

# CRS Issue Brief for Congress

Received through the CRS Web

## China-U.S. Trade Issues

Updated September 3, 2003

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## China-U.S. Trade Issues

### SUMMARY

U.S.-China economic ties have expanded substantially over the past several years. Total U.S.-China trade rose from \$5 billion in 1980 to \$147 billion in 2002. China is now the fourth-largest U.S. trading partner. With a huge population and a rapidly expanding economy, China is a potentially huge market for U.S. exporters. Yet, U.S.-China commercial relations have been strained by a number of issues, including a surging U.S. trade deficit with China (\$103.1 billion in 2002), China's restrictive trade and investment practices, and its failure to provide adequate protection for U.S. intellectual property rights (IPR).

In recent years, the U.S. has sought to use China's application to join the World Trade Organization (WTO) to gain greater market access in China. The U.S. insisted that China could join the WTO only if it substantially cut trade barriers. After many years of negotiations, a consensus was reached in the WTO on the terms of China's membership. China's entry was formally approved by the WTO on November 10, 2001, and on December 11, 2001, it formally became a WTO member. The 106<sup>th</sup> Congress passed legislation giving the President the authority to extend China permanent normal trade relations status to China after it joined the WTO, thus ending the annual and debate over China's trade status.

China's entry into the WTO requires it to significantly reform its trade regime by eliminating or reducing an extensive array of tariff and non-tariff barriers on goods, services, and foreign investment. The removal of these barriers could result in significant new oppor-

tunities for U.S. exporters.

Many Members of Congress have called on the Bush Administration to closely monitor China's compliance with its WTO commitments. In December 2002, the USTR issued its first annual China WTO compliance report, finding that, although China had made significant progress in meeting its WTO obligations, a number of major problems remained, especially in regards to agriculture, services, IPR protection, and transparency of trade laws and regulations.

The continued rise in the U.S.-China trade imbalance, complaints from several U.S. manufacturing firms over the competitive challenges posed by cheap Chinese imports, and concerns that U.S. manufacturing jobs are being lost to Chinese competitors or from U.S. firms relocating production facilities to China, have led several Members to call on the Bush Administration to take a more aggressive stance against certain Chinese trade policies. For example, some Members have called on the Administration to pressure China to appreciate its currency, which is currently pegged to the U.S. dollar (thus making China's exports more expensive and its imports cheaper). Other Members want the Administration to utilize special safeguard provisions to restrict imports of certain Chinese products which are viewed as harming U.S. producers and jobs, particularly the U.S. textile industry.

## MOST RECENT DEVELOPMENTS

During a visit to China on September 2, 2003, U.S. Treasury Secretary John Snow called on China to adopt a more flexible exchange rate regime. Chinese officials responded by stating that the current system of pegging the yuan to the dollar was needed to maintain economic stability in China.

On June 18, 2003, the U.S.-China Business Council (USCBC) issued its mid-year 2003 report on China's WTO implementation. The report stated that, while China has promptly implemented its WTO tariff-reduction commitments, it has failed to fulfill its obligations in a number of areas, including the removal of agricultural and industrial quotas and tariff-rate quotas, unreasonable standards for genetically modified organisms applied to agricultural trade, high capital requirements for establishment of services businesses, discriminatory tax policies on imports, failure to issue promised regulations for auto finance operations, insufficient regulatory transparency, and lack of protection for U.S. intellectual property rights. The USCBC noted "growing concerns" among U.S. firms over China's ability to deliver on key commitments on time and in full.

## BACKGROUND AND ANALYSIS

### U.S. Trade with China

U.S.-China trade rose rapidly after the two nations established diplomatic relations (January 1979), signed a bilateral trade agreement (July 1979), and provided mutual MFN treatment beginning in 1980. Total trade (exports plus imports) between the two nations rose from \$4.8 billion in 1980 to \$147.2 billion in 2002, making China the 4th largest U.S. trading partner. The U.S. trade deficit with China has grown significantly in recent years, due largely to a surge in U.S. imports of Chinese goods relative to U.S. exports to China. That deficit rose from \$10.4 billion in 1990 to \$103.1 billion in 2002 (see **Table 1**). The U.S. trade deficit with China is now larger than that of any other U.S. trading partner, including Japan (at \$70.1 billion), Canada (\$49.8 billion), or Mexico (\$37.2 billion).

**Table 1. U.S. Merchandise Trade with China: 1988-2002**  
(\$billions)

Year	U.S. Exports	U.S. Imports	U.S. Trade Balance
1988	5.0	8.5	-3.5
1989	5.8	12.0	-6.2
1990	4.8	15.2	-10.4
1991	6.3	19.0	-12.7
1992	7.5	25.7	-18.2
1993	8.8	31.5	-22.8
1994	9.3	38.8	-29.5
1995	11.7	45.6	-33.8
1996	12.0	51.5	-39.5

Year	U.S. Exports	U.S. Imports	U.S. Trade Balance
1997	12.8	62.6	-49.7
1998	14.3	71.2	-56.9
1999	13.1	81.8	-68.7
2000	16.3	100.1	-83.8
2001	19.2	102.3	-83.1
2002	22.1	125.2	-103.1

Source: U.S. Department of Commerce.

