

# Tangled Titans

*The United States and China*

Edited by  
David Shambaugh

ROWMAN & LITTLEFIELD PUBLISHERS, INC.  
*Lanham • Boulder • New York • Toronto • Plymouth, UK*

Published by Rowman & Littlefield Publishers, Inc.  
A wholly owned subsidiary of The Rowman & Littlefield Publishing Group, Inc.  
4501 Forbes Boulevard, Suite 200, Lanham, Maryland 20706  
www.rowman.com

10 Thornbury Road, Plymouth PL6 7PP, United Kingdom

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British Library Cataloguing in Publication Information Available

**Library of Congress Cataloging-in-Publication Data**

Tangled titans : the United States and China / edited by David Shambaugh.  
p. cm.

Includes bibliographical references and index.


ISBN 978-1-4422-1969-4 (cloth : alk. paper) — ISBN 978-1-4422-1970-0  
(pbk. : alk. paper) — ISBN 978-1-4422-1971-7 (electronic)

1. United States—Foreign relations—China. 2. China—Foreign relations—  
United States. I. Shambaugh, David L.

E183.8.C5T289 2013

327.73051—dc23

2012021175

™ The paper used in this publication meets the minimum requirements of American National Standard for Information Sciences—Permanence of Paper for Printed Library Materials, ANSI/NISO Z39.48-1992.

Printed in the United States of America

To America's China watchers  
and China's America watchers,  
in their continual and challenging effort  
to interpret the "Other"

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## The Commercial and Economic Relationship

*Charles W. Freeman III*

In the early 1970s, when the United States and China began the set of official exchanges that would attempt to map out the broad parameters of their relationship, commercial relations were essentially an afterthought. The fundamental purpose of the early overtures was geo-strategic, and trade was far from the minds of U.S. officials. Ambassador John Negroponte, who accompanied Dr. Kissinger to China in 1972, recalls colleagues at the State Department asking one another incredulously during the early years before normalization, “What are we going to buy from these people?”

In 1972, the first year the two countries resumed trade relations, the United States imported \$32.4 million in goods from China, and exported \$63.5 million in goods to China. In 2011, nearly 40 years later, U.S. imports from China were \$399.3 billion and exports were \$103.9 billion. China was the United States’ second largest trading partner after Canada in 2011 and its largest source of imports by nearly \$83 billion. By December 2011 China held \$3.2 trillion in foreign exchange reserves, largely in U.S. dollar denominated assets.<sup>1</sup> U.S. negotiators no longer wonder what China can sell the United States. Rather, U.S. officials are now confronted by a public that is increasingly alarmed at the extent to which China is a primary source of consumer goods and a major creditor of the United States.<sup>2</sup>

The explosion of China’s importance as an import source and holder of U.S. debt is not the whole story of U.S.-China economic relations. By 2011, China had been the fastest growing export market for U.S. firms for some 15 years. Between 2000 and 2011, U.S. exports to China grew by 542 percent compared to 80 percent export growth with the rest of the world.<sup>3</sup> U.S.-based multinationals with operations in China were overwhelmingly focused not

**TABLE 8.1. China's Trade with the United States, 2001–2011 (\$ billion)**

|                     | <b>2000</b> | <b>2001</b> | <b>2002</b> | <b>2003</b> | <b>2004</b> | <b>2005</b> | <b>2006</b> | <b>2007</b> | <b>2008</b> | <b>2009</b> | <b>2010</b> | <b>2011</b> |
|---------------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| <b>U.S. exports</b> | 16.3        | 19.2        | 22.1        | 28.4        | 34.7        | 41.8        | 55.2        | 65.2        | 71.5        | 69.6        | 91.9        | 103.9       |
| <i>% change</i>     | 23.9        | 18.3        | 14.7        | 28.9        | 22.2        | 20.5        | 32.0        | 18.1        | 9.5         | -2.6        | 32.1        | 13.1        |
| <b>U.S. imports</b> | 100.1       | 102.3       | 125.2       | 152.4       | 196.7       | 243.5       | 287.8       | 321.5       | 337.8       | 296.4       | 364.9       | 399.3       |
| <i>% change</i>     | 22.3        | 2.2         | 22.4        | 21.7        | 29.1        | 23.8        | 18.2        | 11.7        | 5.1         | -12.3       | 23.1        | 9.4         |
| <b>U.S. balance</b> | -83.8       | -83.0       | -103.1      | -124.0      | -162.0      | -201.6      | -232.5      | -256.3      | -266.3      | -226.8      | -273.1      | -295.5      |

Source: U.S. International Trade Commission; U.S. Department of Commerce.

on using China as an export platform, but on serving the growing Chinese domestic market. Indeed, given the slowing opportunities for new growth in mature markets in North America and Europe, U.S. multinationals had become increasingly reliant on China's market to provide significant current and long-term revenue growth.

### THE U.S. ECONOMY AS A MODEL

China's extraordinary rise from underachiever to become the world's second largest economy just over 30 years after Deng Xiaoping initiated the "reform and opening up" process parallels the expansion of relations with the United States. Indeed, while one would not want to overstate the enormity of importance the United States played in that rise as both a market and a mentor, the U.S. relationship has certainly been a critical factor. For one thing, net exports have been a significant contributor to China's gross domestic product (GDP) growth over that period (although characterizing China's economy as purely "export driven" is inaccurate), and demand from the United States has been a fundamental driver of positive export growth.<sup>4</sup> Furthermore, China's embrace of market principles and the norms of international trade were made with an eye to the United States as an economic model. While few Chinese officials have viewed the United States as an ideal for Chinese development, during the 30 years of reform and opening up between 1978 and 2007 the U.S. way was accorded tremendous deference among leading Chinese policy circles.<sup>5</sup>

During the run-up to and in the years immediately following China's 2001 accession to the World Trade Organization (WTO), PRC policymakers routinely studied U.S. economic systems with a view to their application to China's unique paradigm. The operation of U.S. banking, insurance, logistics, manufacturing, and other sectors were analyzed with almost devotional fervor. While Chinese policy professionals were always certain to warn that China's unique economic structure would make wholesale adoption of these systems impossible, the unspoken goal of the efforts to understand the U.S. economic structure was to seek to adopt as much of the underpinnings of this structure as possible while still maintaining the underlying socioeconomic oversight mandated by Communist Party control.<sup>6</sup>

China's drive to WTO accession is a useful example of the influence of the U.S. market and economic model on Chinese policymaking during the heyday of economic reform.<sup>7</sup> While the WTO accession process was fueled in part by a raw patriotic desire to achieve membership in a prestigious multilateral body, two practical economic rationales also animated the effort. First, then Premier Zhu Rongji and other reformers had decided that vested interests among Chinese state-owned enterprises and the economic bureaucracy were obstacles

