



# China-U.S. Trade Issues

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## Summary

U.S.-China economic ties have expanded substantially over the past three decades. Total U.S.-China trade rose from \$2 billion in 1979 to \$457 billion in 2010. China is currently the second-largest U.S. trading partner, its third-largest export market, and its biggest source of imports. Because U.S. imports from China have risen much more rapidly than U.S. exports to China, the U.S. merchandise trade deficit has surged, rising from \$10 billion in 1990 to \$273 billion in 2010.

The rapid pace of economic integration between China and the United States, while benefiting both sides overall, has made the trade relationship increasingly complex. On the one hand, China's large population and booming economy have made it a large and growing market for U.S. exporters. Over the past decade, China has been the fastest-growing market for U.S. exports. U.S. imports of low-cost goods from China greatly benefit U.S. consumers by increasing their purchasing power. U.S. firms that use China as the final point of assembly for their products, or use Chinese-made inputs for production in the United States, are able to lower costs and become more globally competitive. China's purchases of U.S. Treasury securities (which stood at nearly \$1.2 trillion at the end of 2010) help keep U.S. interest rates relatively low. On the other hand, many analysts argue that growing economic ties with China have exposed U.S. manufacturing firms to greater, and what is often perceived to be "unfair" competition from low-cost Chinese firms. They argue that this has induced many U.S. production facilities to relocate to China, resulting in the loss of thousands of U.S. manufacturing jobs. Some policymakers have also raised concerns that China's large holdings of U.S. government debt may give it leverage over the United States.

China's incomplete transition to a free market economy and its use of distortive economic policies have contributed to growing trade friction with the United States over a number of issues, including China's refusal to allow its currency to appreciate to market levels, its mixed record on implementing its World Trade Organization (WTO) obligations, its relatively poor record on protecting intellectual property rights (IPR), and its extensive use of industrial policies and discriminatory government procurement policies to subsidize and protect domestic Chinese firms at the expense of foreign companies. The United States initiated three WTO trade dispute resolutions against China in 2010, dealing with such issues as China's use of subsidies to promote its wind power industries, its use of trade remedy laws to protect domestic industries, and restrictions on electronic payment services. Some Members of Congress have argued that, given the slow rate of U.S. economic growth and the high rate of unemployment, China's distortive trade policies can no longer be tolerated and have called for tougher action to be taken against China to induce it to eliminate policies that are deemed damaging to U.S. economic interests. These trade frictions may intensify in the future as China attempts to implement policies to increase the output of more advanced products.

Opinions differ as to the most effective way of dealing with China on major economic issues. Some support a policy of engagement with China using various forums, such as the U.S.-China Strategic and Economic Dialogue (S&ED). Others support a somewhat mixed policy of using engagement when possible, coupled with a more aggressive use of WTO dispute settlement procedures to address China's unfair trade policies. Still others, who see China as a growing threat to the U.S. economy and the global trading system, advocate a policy of trying to contain China's economic power and using punitive measures when needed to force China to "play by the rules." This report provides an overview of U.S.-China trade relations. It describes the trends in commercial ties, identifies major trade issues, and lists major legislation in the 112<sup>th</sup> Congress.

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Economic and trade reforms (begun in 1979) have helped transform China into one of the world's fastest-growing economies. China's economic growth and trade liberalization, including comprehensive trade commitments made upon entering the World Trade Organization (WTO) in 2001, have led to a sharp expansion in U.S.-China commercial ties. Yet, bilateral trade relations have become increasingly strained in recent years over a number of issues, including a large and growing U.S. trade deficit with China, resistance by China to reform its currency policy, U.S. concerns over China's mixed record on implementing its WTO obligations, and numerous Chinese industrial policies that appear to impose new restrictions on foreign firms. Several Members of Congress have called on the Obama Administration to take a tougher stance against China to induce it to eliminate economic policies deemed harmful to U.S. economic interests and/or inconsistent with WTO rules. This report provides an overview of U.S.-China economic relations, surveys major trade disputes, and lists bills introduced in Congress that could affect bilateral commercial ties.

## U.S. Trade with China<sup>1</sup>

U.S.-China trade rose rapidly after the two nations reestablished diplomatic relations (in January 1979), signed a bilateral trade agreement (July 1979), and provided mutual most-favored-nation (MFN) treatment beginning in 1980.<sup>2</sup> In 1979 (when China's reforms began), total U.S.-China trade (exports plus imports) was \$2 billion; China ranked as the 23<sup>rd</sup>-largest U.S. export market and its 45<sup>th</sup>-largest source of U.S. imports. In 2010, bilateral merchandise trade was \$457 billion; China was the second-largest U.S. trading partner (after Canada), the third-largest U.S. export market (after Canada and Mexico), and the largest source of U.S. imports. In recent years, China has been one of the fastest-growing U.S. export markets, and the importance of this market is expected to grow even further, given the pace of China's economic growth, and as Chinese living standards continue to improve and a sizable Chinese middle class emerges.

The U.S. trade deficit with China has surged over the past two decades, as U.S. imports from China have grown much faster than U.S. exports to China. That deficit rose from \$10 billion in 1990 to \$266 billion in 2008, fell to \$227 billion in 2009, and then rose to \$273 billion in 2010 (see **Table 1** and **Figure 1**). As can be seen in **Figure 2**, the U.S. trade deficit with China in 2010 was significantly larger than that with any other U.S. trading partner and several trading groups. For example, it was larger than the combined U.S. trade deficits with the Organization of the Petroleum Exporting Countries (OPEC), the 27 nations that make up the European Union (EU27), Mexico, Japan, and Canada (together they totaled \$235 billion). During the first two months of 2011, the U.S. trade deficit with China was 21% over the same period in 2010. If this trend continued, the total U.S. trade deficit for the full year in 2011 could top \$330 billion.

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<sup>1</sup> For more information on China's economy, see CRS Report RL33534, *China's Economic Conditions*, by Wayne M. Morrison. For general information on U.S.-China ties, see CRS Report R41108, *U.S.-China Relations: Policy Issues*, by Susan V. Lawrence and Thomas Lum.

<sup>2</sup> The United States suspended China's MFN status in 1951, which cut off most bilateral trade. China's MFN status was conditionally restored in 1980 under the provisions set forth under Title IV of the 1974 Trade Act, as amended (including the Jackson-Vanik freedom-of-emigration provisions). China's MFN status (which was re-designated under U.S. trade law as normal trade relations status, or NTR) was renewed on an annual basis until January 2002, when permanent NTR was extended to China (after it joined the WTO in December 2001).

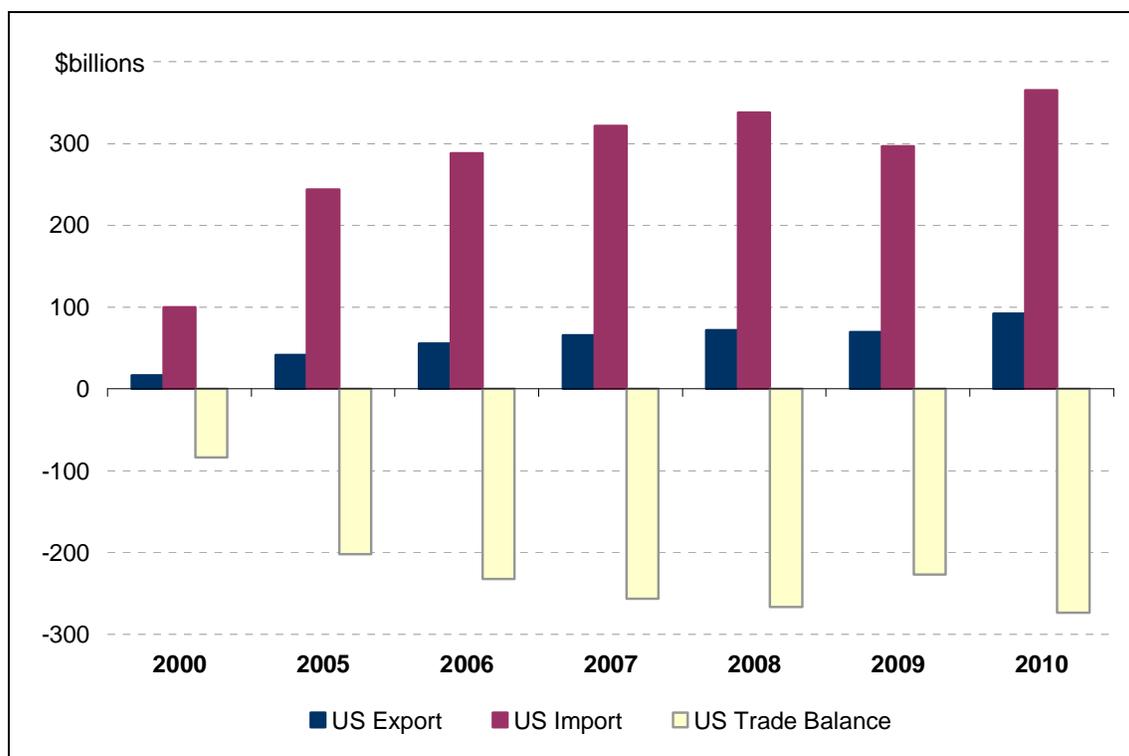
**Table I. U.S. Merchandise Trade with China:  
1980-2010**  
(\$ billions)

Year	U.S. Exports	U.S. Imports	U.S. Trade Balance
1980	3.8	1.1	2.7
1985	3.9	3.9	0.0
1990	4.8	15.2	-10.4
1995	11.7	45.6	-33.8
2000	16.3	100.1	-83.8
2005	41.8	243.5	-201.6
2006	55.2	287.8	-232.5
2007	65.2	321.5	-256.3
2008	71.5	337.8	-266.3
2009	69.6	296.4	-226.8
2010	91.9	364.9	-273.1

**Source:** U.S. International Trade Commission DataWeb.

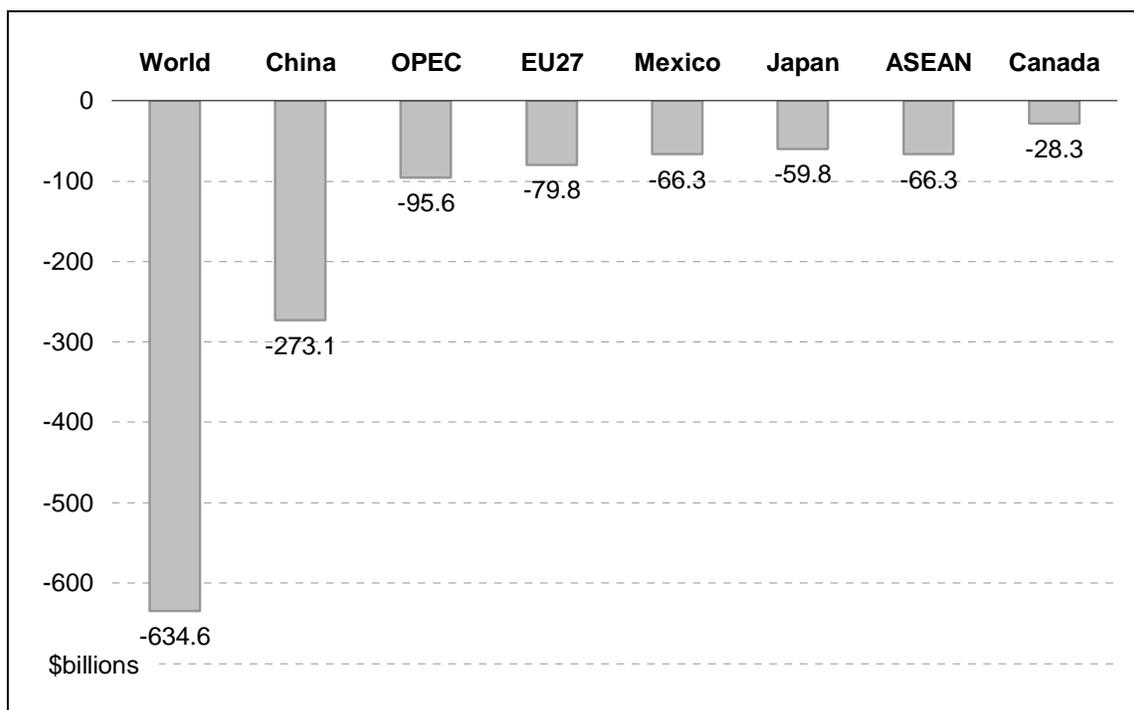
**Note:** Data may not add up due to rounding.

**Figure I. U.S. Trade With China: 2000-2010**



**Source:** U. S. International Trade Commission DataWeb.

**Figure 2. U.S. Trade Balances with the World and Various Trading Partners: 2010**  
(\$ billions)



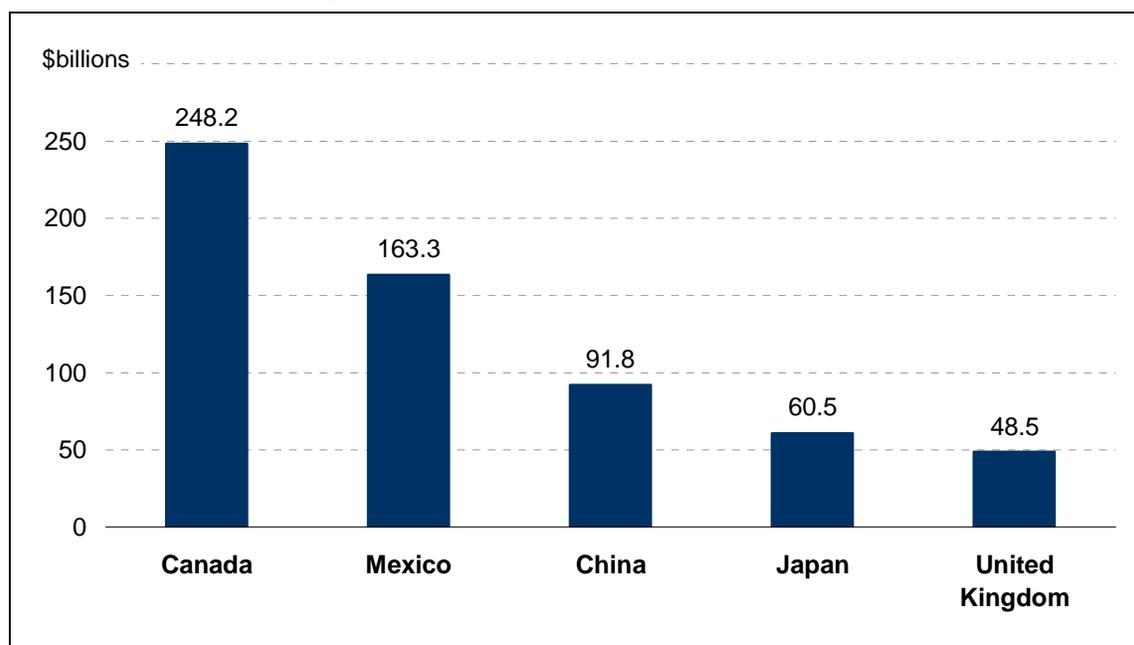
Source: U.S. International Trade Commission DataWeb.