U.S.-China trade in 2003 has increased sharply. Data for January- June 2003, show that U.S. imports from, and exports to, China were up 25.0% and 24.2%, respectively, over the same period in 2002. At this pace, the U.S. trade deficit with China could reach about \$130 billion for the full year.

## Major U.S. Exports to China

U.S. exports to China in 2002 totaled \$22.1 billion, accounting for 3.2% of total U.S. exports to the world, and making China the 7<sup>th</sup> largest market for U.S. exports. (During the first half of 2003, China was the 6<sup>th</sup> largest U.S. export market.) The top five U.S. exports to China in 2002 were transport equipment (mainly aircraft and parts), electrical machinery, office machines (mainly computers), general industrial machinery and equipment, and specialized machinery. Together, these five commodities accounted for about 57% of total U.S. exports to China in 2002. U.S. exports to China in 2002 were 14.6% higher than 2001 levels. Much of that increase was accounted for by a surge in U.S. exports of transport equipment, which rose by 39.4%.

**Table 2. Top 5 U.S. Exports to China: 1999-2002**  
(\$ in millions)

SITC Commodity Groupings	1999	2000	2001	2002	2001/2002 % Change
Total All Commodities	13,118	16,253	19,235	22,053	14.6
Transport equipment (mainly aircraft and parts)	2,326	1,698	2,471	3,444	39.4
Electrical machinery, apparatus and appliances, and parts	1,381	1,747	2,110	2,658	26.0
Office machines and automatic data processing machines	843	1,498	1,602	1,193	-25.5
General industrial machinery & equipment and parts	685	839	1,081	1,146	6.0
Specialized machinery	481	758	820	1,124	37.2
Total Top 5	5,716	6,540	8,084	9,565	18.3

Commodities sorted by top 5 exports in 2002.

Source: U.S. Department of Commerce.

Many trade analysts argue that China could prove to be a significant market for U.S. exports in the future. China is one of the world's fastest growing economies, and rapid economic growth is likely to continue in the near future, provided that economic reforms are continued. China's goal of modernizing its infrastructure and upgrading its industries is predicted to generate substantial demand for foreign goods and services. According to a U.S. Department of Commerce report: "China's unmet infrastructural needs are staggering. Foreign capital, expertise, and equipment will have to be brought in if China is to build all the ports, roads, bridges, airports, power plants, telecommunications networks and rail lines that it needs." Finally, economic growth has substantially improved the purchasing power of Chinese citizens, especially those living in urban areas along the east coast of China. It is projected that by the year 2005, China will have more than 230 million middle-income consumers (i.e., those earning \$1,000 or more annually), whose combined retail spending will exceed \$900 billion. China's growing economy and large population make it a potentially enormous market. To illustrate:

- ! China currently has the world's largest market mobile phone network (with 145 million cellular phone uses), even though only 13% of the population uses mobile phones.
- ! Boeing Corporation predicts that China will be the largest market for commercial air travel outside the U.S. for the next 20 years; during this period, China will purchase 1,912 aircraft valued at \$165 billion.
- ! In 2002, China replaced Japan as the world's second largest PC market. China also became the world's second largest internet user (after the U.S.) with over 56 million users.
- ! Demand for autos in China is rising so quickly (20 to 30% annually) that some analysts predict that China will become the third largest market for autos by 2003 or 2004.

## Major U.S. Imports from China

China is a relatively large source of many U.S. imports, especially labor-intensive products. In 2002, imports from China totaled \$125.2 billion, accounting for 10.8% of total U.S. imports, and making China the 3<sup>rd</sup> largest supplier of U.S. imports. U.S. imports from China increased by 22.4% in 2002. The top five U.S. imports from China were miscellaneous manufactured articles (such as toys, games, etc.); office machines; telecommunications equipment, sound recording, and reproducing equipment (such as telephone answering machines, radios, tape recorders and players, televisions, VCRs, etc.); electrical machinery; and footwear (see **Table 3**). Together, imports of these five commodities accounted for about 59% of total U.S. imports from China in 2002. Traditionally, nearly all of U.S. imports from China have been low value, labor intensive, products such as toys and games, footwear, and textiles. Over the past few years, however, an increasing level of U.S. imports from China have consisted of more technologically advanced products, such as computers and parts.

