

Statement before the Senate Banking Committee

“THE TREASURY DEPARTMENT’S REPORT ON INTERNATIONAL ECONOMIC AND EXCHANGE RATE POLICIES”

A Statement by

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Mr. Chairman, esteemed members of the Committee, it is my honor to testify today on the factors in China that contribute to the undervaluation of the renminbi (RMB) and other economic policies that may act to disadvantage American businesses and their workers.

Much has been written about the RMB and its value relative to the dollar and other major currencies. China has largely maintained a fixed exchange rate for the entire history of the People's Republic of China (PRC) since its foundation in 1949. For the first three decades of the PRC, the RMB was pegged at an absurdly overvalued rate of between 2.5 to 1.5 RMB to the US dollar. In the early 1980s, as China began to open to the outside world and the country became focused on export-driven growth, the RMB was devalued to improve export competitiveness such that, by 1994, the RMB was valued at 8.62 to the dollar. Following the Asian financial crisis of the late 1990s, China maintained a peg of 8.27 to the dollar from 1997 until 2005 when, in the midst of vocal international criticism (led in no small part by Congress), China announced an intent to gradually relax the peg.

The decision in 2005 to loosen its exchange rate policy to allow appreciation certainly came in the midst of extraordinary international outcry, but it also followed a lengthy period of heated external debate within China. Many of China's financial regulatory officials had long argued that the peg was undermining China's efforts to create a modern financial system; that it misallocated investments domestically; and that it contributed to what was then just becoming a chronic global current account surplus. These financial mandarins have faced a recalcitrant and powerful set of interests committed to maintaining export competitiveness as a key pillar in China's economic policy. When the financial crisis

took the world by storm in 2007, those Chinese officials determined to prop up exports put the brakes on additional appreciation so that global economic uncertainty would not undercut China's perceived export advantage conveyed by a competitively-valued currency. For all the wringing of hands within China about a loss of competitiveness that significant RMB appreciation would yield, China's enormously impressive economic performance suggests that fears of RMB appreciation are misplaced.

Despite the dramatic levels of economic and export growth behind China's frustrating refusal to meaningfully appreciate the RMB lays an almost stunning insecurity about China's political and economic stability. The PRC's leadership is deeply concerned about its ability to maintain domestic economic stability, given the challenges (many of which are admittedly staggering) of income and development disparity, and other factors. Since many in China's leadership consider economic growth and stability to be a sine qua non of political stability, maintaining any competitive advantage to drive economic growth is a political necessity: without growth, the Communist Party is out of power, or so the thinking goes. While many of China's economic policymakers are seeking to reduce the country's reliance on exports for economic growth, there remains much skepticism that alternative pathways – particularly through increasing the share of consumption in GDP – are available in the near term to export growth. Accordingly, maintaining an export advantage is part and parcel of maintaining political control. Small wonder that Chinese officials are loath to answer the entreaties of Treasury and Congress to remove the RMB's peg to the dollar. They fear the domestic consequences: a loss of jobs and competitiveness that will stir public antipathy and, ultimately, cost them their political authority.

These concerns will no doubt be familiar to many in this body. To the extent concern in the United States public over Chinese economic policies can be said to reduce competitiveness, and lead to the loss of jobs and business opportunities, the administration and Congress have a solemn responsibility to the American public to confront those policies. So in many respects Chinese officials

are pursuing the same fundamental political goals we are. Their motivations, however, should not excuse policymaking behavior that undermines U.S. and global confidence in the fairness of the world's trade and financial architecture. More recently, this behavior has increasingly been bolstered by an increasing confidence among Chinese policymakers that their policies are right, and our concerns are misplaced.