**TABLE 8.2. Selected Economic and Financial Indicators, 2000–2011**

|                                       | 2000    | 2001     | 2002     | 2003     | 2004     | 2005     | 2006     | 2007     | 2008     | 2009     | 2010     | 2011     |
|---------------------------------------|---------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|
| <b>GDP</b>                            | 9,921.5 | 10,965.5 | 12,033.3 | 13,582.3 | 15,987.8 | 18,493.7 | 21,631.4 | 26,581.0 | 31,404.5 | 34,090.3 | 40,120.2 | 47,156.4 |
| <i>% growth (real GDP growth)</i>     | 8.4     | 8.3      | 9.1      | 10.0     | 10.1     | 10.4     | 11.6     | 13.0     | 9.0      | 8.7      | 10.4     | 9.2      |
| <b>Consumer price index</b>           | 0.4     | 0.7      | -0.8     | 1.2      | 3.9      | 1.8      | 1.5      | 4.8      | 5.9      | -0.7     | 3.3      | 5.4      |
| <b>Industrial value-added output*</b> | 2,539.5 | 2,832.9  | 3,299.5  | 4,199.0  | 5,480.5  | 7,218.7  | 9,107.6  | 11,704.8 | N/A      | N/A      | N/A      | N/A      |
| <i>% growth</i>                       | 17.8    | 11.6     | 16.5     | 27.3     | 30.5     | 31.7     | 26.2     | 28.5     | 12.9     | 11.0     | 15.7     | 13.9     |
| <b>Fixed-asset investment**</b>       | 3,291.8 | 3,721.3  | 4,350.0  | 5,556.7  | 7,047.7  | 8,877.4  | 10,999.8 | 13,732.4 | 17,282.8 | 22,459.9 | 27,812.2 | N/A      |
| <i>% growth</i>                       | 10.3    | 13.0     | 16.9     | 27.7     | 26.8     | 26.0     | 23.9     | 24.8     | 25.9     | 30.0     | 23.8     | N/A      |

Source: China National Bureau of Statistics. All GDP-related figures in billions of RMB.

\*All state-owned industrial enterprises and all non-state industrial enterprises with revenue from principal business of more than RMB 5 million. Beginning in 2008, NBS releases listed only the growth rate, not the absolute figure.

\*\*2011 overall fixed-asset statistics not available, though NBS has reported official fixed-asset investment statistics for China excluding rural areas, which came to RMB 30,193.3 and a growth rate of 23.8% over a similar figure from the year before. These are not comparable, however, with the overall fixed-asset investment figures reported previously.

to the development-through-reform agenda.<sup>8</sup> By seizing on the national goal of WTO membership, the reformers effectively deployed external pressures to overcome domestic intransigence to implementation of their agenda. Not surprisingly, the most active and forceful source of external pressure was the United States which, through the negotiating team led by the United States Trade Representative, sought to make China's commercial regulatory landscape as friendly to U.S. sectoral interests, and thus as similar to U.S. economic structures, as possible. This is not to suggest that the negotiations between the United States and other WTO members were not hard-fought and occasionally bare-knuckled. But the prevailing economic policymaking authorities in China were deeply enamored of the U.S. economic system, so a process that forced recalcitrant Chinese industries and bureaucracies to become more like U.S. counterparts was far from unwelcome to the architects of reform and WTO accession.<sup>9</sup>

A second major practical motivator behind China's WTO accession was a desire to overcome the embarrassment and uncertainty that was the annual "most favored nation" (MFN, also called "normal trade relations" or NTR) debate in the United States Congress.<sup>10</sup> The 1974 Jackson-Vanick amendment to U.S. trade law effectively allows the United States to treat as conditional the rights of certain, "non-market" economies to enjoy access to the United States market on terms no less favorable than any other economy with which the United States trades on a "normal" basis. While Jackson-Vanick is inconsistent with WTO rules, U.S. trade with China, as a non-member of WTO, was the subject of ferocious congressional debate each spring in the 1990s when representatives from the business and labor lobbies would descend on Capitol Hill, with representatives of religious freedom and human rights organizations and others joining the fray.<sup>11</sup> On one hand, that debate was deeply offensive to Chinese leaders that viewed the public criticism of China as an effort to interfere in Chinese internal affairs. On the other, and more alarming to the architects of Chinese economic policy, the annual debate and maintenance of China's "conditional" MFN or NTR status injected significant risk for investors into the Chinese export sector that the U.S. market was only temporarily open. Joining WTO would require the United States to accord China "permanent" NTR and thus allow greater certainty for investors in China's important export sector.

Clearly the United States was not the sole market of importance nor economic policy beacon for Beijing during the 30-year period of reform and opening up between 1978 and 2007. Chinese officials carefully studied Europe, Japan and the Asian tigers for policy elements that worked and might have application for Chinese development.<sup>12</sup> But in many respects, many Chinese economic thinkers viewed the United States economy as the gold standard,

and policymakers took seriously the policy recommendations of U.S. counterparts. For the better part of the years leading up to WTO accession and the six years that followed, standard practice among U.S. trade negotiators when faced with Chinese trade policies they did not like was to negatively contrast those policies with U.S. standards. While this certainly did not guarantee a fix to the policies, it almost always guaranteed a respectful audience.<sup>13</sup>

### Financial Crisis and Revelation

The post-2008 global economic crisis changed that dynamic dramatically. The rapid unraveling of the U.S. financial markets, the revelation of previously undisclosed hazards, and the fragility of the U.S. economy to credit risks were deeply alarming to many Chinese that had staked their professional lives and reputations on aspirations to achieve American-style economic systems. As Vice Premier Wang Qishan noted in 2008 with both sarcasm and understatement: "The teachers now have some problems."<sup>14</sup> The public reaction among Chinese commentators to the crisis and the apparent humbling of the "teachers" was a hysterical mix of outraged betrayal, embarrassment at having been "hoodwinked," and nervousness at being set adrift in uncertain economic waters. The crisis also sparked a furious debate about why China emerged from the crisis in relatively robust economic health, and an attempt to define and put forward China's unique economic model as having been successful *because* of the differences from U.S. and other Western economies, rather than because of the similarities or borrowed policies.<sup>15</sup>

In any case, the crisis effectively ended the automatic granting of a respectful audience to U.S. trade negotiators and economic policymakers who seek to counsel Chinese officials on the "correct" (i.e., American standard) way of doing things. Whether or not the "China model," loosely defined by some commentators as referring to "state directed capitalism," is an effective alternative to U.S. and other Western models to deliver long-term sustainable and equitable development, Chinese officials are increasingly convinced that they no longer have much to learn from American counterparts on economic matters.<sup>16</sup> At the same time, political interests in the United States increasingly view trade with suspicion and see China as a peer competitor in strategic, economic and normative terms; chipping away at the 60-year consensus that supported a global liberalized trade agenda and viewed constructive engagement with China as a *sine qua non* of a successful Asia-Pacific diplomatic strategy.<sup>17</sup> As a result, the already testy trade relationship between the two countries, beset by public suspicions of unfairness in both countries, has become that much less simple for the two governments to manage.<sup>18</sup>

### Public Mistrust

The disconnect in perceptions between the two countries on their economic relationship is palpable. While many Americans believe that China is singularly responsible for the hollowing out of the U.S. manufacturing sector, many Chinese believe that U.S. policy is deliberately aimed at maintaining China as a low-value, labor-intensive economy. A common Chinese narrative portrays U.S. and other foreign interests as carefully constraining Chinese production to final processing of goods of which the lion's share of the value is owned and controlled by U.S. and other foreign interests. Both officials and members of the Chinese public frequently complain that foreigners are profiting excessively from China's export machine, either by hoarding rights to higher value components of Chinese-assembled goods, or by commanding retail prices from final consumers that represent dramatic mark-ups to the price paid to Chinese suppliers.<sup>19</sup> This sense that China needs to reassert control over a larger share of the value of goods that pass through the Chinese supply chain is reflected in a variety of policies that add to suspicions among Americans that China is seeking to undercut comparative advantages of the United States.<sup>20</sup> A 2010 American Chamber of Commerce survey indicated growing concerns among U.S. businesses in China about discriminatory government regulations that favor domestic companies and other policies that limit market access to sectors that had been open to foreign investment for the past 30 years.<sup>21</sup> A CNN poll in November 2010 revealed that 58 percent of American respondents saw "China's wealth and economic power" as a threat to the United States compared to 35 percent who saw it as an opportunity.<sup>22</sup>

### A HAPPY INTERDEPENDENCE

The shifting paradigm and the rancorous political overtones of the U.S.-China economic relationship emanating from both Washington and Beijing tend to obscure the essential feature of that relationship: for most of the decade from 1998–2008 during which trade relations between the United States and China exploded in importance, the two economies have been intimately interdependent and remarkably complementary. While the prevailing political narrative in the United States is that China's economic success has been a result of U.S. manufacturers shifting jobs and production to China as imports from China displace goods made in the United States, that traditional story does not bear up under rigorous scrutiny.