**Table 3. Top 5 U.S. Imports from China: 1999-2002**  
(\$ in millions)

SITC Commodity	1999	2000	2001	2002	2001/2002 % Change
Total All Commodities	81,786	100,063	102,280	125,168	22.4
Miscellaneous manufactured articles (e.g., toys, games, etc.)	17,273	19,441	19,764	23,492	18.9
Office machines and automatic data processing machines	8,259	11,000	10,764	15,256	41.7
Telecommunication & sound record & reproduce app. & equip.	7,502	9,935	10,118	14,254	40.9
Electrical machinery, apparatus and appliances, and parts	7,062	9,119	9,111	10,253	12.5
Footwear	8,434	9,195	9,758	10,227	4.8
Total Top 5	48,529	58,690	59,515	73,482	23.5

Commodities sorted by top 5 imports in 2002.

Source: U.S. Department of Commerce.

## China's Economy

China's economic reforms and open investment policies (which were begun in 1978) have contributed to a surge in economic growth. From 1979 to 2002, China's real gross domestic product (GDP) grew at an average annual rate of 9.3%, making it one of the world's fastest growing economies; real GDP grew by about 8.0% in 2002; it is projected to grow by about 8% in 2003, despite the effects of the outbreak in China of a highly contagious virus, called Severe Acute Respiratory Syndrome (SARS). China's long term economic outlook remains positive, provided that China continues to implement economic reforms (see CRS Issue Brief IB98014, *China's Economic Conditions*).

China has become a major recipient of foreign direct investment (FDI), a key factor in its rapid economic growth. Much of that investment has gone into export-oriented production facilities. In 2002, China overtook the United States as the world's largest destination for FDI. The United States is the second largest investor in China. Major U.S. corporate investors in China include Motorola, Atlantic Richfield, Coca Cola, Amoco, United Technologies, Pepsi Cola, Lucent Technologies, General Electric, General Motors, and Ford Motor Company.

## Major U.S.-China Trade Issues

Although China's economic reforms and rapid economic growth have expanded U.S.-China commercial relations in recent years, disputes have arisen over a wide variety of issues, including, pervasive Chinese trade and investment barriers and China's failure to provide adequate protection of U.S. intellectual property rights (IPR). Many U.S. concerns

over China's trade practices were addressed in negotiations with China over its accession to the World Trade Organization. However, U.S. officials have complained that China has failed to implement many of its WTO obligations. Other concerns expressed by various U.S. policymakers include China's currency peg (which some blame for the rising U.S. trade deficit with China) and other trade practices which are deemed harmful to certain U.S. industries.

## China and the World Trade Organization

The rapid rise of China as an economic and trade power during the 1980s led U.S. trade officials to take a greater interest in China's trade regime. U.S. officials complained that, while U.S. markets were generally open to Chinese products, Chinese markets were largely closed to U.S. products, due to China's extensive use of tariff and non-tariff barriers. In 1991, the United States threatened to impose \$3.9 billion in trade sanctions against China unless it removed specific trade barriers. In October 1992, the United States and China settled the trade dispute after China agreed to reduce or eliminate a wide variety of trade barriers, make its trade regime more transparent, and to eliminate scientific standards and testing barriers to agricultural imports. The 1992 accord was somewhat successful in getting China to liberalize its trade regime. Thereafter, U.S. officials sought to use China's desire to join the World Trade Organization (WTO) as a means to negotiate even greater access to China's markets.

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

**Background on U.S.-China WTO Negotiations.** China and the United States reportedly made significant progress towards resolving major differences in their bilateral WTO negotiations during Chinese Premier Zhu Rongji's meeting with President Clinton on April 8, 1999. According to U.S. officials, China offered to cut tariffs significantly and remove non-tariff barriers on U.S. trade in agriculture, industrial goods, and services, and to eliminate various restrictions on foreign investment, trading rights, and distribution for U.S. firms in China. Separately, China agreed to eliminate unjustified sanitary and phytosanitary (SPS) bans on wheat, citrus, and beef immediately.

Although the Clinton Administration stated that China's market access offer would bring China into the WTO at above existing WTO standards on issues and sectors of major concern to the U.S., it concluded that an agreement could not be finalized until certain outstanding issues could be resolved, namely market access in China for banking, securities, and audio visual services, and safeguard provisions on potential import surges. However, the United States and China did reach an agreement (the Bilateral Agricultural Cooperation Agreement) under which China agreed to remove technical barriers to trade (such SPS restrictions) on U.S. meat, citrus, and wheat exports to China.



On April 13, 1999, the two sides agreed to intensify negotiations towards reaching a final agreement. However, following the accidental NATO bombing of the Chinese embassy in Belgrade on May 7, 1999, China suspended the WTO talks (as well as its implementation of the bilateral agreements on wheat, citrus, and beef). These talks were officially resumed on September 11, 1999, during a meeting between President Clinton and Chinese President Jiang Zemin in New Zealand.

