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China-U.S. Trade Issues

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China-U.S. Trade Issues

SUMMARY

U.S.-China economic ties have expanded substantially over the past several years. Total U.S.-China trade rose from \$5 billion in 1980 to an estimated \$231 billion in 2004. China is now the third-largest U.S. trading partner, its second-largest source of imports, and its fifth-largest export market. With a huge population and a rapidly expanding economy, China is becoming a large market for U.S. exporters. Yet, U.S.-China commercial ties have been strained by a number of issues, including a surging U.S. trade deficit with China (\$162 billion in 2004), lax protection of U.S. intellectual property rights (IPR), widespread trade barriers, and China's pegged currency policy.

China joined the World Trade Organization (WTO) in 2001. WTO membership requires China to eliminate or reduce an extensive array of tariff and non-tariff barriers on goods, services, and foreign investment. In December 2004, the U.S. Trade Representative (USTR) issued its third annual China WTO compliance report, stating that, while China's efforts to implement its WTO commitments have been "impressive," they remain "far from complete and have not always been satisfactory." Major areas of concern identified by the USTR's report include IPR protection, agriculture, services, industrial policies, trading rights and distribution, and transparency of trade laws.

The continued rise in the U.S.-China trade imbalance, complaints from several U.S. manufacturing firms over the competitive challenges posed by cheap Chinese imports, and concerns that U.S. manufacturing jobs are being lost due to unfair Chinese trade prac-

tices have led several Members to call on the Bush Administration to take a more aggressive stance against certain Chinese trade policies deemed to be unfair. For example, some Members argue that China's policy of pegging its currency (the yuan) to the U.S. dollar makes U.S. exports to China more expensive, and U.S. imports from China cheaper, than they would be if the yuan were fully convertible. In the 109th Congress, a variety of bills have been introduced to address China's currency peg, including some that would raise U.S. tariffs on Chinese goods by an additional 27.5% unless China appreciated its currency, and others that would apply U.S. countervailing laws (dealing with government subsidies) to nonmarket economies such as China.

Many U.S. industry and labor groups have called on the Administration to utilize special safeguard provisions to restrict imports from China that threaten to harm U.S. firms, especially textiles. U.S. textile and apparel imports from China have surged in recent years and now account for over a quarter of all U.S. imports of such products. U.S. industry officials and labor groups have raised concerns over the potential impact a continued influx of Chinese textile and apparel products.

Recent attempts by largely state-owned Chinese companies to purchase U.S. companies has raised concerns among many U.S. policymakers. On June 22, 2005, CNOOC, a Chinese company made a \$18.5 billion bid to purchase Unocal Corporation, a U.S. energy company. Many Members have expressed opposition to the takeover.

MOST RECENT DEVELOPMENTS

On June 22, 2005, CNOOC, a Chinese company made a \$18.5 billion bid to purchase Unocal Corporation, a U.S. energy company. News of the bid raised concern among several Members, many of who contend that the deal would threaten U.S. national security. On June 30, 2005, the House passed H.Res. 344 (Pombo) by a vote of 398 to 15, expressing the sense of the House of Representatives that a Chinese state-owned energy company exercising control of critical United States energy infrastructure and energy production capacity could take action that would threaten to impair the national security of the United States. On the same day, the House passed an amendment (H.Amdt. 431) to an appropriations bill (H.R. 3058) that would prohibit the use of funds from being made available to recommend approval of the sale of Unocal Corporation to CNOOC.

On May 17, 2005, the Treasury Department released its latest International Economic and Exchange Rate Policies report to Congress. The report stated that China's currency peg policy "is a substantial distortion to world markets" and that "China is now ready to move to a more flexible exchange rate and should move now." The report warned that Treasury would closely monitor China's progress over the next six months.

On April 29, 2005, the USTR announced that it had placed China on the Special 301 Priority Watch List because of its failure to significantly improve protection of U.S. intellectual property rights. The USTR urged China to launch more criminal piracy cases and to improve market access for IPR-related products, and warned it was considering bringing a case against China in the WTO for failing to enforce IPR laws.

On April 6, 2005, the Senate failed (by a vote of 33 to 67) to table an amendment (S.Amdt. 309) to S. 600, which would impose an additional 27.5% tariff on Chinese goods if China failed to appreciate its currency to market value levels. In response to the vote, the Senate leadership moved to allow a vote on S. 295 (which has same language as S.Amdt. 309) no later than July 27, 2005, as long as the sponsors of the amendment agree not to sponsor similar amendments for the duration of the 109th Congress. However, on June 30, Senator Schumer and other sponsors of S. 295 agreed to delay consideration of the bill after they received a briefing from Administration officials and were told that China is expected to make significant progress on reforming its currency over the next few months.

BACKGROUND AND ANALYSIS

U.S. Trade with China

U.S.-China trade rose rapidly after the two nations established diplomatic relations (January 1979), signed a bilateral trade agreement (July 1979), and provided mutual most-favored-nation (MFN) treatment beginning in 1980. Total trade (exports plus imports) between the two nations rose from about \$5 billion in 1980 to \$231 billion in 2004; China is now the third-largest U.S. trading partner. Over the past few years, U.S. trade with China has grown at a faster pace than that of any other major U.S. trading partner.