## U.S. Merchandise Exports to China

U.S. merchandise exports to China in 2010 were \$91.9 billion (up 32.1% from 2009 levels).<sup>3</sup> China replaced Japan as the third-largest U.S. merchandise export market in 2007 and has remained so through 2010 (see **Figure 3**). U.S. exports to China in 2010 accounted for 7.2% of total U.S. exports, compared to 2.1% in 2000. The top five merchandise U.S. exports to China in 2010 were oilseeds and grains, waste and scrap, semiconductors and electronic components, aircraft and parts, and resins and synthetic rubber and fibers (see **Table 2**).<sup>4</sup> During the first two months of 2011, U.S. exports to China were up 20.2% on a year-on-year basis.

<sup>3</sup> China is a significant market for U.S. exports of private services; these totaled \$15.6 billion in 2009 (the most recent year available), making China the ninth-largest export market for U.S. private services.

<sup>44</sup> Based on the North American Industry Classification system (NAIC) system on a 4-digit level. Note, rankings and descriptions of major traded commodities (exports and imports) will differ according to which trade classification system is used as well as the level digit-level that is applied. NAIC categories can be aggregated from two to five digit levels.

**Figure 3. Major U.S. Export Markets: 2010**

Source: U.S. International Trade Commission DataWeb.

Over the past few years, China has been among the fastest-growing U.S. export markets, as can be seen in **Table 3**. In 2010, China was the second-fastest-growing export market (after South Korea). From 2001 to 2010, U.S. exports to China increased by about 379%, which was significantly faster than U.S. exports to other major U.S. exports markets.

**Table 2. Major U.S. Exports to China: 2005-2010**

(\$ millions and percent change)

Description	2005	2006	2007	2008	2009	2010	Percent Change 2009–2010 (%)
Oilseeds and grains (mainly soybeans)	2,339	2,593	4,145	7,316	9,376	11,208	19.5
Waste and scrap	3,670	6,071	7,331	7,562	7,142	8,561	19.9
Semiconductors and other electronic components	4,015	6,830	7,435	7,475	6,042	7,555	25.1
Aerospace products and parts (mainly aircraft)	4,535	6,309	7,447	5,471	5,344	5,766	7.9
Resin, synthetic rubber, and artificial & synthetic fibers & filament	2,127	2,548	3,290	3,524	4,036	4,336	7.4
Total U.S. Exports to China	41,837	55,224	65,238	71,457	69,576	91,878	32.1

Source: USITC DataWeb. Top five U.S. exports to China in 2010.

Note: North American Industry Classification (NAIC) system, 4-digit level.

**Table 3. U.S. Merchandise Exports to Major Trading Partners: 2001 and 2010**  
(\$ billions and percent change)

	2001	2010	Percent Change from 2009-2010 (%)	Percent Change from 2001-2010 (%)
Canada	163.7	248.2	21.2	51.6
Mexico	101.5	163.3	26.6	60.9
<b>China</b>	<b>19.2</b>	<b>91.9</b>	<b>32.1</b>	<b>378.6</b>
Japan	57.6	60.5	18.3	5.0
United Kingdom	40.8	48.5	6.1	18.9
Germany	30.1	48.2	11.3	60.1
South Korea	22.2	38.8	35.6	74.8
Brazil	15.9	35.4	35.1	122.6
Netherlands	19.5	35.0	8.2	79.5
Singapore	17.8	29.2	30.8	64.0
World	731.0	1,277.5	20.9	74.8

**Source:** U.S. International Trade Commission DataWeb.

**Note:** Ranked by top 10 U.S. export markets in 2010.

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 goals of modernizing its infrastructure, upgrading its industries, and improving rural living standards could generate substantial demand for foreign goods and services. 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, large foreign exchange reserves (at over \$2.85 trillion as of December 2010), and large population of over 1.3 billion people make it a potentially enormous market. To illustrate:

- According to a report by the Boston Consulting Group, in 2009, China had 148 million "middle class and affluent" consumers, defined as those whose annual household income was 60,000 RMB (\$9,160) or higher, and that level is projected to rise to 415 million by 2020.<sup>5</sup> In a separate report, the Boston Consulting Group estimated that China had 1.1 million millionaires (converted to U.S. dollars) in 2010.<sup>6</sup>
- Although Chinese private consumption as a percent of GDP is much lower than that of most other major economies, the rate of growth of Chinese private consumption has been rising rapidly. For example, private consumption as a percent of GDP in China in 2010 was 35%, compared to 71% in the United

<sup>5</sup> Boston Consulting Group, *Big Prizes in Small Places: China's Rapidly Multiplying Pockets of Growth*, November 2010, p. 10.

<sup>6</sup> *Bloomberg*, "China's Millionaires Jump Past 1 Million on Savings, Expansion of Economy," June 1, 2011.

States. However, the annual rate of growth in Chinese private consumption from 2001 to 2010 averaged 8.2%, while the U.S. annual average was 2.1%.

- China's government has indicated that it plans to step up efforts to boost domestic spending to help lessen its dependence on exports as the major contributor to China's economic growth. In 2008, China began the implementation of a \$586 billion economic stimulus package, largely focused on infrastructure projects. China's goals of developing its western regions, expanding improving its infrastructure, boosting its social safety net (such as health care and pensions), modernizing and developing key industries, reducing pollution, and raising incomes of rural poor will likely result in large-scale government spending levels. The Chinese government's ability to fund these projects is enhanced by the fact that its debt levels are much smaller relatively to those of other major economies. For example, China's central government budget deficit as a percent of GDP in 2010 was 1.6% versus 8.9% for the United States. China's public debt as a percent of GDP at the end of 2010 was 16.3% versus 62.3% for the United States.<sup>7</sup>
- China currently has the world's largest mobile phone network and one of the fastest-growing markets, with an estimated 889 million mobile phone subscribers as of March 2011, up from 87 million subscribers in 2000.<sup>8</sup>
- Boeing Corporation predicts that over the next 20 years (2010-2029), China will buy 4,330 new aircraft, valued at \$480 billion, and will be Boeing's largest commercial airplane customer outside the United States.<sup>9</sup> On January 19, 2011, Boeing Corporation announced that the Chinese government had agreed to purchase 200 planes valued at \$19 billion.<sup>10</sup>
- China replaced the United States as the world's largest Internet user in 2008. At the end 2010, China had an estimated 457 million Internet (up 73 million over the previous year) users versus 240 million in the United States.<sup>11</sup> Yet, the percentage of the Chinese population using the Internet is small relative to the United States: 32% versus 77%, respectively.
- According to *Global Insight*, China reportedly overtook Japan in 2009 to become the largest producer of light vehicles (cars and light trucks) at 16.5 million units and overtook the United States as the global leader in sales of light vehicles at 13.0 million units.<sup>12</sup> China's light vehicle sales nearly doubled from 2008 to 2010, due largely to government tax subsidies and incentives that were implemented in response to the global economic slowdown. By 2020, sales of light vehicles in China are projected to reach 29.1 million units, which would be 70.2% higher than the projected sales in the United States. The number of cars on

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<sup>7</sup> *Economist Intelligence Unit*, Country Data, database.

<sup>8</sup> In comparison, the United States has 303 million mobile phone subscribers. Source: PCWorld, "China Approaches 900 Million Mobile Phone Users," April 25, 2011, available at: [http://www.pcworld.com/businesscenter/article/226159/china\\_approaches\\_900\\_million\\_mobile\\_phone\\_users.html](http://www.pcworld.com/businesscenter/article/226159/china_approaches_900_million_mobile_phone_users.html).

<sup>9</sup> Boeing Corporation, *Current Market Outlook, 2010-2029*, January 26, 2011.

<sup>10</sup> Boeing Media, *Statement on Chinese Approval of 200 Boeing Aircraft*, January 19, 2011.

<sup>11</sup> Internet World Stats, at <http://www.internetworldstats.com/top20.htm>.

<sup>12</sup> HIS Global Insight, *World Car Industry Forecast Report*, December 2010, p. 46.

the road in China rose from 14 million units in 2005 to 40.8 million units 2010, and is projected to reach 93.6 million by 2015, a level that would equal 69% of the projected number of cars on the road in the United States.<sup>13</sup>

- For the first time in its history, General Motors (GM) in 2010 sold more cars and trucks in China (at 2.35 million units) than it did in the United States (2.21 million units).<sup>14</sup> According to GM's website, it operates seven joint ventures and two wholly owned foreign enterprises and has more than 32,000 employees in China. GM sales in China rose by 29% in 2010 while Ford (the second-largest U.S. producer in China) sales increased by 40%.

## Major U.S. Imports from China

China was the largest source of U.S. imports in 2010, at \$365 billion. U.S. imports from China increased by 23.1% in 2010 over the previous year.<sup>15</sup> China accounted for 19.1% of U.S. imports in 2010 (compared to 8.2% in 2000). The importance (ranking) of China as a source of U.S. imports has risen dramatically, from eighth-largest in 1990, to fourth in 2000, to second in 2004-2006, to first in 2007-2010. The top five U.S. imports from China in 2010 were computers and parts, miscellaneous manufactured articles (such as toys, games, etc.), communications equipment and parts, apparel, and audio and video equipment (see **Table 4**). U.S. imports from China from January-February 2011 rose by 20.8% on a year-on-year basis.

**Table 4. Major U.S. Imports From China: 2005-2010**

(\$ millions and percent change)

Commodity Description	2005	2006	2007	2008	2009	2010	Percent Change 2009-2010 (%)
Computer equipment and parts	35,467	40,046	44,462	45,820	44,818	59,800	33.4
Misc. manufactured commodities (toys, games, etc.)	26,449	28,888	34,827	35,835	30,668	34,168	11.4
Communications equipment and parts	14,121	17,977	23,192	26,618	26,362	33,464	26.9
Apparel	16,362	19,228	22,955	22,583	22,669	26,603	17.4
Audio and video equipment and parts	15,287	18,789	19,075	19,715	18,243	19,493	6.8

**Source:** U.S. International Trade Commission DataWeb.

**Note:** North American Industry Classification system, 4-digit level.

<sup>13</sup> For additional information on the U.S. auto industry in China, see CRS Report R40924, *The Rise of China's Auto Industry and Its Impact on the U.S. Motor Vehicle Industry*, by Rachel Tang.

<sup>14</sup> USA Today, *GM sells more vehicles in China than in U.S.*, January 21, 2011, available at: [http://www.usatoday.com/money/autos/2011-01-24-gm-china-sales\\_N.htm](http://www.usatoday.com/money/autos/2011-01-24-gm-china-sales_N.htm).

<sup>15</sup> In 2009, U.S. imports fell by 12.4% over the previous year because of the effects of the global economic slowdown.

## Advanced Technology Trade With China

Throughout the 1980s and 1990s, nearly all of U.S. imports from China were low-value, labor-intensive products, such as toys and games, consumer electronic products, footwear, and textiles and apparel. However, over the past few years, an increasing proportion of U.S. imports from China have been comprised of more technologically advanced products. For example, according to the U.S. Census Bureau, U.S. imports of advanced technology products (ATP) from China in 2010 totaled \$115.7 billion. ATP products accounted for 31.3% of total U.S. imports from China, compared with 19.2% (\$29.3 billion) in 2003.<sup>16</sup> In addition, China in 2010 accounted for 38.5% of total U.S. ATP imports, compared with 14.1% in 2003. U.S. ATP exports to China in 2010 were \$21.5 billion; these accounted for 23.4% of total U.S. exports to China and 8.8% of U.S. global ATP exports. In comparison, U.S. ATP exports to China in 2003 were \$8.3 billion, which accounted for 29.2% of U.S. exports to China and 4.6% of total U.S. ATP exports to the world.

The United States ran a \$94.2 billion deficit in its ATP trade with China in 2010, up from a \$21.0 billion deficit in 2003. Some see the large and growing U.S. trade deficit in ATP with China as source of concern, contending that it signifies the growing international competitiveness of China in high technology. Others dispute this, noting that a large share of the ATP imports from China are in fact relatively low-end technology products and parts, such as notebook computers, or are products that are assembled using imported high technology parts that are largely developed and/or made elsewhere.