**The U.S.-China WTO Agreement.** On November 15, 1999, U.S. and Chinese officials announced that a bilateral agreement relating to China's WTO bid was reached. The Clinton Administration released the full text of the agreement on March 14, 2000. Under the agreement, China promised that after gaining WTO membership it would take the following steps (some on accession and others over specified phase-in periods):

- ! Provide full trading and distribution rights (including the ability to provide services auxiliary to distribution) for U.S. firms in China.
- ! Cut average tariffs for U.S. priority agriculture products (beef, grapes, wine, cheese, poultry, and pork) from 31.5% to 14.5% by 2004. Overall industrial tariffs would fall from an average of 24.6% to 9.4% by 2005 (tariffs on U.S. "priority products," such as wood, paper, chemicals, and capital and medical equipment, would fall even further). Tariffs on information technology products, such as computers, semiconductors, and telecommunications equipment, would be cut from an average level of 13.3% to zero by 2005.
- ! Establish a tariff-rate quota system for imports of agricultural bulk commodities (such as wheat, corn, cotton, barley, and rice), i.e., imports up to a specified quota level would be assessed a low tariff (1-3%), while imports above a certain level would be assessed a much higher tariff rate. Private trade in agricultural products would be permitted for the first time.
- ! Phase out quotas and other quantitative restrictions (some upon accession, many within two years, and most within five years). Quota levels for many products would expand by 15% each year until the elimination of the quota.
- ! Eliminate unscientifically based SPS restrictions on agricultural products and end export subsidies.
- ! Open service sectors (many of which are currently closed to foreign firms), including distribution, value-added telecommunications, insurance, banking, securities, and professional services (including legal, accountancy, taxation, management consultancy, architecture, engineering, urban planning, medical and dental, and computer-related services). China would expand (over various transitional periods) the scope of allowed services and gradually remove geographical restrictions on foreign service providers. The amount of permitted foreign ownership in service industries would vary (and in some cases expand over time) from sector to sector.
- ! Reduce restrictions on auto trade. Tariffs on autos would fall from 80-100% to 25% (tariffs on auto parts reduced to an average rate of 10%) by 2006.

Auto quotas would be eliminated by 2005. U.S. financial firms would be allowed to provide financing for the purchase of cars in China.

- ! Provide fair treatment for foreign firms operating in China by removing government rules requiring technology transfer, local content, and export performance conditions.
- ! Provide that Chinese state-owned firms make purchases and sales based on commercial considerations and give U.S. firms the opportunity to compete for sales on a non-discriminatory basis.
- ! Accept the use by the United States of certain safeguard, countervailing, and antidumping provisions (over transitional periods) to respond to possible surges in U.S. imports from China of various products, such as textiles, that might cause or threaten to cause market disruption to a U.S. industry.

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

Under the WTO accession agreement, China agreed to:

- ! Bind all tariffs. The average tariff for industrial goods will fall to 8.9% (and range from 0 to 47%) and to 15% for agriculture (and range from 0 to 65%). Most tariff cuts will be made by 2004; all cuts will occur by 2010.
- ! Limit subsidies for agricultural production to 8.5% of the value of farm output and will not maintain export subsidies on agricultural exports.
- ! Within three years of accession, grant full trade and distribution rights to foreign enterprises (with some exceptions, such as for certain agricultural products, minerals, and fuels).
- ! Provide non-discriminatory treatment to all WTO members. Foreign firms in China will be treated no less favorably than Chinese firms for trade purposes. Dual pricing practices will be eliminated as well as differences in the treatment of goods produced in China for the domestic market as oppose to those goods produced for export. Price controls will not be used to provide protection to Chinese firms.
- ! Implement the WTO's Trade-Related Aspects of Intellectual Property Rights (TRIPs) Agreement upon accession.

- ! Accept a 12-year safeguard mechanism, available to other WTO members in cases where a surge in Chinese exports cause or threaten to cause market disruption to domestic producers.
- ! Fully open the banking system to foreign financial institutions within five years. Joint ventures in insurance and telecommunication will be permitted (with various degrees of foreign ownership allowed).

**WTO Implementation Issues.** On December 11, 2002, the USTR released its first annual China WTO compliance report. While stating that China had made significant overall progress in meeting its WTO obligations, the report raised serious concerns over China's compliance with its commitments on agriculture, services, IPR protection, and transparency of trade laws and regulations. The U.S.-China Business Council (USCBC) raised similar concerns in its mid-year 2003 report on China's WTO implementation issued on June 18, 2003. The report stated that, while China has promptly implemented its WTO tariff-reduction commitments, it has failed to fulfill its obligations in a number of areas, including the removal of agricultural and industrial quotas and tariff-rate quotas, unreasonable standards for genetically modified organisms applied to agricultural trade, high capital requirements for establishment of services businesses, discriminatory tax policies on imports, failure to issue promised regulations for auto finance operations, insufficient regulatory transparency, and lack of protection for U.S. intellectual property rights. The USCBC noted "growing concerns" among U.S. firms over China's ability to deliver on key commitments on time and in full.