The U.S. trade deficit with China has grown significantly in recent years, due largely to a surge in U.S. imports of Chinese goods relative to U.S. exports to China. That deficit rose from \$30 billion in 1994 to \$162 billion in 2004 (see **Table 1**). The U.S. trade deficit with China is now larger than that of any other U.S. trading partner, including Japan (\$75.2 billion), Canada (\$65.8 billion), and Mexico (\$45.1 billion). The U.S. trade deficit with China in 2004 was 30.6% higher than it was in 2003. During the first four months of 2005, the U.S. trade deficit with China was 35% higher than the same period in 2004 and averaged \$3.5 billion per week; in 1989, the U.S. trade deficit with China for the entire year was \$3.5 billion. If current trends continue, the total U.S. trade deficit with China in 2005 could hit \$218 billion.

Table 1. U.S. Merchandise Trade with China: 1994-2004
(\$ in billions)

Year	U.S. Exports	U.S. Imports	U.S. Trade Balance
1994	9.3	38.8	-29.5
1995	11.7	45.6	-33.8
1996	12.0	51.5	-39.5
1997	12.8	62.6	-49.7
1998	14.3	71.2	-56.9
1999	13.1	81.8	-68.7
2000	16.3	100.1	-83.8
2001	19.2	102.3	-83.1
2002	22.1	125.2	-103.1
2003	28.4	152.4	-124.0
2004	34.7	196.7	-162.0

Source: U.S. Department of Commerce.

Major U.S. Exports to China

U.S. exports to China in 2004 totaled \$34.7 billion, up 22.2% over 2003 levels, making China the 5th largest U.S. export market in 2004 (it ranked 6th in 2003). U.S. exports to China accounted for 4.2% of total U.S. exports in 2004 (compared to 3.9% in 2003). The top five U.S. exports to China in 2004 were semiconductors and electronic components, soybeans, waste and scrap, aircraft, and chemicals (see **Table 2**). During the first four months of 2005, U.S. exports were up by 5.8%. The lack of growth in total U.S. exports to China appears to have been caused by a 74% drop in U.S. cotton exports to China over this period.

Table 2. Top Five U.S. Exports to China: 2000-2004
(\$ in billions and % change)

NAIC Commodity Groupings	2000	2001	2002	2003	2004	2003-2004 % Change	2000-2004 % Change
Total all commodities	16.3	19.2	22.1	28.4	34.7	22.2	112.9
Semiconductors and other electronic components	1.3	1.7	2.2	3.0	3.6	20.0	176.9
Oilseeds and grains (mainly soybeans)	1.0	1.0	0.9	2.9	2.8	-1.4	180.0
Waste and scrap	0.7	1.1	1.2	1.9	2.5	29.1	257.1
Aerospace products and parts (mainly aircraft)	1.8	2.6	3.6	2.7	2.1	-22.1	16.7
Basic chemicals	0.7	0.6	0.8	1.4	2.0	41.1	187.4

Commodities sorted by top five exports in 2004 using NAIC classification, four-digit level.

Source: U.S. International Trade Commission Database.

Many trade analysts argue that China could prove to be a much more significant market for U.S. exports in the future. China is one of the world's fastest-growing economies, and rapid economic growth is likely to continue in the near future, provided that economic reforms are continued. China's goal of modernizing its infrastructure and upgrading its industries is predicted to generate substantial demand for foreign goods and services. According to a U.S. Department of Commerce report: "China's unmet infrastructural needs are staggering. Foreign capital, expertise, and equipment will have to be brought in if China is to build all the ports, roads, bridges, airports, power plants, telecommunications networks and rail lines that it needs." Finally, economic growth has substantially improved the purchasing power of Chinese citizens, especially those living in urban areas along the east coast of China. China's growing economy and large population make it a potentially enormous market. To illustrate:

- China currently has the world's largest mobile phone network, and one of the fastest-growing markets, with 320 million cellular phone users as of 2004 (50 million new subscribers were added in 2004). In 2004, 73.3 million mobile phones (were sold in China and the predicts this level will rise to 112 million by 2007).
- Boeing Corporation predicts that China will be the largest market for commercial air travel outside the U.S. for the next 20 years; during this period, China will purchase 2,300 aircraft valued at \$183 billion. On January 28, 2005, Boeing Corporation signed a preliminary agreement with Chinese officials to sell 60 planes to China valued at \$7.2 billion.
- In 2002, China replaced Japan as the world's second-largest PC market. China also became the world's second-largest Internet user (after the United States) with nearly 94 million users at the end of 2004.

- The Chinese government projects that by the year 2020, there will be 140 million cars in China (seven times the current level), and that the number of cars sold annually will rise from 4.4 million units to 20.7 million units.