## China as a Major Center for Global Supply Chains

Many analysts contend that the sharp increase in U.S. imports from China (and hence the growing bilateral trade imbalance) is largely the result of movement in production facilities from other (primarily Asian) countries to China. That is, various products that used to be made in such places as 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. To illustrate, in 1990, 47.1 % of the value of U.S. manufactured imports came from Pacific Rim countries (including China).<sup>17</sup> In 2010, Pacific Rim countries accounted for 42.7% of total U.S. manufactured imports. Over the same period, the share of total U.S. manufactured imports that came from China increased from 3.6% to 21.4%. In other words, while China was becoming an increasingly important source for U.S. manufactured imports, the relative importance of the rest of the Pacific Rim as a whole was declining, in part because many Pacific Rim firms were shifting their export-oriented manufacturing facilities to China (see **Figure 4**).<sup>18</sup>

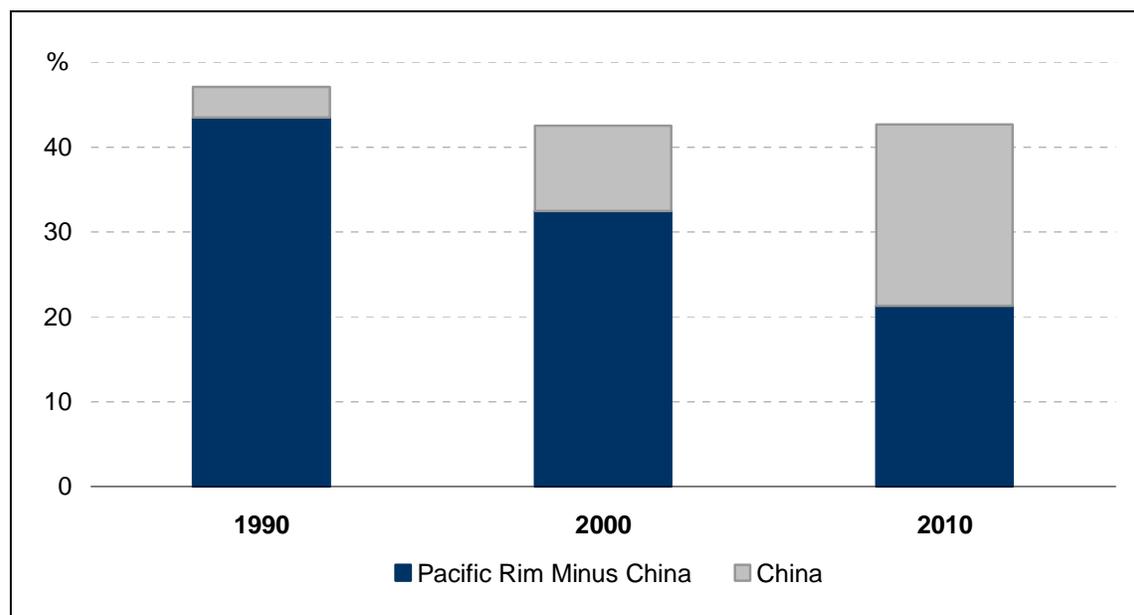
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<sup>16</sup> Census broadly defines ATP as products whose technology is from a recognized high technology field and represent leading edge technology in that field. Broad product categories include biotechnology, life sciences, opto-electronics, information and communications, electronics, flexible manufacturing (e.g., robots), advanced materials, aerospace, weapons, and nuclear technology.

<sup>17</sup> Pacific Rim countries include Australia, Brunei, Cambodia, China, Hong Kong, Indonesia, Japan, South Korea, Laos, Macao, Malaysia, New Zealand, North Korea, Papua New Guinea, the Philippines, Singapore, Taiwan, Thailand, Vietnam, and several small island nations.

<sup>18</sup> U.S. manufactured imports from Pacific Rim countries minus China as a percent of total U.S. manufactured imports fell from 43.5% in 1990 to 21.3% in 2010.

**Figure 4. U.S. Manufactures Imports from Pacific Rim Countries as a Percent of Total U.S. Manufactures Imports 1990, 2000, and 2010**



**Source:** U.S. International Trade Commission DataWeb.

**Notes:** Standard International Trade Classification definition of manufactured imports.

Another illustration of the shift in production can be seen in the case of U.S. computer imports, which currently are the largest category of U.S. imports from China on an NAIC basis, 4-digit level. **Table 5** lists U.S. imports of computer equipment and parts from 2000-2010. In 2000, Japan was the largest foreign supplier of U.S. computer equipment (with a 19.6% share of total U.S. imports), while China ranked fourth (with a 12.1% share). By 2010, Japan's ranking had fallen to third; the value of its shipments dropped by 61% over 2000 levels, and its share of U.S. computer imports declined to 5.3% (2010). China was by far the largest foreign supplier of computer equipment in 2010 with a 61.5% share of total U.S. imports, compared to 12.0% in 2000 (see **Figure 5**). While U.S. imports of computer equipment from China from 2000-2010 rose by 620.5%, the total value of U.S. computer imports worldwide rose by 41.9%.<sup>19</sup> A study by the U.S. International Trade Commission (USITC) estimated that in 2002 over 99% of computer exports in China were from foreign-invested firms in China<sup>20</sup> Taiwan, one of the world's leaders in sales of information technology, produces over 90% its information hardware equipment (such as computers) in China.

<sup>19</sup> China's accession to the WTO (with the reduction of trade and investment barriers) appears to have been a major factor behind the migration of computer production from other countries to China.

<sup>20</sup>USITC, *How Much of Chinese Exports Is Really Made In China? Assessing Foreign and Domestic Value-Added in Gross Exports*, report number 2008-03-B, March 2008, p. 21.

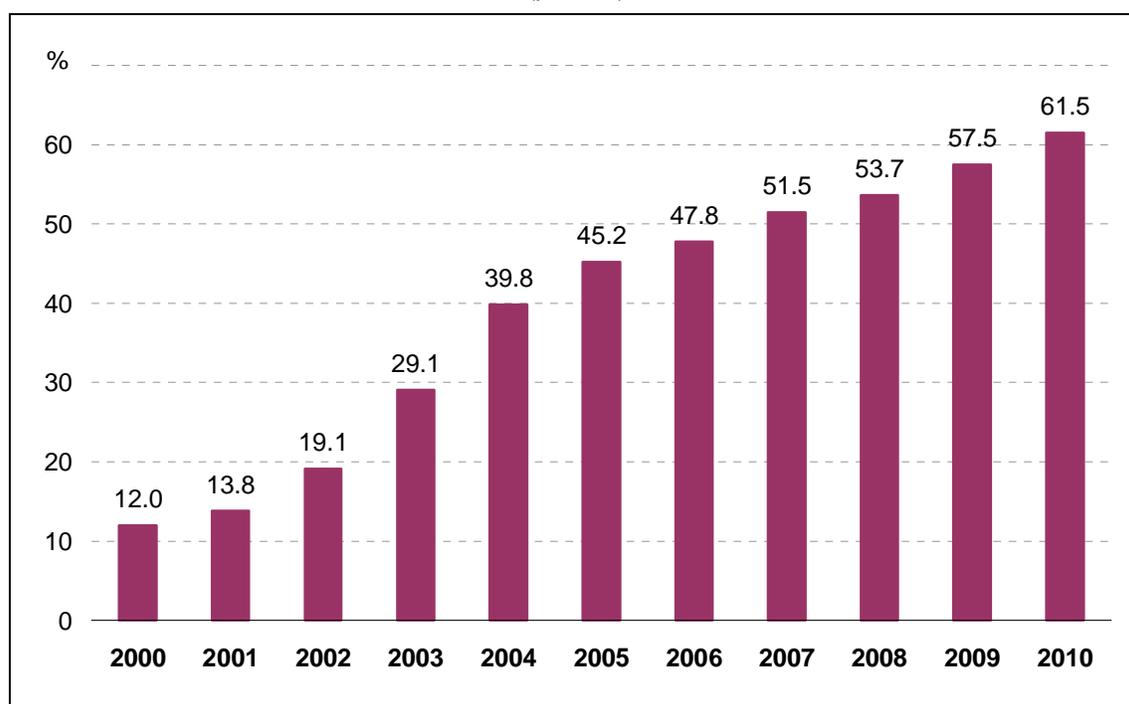
**Table 5. Major Foreign Suppliers of U.S. Computer Equipment Imports: 2000-2010**  
(\$ billions and percent change)

	2000	2002	2004	2006	2008	2010	2000-2010 % change
Total	68.5	62.3	73.9	83.8	85.4	97.2	41.9
<b>China</b>	<b>8.3</b>	<b>12.0</b>	<b>29.5</b>	<b>40.0</b>	<b>45.8</b>	<b>59.8</b>	<b>620.5</b>
Mexico	6.9	7.9	7.4	6.6	6.2	13.6	97.1
Japan	13.4	8.1	6.3	6.3	6.6	5.2	-61.2
Singapore	8.7	7.1	6.6	5.6	4.0	3.6	-58.6
Thailand	2.4	2.1	2.3	3.2	3.7	3.5	45.8

**Source:** U.S. International Trade Commission Trade DataWeb.

**Note:** Ranked according to top five suppliers in 2010.

**Figure 5. Share of U.S. Computer Imports from China: 2000-2010**  
(percent)



**Source:** U.S. International Trade Commission DataWeb.

### Global Supply Chains, China, and the Apple iPod: Who Benefits?

Many U.S. companies sign contracts with Taiwanese firms to have their products manufactured (mainly in China), and then shipped to the United States where they are sold by U.S. firms under their own brand name. In many instances, the level of value-added that occurs in China (often it simply involves assemblage) can be quite small relative to the overall cost/price of the final product. One study by researchers at the University of California looked at the production of a 2005 Apple 30 gigabyte video iPod, which is made in China by Foxconn, a Taiwanese company, using parts produced globally (mainly in Asia). The study estimated that it cost about \$144 to make each iPod unit. Of this amount, only about \$4, or 2.8% of the total cost, was attributable to the Chinese workers who assembled it; the rest of the costs were attributable to the numerous firms involved in making the parts (for example, Japanese firms provided the highest-value components—the hard drive and the display).<sup>21</sup> From a trade aspect, U.S. trade data would have recorded the full value of each iPod unit imported from China at \$144 (excluding shipping costs) as originating from China, even though the value added in China was quite small. The retail price of the iPod sold in the United States was \$299, meaning that there was a mark-up of about \$155 per unit, which was attributable to transportation costs, retail and distributor margins, and Apple's profits. The study estimated that Apple earned at least \$80 on each unit it sold in its stores, making it the single largest beneficiary (in terms of gross profit) of the sale of the iPod. The study concluded that Apple's innovation in developing and engineering the iPod and its ability to source most of its production to low-cost countries, such as China, has helped enable it to become a highly competitive and profitable firm (as well as a source for high-paying jobs in the United States). The iPod example illustrates that the rapidly changing nature of global supply chains has made it increasing difficult to interpret the implications of U.S. trade data. Such data may show where products are being imported from, but they often fail to reflect who benefits from that trade. Chinese trade data indicate that over 50% of its exports are generated by foreign-invested firms in China. Thus, in many instances, U.S. imports from China are really imports from many countries.

## U.S.-China Investment Ties and Issues<sup>22</sup>

Investment plays a major role in U.S.-China commercial ties.<sup>23</sup> China's investment in U.S. assets can be broken down into several categories, including holdings of U.S. securities, foreign direct investment (FDI), and other non-bond investments. A significant share of China's investment in the United States is comprised of U.S. securities, while FDI constitutes the bulk of U.S. investment in China. The Treasury Department defines foreign holdings of U.S. securities as "U.S. securities owned by foreign residents (including banks and other institutions) except where the owner has a direct investment relationship with the U.S. issuer of the securities." U.S. statutes define FDI as "the ownership or control, directly or indirectly, by one foreign resident of 10 percent or more of the voting securities of an incorporated U.S. business enterprise or the equivalent interest in an unincorporated U.S. business enterprise, including a branch."<sup>24</sup> The U.S. Bureau of Economic Analysis (BEA) reports data on FDI flows to and from the United States.<sup>25</sup>

<sup>21</sup> Communications of the ACM, *Who Captures Value in a Global Innovation Network? The Case of Apple's iPod*, March 2009.

<sup>22</sup> U.S. data on FDI flows to and from China differ sharply from Chinese data on FDI flows to and from the United States. This section uses U.S. data only.

<sup>23</sup> Investment is often a major factor behind trade flows. Firms that invest overseas often import machinery, parts, and other inputs from the parent company to manufacture products for export or sale locally. Other such invested overseas firms may produce inputs and ship them to their parent company for final production.

<sup>24</sup> 15 CFR 806.15(a)(1). The 10% ownership share is the threshold considered to represent an effective voice or lasting influence in the management of an enterprise. See BEA, *International Economic Accounts, BEA Series Definitions*, available at <http://www.bea.gov/international>

<sup>25</sup> BEA also reports FDI data according to broad industrial sections, including mining; utilities; wholesale trade; information; depository institutions; finance (excluding depository institutions); professional, scientific, and technical services; non-bank holding companies; manufacturing (including food, chemicals, primary and fabricated metals, machinery, computers and electronic products, electrical equipment, appliances and components, transportation equipment, and other manufacturing); and other industries.

China has also invested in a number of U.S. companies, projects, and various ventures which do meet the U.S. definition of FDI, but which, when added up, are significant.

## China's Holdings of U.S. Securities<sup>26</sup>

China's holdings of U.S. securities are significant.<sup>27</sup> These include U.S. Treasury securities, U.S. government agency (such as Freddie Mac and Fannie Mae) securities, corporate securities, and equities (such as stocks). U.S. Treasury securities, which help the federal government finance its budget deficit, are the largest category of U.S. securities held by China.<sup>28</sup> As indicated in **Table 6** and **Figure 6**, China's holdings of Treasury securities increased from \$118 billion in 2002 to nearly \$1,160 billion in 2010 (year-end), and its share of total foreign holdings of U.S. Treasury securities increased from 9.6% to 26.1%, making China the largest foreign holder of U.S. Treasury securities (it overtook Japan in September 2008). The Department of the Treasury reported in May 2011 that China's Treasury securities holdings had fallen to \$1,145 billion as of March 2011.<sup>29</sup> However, this figure likely understates China's actual holdings.<sup>30</sup>

China's large holdings of U.S. securities can be largely attributed to its policy of intervening in exchange rate markets to limit the appreciation of its currency, the renminbi (RMB), to the U.S. dollar (discussed in more detail below). For example, the Chinese government requires Chinese exporters (who are often paid in dollars) to turn over their dollars in exchange for RMB. As a result, the Chinese government has accumulated a significant amount of dollars. Rather than hold onto U.S. dollars, which earn no interest, the Chinese government has chosen to invest many of them into U.S. Treasury securities because they are seen as a relatively safe investment.

