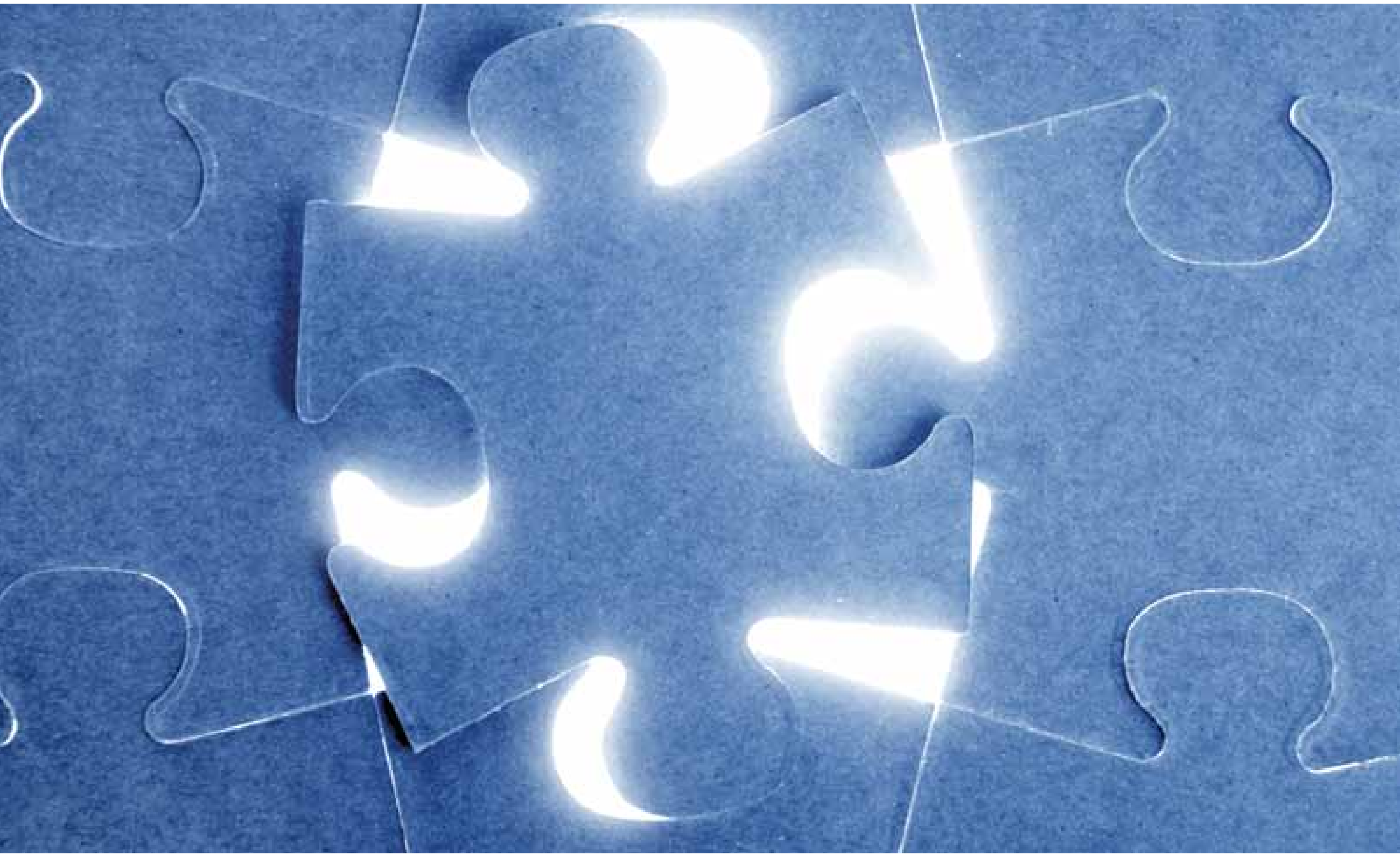

Chapter 6

Difficulties and Impediments in the U.S.-China Economic Relationship

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Executive Summary

The U.S.-China economic relationship has developed rapidly during the past few decades. But given the vast difference between the two countries' economies, political systems, history, culture and values, major problems and disputes arise from time to time in their interactions.