Major U.S. Imports from China

China is a relatively large source of many U.S. imports, especially labor-intensive products. In 2004, imports from China totaled \$196.7 billion, accounting for 13.4% of total U.S. imports in 2004 (up from 12.1% in 2003 and 6.5% in 1996). U.S. imports from China rose by 29.1% in 2004 over the previous year; over the past four years they have risen by 92.3%. The importance (ranking) of China as a source of U.S. imports has risen dramatically, from 8th largest in 1990, to 4th in 2000, to 2nd in 2004. During the first four months of 2005, U.S. imports from China were 28.3% higher than the same period in 2004.

As indicated in **Table 3**, the top five U.S. imports from China in 2004 were computers and parts, miscellaneous manufactured articles (such as toys, games, etc.), audio and video equipment, footwear, and apparel. Traditionally, nearly all of U.S. imports from China have been low-value, labor-intensive products such as toys and games, footwear, and textiles. However, over the past few years, however, an increasing proportion of U.S. imports from China has comprised more technologically advanced products, such as computers.

Table 3. Top Five U.S. Imports from China: 2000-2004
(\$billions and % change)

NAIC Commodity	2000	2001	2002	2003	2004	2003-2004 % Change	2000-2004 % Change
Total All Commodities	100.1	102.3	125.2	152.4	196.7	28.7	92.3
Computer equipment	8.3	8.2	12.0	18.7	29.5	58.1	255.4
Miscellaneous manufactured commodities (e.g., toys, games, etc.)	16.3	16.5	19.5	21.8	23.7	8.9	45.4
Audio and video equipment	6.3	6.3	8.9	10.0	11.2	26.4	77.8
Footwear	9.1	9.6	10.1	10.4	11.2	7.4	23.1
Apparel	7.0	7.2	7.7	9.0	10.5	16.8	50.0

Commodities sorted by top five imports in 2004 using NAIC classification, four-digit level.

Source: U.S. International Trade Commission Trade Data Web.

U.S. trade data strongly suggest that the sharp increase in U.S. imports from China is largely the result of movement in production facilities from other Asian countries to China.¹ That is, various products that used to be made in Japan, Taiwan, Hong Kong, etc., and then exported to the United States are now being made in China (in many cases, by foreign firms in China) and exported to the United States. An illustration of this phenomenon can be seen

¹ Chinese data indicate that the share of China's exports produced by foreign-invested enterprises (FIEs) in China rose from 1.9% in 1986 to 54.8% in 2003.

in **Table 4** on U.S. imports of computer equipment and parts from 2000-2004. In 2000, Japan was the largest foreign supplier of U.S. computer equipment (with a 19.6% share of total shipments), while China ranked 4th (at 12.1%). In just five years, Japan's ranking fell to 5th, the value of its shipments dropped by over half, and its share of shipments declined to 8.5% (2004); Singapore and Taiwan also experienced significant declines in their computer equipment shipments to the United States over this period. In 2004, China was by far the largest foreign supplier of computer equipment with a 39.9% share of total imports. However, while U.S. imports of computer equipment from China rose by 255% over the past five years, the total value of U.S. imports of these commodities rose by only 7.9%, an indicator that several foreign firms have shifted their production facilities to China.

Table 4. Major Foreign Suppliers of U.S. Computer Equipment Imports: 2000-2004 (\$billions and % change)

	2000	2001	2002	2003	2004	2000-2004 % Change
Total	68.5	59.0	62.3	64.0	73.9	7.9
China	8.3	8.2	12.0	18.7	29.5	255.4
Malaysia	4.9	5/0	7.1	8.0	8.7	77.6
Mexico	6.9	8.5	7.9	7.0	7.4	7.2
Singapore	8.7	7.1	7.1	6.9	6.6	-24.1
Japan	13.4	9.5	8.1	6.3	6.3	-53.0
Taiwan	8.3	7.0	7.1	5.4	4.1	-50.6

Ranked according to top 6 suppliers in 2004.

Source: U.S. International Trade Commission Trade Data Web.

China's growth into a major manufacturing center for increasingly sophisticated products has raised concerns among some U.S. policymakers over the competitive challenge posed by China, especially because wage rates in China are so low vis-à-vis the United States and because of the perception that China maintains a number of unfair trade policies.

Major U.S.-China Trade Issues

Although China's economic reforms and rapid economic growth have expanded U.S.-China commercial relations in recent years, tensions have arisen over a wide variety of issues, including the growth and size of the U.S. trade deficit with China (which is viewed by many Members as an indicator that the trade relationship is unfair), China's currency peg (which many Members blame for the size of the U.S. trade deficit with China and the loss of manufacturing jobs in the United States), China's mixed record on implementing its obligations in the WTO, failure to provide adequate protection of U.S. intellectual property rights, and over the competitive challenge posed by China's rising economic power.