**Table 6. China's Holdings of U.S. Treasury Securities: 2002-2010**

(\$ billions and as a percent of total foreign holdings)

	2002	2003	2004	2005	2006	2007	2008	2009	2010
China's Holdings (\$ billions)	118.0	159.0	222.9	310.0	396.9	477.6	727.4	894.8	1,160.1
China's Holdings as a Percent of Total Foreign Holdings	9.6%	10.4%	12.1%	15.2%	18.9%	20.3%	23.6%	24.2%	26.1%

**Source:** U.S. Treasury Department, year end data.

<sup>26</sup> For additional information on this issue, see CRS Report RL34314, *China's Holdings of U.S. Securities: Implications for the U.S. Economy*, by Wayne M. Morrison and Marc Labonte.

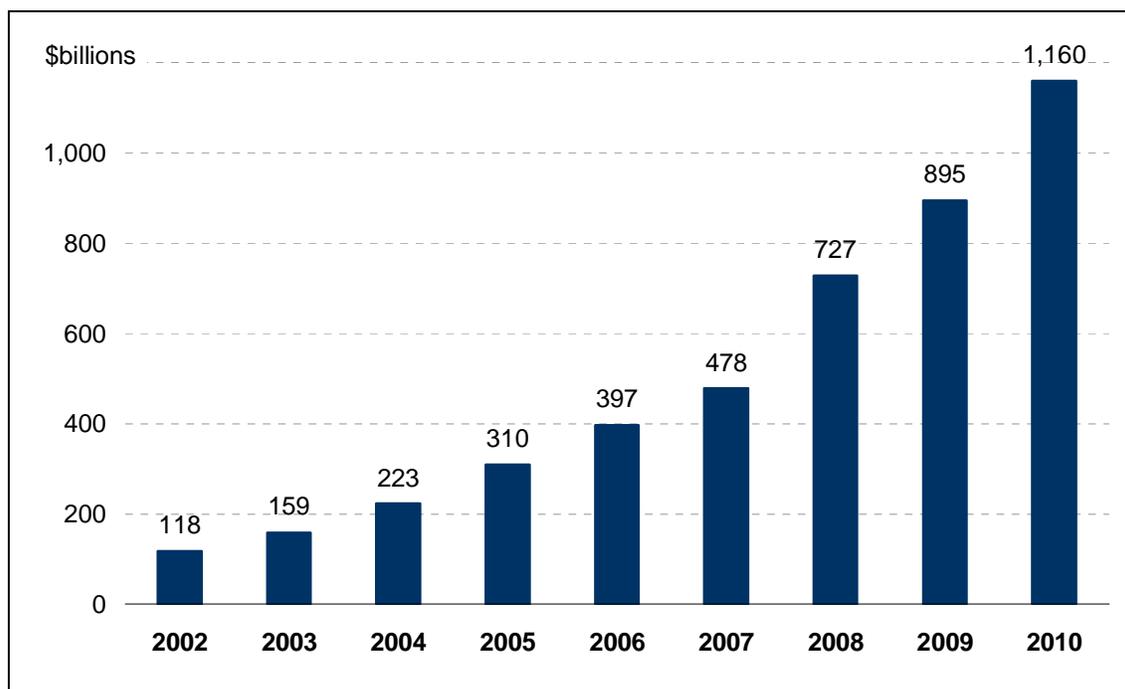
<sup>27</sup> It is estimated China's total holdings of U.S. securities was nearly \$1.9 trillion at the end of 2010.

<sup>28</sup> Some observers characterize foreign holdings of U.S. Treasury securities as "foreign ownership of U.S. government debt."

<sup>29</sup> U.S. Department of the Treasury, *Major Foreign Holders of U.S. Treasury Securities*, May 16, 2011.

<sup>30</sup> The Department of the Treasury reports foreign holdings of U.S. Treasury securities on a monthly basis. These monthly data generally reflect the country where the purchase was made. Treasury makes revisions to its monthly data at least once a year, based on a department survey which attempts to determine the country of origin of the purchaser of the security, rather than where it was purchased. Treasury's revisions usually show a significant increase in the estimated level of China's Treasury holdings for that year. For example, on February 15, 2011, Treasury reported that China's holdings of U.S. Treasury securities totaled about \$892 billion at the end of 2010. But on February 23, 2011, it revised this number upward by 30% to \$1,160 billion, based on the result of its survey of actual holders.

**Figure 6. China's Holdings of U.S. Treasury Securities: 2002-2010 (year-end)**  
(\$ billions)



**Source:** U.S. Department of the Treasury.

Many U.S. policymakers have expressed concern over China's large holdings of U.S. securities, especially U.S. Treasury securities. They argued that although such purchases have contributed to the ability of the United States to meet its investment needs and have helped fund the growing U.S. federal budget deficit (thus helping to keep real U.S. interest rates low), they could give China increased leverage over the United States on major bilateral political and economic issues.<sup>31</sup> In the 112<sup>th</sup> Congress, S. 1028 (Cornyn) would seek to increase the transparency of foreign ownership of U.S. debt instruments, especially in regards to China, in order to better assess the potential risks such holdings could pose for the United States.<sup>32</sup> The bill would require the President to issue a quarterly report on foreign holders of U.S. debt instruments, which would include a breakdown of foreign ownership by country of domicile and by the type of creditor (i.e., public, quasi-public, private); an analysis of the country's purpose and long-term intentions in regard to its U.S. debt holdings; an analysis of the current and foreseeable risks to U.S. national security and economic stability of each nation's U.S. debt holdings; and a determination whether such risks are "acceptable or unacceptable."<sup>33</sup>

<sup>31</sup> Some policymakers argue, for example, that China could threaten to sell off a large share of its dollar holdings, which could have a number of significant consequences for the U.S. economy.

<sup>32</sup> The bill states, for example, that under certain circumstances, China's holdings of U.S. debt could give it a tool with which it can try to manipulate U.S. domestic and foreign policymaking, including the U.S. relationship with Taiwan; and that China could attempt to destabilize the U.S. economy by rapidly divesting large portions of its holdings of U.S. debt instruments.

<sup>33</sup> If the President determines that a foreign country's holdings of U.S. debt instruments was an unacceptable risk, he would be required to formulate an action plan to reduce that risk.

Many analysts contend that China's holdings of U.S. debt gives it very little practical leverage over the United States. They argue that, given China's economic dependency on a stable and growing U.S. economy, and its substantial holdings of U.S. securities, any attempt to try to "dump" a large share of those holdings would likely damage both the U.S. and Chinese economies.<sup>34</sup> Such a move could also cause the U.S. dollar to sharply depreciate against global currencies, which could reduce the value of China's remaining holdings of U.S. dollar assets. Analysts also note that, while China is the largest foreign owner of U.S. Treasury Securities, those holdings are equal to only 8.3% of total U.S. public debt.<sup>35</sup> Finally, it is argued that, as long as China continues to largely peg the RMB to the U.S. dollar, it has little choice but to purchase U.S. dollar assets in order to maintain that peg, which, it is argued, gives China very little leverage over the United States.

Over the past years, Chinese officials have expressed concern over the "safety" of their large holdings of U.S. debt. They worry that growing U.S. government debt and expansive monetary policies will eventually spark inflation in the United States, resulting in a sharp depreciation of the dollar. This would diminish the value of China's dollar asset holdings.<sup>36</sup> Several Chinese officials have publicly called for replacing the dollar as the world's major reserve currency with some other currency arrangement, such as through the International Monetary Fund's special drawing rights system. Most mainstream economists do not think this would be a feasible alternative in the short run.

## **Bilateral FDI Flows**

China's FDI in the United States is quite small relative to its investments in U.S. securities.<sup>37</sup> According to the U.S. Bureau of Economic Affairs (BEA), the cumulative level of Chinese FDI in the United States through the end of 2009 was \$791 million on a historical-cost (or book value) basis, while China's investments in U.S. securities were an estimated \$1.6 trillion at year-end 2009.<sup>38</sup> According to the BEA, in 2009, China ranked as the 34<sup>th</sup>-largest source of cumulative FDI in the United States.<sup>39</sup> Several analysts note that China often uses offshore locations (such as Hong Kong) to invest in other countries. BEA also reports cumulative FDI data according to the country of ultimate beneficial owner (UBO). Those data indicate that Chinese FDI in the United States through 2009 was actually \$2.3 billion.<sup>40</sup>

U.S. FDI in China is significantly higher than China's FDI in the United States, according to BEA data. Cumulative U.S. FDI in China through 2009 was \$49.4 billion (roughly the size of cumulative U.S. FDI in Spain), making it the 17<sup>th</sup>-largest overall destination of U.S. FDI. U.S. FDI flows to China fell by about \$7 billion in 2009, due largely to the effects of the global

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<sup>34</sup> Some analysts counter that the ability of China to possibly disrupt the U.S. economy through selling off U.S. government debt (despite the potential costs to the Chinese economy) potentially puts the United States in a vulnerable position.

<sup>35</sup> The U.S. federal debt at the end of 2010 was \$14.0 trillion. Of this amount, 40.3% was publicly-owned and 59.7% was privately-owned. Foreign investors held 53.5% of privately-owned U.S. federal debt and 31.9% of total U.S. federal debt.

<sup>36</sup> See *China View*, "U.S. stimulus-related debt could hurt investors, China warns," February 18, 2009.

<sup>37</sup> U.S. and Chinese data on FDI flows between each other differ significantly.

<sup>38</sup> However, according to Chinese data, its cumulative FDI in the United States from 2003 to 2009 totaled \$3.3 billion.

<sup>39</sup> BEA data on bilateral investment flows can be found at <http://www.bea.gov/international/index.htm#iip>.

<sup>40</sup> See BEA UBO tables at <http://www.bea.gov/international/di1fdibal.htm>.

economic slowdown (see **Table 7**). According to BEA, U.S. majority-owned nonbank affiliates in China employed 774,000 workers in China in 2008.<sup>41</sup>

**Table 7. U.S. Data on U.S.–China Bilateral FDI Flows: 2003-2009 and Cumulative Value at Year-End 2009**

(\$ millions)

	2003	2004	2005	2006	2007	2008	2009	Cumulative: Value of FDI in 2009 Year-End
China's FDI in the U.S.*	-62	150	146	315	137	368	-271	791
U.S. FDI in China	1,273	4,499	1,955	4,226	5,331	15,726	-6,997	49,403

**Source:** U.S. Bureau of Economic Analysis.

**Notes:** Cumulative data are on a historical-cost basis. \*Excludes Chinese FDI in the United States that may have made through other countries.

### Chinese Companies in the United States

Although the level of Chinese FDI in the United States is relatively small, many Chinese firms view the United States as a key part of their efforts to become more globally competitive companies, move closer to their U.S. customers, and to circumvent perceived trade and investment barriers (such as the Buy American Act). Some examples of Chinese FDI in the United States include the following:

**Suntech Power Holdings Co., Ltd**, the world's largest producer of solar panels, opened a solar plant in Goodyear, AZ, in October 2010 and plans to employ 150 workers by the end of 2011.

**Pacific Century Automotive Systems Co., Ltd** (an entity formed by the Tempo Group and an affiliate of the Beijing Municipal Government), acquired U.S. auto parts supplier Nexteer Automotive from General Motors Co. for \$420 million in November 2010. Under the agreement, Saginaw, MI, will remain as Nexteer's global headquarters, where it reportedly employs 3,000 workers.<sup>42</sup>

**Sany Group**, a global producer of construction equipment, founded Sany America Inc. in 2006, headquartered in Peachtree City, GA. In 2007 announced it would invest \$100 million to create and establish a manufacturing facility for constructing and engineering Sany products, with expected employment of 300 workers by the time the project is completed.<sup>43</sup>

**Wanxing Group**, an automotive parts manufacturer, established Wanxiang America Corporation in 1994, based in Illinois. Over the past decade, Wangxing America reportedly has purchased or invested in more than 20 U.S. firms and employs 5,000 U.S. workers—more than any other Chinese company.<sup>44</sup>

<sup>41</sup> BEA, U.S. *Direct Investment Abroad: Financial and Operating Data for U.S. Multinational Companies*, available at <http://www.bea.gov/international/di1usdop.htm>.

<sup>42</sup> New York Times, "G.M. Sells Parts Maker to a Chinese Company," November 29, 2010, available at <http://www.nytimes.com/2010/11/30/business/30gm.html>.

<sup>43</sup> Sany America website at <http://www.sanyamerica.com/about-sany-america.php#ribbon>.

<sup>44</sup> Washington Post, "Job creation seen as key to China's investment in U.S.," January 19, 2011, available at <http://www.washingtonpost.com/wp-dyn/content/article/2011/01/18/AR20110118066676.html>.

## Other Investment Indicators

In addition to China's FDI in the United States and its holdings in U.S. Treasury securities, China (as of June 2010) held to \$127 billion in U.S. equities (such as stocks), up from \$3 billion in June 2005. It also held \$360 billion in U.S. agency securities, many of which are asset-backed (such as Fannie Mae and Freddie Mac securities).<sup>45</sup> The China Investment Corporation (CIC), a sovereign wealth fund established by the Chinese government in 2007 with \$200 billion in registered capital to help better manage China's foreign exchange reserves, has been one of the largest Chinese purchasers of U.S. equities and other U.S. assets; it has stakes in such firms as Morgan Stanley, the Blackstone Group, and J.C. Flowers & Co.<sup>46</sup> It appears that many of the investments by the CIC and other Chinese entities has attempted to avoid political controversy in the United States by limiting its ownership shares to less than 10%.

## Investment Issues

Many U.S. analysts contend that greater Chinese FDI in the United States, especially in "greenfield" projects (new ventures) that manufacture products or provide services in the United States and create new jobs for U.S. workers,<sup>47</sup> could help improve bilateral economic relations and might lessen perceptions among some critics in the United States that growing U.S.-China trade undermines U.S. employment and harms U.S. economic interests.<sup>48</sup> A number of analysts note that China's outward FDI has been growing rapidly since around 2004 and this is likely to continue in the years ahead.<sup>49</sup> Such analysts contend that greater efforts should be made by U.S. policymakers to encourage Chinese firms to invest in the United States rather than block them for political reasons.