For one thing, the story fails to account for the realities of the hyper-efficient global supply chain.<sup>23</sup> What we buy from China and what we sell to



China have been, for the great majority of the last 30 years, very different. We have been in large part buying products from China of which our manufacturers ceased final assembly years prior to China's arrival on the international trade scene. Final production of electronics, toys, garments, and other labor-intensive goods began migrating from Hong Kong, Japan, Taiwan and Korea to mainland China in the 1990s and, while those economies maintained footholds in the supply chain that led to China, the origin of U.S. imports of these goods began to be stamped "Made in China" at that time. This phenomenon has resulted in a relative (as a percentage of GDP) reduction of the trade deficit from other Asian markets even as the U.S. deficit with China has ballooned to compensate.<sup>24</sup> Taken together, however, the U.S. deficit with Asia has remained fairly constant relative to GDP, so discerning unique employment and manufacturing losses to China is hard to pinpoint by product category.

On the other hand, the United States primarily sells products to China that are not made competitively in China, such as higher-end technology and manufactured goods; branded products; and agricultural goods that China struggles to produce domestically to meet expanding consumer demands. For these sectors, the primary source of competition for the United States is not China or developing Asia. Rather, it is Japan and Western Europe. While some stages of goods production have shifted from the United States to China in the past 30 years, U.S. exports to China and production of higher-value inputs that are embodied in Chinese-assembled goods are an important part of the China trade story.<sup>25</sup>

A significant problem with identifying which imports from China might be displacing U.S. production is that the dynamic global supply chain has made bilateral and even regional trade statistics relatively meaningless.<sup>26</sup> Quite simply, the statistical methodology utilized to determine the origin of an import assigns the full value of an import to the country in which the good in question was finally assembled. An enormous number of products that Americans buy from China are *processing trade goods*. That is, the only value that China adds to the goods is the labor required to assemble a number of inputs exported to China from East Asia, primarily, but also other parts of the world, including the United States. In other words, a good assembled in China may contain technology produced in Taiwan, Japan, Korea or Thailand under license from a U.S. intellectual property owner. The value of the other inputs, particularly that of the U.S. intellectual property, may vastly exceed that of the Chinese value added, but the imported product is treated for statistical purposes as having been designed and built completely within China.

**TABLE 8.3. U.S. Trade Deficit with China and Other Countries, 2000–2011**

|                           | 2000       | 2001       | 2002       | 2003       | 2004       | 2005       | 2006       | 2007       | 2008       | 2009       | 2010       | 2011       |
|---------------------------|------------|------------|------------|------------|------------|------------|------------|------------|------------|------------|------------|------------|
| <b>China</b>              | -83,833.0  | -83,096.1  | -103,064.9 | -124,068.2 | -162,254.3 | -202,278.1 | -234,101.3 | -258,506.0 | -268,039.8 | -226,877.2 | -273,063.2 | -295,456.5 |
| <b>% of trade deficit</b> | 19.2       | 20.2       | 22.0       | 23.3       | 24.8       | 26.2       | 28.3       | 32.0       | 32.8       | 45.1       | 43.0       | 40.7       |
| <b>Other East Asia</b>    | -142,763.6 | -121,955.6 | -126,258.0 | -123,330.1 | -141,534.7 | -152,500.1 | -162,109.5 | -146,891.7 | -126,677.9 | -84,937.0  | -94,220.9  | -99,037.1  |
| <b>% of trade deficit</b> | 32.7       | 29.6       | 27.0       | 23.2       | 21.6       | 19.7       | 19.6       | 18.2       | 15.5       | 16.9       | 14.8       | 13.6       |
| <i>Brunei</i>             | -227.5     | -295.0     | -240.7     | -385.0     | -358.0     | -513.1     | -502.2     | -264.9     | -2.7       | 58.6       | 112.3      | 160.9      |
| <i>Burma</i>              | -453.8     | -458.5     | -346.1     | -268.8     | 11.7       | 5.4        | 7.5        | 8.7        | 10.8       | 6.8        | 9.7        | 48.8       |
| <i>Cambodia</i>           | -793.9     | -932.9     | -1,041.8   | -1,204.2   | -1,438.5   | -1,697.3   | -2,113.9   | -2,324.6   | -2,257.3   | -1,797.1   | -2,147.0   | -2,526.6   |
| <i>Hong Kong</i>          | 3,133.0    | 4,381.4    | 3,266.2    | 4,699.3    | 6,513.5    | 7,459.3    | 9,795.5    | 12,875.7   | 15,015.2   | 17,479.6   | 22,274.1   | 32,214.8   |
| <i>Indonesia</i>          | -7,965.2   | -7,583.0   | -7,087.6   | -6,998.7   | -8,139.1   | -8,960.4   | -10,346.2  | -10,331.6  | -10,154.7  | -7,831.6   | -9,532.2   | -11,696.4  |
| <i>Japan</i>              | -81,555.0  | -69,021.6  | -69,979.4  | -66,032.4  | -76,236.5  | -83,323.1  | -89,721.8  | -84,303.8  | -74,120.4  | -44,669.5  | -60,059.6  | -62,643.0  |
| <i>Laos</i>               | -5.4       | -0.1       | 1.4        | 0.6        | 2.5        | 5.6        | -1.7       | -14.5      | -24.1      | -23.1      | -47.1      | -32.8      |
| <i>Malaysia</i>           | -14,630.9  | -12,962.6  | -13,665.3  | -14,526.1  | -17,328.7  | -23,224.3  | -24,089.1  | -20,948.3  | -17,786.6  | -12,879.3  | -11,820.5  | -11,553.9  |
| <i>Mongolia</i>           | -99.2      | -131.8     | -95.5      | -162.6     | -211.0     | -121.8     | -90.8      | -57.5      | 4.5        | 25.7       | 103.9      | 302.3      |
| <i>North Korea</i>        | 2.6        | 0.5        | 25.0       | 8.0        | 22.3       | 5.8        | 0.0        | 1.7        | 52.2       | 0.9        | 1.9        | 9.4        |
| <i>Singapore</i>          | -1,372.0   | 2,651.8    | 1,415.5    | 1,422.4    | 4,027.0    | 5,356.0    | 6,057.5    | 7,224.9    | 11,968.7   | 6,526.9    | 11,590.2   | 12,282.3   |
| <i>South Korea</i>        | -12,477.7  | -13,000.8  | -12,996.0  | -13,156.8  | -19,981.2  | -16,209.8  | -13,584.5  | -13,160.6  | -13,400.4  | -10,603.7  | -10,028.9  | -13,130.5  |
| <i>Taiwan</i>             | -16,096.7  | -15,252.6  | -13,766.2  | -14,151.5  | -13,038.4  | -13,211.3  | -15,502.5  | -12,448.9  | -11,399.8  | -9,876.5   | -9,802.6   | -15,429.4  |
| <i>Thailand</i>           | -9,768.1   | -8,737.6   | -9,932.7   | -9,343.2   | -11,210.5  | -12,633.1  | -14,550.9  | -14,418.2  | -14,471.7  | -12,164.1  | -13,716.2  | -13,898.5  |
| <i>Vietnam</i>            | -453.8     | -592.8     | -1,814.8   | -3,231.1   | -4,169.8   | -5,438.0   | -7,466.4   | -8,729.8   | -10,111.6  | -9,190.6   | -11,158.9  | -13,144.5  |
| <b>Overall U.S.</b>       | -436,103.0 | -411,899.0 | -468,262.0 | -532,350.0 | -654,828.5 | -772,374.2 | -827,970.0 | -808,765.0 | -816,200.0 | -503,582.0 | -634,896.0 | -726,714.0 |
| <b>Trade Deficit</b>      |            |            |            |            |            |            |            |            |            |            |            |            |
| <b>U.S. GDP</b>           | 10.0       | 10.3       | 10.6       | 11.1       | 11.9       | 12.6       | 13.4       | 14.0       | 14.3       | 13.9       | 14.5       | 15.1       |
| <b>(U.S.\$ trillion)</b>  |            |            |            |            |            |            |            |            |            |            |            |            |