China's compliance with its WTO obligations have often been hampered by resistance to reforms by central and local government officials seeking to protect or promote industries under their jurisdictions, government corruption, and lack of resources devoted by the central government to ensure that WTO reforms are carried out in a uniform and consistent manner (especially in regards to IPR enforcement).

U.S. officials have raised a number of implementation issues with Chinese officials over the past year:

- ! **Soybeans.** China is a major soybean importer. The United States exports about \$1 billion in soybeans to China annually, making it the top foreign purchaser of U.S. soybeans. In June 2001, China announced it would implement new rules on bio-engineered foods, effective in 2002. However, China did not provide details of these rules which led to a disruption in U.S. soybean exports to China from January-March 2002. President Bush raised the issue with Chinese President Jiang Zemin in October 2001 and in March 2002, which led China to agree to the interim use of U.S. and foreign safety certificates until China implements its new biotechnology regulations. On October 18, 2002, China issued regulations applying this policy through September 2003. U.S. officials stated that the regulation "should remove the threat of an interruption of U.S. soybean sales to China." However, U.S. exporters have complained that the regulations require each GMO shipment to have an interim biotech safety certificate and a Chinese government import license. Additionally, in January 2003, the Chinese government indicated that it might delay permanent approval of various GMO crops and

might require another round of food safety studies, a move that led the U.S. to issue an official protest. Some analysts charge that China may be attempting to use such regulations to limit biotech imports in order to protect its domestic producers as well as its own biotech industries. U.S. officials have warned that they make take this issue to the WTO for resolution.

- ! **Tariff-rate quotas.** In November 2001, the Chinese government developed new rules on tariff-rate-quotas on certain agricultural products that the U.S. charged were discriminatory and violated WTO rules because they created two categories of import quota licenses: one for domestic consumption and one for “processing” trade. The U.S. further charged that China has failed to provide adequate information on the administration of its tariff-rate quotas (TRQs) for farm commodities. In July 2002, the U.S. Department of Agriculture (USDA) reported that China’s TRQ licenses had authorized relatively small levels of imports, making their use impractical. For example, under the WTO accession agreement, China’s TRQ for cotton in 2002 was 818,500 tons. In June 2002, China announced that the TRQ would be distributed as follows: 500,000 tons for processing trade, 270,000 tons for state-owned mills, and 48,500 tons for private mills. U.S. firms charge that this allocation policy violates WTO rules on national treatment. In other instances, China announced TRQs for various agriculture and manufactured products several months after their required implementation date. In December 2002, USTR Robert Zoellick sent a letter to China’s Ministry of Foreign Trade and Economic Cooperation (MOFTEC) expressing U.S. concern over China’s administration of TRQs. In January 2003, Zoellick was quoted in the press as saying that the TRQ issue was “one of the areas we’re most frustrated with” in terms of China’s WTO compliance.
- ! **Export subsidies and discriminatory taxes.** U.S. officials charge that China has subsidized grain exports (mainly corn) and cotton, and uses its tax system to promote exports and discourage imports, contrary to its WTO commitments. For example, China continues to give rebates on value-added taxes (VAT) for certain exports, especially high tech. In some instances, China imposes higher VAT rates on certain imported products (such as fertilizers and various agricultural products) than it does for similar products produced domestically.
- ! **Autos.** Some U.S. businesses claim that China has failed to fully implement its commitments on autos (especially in regards to quota allocations, trading rights for foreign firms, local content requirements, and auto financing).
- ! **Services.** U.S. firms have complained that Chinese regulations on services are confusing and often discriminatory. China maintains high capital requirements, restrictions on branching, and prudential requirements (e.g., already operating in China for a certain number of years, profit requirements, etc.) in order for firms to enter the market. In addition, many U.S. firms have complained that they have not been afforded the extent of

market access promised under China's WTO accord, especially regarding geographic market access and the amount of foreign ownership allowed for insurance and telecommunications companies in China.

- ! **Health and safety requirements.** U.S. officials charge that China continues to use a variety of health and safety regulations to effectively bar foreign imports, especially food products (such as wheat, poultry and meats, and citrus). Many of these issues were supposed to have been resolved under a 1999 agreement with China.
- ! **IPR.** While China has enacted a variety of new IPR laws, enforcement of those laws remains relatively weak (see section on IPR below).