Some critics of China's current FDI policies and practices contend that they are largely focused on mergers and acquisitions that are geared toward boosting the competitive position of Chinese firms and enterprises favored by the Chinese government for development (some of which also may be receiving government subsidies as well). In some instances, it is argued, such investment is done largely to transfer technology and know-how to Chinese firms, but do little to help the U.S. economy. Another major problem relating to Chinese FDI in the United States is the relative lack of transparency of Chinese firms, especially in terms of their connections to the central government. Whenever Chinese state-owned enterprises (SOEs) attempt to purchase U.S. company assets, many U.S. analysts begin to ask what role has Beijing played in that decision. Many U.S. policymakers are troubled by the possibility that efforts by Chinese SOEs to acquire U.S. company assets could be part of the Chinese central government strategy to develop global Chinese firms that may one day threaten the economic viability of U.S. firms. Chinese officials contend that investment decisions by Chinese companies, including SOEs and publicly held firms

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U.S. Department of the Treasury, *Report on Foreign Portfolio Holdings of U.S. Securities as of June 30, 2010*, April 2011.

<sup>46</sup> For more information on the CIC, see CRS Report R41441, *China's Sovereign Wealth Fund: Developments and Policy Implications*, by Michael F. Martin.

<sup>47</sup> According to the BEA, Chinese majority-owned nonbank affiliates in the United States employed only 1,700 U.S. workers in 2006 (most recent data available).

<sup>48</sup> During the 1980s, Japanese firms significantly boosted their FDI in the United States, such as in automobile manufacturing, in part to help to alleviate bilateral trade tensions.

<sup>49</sup> China reports that its overseas FDI in 2009 was \$56.3 billion and accumulated overseas FDI was \$245.8 billion through 2009.

(where the government is the largest shareholder), are based on commercial considerations, and have criticized U.S. investment policies as “protectionist.”

According to the Foreign Investment and National Security Act (FISIA) of 2007 (P.L. 110-149), the Committee on Foreign Investment in the United States (CFIUS) is required to conduct an investigation on the effect of the transaction on national security if the covered transaction is a foreign government-controlled transaction (in addition to if the transaction threatens to impair national security, or results in the control of a critical piece of U.S. infrastructure by a foreign person).<sup>50</sup> The House report on the bill (H.Rept. 110-24, H.R. 556) noted: “The Committee believes that acquisitions by certain government-owned companies do create heightened national security concerns, particularly where government-owned companies make decisions for inherently governmental—as opposed to commercial—reasons.”

In some instances, efforts by Chinese firms to acquire U.S. companies (or major parts of those companies) have raised concerns or generated controversy in the United States. To illustrate:

- In 2004, Lenovo Group Limited, a computer company primarily owned by the Chinese government, signed an agreement with IBM Corporation to purchase IBM’s personal computer division for \$1.75 billion. Some U.S. officials raised national security concerns over potential espionage activities that could occur in the United States at IBM research facilities by Lenovo employees if the deal went through. A review of the agreement by CFIUS took place in which IBM and Lenovo were able to address certain national security concerns and, as a result, the acquisition was completed in April 2005.<sup>51</sup>
- In 2005, the China National Offshore Oil Corporation (CNOOC), a Chinese SOE, made a bid to buy UNOCAL, a U.S. energy company, for \$18.5 billion, but widespread opposition in Congress led CNOOC to withdraw its bid. Some Members argued at the time that the proposed takeover represented a clear threat to the energy and national security of the United States, would put vital oil assets in the Gulf of Mexico and Alaska into the hands of a Chinese state-controlled company, could transfer a host of highly advanced technologies to China, and that CNOOC’s bid to take over UNOCAL would be heavily subsidized by the Chinese government. Some Members contended that “vital” U.S. energy assets should never be sold to the Chinese government. CNOOC officials referred to U.S. political opposition to the sale as “regrettable and unjustified.”<sup>52</sup>
- In September 2007, the Chinese firm, Huawei Technologies Co., Ltd, a leading global telecommunications equipment supplier, announced plans, along with its

<sup>50</sup> CFIUS is an interagency committee that serves the President in overseeing the national security implications of foreign investment in the U.S. economy. See CRS Report RL33388, *The Committee on Foreign Investment in the United States (CFIUS)*, by James K. Jackson.

<sup>51</sup> IBM and Lenovo reportedly agreed to address national security concerns by CFIUS. For example, it was agreed that 1,900 employees from a North Carolina research facility, which IBM had shared with other technology companies, would move to another building. See the *Financial Times*, “US State Department limits use of Chinese PCs,” May 18, 2006.

<sup>52</sup> The Senate report of its version of FISIA (S.Rept. 110-80, S. 1610) noted that CNOOC’s attempt to acquire UNOCAL “led many members of Congress to raise questions about the transfer of ownership or control of certain sectors of the U.S. economy to foreign companies, especially to foreign companies located within or controlled by countries the governments of which might not be sympathetic to U.S. regional security interests.”

partner, Bain Capital Partners, to buy the U.S. firm 3Com Corporation, a provider of data networking equipment, for \$2.2 billion. However, the proposed merger was withdrawn in February 2008 following a review of the deal by CFIUS when Huawei and its partner failed to adequately address U.S. national security concerns raised by CFIUS members.

- In July 2009, China's Northwest Nonferrous International Investment Company, a Chinese SOE, made a \$26 million offer to purchase a 51% stake in the Firstgold Corporation, a U.S. exploration-stage company. However, the deal reportedly raised national concerns within CFIUS because some of the mines controlled by Firstgold were near U.S. military installations. As a result, the Chinese firm withdrew its bid in December 2009.<sup>53</sup>
- In February 2010, Emcore Corporation, a provider of compound semiconductor-based components, subsystems, and systems for the fiber optics and solar power markets, announced it had agreed to sell 60% interest in its fiber optics business (excluding its satellite communications and specialty photonics fiber optics businesses) to China's Tangshan Caofeidian Investment Corporation (TCIC) for \$27.8 million. However, Emcore announced in June 2010 that the deal had been ended because of concerns by CFIUS.<sup>54</sup>
- In May 2010, Anshan Iron and Steel Group Corporation (Ansteel), a major Chinese state-owned steel producer, announced plans to form a joint venture with the U.S. firm Steel Development Company in Mississippi to build and operate four mills to produce reinforcing bar and other bar products used in infrastructure applications, and one mill that would be capable of producing electrical and silicon grades of steel used in energy applications.<sup>55</sup> In July 2010, the Congressional Steel Caucus sent a letter signed by 50 Members to Secretary of the Treasury Tim Geithner, expressing concerns over the effect the investment would have "on American jobs and our national security."<sup>56</sup>
- In May 2010, Huawei bought certain intellectual property assets of 3Leaf Systems (an insolvent U.S. technology firm) for \$2 million. A February 2011 letter by issued Senators Jim Webb and Jon Kyl to Commerce Secretary Gary Locke and Treasury Secretary Tim Geithner stated: "We are convinced that any attempt Huawei makes to expand its presence in the U.S. or acquire U.S. companies warrants thorough scrutiny. Moreover, the 3Leaf acquisition appears certain to generate transfer to China by Huawei of advanced U.S. computing technology. Allowing Huawei and, by extension, communist China to have access to this core technology could pose a serious risk as U.S. computer networks come to further rely on and integrate this technology."<sup>57</sup> In February 2011, Huawei stated that CFIUS had formally notified Huawei that it should

<sup>53</sup> *New York Times*, "Chinese Withdraw Offer for Nevada Gold Concern," December 21, 2009.

<sup>54</sup> Emcore Press Release, June 28, 2010, available at [http://www.emcore.com/news\\_events/release?y=2010&news=249](http://www.emcore.com/news_events/release?y=2010&news=249).

<sup>55</sup> A press release by Ansteel stated that its intentions are "to capitalize on the opportunity to enter into an overseas joint venture with a company that is focused on utilizing advanced technology in an environmentally friendly and highly profitable manner." See, <http://www.steeldevelopment.com/documents/ansteel2010.pdf>.

<sup>56</sup> See letter at [http://visclosky.house.gov/7.29.10%20sc\\_letter\\_to\\_white\\_house.pdf](http://visclosky.house.gov/7.29.10%20sc_letter_to_white_house.pdf).

<sup>57</sup> The letter also raised concerns over allegations that Huawei had ties to the Iranian government, had received substantial subsidies from the Chinese government, and had a poor record of protecting intellectual property rights.

withdraw its application to acquire 3Leaf's assets, which it later did<sup>58</sup> In an "Open Letter," Huawei invited the U.S. government to carry out a formal investigation on any concerns it may have about Huawei.<sup>59</sup>

## **U.S. Concerns over China's Investment Regime**

U.S. trade officials have urged China to liberalize its investment regime as part of their efforts to expand U.S. exports to China. Although China is one of the world's top recipients of FDI, the Chinese central government imposes numerous restrictions on the level and of types of FDI allowed in China. To a great extent, China's investment policies appear to be linked to industrial policies that seek to promote the development of key industries in China. FDI inflows are viewed by the government as a method to help Chinese domestic firms gain access to capital, technology, and know-how, which, it is hoped, will help speed up their development. In many cases, the level and scope of FDI in China is restricted in order to prevent foreign firms from dominating any one sector. For example, the Chinese government has made the development of its domestic auto industry a top priority. To that end, the government has encouraged foreign auto companies to invest in China, but limits FDI in that sector to 50-50 joint venture. Many critics contend that the Chinese government often requires foreign firms to transfer technology to their China partners, and sometimes to set up research and development facilities in China, in exchange for access to China's markets.

The United States and China are currently negotiating a bilateral investment treaty (BIT) with the goal of expanding bilateral investment opportunities. U.S. negotiators hope such a treaty would improve the investment climate for U.S. firms in China by enhancing legal protections and dispute resolution procedures, and by obtaining a commitment from the Chinese government that it would treat U.S. investors no less favorably than Chinese investors. However, some U.S. groups have expressed reservations concerning a China-U.S. BIT, arguing that it would encourage U.S. firms to relocate to China.<sup>60</sup>

## **Major U.S.-China Trade Issues**

China's economic reforms and rapid economic growth, along with the effects of globalization, have caused the economies of the United States and China to become increasingly integrated.<sup>61</sup> Although growing U.S.-China economic ties are considered by most analysts to be mutually beneficial overall, tensions have risen over a number of Chinese economic and trade policies that many U.S. critics charge are protectionist, economically distortive, and damaging to U.S.

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<sup>58</sup> Huawei initially stated that it would decline CFIUS's recommendation with the intent of going through all of the procedures of the CFIUS process (including a potential decision by the President) in order to "reveal the truth about Huawei."

<sup>59</sup> Huawei Open Letter, February 25, 2011, available at [http://www.huawei.com/huawei\\_open\\_letter.do](http://www.huawei.com/huawei_open_letter.do)

<sup>60</sup> *Inside U.S.-China Trade*, April 28, 2010.

<sup>61</sup> The impact of globalization has been a controversial topic in the United States. Some argue that it has made it easier for U.S. firms to shift production overseas, resulting in lost jobs in the United States (especially in manufacturing) and lower wages for U.S. workers. Others contend that globalization has induced U.S. firms to become more efficient and to focus a greater share of their domestic manufacturing on higher-end or more technologically advanced production (while sourcing lower-end production abroad), making such firms more globally competitive. The result has been that the United States continues to be a major global manufacturer in terms of value-added, but there are fewer U.S. workers in manufacturing.

economic interests. These include China's resistance to adopting a market-based currency; its mixed record on implementing its obligations in the World Trade Organization (WTO), including its failure to provide adequate protection of U.S. intellectual property rights (IPR); and its use of industrial policies, including discriminatory government procurement policies, to promote and protect various Chinese domestic industries. Some Members have argued that, given the high rate of U.S. unemployment, China's "unfair" economic and trade policies can no longer be tolerated, and have urged the Obama Administration to more aggressively use the trade tools at its disposal to challenge such policies whenever possible, such as U.S. trade remedy laws and the WTO's dispute resolution mechanism.

A 2011 survey by the American Chamber of Commerce of its members in China illustrates China's opportunities and challenges for U.S. firms. It reported that 78% of those surveyed said that they made a profit in China in 2010, and 85% said they would boost investment in their Chinese operations in 2010. However, 35% of respondents stated that it has become more difficult to obtain businesses licenses in recent years and 25% said that China's indigenous innovation policies (discussed below) were hurting their businesses.<sup>62</sup>

### **China's Currency Policy<sup>63</sup>**

Unlike most advanced economies (such as the United States), China does not maintain a market-based floating exchange rate. Between 1994 and July 2005, China pegged its currency, the renminbi (RMB) or yuan, to the U.S. dollar at about 8.28 yuan to the dollar.<sup>64</sup> In July 2005, China appreciated the RMB to the dollar by 2.1% and moved to a "managed float," based on a basket of major foreign currencies, including the U.S. dollar. In order to maintain a target rate of exchange with the dollar (and other currencies), the Chinese government has maintained restrictions and controls over capital transactions and has made large-scale purchases of U.S. dollars (and dollar assets).<sup>65</sup> According to the Bank of China, from July 2005 to July 2009, the dollar-yuan exchange rate went from 8.27 to 6.83 yuan per dollar, an appreciation of 21.1%.<sup>66</sup> However, once the effects of the global financial crisis became apparent, the Chinese government halted its appreciation of the RMB and subsequently kept the yuan/dollar exchange rate relatively constant at 6.83 from July 2009 to June 2010 in order to help limit the impact of the sharp decline in global demand for Chinese products.

Many U.S. policymakers, labor groups, and business representatives of import-sensitive industries have charged that, despite minor reforms, the Chinese government continues to manipulate its currency in order to keep the value of its currency artificially low against the dollar (with estimates of undervaluation ranging from 15% to 50%). They claim that this policy constitutes a de facto subsidy for Chinese exports to the United States, and acts as a de facto tariff on Chinese imported U.S. goods. They complain that this policy has particularly hurt several U.S. manufacturing sectors that are forced to compete against low-cost Chinese products, and has led

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<sup>62</sup> The American Chamber of Commerce, People's Republic of China, *China's Business Climate Survey, 2011*, March 19, 2011.