In the commercial arena, U.S. businesses have often complained about China's unwillingness to open up its markets in a faster manner, about the unfair treatment foreign investors get in China, and the inadequacies of China's rules and regulations that put foreign investors at a competitive disadvantage. In recent years, the more important issues of concern include the inadequacies of China's intellectual property protection regime, cyber security problems, state-owned enterprises (SOEs) and market access issues.

China has defended its position by pointing out that while China has achieved very rapid development under the reform and opening-up policies for the past 35 years, the country as a whole is still a developing country with vast differences across geographies. China has also asked the U.S. to be patient as China is also keen to pursue further reform and modernization, but that these will take time, given the complexities of the issues involved and the need to introduce changes at a prudent pace.

Meanwhile, China also complains about the U.S.' restrictions on high-tech exports to China, the unwillingness of the U.S. to grant market economy status to China, and the politicization of events related to China's trade and investment dealings with the U.S., thus resulting in U.S. government actions that often appear arbitrary and protectionist.

Many of these problems and difficulties are legitimate concerns. They need to be taken seriously. Proactive attitudes in dealing with these grievances by the two governments should, in time, help to resolve some of them. But some of these disagreements will not be fully resolved in the short term. New issues will also arise in the future as the two countries engage with each other further in the coming years.

Notwithstanding these differences and arguments, the two countries have not allowed these difficulties to become impediments to the continued growth in the bilateral economic relationship, which has grown over the years to become one of the most important bilateral relationships in the world. Indeed, given that the two countries view each other with some degree of suspicion, a continued growth in the economic relationship will help to build mutual understanding and enhance mutual trust. Such growth in economic links will build the determination and common interests that will in turn enable the two countries to overcome the difficulties in their relations in the future.

Difficulties and Impediments in the U.S.-China Economic Relationship

Introduction

China decided to reform and open up its economy in 1978. Since then, China has followed a step-by-step approach to turn a centrally-planned and heavily government-controlled economy gradually into a 'socialist market economy'. Decentralization of economic decision-making power, introduction of market forces and the freeing up of controls over foreign trade and foreign investments are some of the key policy directions in the process. This reform and opening-up process takes place at varying paces in different localities and different sectors, depending on the readiness for reform of the regions or economic sectors concerned, and also depending on the development strategies of the government.

This step-by-step approach to reform has enabled China to develop rapidly in the past 35 years without going through a painful 'shock therapy' that marked the experience of many Eastern European economies in the 1990s. But this gradualist approach has also brought many difficulties and challenges. One such challenge is the co-existence of market-oriented and government-controlled elements in the economy for a prolonged period of time. For example, in the early days of reform, both government-controlled prices and free market prices co-existed, and this opened up opportunities for arbitrage opportunities to those in power and therefore also for corruption. Today, in many sectors in China's economy, government-owned enterprises compete with private enterprises, and this often leads to complaints about unfair competition, not only from foreign investors, but also from local entrepreneurs. Furthermore, some of these government-owned enterprises that enjoy preferential treatment would gradually become vested interests that would try to protect their privileges and post obstacles to further reform.

Another characteristic of China's development is that while some sectors and regions have developed very rapidly over the past 35 years, some other sectors and regions lag behind – sometimes far behind – the rest of the country. The need to take into account the needs of the less-developed sectors or regions often means that policies adopted by the government would be too conservative for investors who typically operate in the more developed sectors and regions.

China's economy has developed rapidly. But as with most societies, customs and practices, social values, cultural preferences and institutional capacity all change at a much slower pace. It takes a very long time to educate the people and to engineer changes in mindsets and behavior. The building up of the institutions and fabrics of an efficient, modern market economy will require not only new rules and regulations, new institutional structures and an abundant supply of experienced professionals in many professional services, but also the evolution of many unwritten codes of behavior, case laws and precedents, and a compliance culture.