Source: U.S. Census Bureau. Figures listed are in millions of U.S. dollars unless otherwise listed.

## SHIFTING SANDS AND THE REBALANCING AGENDA

The post-2008 global financial crisis was not only a psychological shock to those in China that believed in the fundamental health of the U.S. economy and the wisdom of U.S. economic policy, it was also an important turning point in assumptions about the long-term sustainability of the two countries' respective economic structures. As the investment bank Lehman Brothers collapsed in September 2008, household consumption in the United States as a percentage of GDP was over 70 percent, with real consumption having grown faster than GDP growth since 1980. Chinese household consumption, though growing in real terms, had fallen relative to GDP to around 35 percent of GDP by the fall of 2008.<sup>27</sup> The two economies were effectively mirror images of one another, with U.S. consumption reaching unsustainable excesses fueled in no small part by deficit spending enabled by cheap credit, while Chinese consumption was taking a backseat to investment and exports as the primary drivers of its economy. To U.S. and Chinese economic officials, the long-term sustainability of a system in which the appetite of U.S. consumers for imports above and beyond their ability to pay for them absent the willingness of exporters, China chief among them, to finance these consumption excesses, was clearly dubious.

The two governments have devoted much time and energy, independently and in consultations with each other, to the concept of economic rebalancing. President Obama pledged to double U.S. exports in five years and has initiated a series of programs designed to stimulate new, productive investment (including efforts to attract FDI from China).<sup>28</sup> China's 12th Five-Year Plan, unveiled in the spring of 2011, is almost completely focused on the concept of rebalancing, with the emphasis on boosting domestic consumption by reducing public concerns about the lack of a social safety net and shifting production to higher-value goods and services.<sup>29</sup>

Recognizing the unsustainability of and committing to reform the structural weight of various components of GDP is one thing. Implementing corrections to the relative imbalances by restructuring their respective economies is quite another. Any significant move to reduce long-term consumption in the United States and reduce excessive reliance on investment and exports in China will require both massive re-allocations of capital and enormous reserves of political will, neither of which would be in ample supply even in the best of times. With the global economy still beset by fragilities and with both the United States and China in the midst of difficult political transitions, acting to curb traditional sources of growth in either economy while hoping other sources will compensate is necessarily a leap of faith. Any move that acts to increase unemployment in either country would be an act of political suicide for that country's respective leadership.

**TABLE 8.4. GDP by Expenditure Approach, 2000–2011**

|  | 2000    | 2001     | 2002     | 2003     | 2004     | 2005     | 2006     | 2007     | 2008     | 2009     | 2010     | 2011* |
|--|---------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|-------|
| <b>GDP (by expenditure approach)</b>     | 9,874.9 | 10,902.8 | 12,047.6 | 13,663.5 | 16,080.0 | 18,713.1 | 22,224.0 | 26,583.4 | 31,490.1 | 34,631.7 | 39,430.8 | N/A   |
| <b>Final Consumption Expenditures</b>    | 6,151.6 | 6,693.4  | 7,181.7  | 7,768.6  | 8,755.3  | 9,905.1  | 11,263.2 | 13,151.0 | 15,234.7 | 16,682.0 | 18,690.5 | N/A   |
| <b>% of total GDP</b>                    | 62.3    | 61.4     | 59.6     | 56.9     | 54.4     | 52.9     | 50.7     | 49.5     | 48.4     | 48.2     | 47.4     | N/A   |
| <i>Household Consumption</i>             | 4,585.5 | 4,943.6  | 5,305.7  | 5,765.0  | 6,251.9  | 7,265.3  | 8,210.4  | 9,651.0  | 11,059.5 | 12,113.0 | 13,329.1 | N/A   |
| <i>Government Consumption</i>            | 1,666.1 | 1,749.8  | 1,876.0  | 2,003.6  | 2,233.4  | 2,639.9  | 3,052.8  | 3,590.0  | 4,175.2  | 4,569.0  | 5,361.4  | N/A   |
| <b>Gross Capital Formation</b>           | 3,484.3 | 3,976.9  | 4,556.5  | 5,596.3  | 6,916.8  | 7,785.7  | 9,295.4  | 11,094.3 | 13,832.5 | 16,446.3 | 19,169.1 | N/A   |
| <b>% of total GDP</b>                    | 35.3    | 36.5     | 37.8     | 41.0     | 43.0     | 41.6     | 41.8     | 41.7     | 43.9     | 47.5     | 48.6     | N/A   |
| <i>Gross Fixed Capital Formation</i>     | 3,384.4 | 3,775.5  | 4,363.2  | 5,349.1  | 6,511.8  | 7,423.3  | 8,795.4  | 10,394.9 | 12,808.4 | 15,668.0 | 18,234.0 | N/A   |
| <i>Change in Inventories</i>             | 99.8    | 201.5    | 193.3    | 247.2    | 405.1    | 362.4    | 500.0    | 699.5    | 1,024.1  | 778.3    | 935.1    | N/A   |
| <b>Net Exports of Goods and Services</b> | 239.0   | 232.5    | 309.4    | 298.6    | 407.9    | 1,022.3  | 1,665.4  | 2,338.1  | 2,422.9  | 1,503.3  | 1,571.2  | N/A   |
| <b>% of total GDP</b>                    | 2.4     | 2.1      | 2.6      | 2.2      | 2.5      | 5.5      | 7.5      | 8.8      | 7.7      | 4.3      | 4.0      | N/A   |

Source: China National Bureau of Statistics. All GDP-related figures in billions of RMB.

\*2011 statistics not yet available from the National Bureau of Statistics.