**China's NTR Status and WTO Accession.** Prior to January 2002, U.S. law required China's normal trade relations (NTR) status (formally referred to in U.S. law as most-favored-nation, or MFN, status) to be renewed on an annual basis, based on the freedom-of-emigration requirements under the so-called Jackson-Vanik amendment, and was subject to possible congressional disapproval through passage and enactment of a joint resolution. From 1980 (when NTR status was restored to China after being suspended in 1951) to 1989, the renewal of China's NTR status was relatively noncontroversial and was relatively unopposed by Congress. However, congressional concern over the Tiananmen Square incident in 1989 and subsequent crackdown on human rights led many Members to support legislation terminating the extension of China's NTR status or to condition that status on additional requirements, mainly dealing with human rights. Although none of these measures were enacted, many Members sought to use the annual renewal of China's NTR status as a focal point to express concerns, as well as to pressure the executive branch, over a wide range of Chinese trade (e.g., trade barriers and failure to protect IPR) and non-trade (e.g., human rights, prison labor, Taiwan security, and weapons proliferation) issues. Several members opposed such linkage, arguing that it had little effect on Chinese policies and that the often rancorous congressional debate over China's trade status undermined long-term U.S.-Chinese relations and added uncertainty to the trade relationship.

During its negotiations with China over the terms of its WTO accession, the Clinton Administration pledged that, in return for significant market opening commitments on the part of China, it would press the Congress to enact PNTR legislation. Once a satisfactory bilateral agreement was reached with China in November 1999, the Clinton Administration began to push for PNTR legislation.

The Clinton Administration and its supporters argued that China would get into the WTO with or without congressional approval of PNTR status for China, and that failure to pass such legislation would prevent the United States and China from having an official trade relationship in the WTO. As a result, it was contended, U.S. firms would be excluded from the trade concessions made by China to gain entry into the WTO, while U.S. competitors in the WTO would be able to take full advantage of new business opportunities in China, and the United States would be unable to use the WTO dispute resolution process to resolve trade disputes with China. The Clinton Administration further maintained that China's accession to the WTO would promote U.S. economic and strategic interests, namely by inducing China to deepen market reforms, promote the rule of law, reduce the government's role in the economy, and further integrate China into the world economy, making it a more reliable and

stable partner. Finally, the Administration contended that congressional rejection of PNTR would be viewed by the Chinese as an attempt to isolate China economically; such a move would seriously damage U.S.-China commercial relations and undermine the political position of economic reformers in China.

Despite these arguments and strong lobbying by various U.S. business interests, passage of China PNTR was highly uncertain when Congress began consideration of legislation in May 2000. Many Members raised concerns over the effects China's WTO membership would have on U.S. import sensitive industries, while others expressed reservations over giving up what they perceived as leverage over China's human rights policies. The Clinton Administration and congressional supporters of PNTR legislation sought to craft a compromise that would gain support of undecided members without alienating members who wanted a "clean" PNTR bill.

H.R. 4444, as originally introduced by Representative Bill Archer, would have granted PNTR status to China upon its accession to the WTO as long as the President certified that the terms of its accession were at least equivalent to the November 1999 U.S.-China trade agreement. Several provisions were added by the House to H.R. 4444 in response to various congressional concerns. In addition to the provisions contained in the original version of H.R. 4444, the final bill (which passed in the House on May 24, 2000, in the Senate on September 19, 2000, and signed into law on October 10, 2000):

- ! established a special Congressional-Executive commission to monitor, and report on, various aspects of China's policies on human rights, including labor practices and religious freedom;
- ! requires the USTR to issue a report annually assessing China's compliance with its WTO trade obligations;
- ! codified the anti-surge mechanism established under the November 1999 U.S.-China trade agreement and establishes procedures for obtaining relief from import surges;
- ! authorized additional funding for various U.S. government agencies to monitor and seek enforcement of China's compliance with its WTO trade commitments;
- ! set up a special government task force to halt U.S. imports from China of products suspected of using prison labor; and
- ! authorized funding for programs to promote the development of the rule of law in China.

On November 10, 2001, President Bush certified that the terms of China's WTO accession agreement were at least equivalent to the November 1999 U.S.-China trade agreement, and on December 27, 2001, he issued a proclamation extending PNTR status to China, effective January 1, 2002.

## Violations of U.S. Intellectual Property Rights

Section 182 of the Trade Act of 1974 as amended (also known as “Special 301”), requires the USTR to identify “priority foreign countries” that fail to provide adequate and effective protection of U.S. intellectual property rights (IPR), such as patents, copyrights, trademarks, and trade secrets, or deny fair and equitable market access to U.S. firms that rely on IPR protection. The USTR is directed to seek negotiations with the priority foreign countries to end such violations and, if necessary, to impose trade sanctions if such negotiations fail to produce an agreement.

In April 1991, China (along with India and Thailand) was named as a “priority foreign country” under Special 301. The USTR began a Section 301 investigation in May 1991, claiming China’s laws failed to provide adequate protection of patents, copyrights, and trade secrets. In November 1991, the USTR threatened to impose \$1.5 billion in trade sanctions if an IPR agreement was not reached by January 1992. Last-minute negotiations yielded an agreement on January 16, 1992. China promised to strengthen its patent, copyright, and trade secret laws, and to improve protection of U.S. intellectual property, especially computer software, sound recordings, chemicals, and pharmaceuticals.