China's Currency Peg²

China pegs its currency, the yuan, to the U.S. dollar at about 8.3 yuan to the dollar. It is able to maintain this peg because its currency is not fully convertible in international markets and because it maintains restrictions and controls over capital transactions. As a result, China's exchange rate is not based on market forces. Many U.S. policymakers and business representatives have charged that China's currency is significantly undervalued vis-à-vis the U.S. dollar (with estimates ranging from 15 to 40%), making Chinese exports to the United States cheaper, and U.S. exports to China more expensive, than they would be if exchange rates were determined by market forces. They complain that this policy has particularly hurt several U.S. manufacturing sectors (such as textiles and apparel, furniture, plastics, machine tools, and tool and die), which are forced to compete domestically against low-cost imports from China, and has contributed to the growing U.S. trade deficit with China. They have called on the Bush Administration to pressure China either to appreciate its currency (by increasing the band in which it is allowed to be traded in China) or to allow it to float freely in international markets.

During the mid-1990s, Chinese officials indicated that they were considering making the yuan fully convertible by 2000. However, these plans were abandoned as a result of the 1997 Asian financial crisis, when the economies of East Asian countries experienced a number of economic shocks, including a sharp depreciation in their currencies. China's currency peg and capital controls were a major factor in enabling China to maintain economic growth and stability, while many of its neighbors experienced sharp economic declines. While Chinese exports suffered somewhat from sharp currency depreciations in several East Asian countries, China pledged not to devalue its currency, a policy that many analysts claim helped stabilize the effects of the economic crisis in Asia and gained China high praise from U.S. officials.

Chinese officials argue that its currency peg policy is not meant to favor exports over imports, but instead to foster economic stability. They have expressed concern that abandoning the peg could cause an economic crisis in China and would especially hurt its export industries sectors at a time when painful economic reforms (such as closing down inefficient state-owned enterprises and restructuring the banking system) are being implemented. Chinese officials view economic stability as critical to sustaining political stability; they fear an appreciated currency could reduce jobs and lower wages in several sectors and thus could cause worker unrest.

U.S. critics of China's currency peg contend that the low value of the yuan is forcing other East Asian economies to keep the value of their currencies low (vis-à-vis the U.S. dollar) in order to compete with Chinese products, to the detriment of U.S. exporters and U.S. domestic industries competing against foreign imports. They further note that while China is still a developing country, it has been able to accumulate massive foreign exchange reserves (\$659.1 billion at end of March 2005) and thus has the resources to maintain the

² For additional information on this issue, see CRS Report RS21625, *China's Currency Peg: A Summary of the Economic Issues*, by Wayne Morrison and Marc Labonte; and CRS Report RL32165, *China's Exchange Rate Peg: Economic Issues and Options for U.S. Trade Policy*, by Wayne Morrison and Marc Labonte.

stability of its currency if it were fully convertible. They also argue that appreciating the yuan would greatly benefit China by lowering the cost of imports for Chinese consumers and producers who use imported parts and machinery. Finally, critics of the peg argue that China's accumulation of large amounts of foreign exchange reserves (in order to maintain the currency peg) could be better spent on investment in infrastructure and development of poor regions.

Some economists are skeptical over the wisdom of pushing China too hard to appreciate its currency. They note that a significant share of U.S. imports from China is produced by foreign multinational corporations that are increasingly shifting production to China (and other countries) to take advantage of low costs there and that a change in China's peg would do little to reverse this trend. Many warn that, given the weak state of China's banking system, moving to a fully convertible currency might actually cause the yuan to depreciate, rather than appreciate. Such analysts have called on the United States to press China to implement currency reform in stages over time. Finally, economists note that China is the second-largest purchaser of U.S. Treasury securities (\$223.5 billion as of March 2005), which helps to fund the U.S. federal budget deficit and helps keep U.S. interest rates low.

Legislation Addressing China's Currency Policy. A number of bills addressing China's currency have been introduced in 109th Congress:

- S. 14 (Stabenow), S. 295 (Schumer), and H.R. 1575 (Myrick) direct the Secretary of the Treasury to negotiate with China to accept a market-based system of currency valuation, and imposes an additional duty of 27.5% on Chinese goods imported into the United States unless the President submits a certification to Congress that China is no longer manipulating the rate of exchange and is complying with accepted market-based trading policies. H.R. 3004 (English) would require the Treasury Department to determine if China manipulated its currency and to impose additional tariffs on Chinese goods comparable to the rate of currency manipulation.
- S. 377 (Lieberman) directs the President to negotiate with those countries determined to be engaged most egregiously in currency manipulation and to seek an end to such manipulation. If an agreement is not reached, the President is directed to institute proceedings under the relevant U.S. and international trade laws and to seek appropriate damages and remedies for the U.S. manufacturers and other affected parties.
- H.R. 2208 (Manzullo), S. 984 (Snowe), and S. 1048 (Schumer) adds changes to the criteria that the U.S. Treasury Department is required to consider when making a determination on currency manipulation (including a protracted large-scale intervention in one direction in the exchange markets) in its bi-annual reports on International Economic and Exchange Rate Policies.³

³ A country would be considered to be manipulating its currency if there was a protracted large-scale intervention in one direction in the exchange markets.

