As Prepared for Delivery – Embargoed until 2:00pm EST, January 30, 2008

Economic Engagement with a Rising China

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Washington, D.C.
January 30, 2008

A few years ago, I listened to a very good speech on China policy. It outlined in compelling terms why China's economic integration with the world is good for the United States, and argued for a common-sense policy of engaging China economically. I remember one part of that speech in particular:

> *"The path that China takes to the future is a choice China will make. We cannot control that choice, we can only influence it. But we must recognize that we do have complete control over what we do. We can work to pull China in the right direction, or we can turn our backs and almost certainly push it in the wrong direction."*

Because of my background, some of you might assume that quote came from a notable speech on China given by my former boss, Bob Zoellick, when he served as Deputy Secretary of State. But in fact, those words were spoken on March 8, 2000, by then-President Bill Clinton.

In 2000, the United States was at a crucial juncture in its policy toward China. We faced a fundamental decision: whether to further integrate China into the global economy, or turn away from decades of positive engagement. The immediate question was whether to support Permanent Normal Trade Relations (PNTR) and benefit from China's entry into the World Trade Organization (WTO). Supporters of PNTR understood that economic engagement presented the United States with an opportunity to guide China toward peaceful integration into the global community. After a vigorous debate in Congress and in the country at large, a bipartisan majority agreed.

Before 2000, Chinese goods already enjoyed broad access to American markets; PNTR was mostly about opening China's market to *our* products. And it worked: China has grown to become America's third-largest export market, and among the fastest-growing. American exports to China have risen by more than 188 percent since 2001, a rate that far outpaces the growth in imports. Of course, in absolute terms, the bilateral trade deficit with China is America's largest, and a consistent source of concern.

Protectionism on Both Sides of the Pacific

Today the United States and China once again find themselves at a critical juncture. In 2008, powerful groups in both countries will question the benefits of greater integration, calling

for barriers to be erected between us. Economic nationalists in the United States will play on Americans' anxiety about the competitive challenge of China and the global impact of its actions on everything from the safety of our children's toys to the quality of air that we breathe.

But in a new development, the voices of economic nationalism are also speaking Mandarin. China has been more open than many developing countries, but there are increasing signs of policies that seek to direct markets rather than opening them.

Here in the United States, support for engagement does not mean blindness to the enormous challenges resulting from China's economic rise. Just as the world watches closely when the United States holds an election or the Federal Reserve makes decisions about interest rates, it is appropriate for Americans to watch for hints that China is backing away from open trade and economic policies. There are three trends in particular that merit close scrutiny.

Challenges in the Economic Relationship

The first is a new network of policies that appear designed to favor Chinese "national champion" firms over foreign competitors. This trend, perhaps more than any other, worries American business leaders in industries from steel to software.

For example, there is a new Anti-Monopoly Law that may exempt Chinese state-owned firms from the disciplines of competition rules. There are rumored technical standards for cell phone batteries that would make it impossible for Chinese consumers to buy the hottest American technologies on the market. Chinese regulators in industries like insurance and financial services routinely treat foreign firms more harshly than domestic ones. Foreign investment regulations are opaque and, combined with state subsidies to so-called "pillar" industries. We see renewed government efforts to redirect the market with price controls and quotas, resulting in widespread power shortages, transportation bottlenecks and gas lines in the world's fourth largest economy. All these policies raise questions about the direction that the Chinese leadership wants to take – continued reform, or a brand of more insular thinking.

The second concern is that China's regulatory structure has been unable to keep pace with the country's rapid economic growth. One example is China's inability – or unwillingness – to curb rampant piracy and counterfeiting. In 2006, an astounding 81 percent of seizures by U.S. Customs and Border Protection of counterfeit goods were from China. Despite repeated promises, the Chinese government has yet to bring this problem under control.

Most visibly, China's government has struggled to create a modern regulatory structure to ensure product safety. Every day we seem to hear about a new recall of Chinese-made products. My own dog had been eating some of the pet food contaminated with melamine from China. Consumers understand that most Chinese imports are safe – but they also want to know that China has safeguards in place to deal with products that are not.

China's response to date has not inspired confidence. The government's initial reaction to this problem was to deny its severity and blame the media. Then, just a few weeks ago, a

senior Chinese product-safety official assured us that there had been a problem, but that it had been solved four months ahead of schedule and there was nothing left to worry about. Such wildly varying pronouncements do not build trust. Instead, they suggest that China's government does not yet fully understand that it must do the long, hard work of strengthening its product safety regime – or put the "Made in China" brand at even greater risk.