Not all is bad news in the U.S.-China trade and economic relationship. In 1979, total trade between the United States and China was \$2.4 billion. 30 years later, by 2009, that trade had grown to \$365 billion. During this period China became the fastest growing export market in U.S. history; Chinese exports to the United States (which to an overwhelming degree did not compete directly with American production) enhanced the buying power of Americans, particularly those at lower income levels; and China became one of the most profitable and fastest-growing markets for the operations of American businesses. Not insignificantly, the commercial relationship between the United States and China has been an important area of common interest that has reduced bilateral tensions between two countries that are not, to say the least, natural political partners.

Yet, more broadly, Chinese economic policymaking, whether acts of commission like industrial policies that disadvantage U.S. competitiveness in its market; or acts of omission like China's completely ineffectual system of intellectual property rights protection and enforcement, is unquestionably undercutting Americans' faith in the fundamental fairness of trade between the United States and China. On one hand, the fact that China, by the introduction to the global labor market of twenty percent of the world's potential workers, has come into conflict with other countries, is far from surprising. That the rise of China from less than a percentage point of global GDP to around eight percent has created concerns among industrialized nations should further create challenges is hardly shocking either. However, in spite of all the misplaced outrage, the impact of China's rise in the global

trading order has still created valid challenges that need to be confronted. Indeed, China presents a fundamental challenge to the nature of the global trading order and the U.S. role in that order going forward.

The Rise of the Beijing Consensus

This most recent global economic crisis has left many Chinese feeling triumphant. China's economy, after a brief pause, is once again roaring at double-digit growth. China's financial system was -underexposed to many of the "toxic" assets that were the bane of so many other countries', and its stimulus package was targeted and relatively efficient. Chinese media and internet chatting has been full of commentary that the United States was down and out as a result of the crisis and China is scaling new heights. There is a palpable sense among many Chinese that China's economic and political system has distinct advantages over that of the United States. Despite a long-time view that the U.S. model of development – based on the so-called "Washington Consensus"—had much to be admired, many Chinese now perceive that there is a distinct Chinese model of growth – based on "state-directed capitalism" -- that has little to be learned from the American experience favoring open markets and a preference for private activity. As Chinese Vice Premier Wang Qishan said, tongue clearly in cheek, to a forum of American business and government leaders as the extent of the financial crisis became clear: "We have learned that our teacher has some problems."

China's widespread perception that the U.S. economic model is inferior to that of the newer Chinese version has profound implications for both China and the United States. To begin with, it is based on a faulty supposition. China's twenty-five year run of breakneck growth is not the result of effective state-owned firms or savvy industrial policies. Rather, China's economy has largely grown by the government getting out of the way of entrepreneurial individuals and companies; by allowing the ambitions of Chinese private individuals to substitute for the will of the state. Rather than clever

planning by Chinese government agencies, as many Chinese now seem to suppose, twenty years of intensive market reform policies that removed the Chinese government from active intervention in market activity have been the primary source of Chinese growth. Chinese state-owned enterprises are largely a drag on growth, consuming 70 percent of Chinese resources and producing only 30 percent of Chinese output. China's industrial planners, those ministries that are heirs to the disastrous economic policies of China's Maoist past such as the Great Leap Forward and other tragic missteps, were largely sidelined during much of the two decades leading up to the beginning of this century as China's leadership sought to replace bureaucratic decision-making with market principles. Fifteen years of painful negotiations with the United States and other economies leading up to Chinese entry into the World Trade Organization in 2001 was intended by those steering the Chinese economy during this period to force reform on an otherwise recalcitrant bureaucracy. The wisdom of Chinese leaders in developing China's economies has not been to construct careful economic plans, but to eschew constructing those plans and drastically reduce state control over the economy. Unfortunately for those in China counting on unabated and efficient economic growth, the new generation of Chinese policymakers seems to have forgotten this important lesson.

