivity, decided to try to investigate and legislate the problem. In May of 2007, Congressman Sander Levin declared that Congress would pursue a hearing on currency manipulation and its effects on American business and workers.⁸ On July 26, 2007, the eve of Secretary of Treasury Paulson's visit to China under the Strategic

Does Chinese policy on foreign currency and its expanding trade surplus account adequately for U.S. concerns? Recently, China announced two measures that appear to respond to the United States' anxiety concerning China's control over its financial markets and currency.

Economic Dialogue,⁹ the Senate Finance Committee passed The Currency Exchange Rate Oversight Act of 2007 out of Committee by a vote of 20-1.¹⁰ According to the Committee, the bill will oblige the Treasury Department to determine whether a currency is "fundamentally misaligned" two times per year. Where the misalignment is caused by the foreign government's economic activity, Treasury must mark these currencies for "priority action" with the legislation spelling out a procedure of consultation and, where re-alignment is unsatisfactory, sanctions.¹¹

Moreover, Congress now has targeted sovereign wealth funds, such as China Investment Corporation, because of concerns over the extent to which the state is involved in the investment of its funds and its potential for control and undue influence.

Does Chinese policy on foreign currency and its expanding trade surplus account adequately for U.S. concerns? Recently, China announced two measures that appear to respond to the United States' anxiety concerning China's control over its financial markets and currency. First, China has widened the band that sets out limitations on the extent to which foreign currency may be used to exchange RMB. The central bank announced that the daily range for exchange between RMB and U.S. dollar will expand from 0.3 to 0.5 percent.¹²

In fact, according to the International Monetary Fund, China has taken steps to liberalize and develop the foreign exchange market, including the establishment of an over-the-counter spot foreign exchange market and markets for currency swaps and futures, these measures are still inadequate. Since the introduction of the basket of currencies approach in July of 2005, the RMB has appreciated by about 4.7 percent. Likewise, few people appreciate that neither Hong Kong nor Singapore, both free market bastions, operate open exchange rates. Hong Kong operates a dollar-linked currency board arrangement, while Singapore, like China's system, is based on undisclosed trade-weighted currencies baskets.

Second, China has decided to raise interest rates — a move that appears tied to concerns that the Chinese economic



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market is too volatile and therefore a potential threat to global growth should something go wrong. This action is largely seen as an effort to staunch the outsized flow of money into a stock market that many feel may be over-valued as it is, and reduces the potential volatility of this market. The one-year lending rate will rise to 6.57 from 6.39 percent. The rate of one-year fixed savings deposits will rise to 3.06 from 2.79 percent. Additionally, over the last few months, the Chinese government has invested billions of dollars in high technology companies here in the United States. Further, since 2005, China has allowed the Yuan to appreciate by approximately 10 percent, certain foreign investors to invest in China's domestic stock market and more foreign joint ventures in the securities industry.¹³

In China, public perceptions of the foreign currency problem are also worth evaluating. Many Chinese are concerned that the formalization of U.S. legal actions against Chinese trade through the use of the WTO's dispute resolution process and domestic sanctions are less about the formality of trade and more about a fundamentally anti-Chinese sentiment. The *China Daily* ran a story emphasizing the Treasury Department's position, underlining the Federal Reserve Bank Chairman's statement that revaluation of the Yuan will not be a panacea for the widening trade deficit. It stated Vice Premier Wu Yi's position as effectively agreeing with the Chairman, saying that most of China's surplus with the U.S. derives from foreign companies exporting products that the U.S. no longer manufactures.¹⁴ According to Zhao Yumin, director of the Chinese Academy of International Trade and Economic Cooperation, a research group affiliated with the Commerce Ministry, "[t]here are lots of disturbances in U.S.-Sino relations [and] [f]rom China's point of view, it just wants stable development. But American enterprises have an anti-Chinese feeling." When trade relations extend beyond economic and technical negotiations



and become part of the political process in China, it is essential to keep in mind China's historical sensitivities toward its foreign colonial past.