<sup>63</sup> For additional information on this issue, see CRS Report RS21625, *China's Currency: An Analysis of the Economic Issues*, by Wayne M. Morrison and Marc Labonte.

<sup>64</sup> The official name of China's currency is the renminbi, which is denominated in units of yuan.

<sup>65</sup> Much of China's trade is believed to be in U.S. dollars (e.g., exporters are often paid in dollars). The central government requires firms to exchange most of their dollars for RMB.

<sup>66</sup> Calculated from Bank of China data using the official middle rate.

to the loss of hundreds of thousands of U.S. jobs. Critics further charge that China's currency policy has been a major factor in the size and growth of the U.S. trade deficit with China. Some Members of Congress contend that, given the current high rate of unemployment in the United States, Chinese "currency manipulation" can no longer be tolerated.

Chinese officials have insisted that the current currency policy is not meant to favor exports over imports, but instead to foster domestic economic stability.<sup>67</sup> They have expressed concern that abandoning the currency policy, especially given the current state of the global economy, could further weaken its export industries and cause wide-scale layoffs. Chinese officials view economic stability as critical to sustaining political stability. However, on June 19, 2010, the Chinese central bank, the People's Bank of China (PBC) stated that, based on current economic conditions, it had decided to "proceed further with reform of the RMB exchange rate regime and to enhance the RMB exchange rate flexibility." It ruled out any large one-time revaluations, stating "it is important to avoid any sharp and massive fluctuations of the RMB exchange rate," in part so that Chinese corporations could more easily adjust (such as through upgrading) to an appreciation of the currency. Many observers contend the timing of the RMB announcement was intended in part to prevent China's currency policy from being a central focus of the G-20 summit in Toronto from June 26-27, 2010, and possibly to head off threatened congressional action over the issue. From June 19, 2010 to June 2, 2011, the RMB appreciated by 5.2% against the dollar, a pace that has been criticized by U.S. officials as far too slow.<sup>68</sup>

Numerous bills have been introduced in Congress over the past few years that would seek to induce China to reform its currency policy or would attempt to address the perceived effects that policy has on the U.S. economy. For example, one bill in the 108<sup>th</sup> Congress (S. 1586) would have imposed an additional duty of 27.5% on imported Chinese products unless China appreciated its currency to near market levels. In the 111<sup>th</sup> Congress, the House passed an amended version of H.R. 2378, which would have made certain misaligned currencies (such as the RMB) actionable under U.S. countervailing duty cases on foreign government export subsidies (although the Senate did not take up the bill); the bill has been re-introduced in the 112<sup>th</sup> Congress (H.R. 639 and S. 328).

## **China's Obligations in 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 was reached that required 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's WTO membership was formally approved at the WTO Ministerial Conference in Doha, Qatar, on November 10, 2001. On November 11, 2001,

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<sup>67</sup> A fixed exchange rate is a relatively common practice among developing countries, especially those that want to attract foreign investment and expand exports. A constant exchange rate, such as one tied to the U.S. dollar, attempts to signal foreign investors that the value of their investments will not be affected by the type of large swings in exchange rates that can occur under a floating exchange rate regime. Given the current size of China's economy and trade flows, most economists question whether the continuation of China's currency policy is appropriate.

<sup>68</sup> China's official middle rate over this period went from 6.83 yuan per dollar to 6.49.

China notified the WTO that it had formally ratified the WTO agreements, and on December 11, 2001, it formally joined the WTO.<sup>69</sup>

Under the WTO accession agreement, China agreed to:

- Reduce the average tariff for industrial goods and agriculture products to 8.9% and 15%, respectively (with most cuts made by 2004 and all cuts completed by 2010).
- Limit subsidies for agricultural production to 8.5% of the value of farm output and eliminate 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 would be treated no less favorably than Chinese firms for trade purposes. End discriminatory trade policies against foreign invested firms in China, such as domestic content rules and technology transfer requirements.
- Implement the WTO's Trade-Related Aspects of Intellectual Property Rights (TRIPS) Agreement upon accession. (That agreement establishes basic standards on IPR protection and rules for enforcement.)
- Fully open the banking system to foreign financial institutions within five years (by the end of 2006). Joint ventures in insurance and telecommunication would be permitted (with various degrees of foreign ownership allowed).

## **WTO Implementation Issues**

Getting China into the WTO under a comprehensive trade liberalization agreement was a major U.S. trade objective during the late 1990s. Many U.S. policymakers at the time maintained that China's WTO membership would encourage the Chinese government to deepen market reforms, promote the rule of law, reduce the government's role in the economy, further integrate China into the world economy, and enable the United States to use the WTO's dispute resolution mechanism to address major trade issues. As a result, it was hoped, China would become a more reliable and stable U.S. trading partner. U.S. trade officials contend that in the first years after it joined the WTO in 2001, China made noteworthy progress in adopting economic reforms that facilitated its transition toward a market economy and increased its openness to trade and FDI. However, beginning in 2006, progress toward further market liberalization appeared to slow. By 2008, U.S. government and business officials noted evidence of trends toward a more restrictive trade regime.<sup>70</sup> The USTR's ninth annual report to China on WTO compliance (issued in December 2010) identified several areas of concern, including:

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<sup>69</sup> Following China's WTO accession, the United States, in January 2002, granted China permanent normal trade relations (PNTR) status (prior to that time, that status was on a conditional basis) to ensure that the United States and China had a formal trade relationship under the rules of the WTO.

<sup>70</sup> China generally implemented its tariff reductions on time. Its average overall tariff dropped from 15.6% in 2001 to 9.8% as of January 2010 (the tariff rate on industrial goods and agricultural products in 2010 was 8.9% and 15.2%, respectively) and a number of non-tariff measures were eliminated.

- failure by the Chinese government to maintain an effective IPR enforcement regime (discussed below);
- industrial policies and national standards that attempt to promote Chinese firms (while discriminating against foreign firms);
- restrictions on trading and distribution rights (especially in regards to IPR-related products, such as movies, books, and music);
- discriminatory and unpredictable health and safety rules on imports (especially agricultural products); and
- burdensome regulations and restrictions on services, and failure to provide adequate transparency of trade laws and regulations.<sup>71</sup>

As of April 2011, the United States has brought 11 trade complaints against China to the WTO's Dispute Resolution Board (DSB), several of which have been resolved or ruled upon. China has brought WTO cases against the United States as well.<sup>72</sup> The U.S. cases are summarized below.

### **Pending U.S. Cases Against China**

- On December 22, 2010, the USTR's office announced that it would bring a WTO case against China over a government program that extended subsidies to Chinese wind power equipment manufacturers that use parts and components made in China rather than foreign-made parts and components.
- On September 15, 2010, the USTR's office announced it was bringing a WTO case against China over its improper application of antidumping duties and countervailing duties on imports of grain oriented flat-rolled electrical steel from the United States.
- On September 15, 2010, the USTR's office announced it was bringing a WTO case against China over its discrimination against U.S. suppliers of electronic payment services.
- On June 23, 2009, the United States brought a case against China's export restrictions (such as export quotas and taxes) on raw materials (bauxite, coke, fluorspar, magnesium, manganese, silicon metal, silicon carbide, yellow phosphorus, and zinc). The United States charges that such policies are intended to lower prices for Chinese firms (steel, aluminum, and chemical sectors) in order to help them obtain an unfair competitive advantage. China claims that these restraints are intended to conserve the environment and exhaustible natural resources. According to some press reports, a WTO panel in April 2011 ruled that China's export restraints violated WTO rules.<sup>73</sup>

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<sup>71</sup> USTR, *2010 Report to Congress on China's WTO Compliance*, December 2010, available at [http://www.ustr.gov/webfm\\_send/2460](http://www.ustr.gov/webfm_send/2460).

<sup>72</sup> China has brought five cases against the United States. These have included challenges to U.S. applications of antidumping and countervailing measures, restrictions on imports of Chinese poultry, and U.S. safeguard measures restricting imports of Chinese tires.

<sup>73</sup> *International Trade Daily*, April 4, 2011.

## **Resolved Cases or a WTO Panel Has Issued a Ruling<sup>74</sup>**

- On December 19, 2008, the USTR filed a WTO case against China over its support for “Famous Chinese” brand programs, charging that such programs utilize various export subsidies (including cash grant rewards, preferential loans, research and development funding to develop new products, and payments to lower the cost of export credit insurance) at the central and local government level to promote the recognition and sale of Chinese brand products overseas. On December 18, 2009, the USTR announced that China had agreed to eliminate these programs.
- On March 3, 2008, the USTR requested WTO dispute resolution consultations with China regarding its discriminatory treatment of U.S. suppliers of financial information services in China. On November 13, 2008, the USTR announced that China had agreed to eliminate discriminatory restrictions on how U.S. and other foreign suppliers of financial information services do business in China.
- On April 10, 2007, the USTR filed a WTO case against China, charging that it failed to comply with the TRIPS agreement (namely in terms of its enforcement of IPR laws). On January 26, 2009, the WTO ruled that many of China’s IPR enforcement policies failed to fulfill its WTO obligations. On June 29, 2009, China announced that it would implement the WTO ruling by March 2010. On the same day the USTR filed another WTO case against China, charging that it failed to provide sufficient market access to IPR-related products, namely in terms of trading rights and distribution services. In August 2009, the WTO ruled that many of China’s regulations on trading rights and distribution that were raised by the U.S. case were WTO-inconsistent. China appealed the decision, but lost, and in February 2010 stated that it would implement the WTO panel decisions (see section on “Violations of U.S. Intellectual Property Rights”).
- On February 5, 2007, the USTR announced it had requested WTO dispute consultations with China over government regulations that give illegal (WTO-inconsistent) import and export subsidies to various industries in China (such as steel, wood, and paper) that distort trade and discriminate against imports.<sup>75</sup> China’s WTO accession agreement required it to immediately eliminate such subsidies. On November 29, 2007, China formally agreed to eliminate the subsidies in question by January 1, 2008.
- On March 30, 2006, the USTR initiated a WTO case against China for its use of discriminatory regulations on imported auto parts (which often applied the high tariff rate on finished autos to certain auto parts), stating that the purpose of these rules was to discourage domestic producers from using imported parts and to encourage foreign firms to move production to China. On February 13, 2008, a WTO panel ruled that China’s discriminatory tariff policy was inconsistent with its WTO obligations (stating that the auto tariffs constituted an internal charge rather than ordinary customs duties, which violated WTO rules on national

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<sup>74</sup> Often cases are resolved through consultations before the case goes to a panel.

<sup>75</sup> Some programs gave tax preferences, tariff exemptions, discounted loans, or other benefits to firms that met certain export performance requirements, while others gave tax breaks for purchasing Chinese-made equipment and accessories over imports.

- treatment). China appealed the decision, but a WTO Appellate Body largely upheld the WTO panel's decision.
- 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. The United States claimed that China applied a 17% value-added tax (VAT) rate on semiconductor chips that were designed and made outside China, but gave VAT rebates to domestic producers. Following consultations with the Chinese government, the USTR announced on July 8, 2004, that China agreed to end its preferential tax policy by April 2005. However, the USTR has expressed concern over new forms of financial assistance given by the Chinese government to its domestic semiconductor industry.

U.S. officials contend that China's incomplete transition to a free market economy is a major factor behind China's failure to fully implement its WTO obligations as well as the source for many U.S. trade disputes with China. Although market forces (and the private sector) play a major role in China's economy, the government continues to play an import role. For example, the banking system is mostly controlled by the government, while SOEs are allowed to dominate certain sectors. Many analysts contend that the main function of China's banking system is to provide low-cost (subsidized) loans to SOEs to promote their development, especially for industries deemed by the government as important to China's future economic development. Some analysts contend that the global economic slowdown has induced the Chinese government to slow or even reverse its long-term movement toward market-based economic reforms, and instead rely more on state intervention in markets to give China a competitive advantage.<sup>76</sup> For example:

- In July 2010, China announced that it would reduce its export quota of rare earth elements (which are used in a wide variety of consumer electronics, green technology products, such as wind turbines, and a number of defense weapon systems) by 70% during the second half of 2010 over the previous year's level (or a 40% drop for the full year over 2009 levels).<sup>77</sup> In December 2010, China announced that quotas on rare earth would be cut further in 2011. China is estimated to produce 95% of the world's rare earth elements. Many analysts have raised concerns that the sharp cuts in China's rare earth exports substantially raised prices of products that use rare earth elements. Some have argued that China's intention is to ensure that its own electronic and high technology industries have access to rare earth elements (and to boost their competitiveness by helping to keep prices low) and to induce foreign technology firms that use rare earth to move their production facilities to China. The USTR has indicated that it may bring a WTO case against China over its restrictions of rare earth elements.
- In March 2010, Google Inc. announced that it would redirect users of its Internet engine, Google.cn in China, to Google.com.hk in Hong Kong. Google said it was taking this step because of cyber attacks on its system believed to have originated

<sup>76</sup> Some analysts refer to this as state capitalism, a condition where free markets exist globally, but competitive outcomes are heavily influenced by direct intervention by a foreign government.

<sup>77</sup> For additional information on this issue, see CRS Report R41347, *Rare Earth Elements: The Global Supply Chain*, by Marc Humphries.

inside China, the hacking of Gmail accounts of Chinese human rights activists, and because Google decided that it would no longer comply with the Chinese government's censorship requirements. On July 9, 2010, Google announced that the Chinese government had renewed its Internet Content Provider license, but stated it would provide limited services in China. A number of analysts contend that Chinese government Internet censorship and cyber attacks have gotten worse recently, and that such trends have undermined the business environment in China. On June 1, 2011, Google reported that it had uncovered a campaign (which appears to have originated from Jinan, China) to gain access to the personal Gmail accounts of hundreds of users including, senior U.S. government officials, Chinese political activists, officials in several Asian countries military personnel, and journalists.<sup>78</sup> Some groups have urged the U.S. government to file a WTO case against China over these activities.