The second problematic impact of a newfound Chinese economic triumphalism is on the ability of U.S. trade and economic officials to convince Chinese counterparts to revise or reverse policies that impact U.S. economic interests. In the past, examples from the U.S. economic experience were important teaching tools that our officials and businesspeople could deploy to demonstrate alternative policies that Chinese officials might choose as alternatives to problematic policies. In an era in which the U.S. model was a powerful case in point of how to get economic development right, Chinese officials were at least willing to provide some deference to these examples. Newly convinced of the superiority of the Chinese system, Chinese policy-makers are less easily converted to replace offensive policies and practices by examples from the "failed" U.S. model. As a result, when attempting to "fix" problems in

U.S.-China trade relations, U.S. trade officials are left with few alternatives and must seek Chinese concessions during high-level summitry like the Strategic and Economic Dialogue or the Joint Commission on Commerce and Trade; by seeking WTO dispute resolution; or through unilateral trade actions. Unfortunately, high-level summitry isn't an efficient process by which to resolve multiple complex trade issues. WTO dispute resolution is slow and unwieldy, and few problems in the relationship are clear violations of China's WTO commitments. Finally, unilateral trade actions can run afoul of our own multilateral trade commitments.

The final challenge placed by China's newfound sense of economic superiority has been to dramatically suppress the forces of reform in China. In 2001, with the goal of Chinese WTO accession realized, the forces of reform were relieved of their primacy in economic policymaking. The planning-oriented ministries and agencies that had been suppressed in the fifteen years of reform found overnight that they no longer were easily coerced by reform oriented ministries like Commerce and Foreign Affairs. The planning forces not only began to flex their muscles in ways that challenged U.S. economic interests, they did so with no small amount of resentment at the perceived heavy-handedness of the forces of reform during the period of their dormancy. Paradoxically, much of the decentralization of power and authority throughout the bureaucratic system that was a hallmark of WTO reform effectively empowered bureaus and offices throughout the Chinese ministerial to come up with creative plans that challenged the spirit of reform that embodied China's WTO push. When these plans challenged U.S. economic interests, however, U.S. officials have been forced to take up their concerns with different ministries, namely Commerce and Foreign Affairs, that may be most sympathetic to our concerns, but without the power and authority that they enjoyed in previous years.¹ Given the unique, stove-piped nature of the Chinese bureaucracy, the effectiveness of those agencies in over-turning

¹, Neither the Ministry of Commerce nor Foreign Affairs has a direct representative on the Politburo, unlike previous years. Experience managing international affairs among China's most senior leadership is therefore in short supply.

policies generated in other ministries is highly limited, absent external intervention from a higher-level authority. In short, the United States has difficulty finding an official audience in China that is both sympathetic and has political capital sufficient to do something about our concerns.

In order for you to approach challenges holistically I believe that it is also critical to address some of the economic and trade challenges not under the purview of the Banking Committee.

Intellectual Property Rights Protection and Enforcement

Not all challenges in the U.S.-China trade relationship are a result of newfound Chinese self-confidence or date from the resurgence of Chinese economic planning. The most costly of China's trade policies to U.S. economic interests has been the same for nearly as long as the relationship began. The counterfeiting and piracy of U.S. intellectual property from software to celluloid to switching technologies has been rampant and virtually unchecked in China for over two decades. This despite China's implementation of a basically WTO-consistent legal framework of intellectual property rights (IPR) protection and enforcement. One of the primary challenges to those seeking to prevent the unopposed theft of their IPR is that China's extreme geographic and political decentralization makes it very difficult for rights-holders to pursue legal protection and enforcement of their rights without having to run a gamut of local and provincial officials and courts that are more likely to side with local violators with more local political clout. When rights-holders are successful at seeking legal redress for their grievances in court, they are frequently awarded damages that are *de minimis* – barely adequate to cover legal costs let alone serve as a deterrent of future IPR theft. For many recidivist IPR pirates and counterfeiters, legal fines are an unfortunate but bearable cost of doing business: the rewards for piracy far outweigh the risks.