While some Americans question the sincerity of the Chinese efforts at liberalization, the *Washington Post* expressed concern that a lack of appreciation of the Chinese progress may result in a potential backlash by China.¹⁵ Furthermore, economists in China see hypocrisy when they observe the extent to which the United States is protecting its own domestic companies while attacking China for doing the same.¹⁶ The *New York Times* suggests that haphazard liberalization may threaten social stability when workers lose jobs to manufacturers in developing countries with even lower labor costs.¹⁷

In a powerful book entitled "The Balance Sheet: China," the Center for Strategic and International Studies as well as the Institute for International Economics likewise raise a skeptical eyebrow, describing our bilateral relations with China as colored by a newly emergent protectionism.¹⁸ Many economists argue that the lack of an open economy and the implementation of a mercantilist trade approach, where China simultaneously

constrains access to its domestic market while pumping up its exports, have contributed to the U.S. trade deficit. The Center and Institute point out, however, that the appearance of many Chinese-made products in US retail outlets, does not prove that the Chinese market is closed to U.S. products. They also assert that one must look at China's global trade balance, not its bilateral accounts, to

determine its openness. In view of its global trade balance, it is clear that China's trade surplus is far more modest than its surplus with the U.S. In addition, the organizations point out that China's trade tariffs have fallen 80 percent since 1982 and, compared to other developing countries, its tariffs are fairly low.

With regard to the argument that U.S. companies cannot compete with the artificially low Chinese labor wages, the Center and Institute say that this narrow economic focus of the

Another powerful explanation for China's large account surplus, vis-à-vis the United States, is the consolidation of much of the final assembly staging for Asian production, which takes advantage of China's economical and available labor pool.

criticism is misleading. Low productivity gives rise to the low wages in China, but the United States' comparative advantage, in terms of lower internal costs (i.e., wages), will not translate into a competitive advantage in the product's price, because the U.S. worker is substantially more productive and will add more value to the good than would be gained from lower employment costs. Further, as one look at countries in sub-Saharan Africa or south Asia — where wages are low but exports to the U.S. are minimal — will prove, lower wages nationally does not guarantee a comparative advantage. Rather than attacking cheap labor, they assert that the United States should be investing in advancing its comparative advantage in productivity.

Another powerful explanation for China's large account surplus, vis-à-vis the United States, is the consolidation of much of the final assembly staging for Asian production, which takes advantage of China's economical and available labor pool. Taken in context, however, one can appreciate how blaming China for the surplus may be inaccurate. First, goods that are assembled in China (i.e., laptops, televisions, etc.) are largely derived from parts made outside of China. Whenever U.S. Customs officials create their statistics, however, in their accounting, the contribution of the export from the other country is ignored and China receives "100 [percent] credit" for the product, thereby artificially inflating China's exports. Additionally, one must recognize that when China receives complete credit for the good as an export, it also deflates the current account surplus of these other developing countries further exacerbating China's deficit with the United States.

The Economist, however, points out that the Chinese assertions that the appreciation of the RMB would be detrimental to the local and global economy are also questionable.¹⁹ One of

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the most curious contradictions arising from Beijing is the idea that a rising RMB would seriously damage economic growth and employment, while apparently at the same time, have little impact on her trade surplus with the United States. Likewise some economists are not convinced by the claim that flexible exchange rates are not possible until China fixes its antiquated banking system. They argue that the closed exchange rate system actually makes the financial regime worse on the grounds that it obliges monetary policy makers to use command and control measures to try to guide the economy rather than interest rates. Further, keeping the RMB virtually pegged to the U.S. dollar keeps inter-

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est rates quite low which, in turn, cheapens money, promotes too much bank lending, and leads to excessive and speculative investment in stocks and properties. Finally, an undervalued RMB makes foreign products expensive and encourages less consumption and more speculative investment. A revalued RMB would encourage more consumer spending. In addition, companies enjoying record profits as well as households anxious about poor health, education, pensions, and other welfare benefits are saving rather than spending thus further contributing to the U.S. trade deficit.