Against the background of these complex issues, private enterprises in China have to overcome many unique challenges. While a rapidly growing Chinese economy offers many opportunities, the playing field is not always level and the rules of the game could change as the economy evolves and develops. It is understandable therefore that many foreign investors and private enterprises have complained about the difficulties and unfair practices when they do business in China.

Opportunities for and Difficulties Encountered in U.S.-China Economic Relations

The U.S. has played an important part in China's reform and development in the past 35 years. It has been the biggest final market for China's exports. American enterprises are a major group of foreign investor in China. In 2012, the bilateral trade in goods and services between the U.S. and China totaled about US$527bn. U.S. enterprises have cumulatively invested over US$70bn in China in the form of direct investment and Chinese enterprises have started to invest actively in the U.S. in recent years. The two countries also have a large amount of cross-border financial investment in each other's markets. Amongst all sovereign investors, the Chinese government is the largest investor in U.S. treasuries and agency securities.

Looking forward, basic economics predicts that bilateral trade will grow roughly in proportion to the sizes of the two economies, so it is not surprising that trade in goods and services between China and the U.S. is predicted to grow along with their economic growth. It has been projected that bilateral trade in goods and services could increase by two and a half times in the ten years to 2022[1]. Furthermore, as China's economy continues to develop, China's demand for high-tech products, high quality consumer goods and services, and professional, business and financial services, will all grow rapidly, and this will play into the strengths of U.S. enterprises.

Apart from trade, investment flows between the two countries are likely to enter a new phase of development[2]. While U.S. direct investment flows to China will continue, as in the past two decades, Chinese direct investments in the U.S. have entered a high growth phase. It has been projected that outbound foreign direct investments (FDIs) by Chinese enterprises could total more than US$1tr in the next 10 years, with a substantial proportion of these funds heading towards the U.S. The annual flow of FDI from China to the U.S. is expected to exceed FDI from the U.S. to China soon. Portfolio investment flows between the two countries have been restricted by China's foreign exchange and investment regulations in the past. But China is actively liberalizing such regulations in recent years, and as this process continues, the amount of portfolio investment flows between the two countries is likely to grow much faster.

The opportunities for further growth in U.S.-China economic cooperation, both in scale and in the range of possibilities, will be substantial. The cooperation has been of tremendous mutual benefit in the past and this will continue to grow significantly in the future. But it has to be recognized that the U.S. and China are two very different countries, in history, culture and values, as well as in economic and political systems. The development of the overall relationship between the two countries is often overshadowed by mistrust and differences on important global strategic issues. The two governments often view each other with some suspicion. In commercial relations, there are serious concerns and disputes raised from time to time by both sides, particularly from U.S. enterprises. Many of these concerns are – at least partially – valid, but some are exaggerated due to misunderstanding, politicization or misinterpretation of the facts.

The two nations must work cooperatively to address these issues seriously, but at the same time seek out new opportunities, if they are to continue to reap and enhance the mutual benefits of the relationship between them. It is therefore imperative that mutual trust be built-up and strategic differences be managed and addressed. Building mutual trust will take time; but the differences should not be allowed to stand in the way of closer economic cooperation between the two countries.

1 See Chapters 8 and 9 for further details.
2 See Chapter 13 for further details.

The business sectors of both countries have identified difficulties and impediments to expanding the economic relationship between them. These issues evolve over time as circumstances change. Recently, on the U.S. side, the major issues include the role of the SOEs in the Chinese economy – and state banks as providers of finance – market access into China, protection and enforcement of intellectual property rights and cyber security – and in particular, theft of commercial secrets. Chinese complaints include restrictions on U.S. exports of high-technology products to China, refusal by the U.S. government to grant market economy status to China, and U.S. government actions that often appear arbitrary and protectionist in the areas of both trade and investment.

These issues are real, and relevant to expanded economic engagement. In a commercial relationship as extensive and dynamic as that between the U.S. and China, there will be points of contention and concern. Candor in recognizing them, and a commitment to resolving them, is a sign of the maturing of the relationship. For these issues to be resolved, the two governments need to face them squarely. It is a difficult task, and will take time, but it must be done.

