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IN FOCUS

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U.S.-China Trade Issues

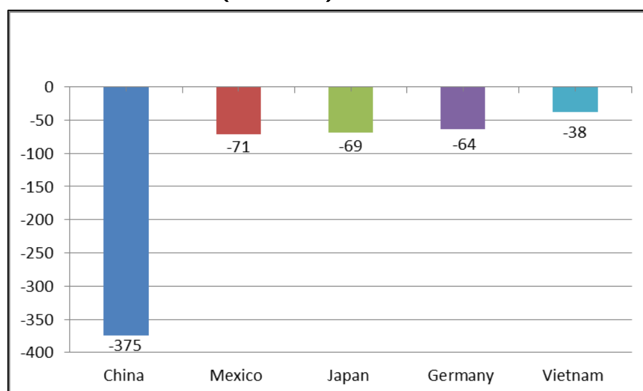
Background

The U.S.-China trade and economic relationship has expanded significantly over the past three decades. In 2017, China was the United States' largest U.S. merchandise trading partner (at $636 billion), third-largest export market ($130 billion), and largest source of imports ($506 billion). China is also the largest foreign holder of U.S. Treasury securities (at $1.17 trillion as of July 2018). However, tensions between the two countries have grown sharply in recent years over a number of economic and trade issues.

Key U.S. Issues

The Trade Deficit. President Trump has complained about the U.S. bilateral trade imbalances. The U.S. merchandise trade deficit with China in 2017 was $375 billion and was by far the largest U.S. bilateral trade imbalance (**Figure 1**). It is projected to rise to $413 billion in 2018. Some U.S. policymakers view large U.S. trade deficits as an indicator of an "unfair" trade relationship. Others, however, view conventional bilateral trade deficit data as misleading, given the growth of global supply chains used by multinational firms. Products may be invented or developed in one country and manufactured or assembled elsewhere using imported components from multiple foreign sources and then exported. Conventional U.S. trade data may not fully reflect the value added in each country, and thus are often a relatively poor indicator of the beneficiaries of its global trade. Also, most economists argue that the overall size of the trade balance is what really matters to the economy (not bilateral balances), and that this is largely a function of macroeconomic forces, such as domestic savings and investment, not trade barriers.

Figure 1. Major U.S. Bilateral Merchandise Trade Imbalances: 2017 ($billions)



Source: USITC Dataweb.

Intellectual Property Rights (IPR) and Cyber-Theft. U.S. firms cite the lack of effective protection of IPR as one of the biggest impediments that they face in conducting business in China and sometimes view lax IPR enforcement in the country as a way to give domestic firms an advantage over foreign competitors. In 2011, the U.S. Office of the National Counterintelligence Executive described Chinese actors as "the world's most active and persistent perpetrators of economic espionage" and as aggressive collectors of sensitive U.S. business information and technologies. In May 2014, the U.S. Justice Department indicted five members of the Chinese People's Liberation Army for government-sponsored cyber-espionage against U.S. companies and theft of proprietary information to aid state-owned enterprises. During Chinese President Xi Jinping's state visit to the United States in September 2015, the two sides reached an agreement on cyber security, pledging that neither country's government would conduct or knowingly support cyber-enabled theft of intellectual property for commercial purposes and to establish a joint dialogue on cybercrime and related issues (which has continued under the Trump Administration). Several U.S. business groups have raised concerns over several recently-enacted Chinese laws relating to national security (such as a 2017 cyber-security law) which, they contend, could restrict market access to U.S. high-technology firms (including digital trade) or condition it to technology transfers.

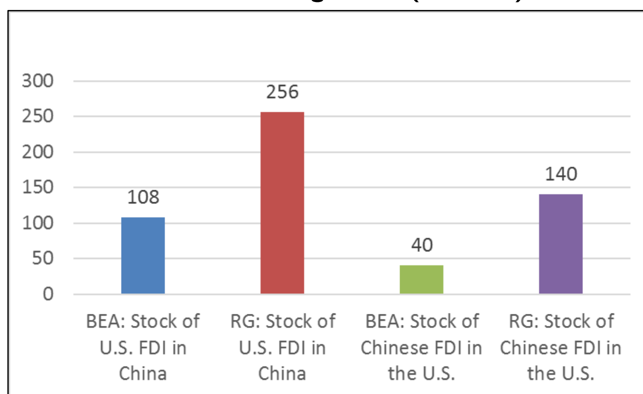
China is considered to be a major source of U.S. economic losses due to IPR violations. The U.S. Trade Representative (USTR) estimates the annual cost to the U.S. economy of certain Chinese intellectual property and technology policies and practices at $50 billion annually.

Industrial Policies. Many U.S.-China trade tensions arise from China's incomplete transition to a market economy, including the use of industrial policies to support and protect domestic firms, especially state-owned enterprises. Major Chinese government practices of concern to U.S. stakeholders include subsidies, tax breaks, and low-cost loans given to Chinese firms; foreign trade and investment barriers; discriminatory IP and technology policies; technology transfer mandates; and the lack of the rule of law. Several recently issued economic plans, such as the "Made in China 2025" initiative, appear to indicate a sharply expanded government role in the economy. The Trump Administration has characterized such policies as "economic aggression." A 2018 American Chamber of Commerce in China survey found that 75% of its members felt less welcomed in China than before.