In June 1994, the USTR again designated China as a Special 301 “priority foreign country,” because it had failed to enforce recently enacted IPR laws. In particular, the USTR cited the establishment of several factories in China producing pirated compact and laser disks, as an example of China’s “egregious” violation of U.S. IPR. In addition, the USTR stated that trade barriers had restricted access to China’s market for U.S. movies, videos, and sound recordings, and that such restrictions encouraged piracy of such products in China. On February 4, 1995, the USTR announced that insufficient progress had been made in talks with Chinese officials and issued a list of Chinese products, with an estimated value of \$1.1 billion, which would be subject to 100% import tariffs. However, a preliminary agreement was reached on February 26, 1995, and a formal agreement was signed on March 11, 1995. The new agreement pledged China to substantially beef up its IPR enforcement regime and to remove various import and investment barriers to IPR-related products. Specifically, China agreed to:

**Take immediate steps to stem IPR piracy in China over the course of the next 3 months** by taking action against large-scale producers and distributors of pirated materials, and prohibiting the export of pirated products.

**Establish mechanisms to ensure long-term enforcement of IPR laws**, such as banning the use of pirated materials by the Chinese government, establishing a coordinated IPR enforcement policy among each level of government, beefing up IPR enforcement agencies, creating an effective customs enforcement system, establishing a title verification system in China to ensure that U.S. audio visual works are protected against unauthorized use, reforming China’s judicial system to ensure that U.S. firms can obtain access to effective judicial relief, establishing a system of maintaining statistics concerning China’s enforcement efforts and meeting with U.S. officials on a regular basis to discuss those efforts, improving transparency in Chinese laws concerning IPR, and strictly enforcing IPR laws.

**Provide greater market access to U.S. products** by removing import quotas on U.S. audio visual products, allowing U.S. record companies to market their entire works in China

(subject to Chinese censorship concerns), and allowing U.S. intellectual property-related industries to enter into joint production arrangements with Chinese firms in certain cities.

Several U.S. firms charged that IPR piracy in China worsened in 1995, despite the 1995 IPR agreement, and pressed the USTR to take tougher action against China. The International Intellectual Property Alliance (IIPA), an association of major U.S. copyright-based industries, estimated that IPR piracy by Chinese firms cost U.S. firms \$2.3 billion in lost trade during 1995.

On April 30, 1996, the USTR again designated China as a Special 301 “priority foreign country” for not fully complying with the February 1995 IPR agreement. According to the USTR, while China had cracked down on piracy at the retail level (launching raids and destroying millions of pirated CDs and hundreds of thousands of pirated books, sound recordings, and computer software), it had failed to take effective action against an estimated 30 or so factories in China that were mass-producing and exporting pirated products. U.S. officials called on the Chinese government to close such factories, prosecute violators, and destroy equipment used in the production of pirated products. Further, the USTR stated that China failed to establish an effective border enforcement mechanism within its customs service to prevent the export of pirated products. Finally, the USTR indicated that China failed to provide sufficient market access to U.S. firms, due to high tariffs, quotas, and regulatory restrictions. Shortly after, the USTR indicated it would impose U.S. sanctions on \$2 billion worth of Chinese products by June 17, 1996, unless China took more effective action to fully implement the IPR agreement. On June 17, 1996, USTR Charlene Barshefsky announced that the United States was satisfied that China was taking steps to fulfill the 1995 IPR agreement. Barshefsky cited the Chinese government’s recent closing of 15 plants producing illegal CDs and China’s pledge to extend a period of focused enforcement of anti-piracy regulations against regions of particularly rampant piracy, such as Guangdong Province. The Chinese government also promised to improve border enforcement to halt exports of pirated products as well as illegal imports of presses used to manufacture CDs. Further, the Chinese government reaffirmed its pledge to open up its market to imports of IPR-related products. Finally, Chinese officials promised to improve monitoring and verification efforts to ensure that products made by Chinese CD plants and publishing houses are properly licensed.

The USTR has stated that China has made great strides in improving its IPR protection regime, noting that it has passed several new IPR-related laws, closed or fined several assembly operations for illegal production lines, seized millions of illegal audio-visual products, curtailed exports of pirated products, expanded training of judges and law enforcement officials on IPR protection, and has expanded legitimate licensing of film and music production in China.