However, both sides should also realize that it is difficult to resolve some of these issues within a short time. Indeed, some issues may never be resolved directly as a standalone subject, but will have to be allowed to evolve through a dynamic and developmental process. It is therefore important to focus also on the future potential of an enhanced economic relationship through cooperation. Successful cooperation by the two countries will not only bring economic benefits to the two peoples, it will also help build the trust between them. The more the two countries are engaged with each other, the more mutual trust could be built and this in turn would help to narrow the differences between the two sides.

Grievances raised by the U.S. and Recommendations of this Study

Intellectual Property Rights Protection[3]

The U.S. side, and indeed international and domestic institutions in China, have pointed out that protection of intellectual property rights (IPR) – whether owned by foreign or Chinese nationals – has not been adequate in China in the past.

The Chinese side acknowledges the shortcomings in protecting IPR, but points out that, over the past decade, China has devoted enormous efforts to improve IPR protection. China's legal and other institutional arrangements are being strengthened, while entrenched cultures are being changed.

As China attempts to bolster its economic growth through science, technology and innovation, as provided for in the 12th Five-Year Plan, it is really in China's own interests to protect the intellectual property developed by its own citizens or enterprises. It should be noted that the Chinese government's commitment to eradicate the use of pirated software products in all central, provincial and municipal-level government units mark an important step in that direction. The proactive approach of the government to protect IPR nationwide is gathering momentum and support.

Recommendations

First, recognizing the need for a single cross-ministerial intellectual property organization within the State Council to fully implement government IPR policies, an organization called the "Leading Group for National IPR Protection" was formed in 2004. Now is the time to further strengthen the enforcement and coordination role of this organization to ensure full compliance.

Second, it may be useful for China to consider

3 See Chapter 14 for more details

establishing a special national court exclusively for intellectual property disputes. The court will have jurisdiction over the entire country and its decisions will be binding and enforced over the entire country. This will greatly facilitate the resolution and settlement of intellectual property disputes in China and strengthen the protection of IPR.

Third, both the U.S. and China should undertake to expedite the registration of approved patents by inventors from the other country upon their application. For example, the Chinese patent authority may consider accepting papers submitted to the U.S. patent authority in the process of approval of the U.S. patent, and vice versa, thus speeding up the process of approval in China and in the U.S.

Fourth, it is recommended that the Chinese government's commitment to eradicate the use of pirated software is applicable not only to the central, provincial and municipal governments, but also to the centrally owned and locally owned SOEs.

Finally, it is also proposed that there should be increased professional exchanges between the U.S. and China to raise the level of awareness and knowledge on the rights of owners of patents, brands and copyrights.

Cyber security[4]

Espionage by governments against one another is nothing new – it has been done from time immemorial and governments are likely to continue to use all means at their disposal, including through cyberspace. However, the use of cyberspace by individuals for commercial or industrial espionage – for theft or for disruptive activities – should be treated as a crime.

The U.S. alleges that the Chinese government has directly or indirectly organized such cyber attacks against the U.S. However, the Chinese government strongly denies this. In fact, China views itself as a victim of cyber attacks. Indeed, recognizing the enormous damage that can be done through cyber attacks, hacking has been made illegal in China. While the Chinese government denies its direct or indirect involvement in organizing such cyber attacks, the Chinese government acknowledges the possibility that individuals in China may be involved in hacking.

At this point in time, there is an urgent need for direct and open dialogue between the two governments. This could bring about better understanding and eventually an agreement to prevent cross-border cyber crimes and bring cyber criminals to justice.

There has been an ongoing "Sino-U.S. Cyber Security Dialogue" between two thinktanks, the Center for Strategic and International Studies (CSIS) in the U.S., and the China Institute for Contemporary International Relations (CICIR) since 2009. They issued a joint announcement in June 2012, summarizing their agreements and differences. Such dialogues are essential to improve trust and should be encouraged.

Recommendation:
Government-to-government dialogue between the two countries is essential to eventually bring about an agreement to prevent cross-border cyber crimes as defined above. Indeed, such dialogue should be held as soon as possible. The two countries should also take initiatives, together with the international community, to develop rules and regulations for international cyber space, which is lacking.