A grand bargain on rebalancing is therefore almost certainly unattainable. Instead, each side is left to its own independent efforts while attempting to cajole the other side into not making damaging moves. For China, that requires that the United States not limit access for Chinese exports (as China attempts to transition to lesser reliance on those exports) or restrict access for Chinese capital into U.S. assets that may be more productive in the long-term than sovereign U.S. debt instruments. For the United States, that means China's market to U.S. exports be increasingly welcoming; and Chinese policies and practices that act to reduce the United States' global competitiveness be reduced.

Rebalancing is not the only agenda item in U.S.-China economic policy: both sides are attempting to jockey for greater competitive positions in an economic world in which the United States (with Europe) has a reduced role; and China (along with India, Brazil, and other fast-growing large emerging economies) has increasing punching power. Since some of the policies designed to promote preferences for domestic growth can be said to create competitive barriers for non-domestic firms, these policies themselves have near term consequences for both the rebalancing agenda and for efforts to reduce economic frictions between the two sides.<sup>30</sup>

## POINTS OF CONTENTION

### Currency

In 2003, a group of American industrial firms and labor organizations first began to lobby Congress and the Bush administration on the fact that the Chinese currency, the *renminbi* or RMB, was undervalued relative to the U.S. dollar and offered an unfair competitive advantage for Chinese exporters to the United States. Senator Charles Schumer of New York and others took up their cause and began to push for legislation that would levy a 27.5 percent tariff on Chinese imports to correct for the undervaluation of the RMB.<sup>31</sup>

Most credible observers, while differing on the extent to which the RMB is undervalued, agree that the value of China's currency is systematically repressed by Chinese intervention in global currency markets on a massive scale.<sup>32</sup> Clearly, if the RMB is undervalued, it ensures that Chinese products will cost less on global markets than they otherwise would and that the RMB's value acts as a *de facto* export subsidy for Chinese manufacturers. For international economic purposes, the undervaluing of the currency of the world's second largest economy has an undeniable distortive effect, reducing the ability of some markets of comparable development and economic structure to compete with China. In this regard, many observers suggest the undervaluation of the RMB acts as a distinct drag on global growth.<sup>33</sup>

**TABLE 8.5. RMB/USD Exchange Rate and U.S. Trade Deficit, 2000–2011**

|  | 2000 | 2001 | 2002  | 2003  | 2004  | 2005  | 2006  | 2007  | 2008  | 2009  | 2010  | 2011  |
|--|------|------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
| <b>Exchange Rate, RMB/USD</b>                    | 8.28 | 8.28 | 8.28  | 8.28  | 8.28  | 8.07  | 7.80  | 7.29  | 6.82  | 6.83  | 6.60  | 6.29  |
| <b>% Appreciation</b>                            | 0.0  | 0.0  | 0.0   | 0.0   | 0.0   | 2.5   | 3.3   | 6.5   | 6.5   | 0.0   | 3.3   | 4.6   |
| <b>U.S. Trade Deficit with China (\$U.S. bn)</b> | 83.8 | 83.1 | 103.1 | 124.1 | 162.3 | 202.3 | 234.1 | 258.5 | 268.0 | 226.9 | 273.1 | 295.5 |

Sources: U.S. Federal Reserve Bank of New York, [http://www.federalreserve.gov/releases/h10/hist/dat00\\_ch.htm](http://www.federalreserve.gov/releases/h10/hist/dat00_ch.htm); U.S. Census Bureau, <http://www.census.gov/foreign-trade/balance/>.

Note: RMB exchange rate listed is that at the closing of the last trading day of the calendar year. Calculation made by subtracting a given year's figure from the previous year's figure, then dividing by the previous year's figure.

Empirical evidence suggests, however, that even taking into account relatively high estimated values for the RMB, the landed U.S. costs of many products produced in China are still below those at which they can be competitively produced in the United States under similar conditions particularly since, as discussed above, most of the products imported from China into the United States have replaced products imported from other countries rather than supplanted U.S. produced goods. This suggests that even if China revalued the RMB to the extent that global trade patterns were altered, production in China would not revert to the United States but would instead go to third country markets and be exported to the United States from there. With this in mind, while some U.S. products may compete with Chinese imports, the overall effect for domestic U.S. economic purposes has been to repress consumer prices for goods and, on the margin, reduce the ability of Chinese firms to source goods from the United States.<sup>34</sup>

Against a backdrop of double-digit unemployment in the United States, the trade deficit with China is strong political brew, and the undervaluation of China's currency has emerged as the most potent issue.<sup>35</sup> Commentators from the left and right have made explicit linkages between the undervaluation of the RMB and lost American employment opportunities. Whether or not the undervaluation of the RMB is a significant bilateral trade issue between the United States and China, the issue continues to crowd out discussion of other issues in the relationship. Although by the summer of 2011 the RMB had appreciated against the dollar in real terms some 27.5 percent (the amount of undervaluation originally identified and the amount of the punitive tariff originally sought by Senator Schumer in his 2004 legislation), the United States Senate in October 2011 formally passed China-focused (though not country-specific) legislation seeking to apply punitive tariffs against currency manipulators. Although this particular legislation is unlikely to achieve bicameral passage, currency will continue to be a focus of political debate about the U.S. economic relationship with China.<sup>36</sup>

At times the politicization of the currency issue in the United States has frustrated members of Chinese officialdom who support a more liberalized exchange rate regime.<sup>37</sup> These officials have quietly complained to U.S. interlocutors that the perceived interference of U.S. officials in China's sovereign decisions with respect to currency management has limited the ability of institutions like the People's Bank of China (PBOC) to make changes in the exchange rate regime for Chinese domestic purposes for fear of criticism that they were kowtowing to American interests. Secretaries of Treasury Henry "Hank" Paulson in the George W. Bush administration and Timothy Geithner of the Obama administration have sought to publicly play down the issue with China in order to give the PBOC political space to make the case internally

within China that a liberalized exchange rate regime would ease pressures on China's financial system and give the PRC government additional tools to manage inflation.<sup>38</sup> However, even absent express U.S. pressure to revalue the RMB, the PBOC has had its hands full with resistance from other parts of the Chinese bureaucracy.

In a late 2003 meeting with a then vice governor of the PBOC, the author raised the issue of China's currency valuation as having political implications in the United States because of the perceived impact on manufacturing job losses. The vice governor shook off an exasperated look and said, in essence, "In China we need to come up with 50,000 new jobs a day to keep ahead of new labor market entries and lay-offs at the State-Owned Industries. The domestic politics of that fact far outweigh international political factors for our government." Indeed, the currency issue is widely viewed outside of the PBOC, notably within the Ministry of Commerce (MOFCOM), as a jobs issue for China. MOFCOM officials and affiliated intellectuals privately suggest that the Chinese export sector, which continues to play an important role in ensuring new growth and has been a consistent source of employment among coastal firms, is heavily reliant on the de facto subsidy of the undervalued RMB. Economist Nicholas Lardy at the Peterson Institute of International Economics has tracked the rise in value of the RMB over the past eight years and showed that China's current account surplus has actually increased as the RMB has increased in value, suggesting that exporters have faced little or no hardship as a result of RMB appreciation.<sup>39</sup> However, many Chinese officials believe that the low margins generated by most Chinese export firms will not sustain those firms in the event of significant RMB appreciation absent a major downsizing by these firms.