Intellectual Property Rights

Another controversial topic on the U.S. trade agenda is intellectual property enforcement in China.²⁰ There is no question that counterfeiting and piracy are rampant in China and the protection of IPR needs to be improved;²¹ the issue, however, is whether blaming the government for failure to enforce intellectual property rights and holding them to account in a formal trial is the most effective way to deal with the problem. Piracy in China costs the motion picture and music industries billions of dollars on an annual basis.²² It is estimated that 92 percent of all business software in China is pirated and that the software industry lost about \$5 billion in 2006.²³ In the same year, the book industry speculates that the lost over \$50 million to piracy in China.²⁴ The production of counterfeit medicine remains a tragic problem: in 2001, Chinese officials closed 1300 fake medicine factories and investigated the manufacture of \$51 million worth of counterfeit drugs and in 2005, the State Food and Drug Administration banned 114,000 unlicensed drug manufactures and shut down over 450 illegal drug-making factories.²⁵ In light of the importance to the U.S. economy of exporting intellectual property and the adverse impact which piracy and counterfeiting have on the trade deficit, the United States has, for years, been pushing China to improve its enforcement record and appears now to be looking toward trade sanctions as the most effective way to move forward.

Since the early 1990's, the U.S. administration has used negotiation, trade sanctions, and other forms of diplomatic pressure to implore China to protect foreign intellectual property on the mainland.²⁶ While progress has been slow, China's accession to WTO and its adherence to the Trade-Related Aspects of Intellectual Property (TRIPS) obligations are indicative of the

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advancement that has been made in intellectual property enforcement. The U.S. administration, however, does not believe that the promulgation and implementation of intellectual property rights has been sufficient and it has worked hard to negotiate satisfactory improvement. For instance, the U.S.-China Joint Liaison Group for Law Enforcement recently announced that Operation Summer Solstice was successful in, amongst other things, dismantling a global criminal network involved in optical disc piracy and seized billions in dollars in pirated software.²⁷

The office of the United States Trade Representative (USTR) has strengthened its institutional resources to combat piracy. Recently, a new position has been created called Chief Counsel for China Trade Enforcement that will complement the work of the Assistant USTR (China) and Assistant USTR (Intellectual Property and Innovation). China is still on this year's Special 301 Watch List and Section 306 monitoring continues. The USTR recognizes that since its accession to the WTO, China has overhauled its intellectual property regulations; nonetheless the Trade Representative believes that there is still need for further amendment and improved enforcement.²⁸ The U.S.-China Joint Commission on Commerce and Trade (JCCT) is another government to government consultative mechanism between China and the United States which has an intellectual property rights working group that has recognized both China's progress in creating laws, but also China's problems with enforcing them.²⁹ The JCCT, among other things, facilitates training with government officials, and meets with trade groups.

The administration has again taken measured actions and filed two complaints within the WTO: one over deficiencies in China's legal regime for protecting and enforcing copyrights and trademarks on a wide range of products,³⁰ and the other over China's barriers to market access for trade in books, music, videos and movies.³¹ The United

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States rationalizes bringing the complaint based on the fact that bilateral dialogue has failed to bring adequate progress in terms of China's compliance with internationally recognized standards of intellectual property protection. Ambassador Schwab of the USTR, in announcing the actions, was careful to acknowledge that China's leadership has taken proactive steps to make the protection and enforcement of intellectual property rights a priority. The USTR has argued, however, that in some specific matters China is simply not meeting its WTO commitments.