- H.R. 2414 (Rogers) would require the Treasury Department to make a determination whether China's currency policy interferes with effective balance of payments adjustments or confers a competitive advantage in international trade that would not exist if the currency value were set by market forces. If such a determination were made, the President would be required to bring a WTO case against China to seek across-the-board tariffs on Chinese goods in order to offset the subsidy effects of undervaluation.
- Some Members of Congress support changing U.S. law to apply countervailing laws to nonmarket economies so that U.S. firms are able to take action against unfair government subsidies, especially in regards to China. They contend that China's currency peg constitutes a government export subsidy that should be actionable under U.S. countervailing laws. H.R. 1216 (English) and S. 593 (Collins) would apply U.S. countervailing laws to nonmarket economies. H.R. 1498 (Tim Ryan) would apply U.S. countervailing laws to countries that manipulate their currencies.

On April 6, 2005, the Senate failed (by a vote of 33 to 67) to table an amendment, S.Amdt. 309 (Schumer) to S. 600 (Foreign Affairs Authorization Act), which would impose a 27.5% tariff on Chinese goods if China failed to substantially appreciate its currency to market levels. In response to the vote, the Senate leadership moved to allow a vote on S. 295 (which has same language as S.Amdt. 309) no later than July 27, 2005, as long as the sponsors of the amendment agree not to sponsor similar amendments for the duration of the 109th Congress. However, on June 30, Senator Schumer and other sponsors of S. 295 agreed to delay consideration of the bill after they received a briefing from Administration officials and were told that China is expected to make significant progress on reforming its currency over the next few months.

President Bush on a number of occasions has criticized China's currency peg, stating that exchange rates should be determined by market forces, and he raised the issue in a meeting with Chinese President Hu Jintao on October 19, 2003. On October 30, 2003, the Treasury Department released its semiannual report on exchange rate policies. Although Treasury was under intense pressure from several Members of Congress to state that China "manipulated" its currency (which by U.S. law would have required Treasury to negotiate with China to end such practices), it did not make such a designation. However, the Bush Administration pledged to pursue the issue with China, largely under the auspices of a joint technical cooperation program, agreed to on October 14, 2003, to promote the development of China's financial markets and to examine ways China can move more quickly toward a floating exchange rate.

The Administration's position on China's currency peg appears to have toughened recently. In April 2005, U.S. Treasury Secretary John Snow stated at a G-7 meeting that "China is ready now to adopt a more flexible exchange rate." On May 17, 2005, the Treasury Department released its latest International Economic and Exchange Rate Policies report to Congress. The report stated that China's currency peg policy "is a substantial distortion to world markets" and that "China is now ready to move to a more flexible exchange rate and should move now." The report warned that Treasury would closely monitor China's progress over the next six months, but did not precisely spell out what moves it expected China to take to make its currency more flexible.

China and the World Trade Organization

Negotiations for China's accession to the General Agreement on Tariffs and Trade (GATT) and its successor organization, the WTO, began in 1986 and took over 15 years to complete. During the WTO negotiations, Chinese officials insisted that China was a developing country and should be allowed to enter under fairly lenient terms. The United States insisted that China could enter the WTO only if it substantially liberalized its trade regime. In the end, a compromise agreement was reached that requires China to make immediate and extensive reductions in various trade and investment barriers, while allowing it to maintain some level of protection (or a transitional period of protection) for certain sensitive sectors.

China Joins the WTO. On September 13, 2001, China concluded a WTO bilateral trade agreement with Mexico, the last of the original 37 WTO members that had requested such an accord. On September 17, 2001, the WTO Working Party handling China's WTO application announced that it had resolved all outstanding issues regarding China's WTO accession. On November 10, 2001, China's WTO membership was formally approved at the WTO Ministerial Conference in Doha, Qatar on November 10, 2001 (Taiwan's WTO membership was approved the next day). On November 11, 2001, China notified the WTO that it had formally ratified the WTO agreements, which enabled China to enter the WTO on December 11, 2001. Under the WTO accession agreement, China agreed to:

- Reduce the average tariff for industrial goods to 8.9% and to 15% for agriculture. Most tariff cuts were implemented by 2004; all cuts will occur by 2010.
- Limit subsidies for agricultural production to 8.5% of the value of farm output and will not maintain export subsidies on agricultural exports.
- Within three years of accession, grant full trade and distribution rights to foreign enterprises (with some exceptions, such as for certain agricultural products, minerals, and fuels).
- Provide non-discriminatory treatment to all WTO members. Foreign firms in China will be treated no less favorably than Chinese firms for trade purposes. Dual pricing practices will be eliminated as well as differences in the treatment of goods produced in China for the domestic market as oppose to those goods produced for export. Price controls will not be used to provide protection to Chinese firms.
- Implement the WTO's Trade-Related Aspects of Intellectual Property Rights (TRIPs) Agreement upon accession.
- Accept a 12-year safeguard mechanism, available to other WTO members in cases where a surge in Chinese exports cause or threaten to cause market disruption to domestic producers.

- Fully open the banking system to foreign financial institutions within five years. Joint ventures in insurance and telecommunication will be permitted (with various degrees of foreign ownership allowed).