Third, China's significant economic imbalances could derail its own growth and affect the United States and others. China suffers from excessive capital accumulation and growing inflation. Economic growth is driven more by investment than consumer spending, partly because the lack of a meaningful social safety net has led to a disproportionately high savings rate among China's households. The government still maintains a heavy role in the economy, and the state-dominated banking sector is burdened with many non-performing loans.

America's Response?

Given these challenges – growing economic nationalism, inadequate policing of the economy, and structural economic imbalances – it is not surprising that many Americans are concerned about China. These concerns are reflected in Congress, with numerous pending bills dealing with China. It is understandable that many in Congress want action. So does the Administration. But as President Clinton pointed out in 2000, we cannot control China's decisions, we can only influence them. So the question is what combination of policies would be most effective in influencing China's behavior.

The blunt instrument of punitive legislation won't work. Many of the pending bills are designed not to solve problems in China, but simply to reduce U.S. imports from China. And they are directed in a scattershot manner at particular symptoms of China's problems, rather than at root causes.

The Chinese currency has received particular legislative attention. I will leave it to my colleagues at the Treasury to discuss currency policy. Instead, I will address the challenges of requiring the Commerce Department to include an assessment of China's currency value in antidumping (AD) or countervailing (CVD) duty margins. This is problematic for at least four different reasons.

First, keep in mind that the central purpose of inserting currency judgments into trade remedy cases is to drive up the price of imports from China. China is the single-largest supplier of inexpensive products purchased by American consumers. In this time of economic uncertainty, as Congress and the Administration work together to stimulate growth, it would be very unwise to pass legislation that could inflate consumer prices.

Second, there are serious questions about how the Commerce Department would administer a trade-remedy regime that turns on currency valuation. The staff of Commerce's Import Administration works hard to measure prices and subsidies in a transparent, objective manner. But I could pick up the phone today and call five economists who would give me five different opinions about the value of the renminbi. Some say it is undervalued by 40 percent.

Others say twenty-five. Last July, *The Economist's* famous Big Mac index found a 58 percent undervaluation of the RMB based on input prices for a hamburger. But even that tongue-in-cheek method of valuing currencies depends heavily on the prices of local inputs which are not easily arbitraged across borders.

There are other such operational problems. The bills require that the Commerce Department consider only how currency affects the *final* price of products assembled in China, discounting that a low currency simultaneously *increases* the price China pays to import components that go into those final products. And currency valuation is to be considered on a one-way basis – only when there is alleged foreign undervaluation, with no offsetting effect when the dollar is relatively weak compared to overseas currencies. I can only imagine what would happen the first time a petitioner appeals to the U.S. Court of International Trade, arguing that the currency valuation used in a trade remedy case was wrong. Do we really want judges to arbitrate the fair market value of the dollar against foreign currencies?

Third, inserting relative currency values into trade remedy cases could open a Pandora's Box of never-ending trade retaliation. The United States is already the third-largest victim of antidumping cases in the world. If we insert our own judgments on the value of foreign currencies into trade remedy cases, we would have to expect that similarly subjective counter-measures would be directed against our exports. It is not hard to imagine foreign trade bureaucrats using the relative value of the dollar as an easy excuse to erect new trade barriers. This would be particularly worrisome at a time when surging exports have been an important counterweight to the downturn in our domestic housing market. And there is a risk of multilateral retaliation as well. As Secretaries Gutierrez, Paulson, and Ambassador Schwab pointed out in a letter to Congress last summer, certain provisions of the pending China bills appear to raise serious concerns under international trade rules and could invite multilateral, WTO-sanctioned retaliation against U.S. goods and services.

Finally, there is no evidence that the proposed bills would reduce the bilateral trade deficit. Consider just two simple facts: According to the Treasury Department, the RMB has appreciated approximately 15% against the dollar since the peg was abandoned in July 2005. Yet over the same period, the Commerce Department reports that the bilateral trade deficit with China has increased by approximately 30%. The deficit is driven by many complex factors, including relative growth and interest rates, relative savings rates, and many others. Passing currency legislation won't make the trade deficit go away.

A Three-Part Engagement Strategy

There is a better approach to our bilateral economic relationship. It has been the policy of seven Presidential administrations of both parties. It is called economic engagement, and it provides the best, most flexible approach to a very complex set of challenges. The Bush Administration is continuing the tradition of economic engagement with a three-pronged strategy that combines dialogue with the intelligent use of leverage.