Democrats have largely applauded the decision to bring the complaint to the WTO, but suggest that it may be too little too late.³² One prominent senator declared satisfaction with the WTO complaint as a first step toward halting China's rip off of U.S. intellectual properties.³³ Another senator, concerned about how American companies continue to be harmed by Chinese counterfeiters and pirates, has introduced the Intellectual Property Rights Enforcement Act which will consolidate U.S. government intellectual property rights enforcement operations and oblige the administration to articulate a strategic plan to halt infringements.³⁴

It is interesting to note that the major intellectual property holders in the United States did not universally approve of the decision to move forward to pursue the WTO. On one hand the Recording Industry Association of America applauded the move as necessary to motivate

China to open its markets for content, thereby removing an illicit market opportunity for pirates and creating more opportunities for foreign and Chinese creators.³⁵ The Motion Picture Association of America likewise approved on the basis that the decision was a logical next step in the process to prod China to improve its intellectual property rights and offer fair market access to all.³⁶ In contrast, the Business Software Alliance asserted that constructive

dialogue was the most effective way to resolve disputes between the United States and China.³⁷ Pharmaceutical Research and Manufacturers of America (PhRMA) on the other hand was less enthusiastic. It acknowledged that the decision to move forward reflected the administration's commitment to strong intellectual property protection, which ultimately impacts the growing global counterfeit business by criminal organizations.³⁸ PhRMA emphasizes



that China has made considerable progress in the enforcement of intellectual property rights but noted that, despite such progress, criminal organizations and increasingly sophisticated networks have continued to counterfeit drugs inside and outside China. PhRMA remains committed to working with China and the United States to combat this criminal behavior. Further, it should be highlighted that the European Union decided not to join the United States in this action.

A recent article in *Business Week* gives some insight as to why the litigation model on dispute resolution with respect to intellectual property rights may be receiving less and less approval amongst businesses looking to enhance commercial cooperation with the mainland.³⁹ The crux of the article's argument is that if American multinational companies continue to spend more time in the courtroom figuring out who to blame and less time in the boardroom negotiating deals, they will forgo the many opportunities found in emerging Chinese intellectual property market. Specifically, the article argues that an ascendent middle class in China will demand quality products and it is questionable whether U.S. products will be competitive in this market. It asserts that as domestic demand for authentic intellectual property grows, the enforcement of intellectual property rights in China will improve. Clever multinational firms holding intellectual property will make sure they are in a strategic position to gain substantive market share in China.

Some companies recognize that politicizing the intellectual property issue is not productive. For instance, Microsoft, which once referred to China as the evil empire, due to its piracy and counterfeiting problems, has recently changed its tune. According to *Fortune*, Microsoft had to learn that the marketing strategy that had worked in the west, namely to protect intellectual property rights at all costs, would not work in China.⁴⁰ Microsoft started selling Windows at very low prices to win over consumer

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confidence and moving to cooperate with, rather than litigate against, the Chinese government with joint ventures. Moreover, the Intel Corporation has decided to settle a three-year old copyright dispute with Shenzhen Donjin Communication Technology Company.⁴¹ Intel had sued the southern Chinese enterprise for infringing Intel's copyright protecting high-end communications technology, Dialogics, a brand it had already sold off.⁴² In response, Donjin countersued on the basis of Intel's use of "monopolistic practices."⁴³ Intel determined that it no longer

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made strategic sense to pursue litigation and instead structured a licensing deal for the use of the technology with Donjin that is to remain confidential. Starbucks⁴⁴ and Pfizer⁴⁵ are other multinational companies that have seen at least some success in their efforts to protect foreign intellectual property in Chinese courts.

Furthermore, one must wonder whether international litigation and the consequent political wrangling only divert attention and resources from the regulatory and practical work that could be pursued cooperatively toward the improvement of the quality of intellectual properties in China. In light of the discovery of tainted petfood,⁴⁶ seafood,⁴⁷ and toothpaste,⁴⁸ as well as lead paint in toys,⁴⁹ there is greater international pressure on the Chinese government to improve the domestic internal governance of not only food and drug safety standards but also counterfeit goods. Even Chinese manufacturers will put more pressure on the Chinese government to improve quality control overall. While some Americans may believe that Chinese government decisions are made on strictly ideological grounds, the truth is probably closer to a situation where the Chinese government will find itself being asked by its own people why the United States merits greater market access when it continues to politicize rather than negotiate intellectual property rights disputes.