State-owned enterprises and market access[5]

The U.S. side has complained about the 'privileged' status of the Chinese SOEs and that competition with SOEs is not on a level playing field – either in China or overseas – because of their monopoly status and

4 See Chapter 14 for more details

5 See Chapter 16 for more details

their preferential access to credit. Moreover, there are also concerns that the SOEs are agents of the Chinese state and do not operate on purely commercial principles. These complaints are not limited only to the U.S. side. There are such complaints voiced internationally and by interested parties within China too.

The Chinese side pointed out that, from an historic point of view, the SOEs have been crucial in nation building in the last 35 years, and their work is not yet complete. In the meantime, they also point out that, after 35 years of reform and opening, and given the impact of the growing market economy, the influence of the SOEs is not as significant as before. Indeed, within China today, there are different views as to what the role of the SOEs should be going forward.

Today, the central government-owned SOEs are responsible for less than 15% of Chinese gross domestic product (GDP) and just over 8% of Chinese employment. They are particularly dominant in industries which are considered strategic and essential for national security. At the same time, the rapidly growing private sector in China is vibrant and has come to dominate the IT sector (Alibaba, Tencent, Huawei, Sina and Baidu) and the real estate sector (Dalian Wanda Commercial Properties, Vanke, Evergrande Group and Country Garden). Even in the energy sector, some private enterprises, such as ENN Energy and China Gas, are now providing domestic gas supply to hundreds of cities in China. There are now also private automobile manufacturers such as Geely and BYD in China which are playing increasingly active roles. Indeed, today China's private sector accounts for more than 50% of the country's GDP and 60% of the employment. The remaining 35% of GDP and 32% of employment that is not generated by the central government-owned SOEs and the private sector is generated by the agricultural sector, the self-employed, local cooperatives, local SOEs, etc.

On the question of market access, the U.S. side has asked for greater and easier market access, in terms of both exports of goods and services and direct investment in China. These complaints are in several areas. They are about the lack of transparency and a level playing field in government and/or SOE procurement, and about Chinese government restrictions on their acquiring controlling interest in a host of industrial and service sectors, in particular in the investment banking and the insurance sectors. Similar concerns have been expressed internationally and within China.

The Chinese side has responded by stating that – in terms of acquiring controlling interest – China's consideration of a step-by-step approach is in the interest of national security and social stability, and the need to protect infant industries. The Chinese side has asked the U.S. side to take a long-term view on their investments in China.

On government procurement, the U.S. side has appealed for a fair and open procurement process, as foreign companies and the Chinese private sector are sometimes excluded in this process. The Chinese side has made well known the government's direction that central and local SOEs should not be favored, and that all participants should be treated equally. However, enforcement needs to be strengthened.

Recommendation

Since the 18th Party Congress in November 2012 and the National People's Congress meeting in March 2013, the new leadership has repeatedly emphasized that, for China to succeed in the restructuring of its economy, continued deepening of its reform and changing the government's role to allow more competition in the marketplace is essential. As China further develops and reforms, it seems that U.S. businesses can play a constructive role in helping China's effort to develop its service sector economy.

Indeed, this restructuring will produce one of the largest marketplaces in the world. Overall, this is an opportunity for U.S. businesses. The American Chamber of Commerce in Shanghai's China Business Report 2012-2013 stated that, although U.S. businesses find China's regulatory and policy environment to be increasingly challenging, a record 91% of survey respondents have an 'optimistic' or 'slightly optimistic' outlook for their five-year business prospects.

Under these circumstances, we propose that thinktanks from both countries undertake a complete and total review of the subject of SOEs and market access from the U.S. and Chinese perspective. This will enhance understanding, and may even help develop recommendations to both governments on how the issues that are raised in the paragraphs above can be moved forward.