WTO Implementation Issues. In December 2004, the USTR issued its third annual China WTO compliance report. It stated that, while China's efforts to implement its WTO commitments have been "impressive," they remain "far from complete and have not always been satisfactory."⁴ Major areas of concern identified by the USTR's report include discriminatory import policies, burdensome regulations and restrictions on agriculture and services, industrial policies that discriminate against foreign companies, restrictions on trading rights and distribution, failure to provide adequate transparency of trade laws and regulations, and poor IPR protection. For example:

- **Export subsidies and discriminatory taxes.** U.S. officials charge that China has subsidized grain exports (mainly corn) and cotton, and uses its tax system to promote exports and discourage imports, contrary to its WTO commitments. For example, China continues to give rebates on value-added taxes (VAT) for certain exports, especially high tech products. In some instances, China imposes higher VAT rates on certain imported products (such as fertilizers and various agricultural products) than it does for similar products produced domestically. On March 18, 2004, the USTR announced it had filed a WTO dispute resolution case against China over its discriminatory tax treatment of imported semiconductors.⁵ Following consultations with the Chinese government, the USTR announced on July 8, 2004, that China agreed to end its preferential tax policy on certain semiconductors by April 2005.
- **Services.** U.S. firms have complained that Chinese regulations on services are confusing and often discriminatory. China maintains high capital requirements, restrictions on branching, and prudential requirements (e.g., already operating in China for a certain number of years, profit requirements) in order for firms to enter the market. In addition, many U.S. firms have complained that they have not been afforded the extent of market access promised under China's WTO accord, especially regarding geographic market access and the amount of foreign ownership allowed for insurance and telecommunications companies in China.
- **Health and safety requirements.** U.S. officials charge that China continues to use a variety of health and safety regulations to effectively bar foreign imports, especially food products (such as wheat, poultry and meats, and citrus). Many of these issues were supposed to have been resolved under a 1999 agreement with China.

⁴ Overall, China has done a good job reducing tariffs on schedule, but has not been as compliant on non-tariff barriers, either failing to meet deadlines, or removing some non-tariff barriers only to replace them with new barriers.

⁵ The United States claims that China applies a 17% VAT rate on semiconductor chips that have been designed and made outside China, but gives VAT rebates to domestic producers.

- **Industry policies.** Although China agreed to make state-owned enterprises (SOEs) operate according to free market principles when it joined the WTO, U.S. officials contend that SOEs are still being subsidized, especially through the banking system. This is seen as a significant problem since nearly half of China's exports come from SOEs. The use of subsidies is viewed as giving Chinese firms an unfair trade advantage.
- **Technical standards.** Many U.S. high tech companies have complained that China's proposed mandatory encryption technical standards on wireless technology are discriminatory (by excluding encryption technology already in existence) and would force U.S. firms to work with Chinese communication companies in order to sell their products in China.
- **IPR.** While China has enacted a variety of new IPR laws, enforcement of those laws remains relatively weak (see section on IPR below).

On April 21, 2004, U.S. and Chinese officials announced that they had made progress with China on a number of trade disputes. China pledged to expand efforts to crack down on IPR piracy, accelerate market liberalization for various services, make its trade rules on agricultural products more transparent, and revise rules on wireless standards for computers and mobile phones.

Some Members have charged that the Administration is not doing enough to force China to comply with its WTO commitments. Some Members have called for allocating more resources for federal agencies charged with monitoring China's compliance with its trade agreements. In the Senate, S. 817 (Stabenow) would create a Special Trade Prosecutor within USTR to ensure compliance with trade agreements. The Special Trade Prosecutor would have to investigate and recommend prosecuting cases before the WTO and other trade agreements to which the United States is a party.

Violations of U.S. Intellectual Property Rights

The United States has pressed China to improve its IPR protection regime since the late 1980s. In 1991, the United States (under a Section 301 case) threatened to impose \$1.5 billion in trade sanctions against China if it failed to strengthen its IPR laws. Although China later implemented a number of new IPR laws, it often failed to enforce them, which led the United States to once again threaten China with trade sanctions. The two sides reached a trade agreement in 1995, which pledged China to take immediate steps to stem IPR piracy by cracking down on large-scale producers and distributors of pirated materials and prohibiting the export of pirated products, establishing mechanisms to ensure long-term enforcement of IPR laws and providing greater market access to U.S. IPR-related products.

Under the terms of China's WTO accession (see above), China agreed to immediately bring its IPR laws in compliance with the WTO agreement on Trade Related Aspects of Intellectual Property Rights (TRIPS). The USTR has stated on a number of occasions that China has made great strides in improving its IPR protection regime, noting that it has passed several new IPR-related laws, closed or fined several assembly operations for illegal production lines, seized millions of illegal audio-visual products, curtailed exports of pirated

products, expanded training of judges and law enforcement officials on IPR protection, and expanded legitimate licensing of film and music production in China. However, the USTR has indicated that much work needs to be done to improve China's IPR protection regime. U.S. business groups continue to complain about significant IPR problems in China, especially of illegal reproduction of software, retail piracy, and trademark counterfeiting. It is estimated that counterfeits constitute between 15 and 20% of all products made in China and totals and accounts for about 8% of China's GDP. Chinese enforcement agencies and judicial system often lack the resources (or the will) needed to vigorously enforce IPR laws; convicted IPR offenders generally face minor penalties. In addition, while market access for IPR-related products has improved, high tariffs, quotas, and other barriers continue to hamper U.S. exports; such trade barriers are believed to be partly responsible for illegal IPR-related smuggling and counterfeiting in China. Industry analysts estimate that IPR piracy in China cost U.S. copyright firms \$2.5 billion to \$3.5 billion in lost sales in 2004.⁶ The piracy rate for IPR-related products in China (such as motion pictures, software, and sound recordings) is estimated at 90% or higher. In addition, China accounts for a significant share of imported counterfeit products seized by U.S. Customs and Border Protection (\$62.5 million, or 66% of total goods seized, in FY2003).