In practice, rising wages among many coastal centers for export industries have put significant pressure on export firms to relocate to less costly areas in the past few years. The increased value of the RMB may be exacerbating these pressures, but Chinese economic policymakers are less focused these days on maintaining low margin, low value-added production in traditional export-intensive geographies and more focused on delivering strategies that improve margins and value for the firms in these geographies.<sup>40</sup>

### **Intellectual Property Rights and Technology Transfer**

One of the most long-standing areas of contention between the United States and China is the concern over the extent to which U.S. intellectual property is misappropriated by Chinese businesses and individuals.<sup>41</sup> Starting as early as the 1980s copyrighted music, films and software along with branded garments with U.S.-origin trademarks began appearing in pirated form in larger Chinese

cities. Copyright piracy and trademark infringement was already rampant at that time in Hong Kong, Taiwan, and other markets in Asia but after migrating to China it achieved a scale for which U.S. industry was unprepared. In the late 1990s and thereafter Chinese firms began to produce counterfeit versions of patented products as diverse as pharmaceuticals and industrial machines. On one level, the sheer moxie and remarkable duplicative skills of Chinese pirates and counterfeiters is astounding. On another, the losses to American innovators and manufacturers from IPR theft are unconscionable.

In any case, even before China joined the WTO and signed onto the Agreement on Trade-Related Aspects of Intellectual Property Rights, the practice of piracy and counterfeiting was illegal under Chinese law. Prior to WTO accession the U.S. and Chinese governments engaged in brinkmanship on the issue a number of times, with the United States coming close to invoking punitive tariffs on Chinese imports to compensate for the perceived losses to IPR violations.<sup>42</sup> After China joined the WTO and put in place a new and extensive regime to protect and enforce IPR, American negotiators were hopeful that the problem of IPR violation in China would be curbed once and for all. Nevertheless, enforcement of China's IPR laws has been distinctly lacking and U.S. rights-holders continue to experience dramatic losses due to Chinese piracy and counterfeiting.

A May 2011 U.S. International Trade Commission report estimated that losses to U.S. industry due to Chinese IPR theft were approximately \$48 billion in 2009, a number that may be understated given that it was based solely on a survey of firms in the IP-intensive part of the U.S. economy.<sup>43</sup> These firms reported that an improvement in China's IPR protection and enforcement to levels comparable to the United States' would likely increase U.S. employment in their operations by approximately 923,000 jobs.

One of the primary challenges to those seeking to prevent the unopposed theft of their IPR is that China's extreme geographic and political decentralization makes it very difficult for rights-holders to pursue legal protection and enforcement of their rights without having to run a gamut of local and provincial officials and courts that are more likely to side with local violators with more local political clout.<sup>44</sup> When rights-holders are successful at seeking legal redress for their grievances in court, they are frequently awarded damages that are *de minimis*—barely adequate to cover legal costs let alone serve as a deterrent of future IPR theft. For many recidivist IPR pirates and counterfeiters, legal fines are an unfortunate but bearable cost of doing business: the rewards for piracy far outweigh the risks.

A primary complaint of Chinese economic policy officials is that China's economy, while it has grown exponentially in the past 30 years, remains on the low end of industrial input values. Searching for a means to bring Chinese

industry up the value chain, some of these policymakers have seized on an effective IPR regime as an important means to an end. If China can better protect IPR, so the theory goes, China's domestic inventors and entrepreneurs will have a greater incentive to build Chinese technology companies and brands. There is thus a highly energized cadre of Chinese officials that understand the importance of IPR to an innovative economy and are seeking to establish a more effective system of IPR protection and enforcement not because of an interest in protecting foreign business interests, but promoting domestic Chinese innovation.<sup>45</sup>

This cadre of officials is bolstered somewhat by the increasing attention of China's most senior leadership to the importance of innovation to China's future growth plans. China's desire for technological advancement is a longstanding obsession. As early as the mid-1970s, China's Premier Zhou Enlai espoused the goal of "Four Modernizations," among which technological modernization was prominent. In the 1980s and 1990s, China sought to increase its technology base through technology transfer, attempting through incentives to encourage Western companies to incorporate higher technology platforms into their production bases.

But China's effort to seek technology transfer, through incentives or (occasional) coercion, has been less than successful. Some Chinese individuals and firms, not necessarily with state sponsorship, have on occasion attempted to access higher technologies from the United States and other Western economies through industrial espionage. But in most cases, U.S. companies have largely abstained from large-scale transfers of technology to China. Chinese officials in many cases suggest that the reason for such abstention is U.S. export control laws. In practice however, the reason for China's lack of success in encouraging technology transfer is not U.S. policy but rather a rational U.S. company approach to risks associated with exposure of technology to the Chinese market: intellectual property theft is so rampant that rational companies think long and hard before willingly exposing their first-line technologies to the Chinese marketplace.

### Domestic Preferential Policies and Market Access

China today is a world leader in technology applied in communications, alternative energy, rail and other sectors. High-tech manufactured goods accounted for 35 percent of China's exports in 2011.<sup>46</sup> Year-on-year growth in Chinese patent filings is astronomical: in 2010 the number of Chinese-filed patents grew by 56.2 percent, while U.S.-filed patents dropped by 1.7 percent.<sup>47</sup> China graduated 10,000 Ph.D. engineers in 2010 while the United States graduated just 8,000 (and of those who are Chinese or of Chinese descent, many have plans to seek



their professional fortunes in China).<sup>48</sup> China's drive to build an enterprise-led "indigenous innovation" capacity has set off alarm bells among multinational companies and the popular press.<sup>49</sup>

In 2006 China's State Council published an ambitious science and technology program to establish China as an innovative nation by 2020. The program outlines a planned expenditure of 2.5 percent of GDP on research and development, such that "by 2020, the progress of science and technology will contribute 60 percent or above to the country's development. Meanwhile, the country's reliance on foreign technology will decline to 30 percent or below. The number of patents granted to Chinese nationals and the introduction of their academic essays are expected to rank among the first five throughout the world."<sup>50</sup>

A national goal to increase technological innovation is laudable both for reasons of economic development and national pride. There are important reasons for China's leadership to focus on improving China's technological capabilities. President Hu Jintao and Premier Wen Jiabao recognized early in their tenure that the economic strategy of the past three decades, one that relies heavily on inputs of land, labor, capital and natural resources, is unsustainable for demographic, environmental and sociopolitical reasons.<sup>51</sup>

Although Chinese capacity to adopt and adapt existing technologies (itself a form of innovation) has been impressive, China's manufacturing prowess remains decidedly low-tech. Indeed, a World Bank study in 2008 suggested that the skill intensity of China's exports remains unchanged since 1992 after adjusting for Chinese processing trade, the business activity of importing all components and accessories from abroad and re-exporting the finished products after processing or assembly by enterprises in China.<sup>52</sup> Stories of remarkable Chinese innovators such as telecommunications giant Huawei aside, Chinese industry today is a combination of a small number of innovators together with a large number of non-innovating manufacturers, the vast majority of whom do not engage in continuous R&D activities.

Hu Jintao's 2005 articulation of the "scientific development strategy" has at its center the notion that China's long-term prosperity requires an economy based more on efficiency and knowledge than on primary inputs.<sup>53</sup> Challenging Chinese enterprises to become more competitive through innovation is therefore highly rational. For the enterprises to respond appropriately, however, their focus must be on serving the ultimate goal of sustaining Chinese economic development, and not simply innovating for innovation's sake.