Over the last fifteen years, the United States, through diplomatic cajoling, has contributed to the advancement of the articulation and enforcement of intellectual property rights in China. There now exists substantive legislation to protect intellectual property rights and domestic courts that are willing to enforce it. The improvement intellectual property rights protection in China is indeed a goal in the interests of American and Chinese creative industries. In light of trepidation of some multinational industries and United States' allies, one must wonder whether, in addition to, or supplemental to, litigation, are there other ways to interact with China to move intellectual property rights protection forward. Piracy and counterfeiting are regrettably still endemic to China; will trade sanctions to force China to improve the technical standards of their laws lead to a decrease in infringements? Would it be more effective to look at more joint policing operations, made all the more difficult with each WTO action, or enhancing criminal penalties?

Conclusion

The U.S. government appears to be moving toward a more confrontational approach on bilateral trade issues with China. The United States' tendency toward litigation to resolve trade disputes is a worrying trend because it formalizes a complex process that requires nuance and agility as well as generalize complaints that need attention for the particular and specific is worrying. In addition to technical non-compliance with WTO rules, United States' trade actions seem to be driven by a fear that China is not fulfilling its promise to incorporate its spirit. In the United States, the operation of a free market and the defense of private property rights are recognized as the DNA of the U.S. economic system. In addition to, and perhaps underlying, claims that China is failing to open up its economy is a skepticism that a China, led by the Communist Party, will ever meet acceptable standards of transparent government decision-making and private property protection without our insistence.

It is critical to be aware that the People's Republic of China is not a monolithic regime simply paying lip service to some economic ideal. To the contrary, the Chinese state is a political machine struggling to come to terms with economic liberalization, the variety of costs that such a policy brings to bear on society, and the emerging demands of stakeholders with their variety of interests and power.⁵⁰ Truly, the Chinese government's ability to sustain political stability will, to a large extent, depend upon its ability to perfect this socialist market where it has failed, ensure that a rising middle class obtains good government service for its payment of taxes and create an economic environment where domestic and foreign investors continue to profit. The important question that policy makers must ask is how the United States can be most effective in facilitating such good governance.

Piracy and counterfeiting are regrettably still endemic to China; will trade sanctions to force China to improve the technical standards of their laws lead to a decrease in infringements?

While trade currently dominates the legal paradigm by which the United States evaluates and defines bilateral relations between the two countries, more serious and graver environmental and energy issues will soon be the new global imperative. Given the stakes, it will be essential that the United States discover innovative, collaborative approaches that will complement the current confrontational, litigious model of global trade and ensure that litigation remains a last resort.⁵¹ One must wonder whether the recent settlement of a trade subsidies' dispute with China⁵² will encourage the United States to bring more litigation in the World Trade Organization,⁵³ particularly with China now apparently and astonishingly, amenable to using the dispute resolution panel, at least with regard to financial information services' disputes.⁵⁴

The goal of the United States must be to create a global trade institution that is so expansive that China has no choice but to become a full participating member.⁵⁵ While the United States will not be able to curtail China's economic ascendancy, it will be in a position to ensure

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that China's authority is executed within rules and institutions that the United States and its partners have designed and that will "protect the (commercial) interests of all states in the more crowded world of the future."⁵⁶ Undoubtedly, the United States patience for China's compliance with the WTO must have limits; when those limitations have been surpassed, however, given the uncertainties associated with trade policy, the pressures surrounding foreign policy and the evolution of globalization, strategic choices must be made carefully. A fragile relationship of considerable value is emerging between the United States and China: it would be a shame to break it. **BLB**

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