IPR protection has become of the most important bilateral trade issues between the United States and China in recent years:

- In April 2004, the Chinese government pledged to “significantly reduce” IPR infringement levels by increasing efforts to halt production, imports, and sales of counterfeit goods and lowering the threshold for criminal prosecution of IPR violations.
- On November 19, 2004, eight members of the House Ways and Means Committee sent a letter to the Chinese Ambassador to the United States (Yang Jiechi) expressing concern that proposed Chinese regulations on government procurement of software would virtually lock out U.S. software companies due to requirements for local content and technology transfer.
- On December 16, 2004, General Motors Daewoo Auto & Technology Company (a division of General Motors) filed a case in China against Chery Automobile Co. Ltd. (a Chinese firm) for allegedly violating its intellectual property rights by copying one of its car models (the Chevrolet Spark) to produce the Chery QQ. The case has generated further interest in the United States because Chery is planning to export its vehicles to the United States beginning in 2007.
- On February 9, 2005, the International Intellectual Property Alliance and the U.S. Chamber of Commerce urged the USTR to initiate a WTO consultations with China for its poor record on IPR enforcement, which could lead the United States to pursue a dispute resolution case against China in the WTO.

⁶ International Intellectual Property Alliance, 2004 Special 301 Report: People's Republic of China, February 2005 (available at [<http://www.iipa.com>]).

On April 29, 2005, the USTR announced that it had placed China on the Special 301 Priority Watch List, due to “serious concerns” over China’s compliance with its WTO IPR obligations and China’s failure to fully implement its pledges on IPR made in April 2004 to make a significant reduction in IPR piracy. The USTR urged China to launch more criminal piracy cases and to improve market access for IPR-related products and warned that it was considering taking a case to the WTO if IPR enforcement do not show significant improvement soon. U.S. officials have asked China to provide detailed statistics on IPR enforcement efforts to determine if China’s recent enforcement efforts is making a difference in bringing down piracy levels. IPR will likely be a major issue when the United States and China meet under the auspices of the U.S.-China Joint Committee on Commerce and Trade (JCCT) on July 11, 2005.⁷

U.S. Restrictions on Certain Imports from China

Various U.S. industry groups have called on the Administration to invoke special safeguard provisions (included in China’s WTO accession package) that would enable the United States to restrict imports of certain Chinese products deemed harmful to U.S. industries. U.S. producers of textile and apparel products have been particularly vocal over the competitive pressures they face from China, especially since U.S. textile and apparel quotas on Chinese goods were eliminated in January 2005. According to the U.S. Commerce Department, China is the United States’ largest foreign supplier of textiles and apparel, accounting for 17.5 percent of total imports in 2004 (or \$14.6 billion), compared with a 9.1% share (\$6.5 billion) in 2000. U.S. textile and apparel imports from China rose by 22% in 2003 and by 25.4% in 2004. Many U.S. textile and apparel representatives argue that the flood of Chinese textile and apparel products into the United States will continue, especially now that the quotas have been eliminated. The Administration has imposed safeguard provisions (i.e. quotas) on textile products on a number of occasions, and has been particularly active in 2005.⁸ The Chinese government has vigorously protested the U.S. use of safeguard measures, calling them protectionist and a violation of WTO rules.

Chinese Acquisition of U.S. Companies

China’s rise as an economic power has raised a number of concerns among U.S. policymakers. Of particular concern over the past year has been efforts by Chinese companies with substantial state ownership to make bids to take over major U.S. companies. Many Members believe these takeovers could pose risks to U.S. economic and national security interests. Some of these major takeover bids include:

⁷ The JCCT was established in 1983 to provide a forum for high level bilateral economic and trade discussions.

⁸ On May 13, 2005, the Administration announced it would invoke safeguard measures on cotton knit shirts and blouses, cotton trousers, and cotton and man-made fiber underwear. On May 15, 2005, it announced it would invoke safeguards on men’s and boys’ cotton and man-made fiber shirts, man-made fiber trousers, man-made fiber knit shirts and blouses, and combed cotton yarn.

- On December 8, 2004, Lenovo Group Limited, a computer company primarily owned by the Chinese government, signed an agreement to with IBM Corporations to purchase IBM's personal computer division for \$1.75 billion. On April 30, 2005, the acquisition was completed.
- On June 20, 2005, Haier Group, a major Chinese home appliances manufacturer, made a \$1.28 billion bid to take over Maytag Corporation.⁹ (Haier owns a \$40 million plant in Camden, South Carolina.)
- On June 23, the China National Offshore Oil Corporation (CNOOC), through its Hong Kong subsidiary (CNOOC Ltd.), made a bid to buy a U.S. energy company, UNOCAL, for \$18.5 billion.