The lessons to date of China's efforts to become an innovative economy are several. The first is that an unquestioning focus on innovation without linkage to genuine economic development may frustrate the ultimate goal of the effort. A broad definition of innovation that includes not only development

of frontier technologies but also adaptive and adoptive technology may better serve the goals of long-term job and wealth creation. To that end, focusing on limiting reliance on foreign technology in pursuit of techno-nationalist goals may be to limit the growth of knowledge and efficiency in the country. The stated goal of reducing to 30 percent China's reliance on foreign technology looks an awful lot like the failed import substitution policies of the past, and is a rather marked departure from the open market policies that have fueled much of China's success to date.

The second lesson is that China's government must recognize where its efforts to promote innovation end, and where those of the market begin. To date, much of the innovation drive has concentrated on promoting research and development in large, state-owned enterprises (SOEs) that are less susceptible to incentives that have traditionally yielded invention and innovation. R&D effectiveness, that is, results for a given level of R&D expenditure and employment, is statistically much lower for SOEs than domestic private firms. Although a crude metric, private firms file more patent applications per million RMB of R&D expenditures, and own more patents per 100 scientists and engineers employed, than do their SOE counterparts. Relying on SOEs to innovate in a way that genuinely delivers economic growth is not an efficient proposition.

Finally, if private firms are likely to be better innovators than state-owned behemoths, China must improve its enforcement of IPR in order to reward them for their inventions. SOEs, with more political power, may be better positioned to protect their inventions from copycats and pirates, but the private companies that ultimately can be more globally competitive are not going to have the incentive to invent. Indeed, a 2007 study of the National Bureau of Statistics showed some 86 percent of medium-sized firms and 96 percent of small firms did not engage in any R&D at all.

### Cross-Border Investment

The past decade has seen an unprecedented boom in Chinese investment flows to the United States. China has been using its massive dollar reserves to purchase U.S. Treasury bills and it is now the largest foreign holder of treasury securities. By February 2012, China held U.S.\$1178.9 trillion in treasuries (Japan, the second largest holder, held U.S.\$1095.9 billion).<sup>54</sup> Moreover, China's Outward Foreign Direct Investment (OFDI) to the U.S. has also soared in recent years. In both 2009 and 2010, the value of China's direct investment assets in the United States increased by 130 percent. The total OFDI flow in 2010 was in the vicinity of U.S.\$5.3 billion, bringing accumulated Chinese direct investment in the U.S. to roughly U.S.\$11.6 billion since 2003.<sup>55</sup>

With the growing amount of Chinese investment inflows, there is an increasing concern among some in the United States that China's investment in the United States is a strategic endeavor of the Chinese government, and one not made based on solely commercial merits, but rather as part of a larger government policy to secure access to natural resources and core technology for China's rapidly growing economy.<sup>56</sup> The subsequent conclusion is that the security of U.S. strategic assets and technology may be threatened by China's government-controlled investment. On the other hand, those who support increased investment from China assume that the United States is able to encourage further investment flows from China through lobbying the Chinese central leadership, operating under the perception that the investment is entirely government controlled.

China's investment flows to the United States are through: (1) The People's Bank of China (PBOC) using the majority of China's foreign reserves to invest in U.S. debt; (2) China's sovereign wealth funds using part of China's foreign reserves to invest in U.S. equities; and (3) China's outward foreign direct investment, in both greenfield transactions as well as mergers and acquisitions (M&A). Among them, the Chinese government exerts tight control over the first and second category of investment, while the third category is partly government controlled and partly market driven.

China's reserves, which have increased significantly since 2000, reached U.S.\$3.2 trillion in June 2011 and now account for around one-third of the global total. Around 70 percent of this is estimated to be denominated in U.S. dollars.<sup>57</sup> Between 2000 and 2005, the bulk of Chinese foreign reserves went to purchase U.S. treasury securities. In response to dollar volatility concerns, however, China's leadership has adopted a more risk-averse investment strategy that aims to diversify into commodities and other hard assets, including equities and OFDI, particularly in resources and technology.<sup>58</sup>

The United States is of two minds on the question of Chinese investment. On the one hand, there is widespread enthusiasm for any new source of investment capital. On the other hand, concerns that Chinese investment is largely driven by strategic Chinese national considerations that may not align with U.S. national security interests make many U.S. policymakers nervous about Chinese investment in "strategic" technology and resource assets. High-profile efforts by the Chinese National Overseas Oil Company to acquire Unocal and Huawei to acquire a division of 3COM failed after intensive scrutiny by the Committee on Foreign Investment in the United States (CFIUS) because of these considerations.<sup>59</sup>

Despite fears among American policymakers that the goal of China's external investment strategy is to put national security considerations ahead of firm-by-firm profitability, the evidence suggests that most companies, whether

state owned or private, are typically driven by profit maximization ahead of any national strategy.<sup>60</sup> Bad overseas investments by state energy companies in particular have received scathing treatment in Chinese popular media, and their proponents within the Chinese government have been criticized for wastefulness. Therefore, it is unlikely that the Beijing authority has a free hand to push non-market-driven OFDI initiatives by fiat in support of narrow security interests. To the extent to which the OFDI strategy is driven by a desire to diversify foreign exchange holdings, channeling these funds to private Chinese firms to invest overseas may be more politically palatable and may be driven by more rational, market-oriented concerns than those of the larger SOEs.

### Industrial Policy

As noted above, the return of industrial planning to the fore of Chinese economic policymaking is a major challenge to market-oriented businesses in China, including U.S. businesses. Policies that encourage the development of one business sector to the disadvantage of another have long been a factor in Chinese economic policy. Each year, China's central government has published an "investment catalogue" that lists businesses that qualify for "encouraged," "accepted" and "discouraged" status. This catalogue has been a guide for local and provincial officials in seeking foreign direct investment. "Encouraged" investments (typically in high-technology, high-employment businesses) have had preferences showered upon them. Subsidies in the form of tax, land and labor breaks as well as dramatically simplified regulatory processes and the easing of other legal burdens have made the process of favoring some businesses over others a fact of life in China's economic landscape.

The process of encouraging and discouraging different businesses has developed into a high art in recent years. Various national and sub-national official groups within China, especially those charged with working with various domestic constituency industries, have increasingly sought to develop new industrial groups in China. On a number of occasions, these groups have developed individual policies, not necessarily with the broad consensus of the Chinese government, that aim to encourage the development of industries in China in ways that challenge or disadvantage American companies and their workers. Certain Chinese companies, not necessarily state-owned companies, have in recent years found special favor as firms that may develop into distinctly Chinese multinational companies.<sup>61</sup> The advantages conferred on these "national champions" vary, but the rationale for their promotion by parts of the Chinese government is straightforward. Chinese government officials, largely for reasons of national pride, favor the existence of Chinese national companies that operate on a world stage with a stature comparable to U.S.,

Japanese and European multinationals. When the interests of these companies compete with those of American companies, the Chinese companies are generally accorded a “patriotic” advantage. An area of particular concern at this point is in green technology, which many Chinese officials perceive to be a competitive international commercial battleground that, given the dramatic scale of China’s domestic market for wind and solar power in particular, Chinese companies will be uniquely poised to capture.