- In November 2009, the Chinese government released a "Circular on Launching the 2009 National Indigenous Innovation Product Accreditation Work," requiring companies to file applications by December 2009 for their products to be considered for accreditation as "indigenous innovation products." The proposal would, in effect, extend preferential treatment for government procurement to domestic firms that developed and owned intellectual property in China projects (discussed in more detail below).
- In February 2009, the Chinese government announced plans to provide financial support to 10 sectors, including autos, steel, shipbuilding, machinery, textiles, electronics and information (e.g., computers), light industry, petrochemicals, metals, and logistics. Financial support would include tax cuts and incentives, subsidies, directives to banks to provide financing, direct funds to support technology upgrades and the development of domestic brands, favorable government procurement policies, the extension of export credits, and funding to help firms invest overseas.

## **Violations of U.S. Intellectual Property Rights**

Lack of effective and consistent protection in China of IPR has been cited by U.S. firms as one of the most significant problems they face in doing business in China. Although China has improved significantly its IPR protection regime over the past few years by beefing up its IPR laws and conducting periodic focused campaigns (such as raids) against major IPR infringers, U.S. industries complain that piracy rates in China remain unacceptably high. The U.S. International Trade Commission (USITC) estimates that U.S. intellectual property-intensive firms that conducted business in China lost \$48.2 billion in sales, royalties, and license fees in 2009 because of IPR violations in China.<sup>79</sup> The International Intellectual Property Alliance (IIPA) estimated that business software piracy in China alone cost U.S. firms \$3.4 billion in lost trade in 2009.<sup>80</sup> The Business Software Alliance (BSA) estimates the commercial value of illegally used software in China in 2009 was \$7.6 billion, a \$900 million increase over 2008 levels.<sup>81</sup> Critics of China's IPR regime note that, even when the Chinese government enforces its IPR laws, the resulting fines, seizures, and other punishments are often not significant enough to act as an effective deterrence against piracy. The U.S. Customs and Border Protection reported that China accounted for 66% of

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<sup>78</sup> Google Blog, June 1, 2011, available at <http://googleblog.blogspot.com>.

pirated goods seized by the agency in FY2010 (based on domestic value). Piracy also has a number of negative effects on China's economy. For example:

- The Chinese government estimates that counterfeits constitute between 15% and 20% of all products made in China and are equivalent to about 8% of China's annual gross domestic product.
- A study by the Motion Picture Association of America estimated that China's domestic film industry lost about \$1.5 billion in revenue to piracy in 2005 (and that the combined losses of both foreign and Chinese film makers totaled \$2.7 billion).<sup>82</sup> It also found that about half of pirated films in China are Chinese movies.
- A BSA study estimates that a 10 percentage point reduction in China's PC software piracy rates within two years would raise Chinese GDP by up to \$20.1 billion and create an additional 250,000 jobs.<sup>83</sup>

Opinions differ as to why the Chinese government has been unable (or unwilling) to make a significant reduction in the level of piracy in China. Some explanations put forward by various analysts include the following:

- China's transformation from a command economy, in which the government owned and controlled nearly every aspect of the economic life, to one that has become more market-based is a relatively recent occurrence in China's history. Thus, IPR is a somewhat alien or unfamiliar concept for most people in China and consequently it is difficult for the government to convince the public that IPR piracy is wrong.
- Chinese leaders want to make China a major producer of capital-intensive and high-technology products, and thus, they are tolerant of IPR piracy if it helps Chinese firms become more technologically advanced. A 2010 report by the International Intellectual Property Alliance (IIPA) contends that "China appears to have adopted an industrial policy in which such theft is a component driving Chinese competitiveness, or at a minimum, permitting free access to American content through unapproved pirate channels which simply ignore censorship controls but to which legitimate rights holders must adhere."<sup>84</sup>
- Although the central government may be committed to protecting IPR, local government officials are often less enthusiastic to do so because production of

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(...continued)

<sup>79</sup> The United States International Trade Commission, *China: Effects of Intellectual Property Infringement and Indigenous Innovation Policies on the U.S. Economy*, USITC Publication 4226, May 2011, p. xiv.

<sup>80</sup> IIPA, *IIPA 2010 'Special 301 Recommendations'*, 2010. Available at <http://www.iipa.com/rbc/2010/2010SPEC301LOSSLEVEL.pdf>.

<sup>81</sup> BSA, *Seventh Annual Global Software Piracy Study*, 2010, p.5. Available at [http://portal.bsa.org/globalpiracy2009/studies/09\\_Piracy\\_Study\\_Report\\_A4\\_final\\_111010.pdf](http://portal.bsa.org/globalpiracy2009/studies/09_Piracy_Study_Report_A4_final_111010.pdf).

<sup>82</sup> *Reuters*, "China Piracy Costs Film Industry \$2.7 Billion in 2005," June 19, 2006.

<sup>83</sup> BSA, *2010 Piracy Impact Study: the Economic Benefits of Reducing Software Piracy*, available at <http://portal.bsa.org/piracyimpact2010/studies/piracyimpactstudy2010.pdf>.

<sup>84</sup> IIPA, *2010 Special 301 Report on Copyright Protection and Enforcement, People's Republic of China*, February 18, 2010.

pirated products generates jobs and tax revenue, and some officials may be obtaining bribes or other benefits, which prompts them to tolerate piracy. As a developing country, China lacks the resources and a sophisticated legal system to go after and punish IPR violators, and hence, establishing an effective enforcement regime will take time.

- As a practical matter, IPR enforcement in China will be problematic until Chinese-owned companies begin to put pressure on the government to protect their own brands and other IPR-related products. U.S. trade officials note that the Chinese government took aggressive action during the 2008 summer Olympics in Beijing to stop infringement activities.
- Chinese trade barriers and restrictive regulations on IPR-related products and their distribution are so onerous that they prevent legitimate products from entering the market, or raise costs so high that they are unaffordable to the average individual, thus creating a huge demand for low-cost pirated products.<sup>85</sup>

### The U.S. WTO Cases Against China on IPR

On April 10, 2007, the USTR brought two IPR cases against China in the WTO involving a number of complaints.<sup>86</sup>

- The thresholds for criminal prosecutions of IPR violations in China are too high, meaning the government will only pursue cases it considers to be serious or excessively large, creating a safe harbor for smaller producers or violators. In addition, the thresholds for prosecuting IPR violations are based on the value of the pirated products rather than the value such legitimate products would fetch in the marketplace. Such thresholds make it very difficult to pursue cases against many commercial producers of illegal IPR-related products.
- The Chinese government often allows seized imported pirated goods to reenter the market rather than disposing of them.
- China's copyright laws fail to protect imported works (such as movies) that are under review by Chinese censorship authorities (and must be approved before the works can be distributed in China). As a result, pirated copies of the works can be widely distributed without violating copyright law and thus do not face prosecution.
- Chinese IPR laws do not appear to allow producers of pirated products to be prosecuted unless they also illegally distribute such products.
- China has not abided by its 2001 WTO accession agreement to liberalize its rules on trading rights and distribution services. As a result, U.S. IPR-related products face significant market access barriers in China, which drive up the price of

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<sup>85</sup> For example, China only allows 20 foreign movies to be imported each year (in part to protect China's domestic movie industry), and these must undergo inspection for content before they can be released for distribution in China. Such restrictions do not effectively stop U.S. movies from entering China, but instead seem to ensure that most of these are pirated versions because of the high Chinese demand for foreign movies.

<sup>86</sup> See USTR April 9, 2007, Press Release and related documents at <http://www.ustr.gov/index.html>.

legitimate products, making them unaffordable for the average Chinese citizen, which in turn encourages high rates of piracy.

On January 26, 2009, a WTO panel ruled on the case dealing with IPR enforcement issues, finding that China failed to protect IPR works under review by the government for content and in regards to the disposal of seized pirated products. However, the panel determined that it needed more evidence on the issue of thresholds for criminal prosecutions of IPR piracy before a determination could be made. The USTR, while admitting disappointment on the WTO findings on thresholds, noted that, right before it filed the WTO case on China's IPR enforcement, China lowered its threshold criminal copyright threshold from 1,000 to 500 infringing copies. China has agreed to implement the WTO ruling.

On August 12, 2009, a WTO panel ruled that a number of China's restrictions on trading rights and distribution of IPR-related products (including reading material, audiovisual home entertainment products, sound recordings, and films for theatrical release) were inconsistent with WTO rules, namely discriminatory regulations on distribution services in China (where foreign firms are treated less favorably than domestic firms) and rules that designate only state-owned monopolies as entities that can import such products. However, the WTO panel did not address whether China's censorship policies, or its limits on the number of foreign films that can be imported, violated WTO rules. China appealed the panel's decision, but lost. Although China agreed to implement the WTO DSB's ruling by March 2011, the United States charges that China has not brought all of its measures in compliance with the WTO ruling.<sup>87</sup>

The USTR's 2010 Special 301 report stated that China continued to be a major focus of U.S. IPR concerns. It noted that, although China had made considerable progress in improving its IPR enforcement regime, IPR piracy rates remained at "unacceptable levels." In addition, USTR head Ron Kirk stated

we are seriously concerned about China's implementation of "indigenous innovation" policies that may unfairly disadvantage U.S. IPR holders. Procurement preferences and other measures favoring 'indigenous innovation' could severely restrict market access for American technology and products. Creating an environment that nurtures innovation and entrepreneurship is a worthy goal, but China must maintain a level playing field.

During the December 2010 U.S.-China Joint Commission on Commerce and Trade (JCCT),<sup>88</sup> the Chinese government announced several new initiatives to improve its IPR protection regime, including boosting purchases of legitimate software by government agencies and 30 large state-owned enterprises.

The USTR's 2011 Special 301 report noted that China had launched the "Program for Special Campaign on Combating IPR Infringement and Manufacture and Sales of Counterfeiting and Shoddy Commodities" (Special Campaign) in October 2010 aimed at a broad ranges of IPR violations, and involving 26 member agencies (led by a Chinese vice premier), which reportedly has improved government coordination of IPR enforcement. The USTR stated that: "If China makes permanent the temporary leadership structure created to manage the Special Campaign, including the key role of the Vice Premier, it could drive lasting improvements in IPR

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<sup>87</sup> If China fails to comply, the United States could request the WTO to authorize it to impose sanctions against China.

<sup>88</sup> The JCCT was established in 1983 to serve as a forum for high-level dialogue on major bilateral trade issues.

enforcement.”<sup>89</sup> However, the USTR noted that it appears that the Special Campaign has not yet had a positive affect on U.S. IPR stakeholders in terms of lowering piracy rates and boosting demand for legitimate products. The report noted U.S. concerns over a May 2010 decision by the Chinese government to triple the threshold for investigating and prosecuting trade in counterfeit products, which, the USTR contends, will further undermine China’s IPR enforcement environment.

The 2011 China Business Climate Survey found that respondents that rated China’s IPR enforcement as effective or very effective had risen from 16% in 2002 to 30% in 2011. Over the same period, respondents who found China’s IPR enforcement to be ineffective or totally ineffective went from 84% to 70%, indicating that, while China’s IPR enforcement regime has shown improvement, it still has a long way to go to be effective at halting widespread IPR piracy in China.<sup>90</sup>

## Indigenous Innovation and Government Procurement Policies

Numerous policies have been implemented in China to promote the development of industries deemed critical for future economic growth. The Chinese government’s 11<sup>th</sup> Five-Year Plan (2006-2010) states that a central goal is to, within 15 years, change China from a major manufacturing center to a major global source of innovation. As a result of the plan, China has focused a large share of its research and development (R&D) on its space programs, aerospace development and manufacturing, renewable energy, computer science, and life sciences.<sup>91</sup> Nearly 70% of the performance (as well as funding) of China’s R&D comes from the government and about 21% from industry.

### Indigenous Innovation Policies

Several U.S. companies have complained about a number of Chinese government (from the central government as well as provincial and local government) circulars that would establish an “Indigenous Innovation Product Accreditation” system; this would give preferential treatment to locally developed technologies in government procurement. U.S. business representatives have sharply criticized the policy, which they contend is “protectionist” because it would require that public procurement projects provide preference to suppliers who have been accredited by the government as having developed their intellectual property in China. A letter written by the U.S. Chamber of Commerce and 33 business associations to the Chinese government on December 10, 2009, stated that the circulars would “make it virtually impossible for any non-Chinese companies to participate in China’s government procurement market—even those that have made substantial and long-term investments in China, employ Chinese citizens, and pay taxes to the Chinese government.” U.S. firms note that a large share of their technology is developed globally and thus it would be difficult to attribute the share of technology developed in China needed to obtain accreditation.<sup>92</sup>

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<sup>89</sup> USTR, *2011 Special 301 Report*, April 2011, p. 19. See, [http://www.ustr.gov/webfm\\_send/2841](http://www.ustr.gov/webfm_send/2841).

<sup>90</sup> The American Chamber of Commerce, People’s Republic of China, *China’s Business Climate Survey, 2011*, March 19, 2011.

<sup>91</sup> *R&D Magazine*, December 22, 2009.

<sup>92</sup> Some analysts contend that one motive for the circulars is to force foreign companies to do more of their research and development in China in order to gain accreditation, thus enhancing China’s access to technology, which the (continued...)

China's proposed indigenous innovation policies were one of the top U.S. priorities at the May 2010 U.S.-China Strategic and Economic Dialogue (S&ED) (discussed below). The two sides reaffirmed that their innovation policies would be consistently based on non-discrimination; support for market competition and open international trade and investment; strong enforcement of IPR; and leaving the terms and conditions of technology transfer, production processes, and other proprietary information to agreement between individual enterprises. The two sides further agreed to conduct "intensive expert and high-level discussions" as early as the summer of 2010 on innovation issues and pledged to take into account the results of these talks in formulating and implementing their innovation measures.<sup>93</sup> During the December 2010 U.S.-China JCCT meeting, China stated that it will give equal treatment to all innovation products produced in China by foreign-invested enterprises and Chinese-invested enterprises alike.

### **Chinese Government Procurement Issues**

Estimates of the value of annual Chinese public procurement differ significantly. The USITC estimated the amount could range from \$88 billion to \$200 billion.<sup>94</sup> China has established a number of restrictive government procurement practices and policies. For example, in November 2008, China announced that it would implement a \$586 billion stimulus package, largely focused on infrastructure projects, in order to boost economic growth in the wake of the global economic slowdown. In June 2009, the government reportedly issued a circular with "Buy China" provisions requiring that projects funded by the stimulus package give preferences to domestic firms.