U.S. business groups continue to experience significant IPR problems in China, especially in terms of illegal reproduction of software, retail piracy, and trademark counterfeiting. It is estimated that counterfeits account for 15 to 20% of all products made in China and totals and accounts for about 8% of China’s GDP. Chinese enforcement agencies and judicial system often lack the resources (or the will) needed to vigorously enforce IPR laws; convicted IPR offenders generally face minor penalties. In addition, while market access for IPR-related products has improved, high tariffs, quotas, and other barriers continue to hamper U.S. exports; such trade barriers are believed to be partly responsible for



illegal IPR-related smuggling and counterfeiting in China. Industry analysts estimate that IPR piracy in China cost U.S. firms \$1.85 billion in lost sales in 2002. The piracy rate for IPR-related products in China (such as motion pictures, software, and sound recordings) is estimated at around 90%. Under the terms of China's WTO accession (see above), China agreed to immediately bring its IPR laws in compliance with the WTO agreement on Trade Related Aspects of Intellectual Property Rights (TRIPS). In September 2002, the WTO members gave a positive review of China's new IPR laws related to the TRIPS agreement. However, U.S. government officials continue to hold that China's enforcement of its IPR remains inadequate.

## China's Currency Peg

China maintains what it refers to as a "managed float" exchange rate system that is pegged to the U.S. dollar. Under this system, China's central bank issues a reference dollar/yuan (China's currency unit) exchange rate along with a limited band in which the reference rate is allowed to fluctuate. This system has been in place since 1994 and the currency has been pegged at about 8.3 yuan to the dollar. China has been able to maintain this peg because its currency is not fully convertible in international markets, and because it maintains restrictions and controls over capital transactions. As a result, China's exchange rate is not based on market forces. Many U.S. policymakers and business representatives have charged that China's currency is significantly undervalued vis-a-vis the U.S. dollar, making Chinese exports to the United States cheaper, and U.S. exports to China more expensive, than they would be if exchange rates were determined by market forces. (For example, a July 23, 2003 press release by the House Small Business Committee stated that estimates by economists of China's currency undervaluation ranged from 15 to 40%.) They complain that this policy has particularly hurt several U.S. manufacturing sectors (such as textiles and apparel) who are forced to compete domestically against low cost imports from China), and have called on the Bush Administration to pressure China to either appreciate its currency (by increasing the band in which it is allowed to be traded in China) or to allow it float freely in international markets.

During the mid-1990s, Chinese officials indicated that they were considering making the yuan fully convertible by 2000. However, these plans were abandoned as a result of the 1997 Asian financial crisis, which significantly affected several East Asian economies. Chinese officials found that having controls over capital transactions was a major factor in China being able to avoid many of the economic difficulties (such as sharp currency depreciation and plunging stock market prices) suffered by its neighbors (who maintained more open exchange rate policies). While Chinese exports suffered somewhat from sharp currency depreciations in several East Asian countries, China pledged not to devalue its currency, a policy that many analysts claim helped stabilize the effects of the economic crisis in Asia and gained China high praise from U.S. officials.

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

stability; they fear an appreciated currency could reduce jobs and lower wages in several sectors and thus could cause worker unrest.

U.S. and foreign critics of China's currency peg counter that China has been able to accumulate massive amounts of foreign exchange reserves (nearly \$347 billion by June 2003) and thus has the resources to maintain the stability of its currency if it were fully convertible. They further argue that appreciating the yuan would greatly benefit China by lowering the cost of imports for Chinese consumers and producers who use imported parts and machinery. Finally, critics argue that China's accumulation of large amounts of foreign exchange reserves (in order to maintain the currency peg) could be better spent on investment in infrastructure and development of poor regions.

Some Members of Congress and certain U.S. business groups charge that China is deliberately attempting to "manipulate" its currency to give its exporters an unfair trade advantage, which, they argue, violates International Monetary Fund and World Trade Organization rules. They have called on the Bush Administration to take tough action against China (as well as other nations that "manipulate" their currencies). Bush Administration officials have indicated that they have urged China to let the exchange rate of the yuan be determined by market forces.

## **Outlook for U.S.-China Trade Relations**

U.S.-China economic ties are likely to expand significantly in the years ahead, due in part to China's rapid economic growth and its trade liberalization policies. However, tensions will likely remain over a number of issues. First, many U.S. firms continue to express frustration over certain aspects of China's implementation of its WTO obligations, particularly in regards to agricultural products and certain services. Some Members have called on the Bush Administration to take action against China in the WTO if it fails to resolve these issues. Second, although U.S. exports to China have risen sharply, U.S. imports from China continue to surge as well. Many U.S. industries and labor unions have raised concern over the effects of low-cost Chinese imports on U.S. manufacturing, employment, and wages (as well as over U.S. firms moving production and service facilities to China). This appears to be a major factor behind the call by several Members of Congress to pressure China to appreciate its currency. Several Members have also called on the Administration to invoke special safeguard provisions (that were included in China's WTO accession package) that would enable the United States to restrict imports of certain Chinese products deemed harmful to U.S. industries, especially textile and apparel products. Because China is a member of the WTO, the United States is required to end its quota system regime on imported textile and apparel products from China by 2005. Many U.S. textile and apparel representatives argue that the elimination of quotas will lead to a new flood of cheap imports from China, which, they contend, could force many U.S. firms out of business.