Congressional concern is driven in part by the perception that China does not play by the rules in international trade policy. For example, most of China's major companies are state-owned or are largely owned by the state.¹⁰ Chinese officials claim such firms, while majority owned by the government, are run and operated like private companies. However, several U.S. analysts believe that Chinese state firms are heavily subsidized by the government (primarily through the banking system). Some analysts believe that the Chinese government has a plan to direct companies under its control to purchase major international companies to obtain their brand names and thus become global companies. Finally, China's rapid economic growth has boosted its demand for energy; China is now the second largest consumer of oil. U.S. policymakers have noticed with alarm China's aggressive attempts to gain access to energy markets throughout the world. This had raised concerns that China's use of state-owned energy companies to gain energy supplies could lead to a restriction of U.S. access to energy and drive up prices.

The CNOOC bid has been of particular concern to Congress. On June 27, Rep. Joe Barton, Chairman of the House Energy and Commerce Committee, and Rep. Ralph Hall, chairman of the House Energy and Commerce Subcommittee on Energy and Air Quality sent a letter to President Bush expressing "deep concern" over CNOOC's bid to take over Unocal, describing it "a clear threat to the energy and national security of the United States." The letter went on to state that the transaction would put vital oil assets in the Gulf of Mexico and Alaska into the hands of a Chinese state controlled company, contrary to the goal of enhanced energy independence embodied in the House-passed energy bill (H.R. 6). Finally, the letter contend that the deal could transfer "a host of highly advanced technologies" to China. The letter concludes by urging the President to ensure that "vital U.S. energy assets are never sold to the Chinese government."

On June 30, 2005, the House passed H.Res. 344 (Pombo) by a vote of 398 to 15, expressing the sense of the House of Representatives that a Chinese state-owned energy company exercising control of critical United States energy infrastructure and energy production capacity could take action that would threaten to impair the national security of the United States. On the same day, the House passed an amendment (H.Amdt. 431) to an

⁹ Haier made the bid under a consortium of investors, which includes U.S. private equity groups.

¹⁰ CNOOC, for example, is 70 percent owned by the Chinese government.

appropriations bill (H.R. 3058) that would prohibit the use of funds from being made available to recommend approval of the sale of Unocal to CNOOC.

The Roll of The Committee on Foreign Investments in the United States (CFIUS)

Section 721 of the Defense Production Act (as amended), better known as the Exon-Florio Amendment, was added in 1988 to provide authority to the President to suspend or prohibit any foreign acquisition, merger, or takeover of a U.S. corporation by a foreign entity that is determined to pose a national security threat to the United States. This provision is implemented by the Committee on Foreign Investments in the United States (CFIUS), an inter-agency committee chaired by the Secretary of Treasury and composed of members from 11 other federal agencies. Under the provision, CFIUS is authorized to receive and examine written notifications voluntarily given by a foreign entity of its takeover bid. Afterwards, CFIUS begins a thorough examination of the notified transaction. If further information is needed after a 30 day period, an investigation is begun, which lasts up to 45 days. Afterwards, it makes a recommendation to the President, who has 15 days to make a determination of whether or not to halt the deal. This process can last longer if the foreign firm withdraws its notification and then re-applies. Although “national security” is not clearly defined in the law, a number of factors are listed for consideration. These deal with such concerns as maintaining domestic production for defense requirements, preventing transactions to countries that supports terrorism and/or proliferate weapons of mass destruction, and stopping the transfer of U.S. technological leadership in areas affecting U.S. national security.

Since 1988, there have been 1,560 applications filed with the CFIUS. In several instances, review by the CFIUS has led to modifications in the transaction in response to concerns raised by various members of the Committee. For example, when Lenovo put in a bid to take over IBM’s PC division, the proposed transaction was modified during the CFIUS’s review of the bid, due to concerns over possible Chinese access to IBM’s high-end technology. In some cases, the CFIUS process can cause a foreign firm to rescind its takeover bid if it is unable, during the CFIUS process, to respond to concerns raised by CFIUS members. For example in 2003, Hutchinson Whampoa, a Hong Kong based firm, made a joint bid with Singapore Technology Telemedia to acquire Global Crossing Ltd, a U.S. telecommunications firm that had gone bankrupt. However concerns over possible links between Hutchinson Whampoa and the Chinese government raised by the CFIUS could not be resolved, despite several proposals given by Hutchinson Whampoa to modify the deal, and the firm subsequently withdrew its bid. In one case, the President has used his authority under Exon-Florio to order a foreign entity to divest its holdings of an American company after a deal had been completed. This occurred in 1990 when President George H.W. Bush ordered the China National Aero-Technology Import and Export Corporation (CATIC) to divest all its interest in MAMCO Manufacturing, a company located in Seattle, Washington, which produced metal parts for aircraft.