First, we must continue our intensive dialogue with China through the Joint Commission on Commerce and Trade (JCCT) and the Strategic Economic Dialogue (SED). Both have proved to be effective vehicles. To address IPR concerns, China agreed in the previous JCCT to require that computers be pre-loaded with legitimate software, and has been cracking down on those that are not. Our governments agreed to exchange information on customs seizures of counterfeit goods in order to focus China's enforcement resources on companies exporting such goods. China agreed to strengthen enforcement of laws against company name misuse, a practice by which some Chinese companies have registered legitimate U.S. trademarks and trade names. We have opened new discussions with China on its Anti-Monopoly Law and other industrial practices, have worked to cancel or delay China-unique technology standards, and are taking concrete action against state subsidies.

In the area of product safety, China has taken action in recent months against hundreds of companies found to be producing unsafe products, but now needs to translate factory raids into a more systematic structure of effective regulation. To that end, at the most recent SED the U.S. Department of Health and Human Services signed a Memorandum of Agreement with China's State Food and Drug Administration on the safety of active pharmaceutical ingredients. And at the JCCT, China agreed to address specific loopholes in its regulation of bulk chemicals used as the underlying source of many counterfeit drugs.

My administration colleague, Treasury Under Secretary David McCormick, is speaking in New York today about China's macroeconomic imbalances. That area is a key focus of the Strategic Economic Dialogue, which is providing new ways to discuss the complex, inter-woven nature of China's structural economic challenges.

In addition to these dialogues, the United States is also sharing ideas with trading partners such as the European Union and Japan on China's integration in the global economy. Such communication will allow us to discuss how major trading nations can best respond to the myriad challenges that all of us face together from China's economic rise.

Dialogue and engagement are producing solid results, but our strategy is not one-dimensional. We are backing words with action, taking tough measures to enforce our rights through the WTO and U.S. trade remedy laws.

The second prong of our strategy is to make full and effective use of the WTO dispute settlement system. This Administration launched the first case by any nation against China at the World Trade Organization, and will continue to exercise U.S. rights under the dispute settlement system when necessary. The United States has brought five cases against China, two of which have been settled by China on favorable terms to the U.S., and three of which are still pending. Cases launched by the United States go to the central issues in the relationship, such as the protection of intellectual property rights, discriminatory taxation systems, state export subsidies, and market access for U.S. products like auto parts and audio-visual goods.

Third, the Administration will make effective use of U.S. trade remedies, vigorously enforcing laws against dumping and government subsidies. In March 2006, the Commerce

Department reversed a 23-year policy of not applying countervailing duty orders against Chinese imports. The Commerce Department has initiated seven CVD investigations of government subsidies to Chinese industry thus far. Meanwhile, we continue to vigorously enforce the antidumping laws; Commerce has in force more than sixty antidumping duty orders against imports from China, and products from China are at issue in about half of all the ongoing AD/CVD investigations by the Department.

The Administration's three-pronged approach offers a comprehensive strategy to influence Chinese behavior on everything from specific market access problems to broad macroeconomic concerns. It combines dialogue with tough enforcement, and can be calibrated carefully to respond to Chinese actions. It can be combined with the efforts of other major trading powers to bring constructive multilateral pressure to bear.

Punitive legislation would accomplish none of this. Instead, such measures run the risk of inflating consumer prices at a time of economic uncertainty, bringing about trade retaliation that would stifle our exports, and setting back efforts to promote reform in China – while doing nothing to reduce the bilateral trade deficit.

Conclusion: Engagement Is Still the Right Choice

Eight years ago, the United States made a fundamental choice. After a vigorous debate, a bipartisan majority agreed that America should not try to isolate China, but rather should encourage its deeper integration into the world economy. At that time, U.S. exports to China were only $16 billion. Today they are almost quadruple that. But while our exports have grown, so have tensions in the bilateral economic relationship. The Bush Administration will not ignore these tensions, or attempt to minimize them.

Congress and the Administration share concerns over many aspects of China's economic rise. The question is how best to address that competitive challenge, and to influence Chinese behavior. Today as in 2000, it would be a mistake to adopt policies that would, as President Clinton then warned, "almost certainly push China in the wrong direction." As then, there is much anxiety in the country about the challenge of Chinese competition. As then, we face a fundamental choice about how to manage our relationship. And as then, the right choice is clear: economic engagement with China remains in our national interest.