The challenge faced by many competitors to Chinese national champions in international markets is the perception that the Chinese state is prepared to subsidize these companies without regard to rational economic behavior. The sense of an unlimited subsidy for these company’s efforts can skew the economic playing field and distort markets. This has particularly manifested in resource and commodities, but increasingly emerging Chinese technology companies are perceived to have the blank checkbook of the Chinese state at their disposal.

Technical standards are another area in which certain Chinese agencies have made an effort to carve out parts of the Chinese marketplace for domestic firms.<sup>62</sup> In some cases citing security concerns, in some cases citing safety, Chinese agencies involved in commercial areas as diverse as agriculture to wireless encryption technology have been active in promoting China-only standards, frequently in collusion with domestic Chinese firms seeking market advantages. Some of these standards issues have become significant sources of friction in the relationship, such as the WLAN Authentication and Privacy Infrastructure (WAPI), a unique wireless encryption standard that Chinese regulators originally insisted be mandatory for all wireless equipment providers.<sup>63</sup> That standard and its progeny, despite numerous high-level interventions at the Vice Premier and Secretary level, continue to percolate under the surface of international trade relations. Numerous other standards in various stages of development, some seemingly created purely to confound the ability of American and other companies to compete with Chinese rival firms in the marketplace, will almost certainly prove to be a major source of commercial friction in the years to come.

#### MECHANISMS FOR MANAGING THE ECONOMIC AND COMMERCIAL RELATIONSHIP

The two governments have since the early twenty-first century dramatically increased their official interaction on economic and trade matters. A range of sleepy dialogues among the various economic ministries and departments designed to promote dialogue and cooperation (and, in many cases, provide a platform for American “instruction” of Chinese counterparts on U.S.-style

economic activities) have been repeatedly upgraded and formalized to the extent that by 2008 sizable percentages of the U.S. cabinet and China’s ministerial cadre were traveling back and forth to their respective capitals to debate and negotiate economic and commercial matters.

In 2003, a long-standing annual bilateral mechanism, the Joint Commission on Commerce and Trade (JCCT), was elevated to Vice Premier representation on the Chinese side with two cabinet officials (the Secretary of Commerce and U.S. Trade Representative) representing the United States. What began as an exercise in promoting cooperation became an effort to solve trade and economic problems and demonstrate the effectiveness of official efforts to respond to public concerns about the state of that relationship. In 2006, incoming Treasury Secretary Henry “Hank” Paulson quietly shelved a dormant dialogue between the Department of the Treasury and Chinese Ministry of Finance (the “Joint Economic Commission”) and replaced it with a Vice Premier-to-Treasury Secretary “Strategic Economic Dialogue” (SED or S&ED<sup>64</sup>) involving multiple U.S. cabinet officials and their Chinese counterparts. That effort—which sought to elevate the discussion from one of bilateral commercial friction to one of global economic strategy—included discussions of financial structure, environmental sustainability, and other matters in which the United States increasingly sought to draft China as a partner in global economic management, rather than a student of U.S. economic policy. Bonnie Glaser’s chapter discusses this process in considerable detail.

The JCCT and S&ED have been important vehicles to both address concrete issues of economic concern in an atmosphere of cooperation. In addition to these very senior-level discussions, a wide range of cabinet and sub-cabinet exchanges on agriculture, energy, innovation and other matters are an important basis for managing and maintaining a positive basis for the commercial and economic relationship. The outcomes of these dialogues, released at their conclusion, reflect the efforts of both governments to simultaneously attack concrete problems and deflect public criticism in both countries of perceived inequities in the relationship.

#### CONCLUSION

Tension over trade issues has, of course, long been a feature of the U.S.-China bilateral relationship. Managing these issues and preserving a domestic consensus in support of open markets to China has been hard but not unrewarding work: despite all the gnashing of teeth and occasional hysteria, by any reasonable accounting the U.S.-China economic relationship is enormously successful and productive for both countries. China is a rare bright spot for U.S. multinationals these days, and many companies are doubling-down on their China

businesses. Nevertheless, trade issues between the two countries are proliferating, and it is getting increasingly difficult to achieve meaningful progress on these issues, in part because Chinese officials don't seem to be taking American counterparts very seriously.

The efforts of China's reformers in the 1990s to use the external pressure of WTO accession and jurisprudence in order to enshrine market principles in the economy delivered remarkable gains for China's economy. Yet today, many Chinese believe the country lost more than it gained by joining the WTO and some privately wonder at the compatibility of the China economic model with the principles of WTO that were in large part shaped by U.S. leadership. At its heart, WTO membership is about two principles: market access (that a country's default position should be to keep its market open) and national treatment (that a country should accord foreign players in its market the same treatment it accords its own). WTO membership is a web spun of reciprocal commitments to openness as a matter of national self-interest. WTO members recognize the benefit of adherence to the two core principles outweighs the parochial benefits to domestic firms that may be lost. The WTO in some respects is an audacious creation: the cession by sovereign governments of some of their rights to restrict and control their own economy. By breaking down trade barriers, the WTO and the consensus among governments it represents stands for the proposition that a borderless commercial world is much bigger than the sum of its constituent parts. That consensus has delivered remarkable benefits and wealth to Americans and Chinese. But the consensus is fragile, and Americans and Chinese, among many others, seem to have forgotten what the alternatives look like.

For China, a more recent entrant into that consensus, this should be troubling: China is very dependent for its economic health and well-being on an effective rules-based system governing global trade. That the United States has wavered in its leadership of a more robust WTO liberalization process and has had trouble articulating much of a trade policy vision (other than one that is strikingly provincial in its approach) may have more to do with China's decreasing willingness to come to the table on substantive trade matters than anything else.

The realities of constituent politics in every political system inevitably claw away at international commitments to market access and national treatment. Domestic actors in every system can and will attempt to access (and sometimes manipulate) political processes to preserve or secure benefits in ways that run contrary to the essential spirit of WTO. It is not surprising that the United States and China both are facing resistance from vested interests to full embrace of the WTO's principles. But the danger is that, in rejecting WTO principles, both sides will reject an essential element of their individual economic success

and thus make more difficult their long-term economic future, and eat away at a fundamental basis for constructive engagement. Dialogues like the S&ED and JCCT are useful mechanisms, but they are far from exercises in building the kind of sustainable win-win approach to trade that is required.

If the United States and China are going to have a relationship that allows both sides to protect their own national interests while affording space to the other side to protect their own, a successful economic relationship is paramount. Domestic political concerns are features of every mature trade relationship. But the two sides must agree, or at least reaffirm certain core principles. That does not mean that China must align itself completely with Washington's view of the world; nor does it require that the United States must sacrifice domestic economic interests in favor of some greater diplomatic good. But the relationship is increasingly defined by discord, rather than shared enterprise. Economic relations used to be the glue that held the two sides together. It is in danger of becoming a force that drives the two apart.

Forty years of commercial interaction has produced one of the most complex and dynamic economic relationships on the planet. The official interaction between governments grabs much of the headlines but increasingly many other stakeholders in both the United States and China drive the relationship. Official dialogues between the two governments are going to continue to be critical both to managing policy challenges and signaling respective publics about the commitment of both sides to an effective relationship. However, direct relationships and dialogue between the stakeholders in both economies are going to be increasingly important as well. Public discourse on the relationship fails to capture the dynamism and success that lies at the heart of that relationship. Interaction between stakeholders in both countries will need to evolve to reflect that dynamism if the relationship is to advance to reach its full potential.

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