Foreign Direct Investment (FDI). U.S.-China FDI flows are relatively small given the high level of bilateral trade, although estimates of such flows differ. The U.S. Bureau of Economic Analysis (BEA) is the official U.S. agency that collects and reports FDI data. BEA estimates the stock of Chinese FDI in the United States through 2017 at $40 billion and the stock of U.S. FDI in China at $108 billion. Some analysts contend BEA's methodology for measuring FDI significantly undercounts the level of actual U.S.-China FDI, in large part because it does not capture all FDI that is made through other countries, territories or tax havens, as well as acquisitions made by U.S. affiliates of foreign firms. The Rhodium Group (RG), a private advisory firm attempts to identify FDI by Chinese firms in the

United States, regardless of where they are based or where the money for investment comes from. RG's data on U.S.-China FDI are much higher than BEA's data. For example, RG estimates the stock of China's FDI in the United States through 2017 at $140 billion and the stock of U.S. FDI in China at $256 billion. RG estimates that China's FDI flows to the United States rose from $14.9 billion in 2015 to $45.6 billion in 2016, but fell to $29.4 billion in 2017 and are projected to total $4 billion in 2018. The decline in Chinese FDI flows to the United States may reflect Beijing's efforts rein in "irrational" capital outflows, as well as enhanced scrutiny by the Trump Administration, which contends that the Chinese government seeks to obtain U.S. cutting-edge technologies and intellectual property in order to further its industrial policy goals, such as its Made in China 2025 initiative.

Figure 2. BEA and RG Estimates of the Stock of U.S-China Bilateral FDI through 2017 ($billions)



Sources: BEA and the Rhodium Group.

Congressional concerns over the ability of the Committee on Foreign Investment in the United States (CFIUS) to adequately screen foreign investment in terms of U.S. national security led to the enactment of the Foreign Investment Risk Review Modernization Act of 2018 (FIRRMA) (P.L. 115-232) in August 2018. The act seeks to modernize CFIUS and expand the types of investment subject to review, including certain non-controlling investments in "critical technology." Prior to the passage of FIRRMA, President Trump had warned on May 29 that he planned to announce new restrictions on Chinese efforts to acquire "industrially significant technology" as part of his response to the U.S. Section 301 case against China (see below), but on June 28, he said he would not impose such restrictions because it appeared that Congress would likely pass FIRRMA legislation.

Tariffs on Steel and Aluminum. On March 8, 2018, President Trump issued a proclamation increasing U.S. import tariffs on steel (by 25%) and aluminum (by 10%), based on "national security" justifications (§232 of the 1962 Trade Act). In response, China on April 2 raised tariffs by 15% to 25% on $3 billion worth of imported U.S. products.

Section 301 Case on China's IPR Policies. On August 14, 2017, President Trump issued a memorandum directing the USTR to determine if China's policies on IPR protection and forced technology requirements "may be harming American intellectual property rights, innovation, or technology development," and thus warranted a Section 301 investigation. On August 18th, the USTR launched a Section 301 investigation, and on March 22, President Trump signed a *Memorandum on Actions by the United States Related to the Section 301 Investigation*. It listed four IPR-related policies that justified U.S. action, including China's forced technology transfer requirements, cyber-theft of U.S. trade secrets, discriminatory licensing requirements, and attempts to acquire U.S. technology to advance its industrial policies. The United States said it would propose to boost tariffs by 25% on about $50 billion worth of Chinese goods, initiate a WTO dispute settlement case against China's discriminatory licensing policies (which it did on March 23) and impose new restrictions on certain Chinese investment in the United States.

On May 19, the United States and China released a joint statement announcing that that progress was made on a number of trade issues, including a Chinese commitment to "significantly increase purchases of United States goods and services," including U.S. agricultural and energy products. On May 21, U.S. Secretary of the Treasury Steven Mnuchin stated that both sides had suspended threatened trade sanctions. However, on May 29, the United States said it would implement the proposed Section 301 measures against China. It subsequently imposed three rounds of tariff increases on a total of $250 billion worth imports from China, while China retaliated with tariff hikes on $110 billion worth of U.S. products (see **Table 1**). President Trump has warned he may increase tariffs on an additional $267 billion worth of imports from China.

Table 1. Section 301-Related Tariff Hikes in 2018

Effective Date	Tariff Hike	Import Value	China's Reaction
July 6	25%	$34 billion	Full retaliation
August 23	25%	$16 billion	Full retaliation
September 24	10% (raised to 25% on 01/01/2019)	$200 billion	5%-10% tariff hikes on $60 billion worth of imports

Source: USTR and Chinese Ministry of Commerce.

The current trade dispute between the United States and China could result in increased tariffs on nearly all bilateral trade. For the United States, this could mean higher prices for U.S. consumers, as well for U.S. firms that use China as part of their global supply chains or utilize Chinese-made parts and inputs in their U.S. production. U.S. exports to China could also be negatively impacted by Chinese tariff hikes, and the Chinese government might target U.S.-invested firms in China with retaliation if trade tensions worsen. On September 26, President Trump said that China "has been attempting to interfere" in the U.S. November 2018 elections because of his trade policies toward China. Chinese officials complain that the U.S. side has not negotiated in good faith or provided a clear description of how the current trade impasse can be resolved.

Wayne M. Morrison, wmorrison@crs.loc.gov, 7-7767

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