Grievances raised by China and Recommendations

Restrictions on high-tech exports

The restriction of exports of high technology products from the U.S. to China was introduced in 1989. Since then, U.S. exports of high-tech products to China have been declining as a share of China's total high-tech imports. Figures show that, in 2001, China's imports of high-tech products globally were valued at US$56bn, of which the U.S.'s share was 16.7%. By 2011, the value grew to US$461bn, with the U.S.'s share shrinking to only 6%. Ironically, over the years, China's demand for high-tech products has been met by imports from Europe, Japan, Israel and many other countries. It is estimated that Chinese demand for high-tech imports will continue to grow by over 20% per annum during the next decade.

It is recognized that certain high-tech products have military applications, and it is perfectly understandable that exports of such products should be restricted. However, export controls sometimes appear to be arbitrary and often result in the large Chinese market being left completely to non-U.S. competitors. Proposals were made to the U.S.' Bush administration as well as the Obama administration in the past, but the matter is still under review. Nothing has been forthcoming.

Recommendation
It is proposed that this review needs to be done with some urgency, and hopefully, a mutually beneficial outcome will emerge.

Market economy status

One recurring Chinese complaint is not being granted 'market economy status' by the U.S. (and the E.U.) despite the fact that market forces play a dominant role in determining almost all prices in China. Not having market economy status penalizes China in anti-dumping investigations because the domestic market price cannot be used to establish whether a country's exporter has been engaged in dumping or not. The use of an 'analog market price' in such investigations frequently biases the decision against the exporting country. China is such an exporting country.

According to China's World Trade Organization Accession Agreement, China will automatically be recognized as a 'market economy' by 2015. Thus, this issue will go away. It is China's view that there is justification to grant market economy status to China now. If this is done, it will be a great gesture of friendship as well.

Recommendation
As the market economy status of China will be recognized by 2015 anyway, we suggest the U.S. give China the market economy status as soon as possible.

Politicization of economic issues and other administrative actions

There are also Chinese complaints of the tendency in the U.S. to overly politicize economic issues on trade and investment between the two countries. Some U.S. government actions – including actions by the Committee on Foreign Investment in the United States – appear to Chinese enterprises to be arbitrary and protectionist in both trade and investment. This includes the imposition of special tariffs and duties on Chinese products, and the disapprovals of certain direct investments by Chinese enterprises, both private and state owned. Decisions based on national security grounds are understood and accepted, but they should be clearly explained and certainly not be based on political considerations.

Recommendation
We propose that clearer rules and regulations on investment approval processes be issued by the U.S. government.

Conclusion

China's economy is going through an important structural transformation process. To avoid falling into the 'middle income trap', the Chinese government understands the need to reform and open up further, to improve market structures and to promote fair competition, and to enhance innovative capabilities through strengthening IPR protection.

Both countries want to establish a pattern of secure, high-quality, sustainable growth and employment for their people. History in the past few decades has demonstrated that the bilateral relationship – built and adapted well over time – can make a material contribution to that shared goal.

U.S. President Barack Obama called Chinese President Xi Jinping in March 2013 to congratulate him on his new position and to discuss the future of the U.S.-China relationship[6]. President Obama underscored the importance of working together to expand trade and investment opportunities and to address issues such as the protection of IPR. In this context, the Chinese president highlighted the importance of addressing cyber-security threats, which represent a shared challenge. The two leaders agreed to maintain frequent and direct communication.

Similarly, in a meeting with U.S. Secretary of State John Kerry in Beijing in April 2013, China's President Xi said that the U.S. and China should work together to explore how to build a new relationship among major powers, and that both sides should insist on handling bilateral relations from a strategic and long-term perspective. President Xi hoped that the two nations would adopt a positive attitude and a vision for future development in promoting dialogue and cooperation, and in seeking common ground while respecting differences. He also pointed out that both sides should build further areas of cooperation that would build mutual engagement, take positive measures to address the concerns of both sides, and not to politicize trade and economic issues[7].

6 Refer to http://www.whitehouse.gov/the-press-office/2013/03/14/readout-president-s-phone-call-chinese-president-xi-jinping

7 Refer to http://www.gov.cn/ldhd/2013-04/13/content_2377091.htm (in Chinese)