Government procurement policies are largely exempt from WTO rules, except for those members which have signed the WTO Government Procurement Agreement (GPA). The GPA is a plurilateral agreement among 41 WTO members (including the United States, Japan, and the 27 members of the European Union) that effectively provides market access for various non-defense government procurement projects to signatories to the agreement. Each member of the Agreement submits lists of government entities and goods and services (with thresholds and limitations) that are open to bidding by firms of the other GPA members.<sup>95</sup> WTO members that are not signatories to the GPA, including those that are GPA observers (such as China), do not enjoy any rights under the GPA. Nor are non-GPA signatories in the WTO generally obligated to provide access to their government procurement markets.

China formally entered negotiations to join the GPA in 2007 and made an official offer, but it was deemed unacceptable by the other WTO GPA parties. China promised to revise its GPA offer, but in October 2008, it notified the GPA parties that it was unable to provide a new offer.<sup>96</sup> During the

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(...continued)

Chinese government will utilize the enhance its own technologic advancement.

<sup>93</sup> U.S. Treasury Department Press Release, *Second Meeting of the U.S.-China Strategic & Economic Dialogue, Joint U.S. China Economic Track Fact Sheet*, May 25, 2010.

<sup>94</sup> Testimony of Karen Laney, Acting Director of Operations, U.S. International Trade Commission before the Subcommittee on Terrorism, Nonproliferation, and Trade, Committee on Foreign Affairs on China's Indigenous Innovation, Trade, and Investment Policies, March 9, 2011.

<sup>95</sup> GPA members are generally obligated to afford each other fair and non-discriminatory treatment for the covered procurement items and to maintain transparency in procurement practices.

<sup>96</sup> A Chinese official claimed they were having difficulties revising their offer due to potential conflicts with current Chinese procurement laws and the lack of consensus over which non-central government entities would be covered.

October 2009 U.S.-China JCCT, China pledged that it would issue a new WTO GPA offer in 2010 and stated that it was the policy of China to treat products produced in China by foreign-invested enterprises the same as domestic products (and promised to issue new rules to clarify this point). At the May 2010 S&ED meeting, China pledged it would submit its revised GPA offer by July 2010, which it did on July 9, 2010. Although some analysts viewed China's latest GPA offer as an improvement over its previous offer, they contend that it fell far short of being acceptable to all the current GPA members. For example, the offer excluded purchases by local and provincial governments as well as state-owned enterprises. During the December 2010 U.S.-China JCCT meeting, China agreed to submit a robust, new offer to the WTO Government Procurement committee before the Committee's final meeting in 2011, which many expect will cover some local governments and SOEs.

Congressional concerns over China's failure to join the GPA resulted in the introduction of legislation in the 111<sup>th</sup> Congress which would have imposed restrictions on U.S. government procurement of Chinese goods until China joined the GPA. In the 112<sup>th</sup> Congress, H.R. 375 would limit the total value of Chinese goods that could be procured by the U.S. government to the same value of U.S. goods procured by the Chinese government in the previous year. Under the bill, the U.S. Department of Commerce would be required to determine whether China had maintained restrictions on public procurement of U.S. goods in the previous year. If a determination was made that China maintained such prohibitions, U.S. government agencies would be barred from awarding contracts for the procurement of Chinese goods.<sup>97</sup> If the Commerce Department determined that no prohibition existed, it would be required to estimate the value of U.S. goods procured by Chinese government agencies (in the previous year), and U.S. public procurement of Chinese goods would be limited to this figure (for the current year).

## **China and U.S. Trade Remedy Laws**

When China entered the WTO in 2001, it agreed to allow the United States to continue to treat it as a non-market economy for 12 years (codified in U.S. law under Sections 421 of the 1974 Trade Act, as amended) for the purpose of U.S. safeguards.<sup>98</sup> This provision enables the United States (and other WTO members) to impose restrictions (such as quotas and/or increased tariffs) on Chinese products when imports of those products have sharply increased and have caused, or threaten to cause, market disruption to U.S. domestic producers.<sup>99</sup> The Bush Administration on six different occasions chose not to extend relief to various industries under the China-specific safeguard, even though in four cases the U.S. International Trade Commission (USITC) recommended relief. A number of U.S. industries and labor groups have called on the Obama

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<sup>97</sup> In addition, the Secretary of Transportation would be required to prohibit States or other entities from using funds from the Highway Trust Fund or the Airport and Airway Trust Fund for the award of a contract for the procurement of Chinese goods.

<sup>98</sup> China also agreed that the United States (and other WTO members) could continue to treat it as a nonmarket economy for antidumping cases for 15 years after accession. This provision enables WTO members to use third-country data to determine fair market prices when determining antidumping duties.

<sup>99</sup> Normally, safeguard provisions apply to all imported products. The China safeguard in U.S. trade law applies only to China. Unlike antidumping and countervailing cases, safeguard cases do not involve a contention that an unfair trade practice is being used.

Administration to utilize the China safeguard provision, especially in the face of the current U.S. recession and because of “unfair” Chinese trade practices.

### **The Chinese Tire Case**

On April 24, 2009, the United Steel, Paper and Forestry, Rubber, Manufacturing, Energy, Allied Industrial and Service Workers International Union (USW) filed a petition with the USITC contending that U.S. imports of passenger vehicle and light truck tires from China caused or threatened to cause market disruption to U.S. domestic producers of like or directly competitive products. In June 2009, the USITC announced that it had determined such imports did in fact cause or threaten to cause market disruption, and recommended the imposition of additional tariffs over three years (55% in the first year, 45% in the second, and 35% in the third) and to provide expedited consideration of Trade Adjustment Assistance for firms and/or workers that are affected by such imports.<sup>100</sup>

The USW argued that the “extraordinary increase in imports” of tires from China had hurt tire producers in the United States and contributed to the loss of 5,100 U.S. tire-related jobs from 2004-2008, and that 3,000 more jobs would be lost in 2009. Producers of tires in the United States, many of whom have joint venture operations in China, did not express support for the safeguard case, and some actively opposed it.<sup>101</sup> Some industry representatives argued that a large share of U.S. tire imports from China were low-end products, that the USITC’s proposed increase in tariffs were excessive and punitive, and that such tariffs would hurt U.S. consumers and do little to boost employment in the U.S. tire industry. On September 11, 2009, President Obama announced that he would impose additional tariffs on certain Chinese tires for three years (35% in the first year, 30% in the second year, and 25% in the final year); these levels were less than the USITC’s recommendations.<sup>102</sup> China called the move protectionist and initiated a WTO trade dispute resolution case against the United States on September 14. In addition, on November 11, 2009, China launched antidumping and countervailing cases against U.S. autos and poultry, seen by many analysts as a retaliatory move over the U.S. safeguard measure on tires.

### **The U.S.-China Strategic and Economic Dialogue**

On September 29, 2006, President George W. Bush and Chinese President Hu Jintao agreed to establish a Strategic Economic Dialogue (SED) in order to have discussions on major economic issues at the “highest official level.” According to a U.S. Treasury Department press release, the intent of the SED was to “discuss long-term strategic challenges, rather than seeking immediate solutions to the issues of the day,” in order to provide a stronger foundation for pursuing concrete

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<sup>100</sup> The USITC determined that the U.S. tire industry had suffered a continuous decline from 2004-2008 in employment, hours worked, and earnings, and that producers’ domestic capacity, production, and shipments had fallen as well. It concluded that the sharp increase in tire imports from China was a major factor in this decline. See *USITC Publication 4085, Certain Passenger Vehicle and Light Truck Tires From China, Investigation No. TA-431-7*, July 2009.

<sup>101</sup> The USITC identified 10 tire producers in the United States, some of which are foreign-owned.

<sup>102</sup> Some analysts have speculated that the President’s decision was partly motivated by the belief that strong “enforcement” of U.S. trade laws would help induce lawmakers to support U.S. free trade agreements. See *Inside U.S. Trade*, “Reid, USTR See Tire Relief As Essential For Support Of Future Trade Deals,” September 10, 2009.

results through existing bilateral economic dialogues.<sup>103</sup> The first meeting was held in December 2006. Four subsequent rounds of talks were held (the last was in December 2008).

While attending the G-20 summit in London on the global financial crisis on April 1, 2009, President Obama and Chinese President Hu agreed to continue the high-level forum, renaming it the U.S.-China Strategic and Economic Dialogue (S&ED). The new dialogue is based on two tracks. The first (the “Strategic Track”) is headed by the Secretary of State on the U.S. side and focuses on political and strategic issues, while the second track (the “Economic Track”) is headed by the U.S. Treasury Secretary on the U.S. side and focuses on financial and economic issues. Areas of discussion include economic and trade issues, counterterrorism, law enforcement, science and technology, education, culture, health, energy, the environment (including climate change), non-proliferation, and human rights.

### **The July 2009 Economic Track Session**

The first round of the S&ED was held in Washington, DC, on July 27-28, 2009, and involved 12 U.S. Cabinet officials and agency heads and 15 Chinese ministers, vice ministers, and agency heads. The session was focused heavily on issues relating to the global economic crisis. Secretary of Treasury Timothy Geithner stated: “Recognizing that cooperation between China and the United States will remain vital not only to the well being of our two nations but also the health of the global economy, we agreed to undertake policies to bring about sustainable, balanced global growth once economic recovery is firmly in place.”

The two sides agreed to establish a framework of cooperation based on four pillars:

- advancing macroeconomic and structural policies to achieve sustainable and balanced growth;
- promoting more resilient, open, and market-oriented financial systems;
- strengthening trade and investment ties; and
- strengthening the international financial architecture.

These pillars appear to have been aimed at by deepening bilateral cooperation in response to the global economic crisis, continuing commitments both sides to promote policies that seek to achieve more balanced economic growth, encouraging China to continue economic and financial reforms, expanding China’s role and/or participation in international economic forums,<sup>104</sup> and attempting to avoid new forms of protection.

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<sup>103</sup> U.S. Treasury Department press release, December 15, 2006.

<sup>104</sup> The United States is seeking to broaden China’s participation in international economic institutions in order to promote the goal of helping to make China a “responsible stakeholder” in the global economy. This implies that, since China’s greatly benefits from the global trading system and is a major global economy, it should shoulder a greater responsibility in maintaining and promoting that system (rather than just enjoying the benefits of that system). U.S. policymakers contend that if China accepts a greater leadership role in global economic affairs, it will induce Chinese leaders to consider how domestic economic policies can affect the global economy.

## May 2010 Economic Track Session

The May 24-25 S&ED economic session focused heavily on the continuing efforts relating to the four pillars identified in the July 2009 session. Although few concrete accomplishments were announced at the end of the meetings (such as on China's currency policy), the two agreed to intensify talks on a number of bilateral economic and trade issues. The two sides pledged to

- sign a cooperation protocol on small and medium-sized firms (SMEs);
- boost economic cooperation at the central and local government level, such as promoting the establishment of state-to-province and city-to-city partnerships;
- conduct “intensive expert and high-level discussions” as early as the summer of 2010 on innovation issues (such as China's indigenous innovation proposals) and to take into account the results of these talks in formulating and implementing their innovation measures;<sup>105</sup>
- improve cooperation to address health and safety issues relating to U.S. sales of soybeans to China;
- establish a cooperative mechanism between the U.S. Export-Import Bank and the Export-Import Bank of China on trade finance, and to develop initiatives to promote exports by SMEs;
- explore the possibility of cooperating to enable the United States to treat China as a market economy, and to treat certain Chinese firms as market-oriented industries, for the purpose of U.S. trade remedy laws; and
- boost investment opportunities and transparency.<sup>106</sup>

## The May 2011 Economic Track

The third round of the S&ED was held in Washington, DC, on May 9-10, 2011. Prior to the meeting, U.S. officials identified several U.S. goals for the economic track of the S&ED, including ensuring that China followed through on previous economic and trade commitments (such as on IPR protection and indigenous innovation policies) and encouraging China to make a number of reforms to its financial sector (such as adopting market-based interest rates on bank deposits and expanding market access in China for U.S. financial firms). China pledged to continue to promote domestic consumption, improve IPR enforcement, eliminate all of its indigenous innovation products catalogues, improve transparency of its economic and trade policies, and provide significant new opportunities for U.S. financial services firms in China.

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<sup>105</sup> The United States also pledged that it would review Chinese concerns relating to U.S. restrictions on high technology exports to China resulting from the current U.S. export control regime.

<sup>106</sup> The United States pledged that it welcomed investment from China and confirmed that reviews foreign investment by the Committee on Foreign Investment in the United States ensures the consistent and fair treatment of all foreign investment without prejudice to the place of origin. China promised to revise its Catalogue Guiding Foreign Investment in Industries and encourage and expand areas open to foreign investment, including those relating to high-technology, energy, and the environment. China also pledged to streamline the process for investment approval.

## **Concluding Observations**

China's rapid economic growth and emergence as a major economic power have given China's leadership increased confidence in its economic model. The key challenges for the United States are to convince China (1) that it has a stake in maintaining the international trading system, which is largely responsible for its economic rise, and to take a more active leadership role in maintaining that system; and (2) that further economic and trade reforms are the surest way for China to expand and modernize its economy. For example, by boosting domestic spending and allowing its currency to appreciate, China would import more, which would help speed economic recovery in other countries, promote more stable and balanced economic growth in China, and lessen trade protectionist pressures around the world. Boosting IPR protection in China would boost innovation and attract more FDI in high technology. Lowering trade barriers on imports would increase competition in China, lower costs for consumers, and boost economic efficiency.

Opinions differ as to the most effective way of dealing with China on major economic issues. Some support a policy of engagement with China using various forums, such as the U.S.-China Strategic and Economic Dialogue (which holds discussions on major issues at the highest government level). Others support a somewhat mixed policy of using engagement when possible, coupled with a more aggressive use of WTO dispute settlement procedures to address China's unfair trade policies. Still others, who see China as a growing threat to the U.S. economy and the global trading system, advocate a policy of trying to contain China's economic power and using punitive measures when needed to force China to "play by the rules."

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