U.S. officials have, for years, attempted to establish with Chinese counterparts an understanding on the utility of an effective IPR regime for Chinese economic development. A primary complaint of

Chinese economic policy officials is that China's economy, while it has grown exponentially in the past 30 years, remains on the low-end of industrial input values. Searching for a means to bring Chinese industry up the value chain, some of these policy-makers have seized on an effective IPR regime as an important means to an end. If China can better protect IPR, so the theory goes, China's domestic inventors and entrepreneurs will have a greater incentive to build Chinese technology companies and brands. There is thus a highly-energized cadre of Chinese officials that understand the importance of IPR to an innovative economy and are seeking to establish a more effective system of IPR protection and enforcement not because of an interest in protecting foreign business interests, but promoting domestic Chinese innovation.

This cadre of officials is bolstered somewhat by the increasing attention of China's most senior leadership to the importance of innovation to China's future growth plans. China's desire for technological advancement is a longstanding obsession. As early as the mid-1970s, China's Premier Zhou Enlai espoused the goal of "Four Modernizations", among which technological modernization was prominent. In the 1980s and 1990s, China sought to increase its technology base through technology transfer, attempting through incentives to encourage Western companies to incorporate higher technology platforms into their production bases.

But China's effort to seek technology transfer, through incentives or (occasional) coercion, has been less-than successful. Some Chinese individuals and firms, not necessarily with state sponsorship, have on occasion attempted to access higher technologies from the United States and other Western economies through industrial espionage. But in most cases, U.S. companies have largely abstained from large scale transfers of technology to China. Chinese officials in many cases suggest that the reason for such abstention is U.S. export control laws. In practice however, the reason for China's lack of success in

encouraging technology transfer is not U.S. policy² but rather a rational U.S. company approach to risks associated with exposure of technology to the Chinese market: intellectual property theft is so rampant that few, if any, companies are likely to expose their technologies to the Chinese marketplace.

Part of the problem with China's approach to IPR is, as most Chinese officials will tell you, that Chinese society is undereducated about the role of IPR in a modern economy. A prevailing Chinese attitude with respect to IPR is that China's development requires the free transfer of Western technologies in order for China to "catch up" with the West. It is not uncommon for Chinese of varying sophistication to demand that the China-based development of gunpowder and paper, which was freely adopted by Western sources, is adequate justification for Chinese citizens' commandeering of such products as Microsoft Windows or other such products. This cultural reality is no excuse for China's failure to effectively enforce the laws on its books, but it does present a significant enforcement challenge. That China has yet to allocate the resources necessary to begin to overcome this reality suggests that the lack of appreciation for the importance of an effective IPR regime is not merely a problem with China's populace, but is a challenge that runs deep within China's officialdom as well. Perhaps, given the apparent fetish within the leadership for policies that encourage innovation, IPR protection may gain increasing acceptance as a necessary part of the equation. That remains, however, to be seen. Simply challenging the WTO consistency of China's IPR regime, however, is unlikely to achieve satisfactory results.

Industrial Policy

As I discussed earlier, the return of industrial planning to the fore of Chinese economic policymaking is a major challenge to market-oriented businesses in China, including U.S. businesses.

² Statistics from the Department of Commerce suggest that only about \$6 million in U.S. export licenses to China are denied each year, significantly undercutting Chinese official's insistence that export controls are a significant factor in both the lack of significant technology transfer and the U.S. trade imbalance with China as a whole.

Policies that encourage the development of one business sector to the disadvantage of another have long been a factor in Chinese economic policy. Each year, China's central government has published an "investment catalogue" that lists businesses that qualify for "encouraged," "accepted" and "discouraged" status. This catalogue has been a guide for local and provincial officials in seeking foreign direct investment. "Encouraged" investments (typically in high technology, high-employment businesses) have had preferences showered upon them. Subsidies in the form of tax, land and labor breaks as well as dramatically simplified regulatory processes and the easing of other legal burdens have made the process of favoring some businesses over others a fact of life in China's economic landscape.

The process of encouraging and discouraging different businesses has developed into a high art in recent years. Various national and sub-national official groups within China, especially those charged with working with various domestic constituency industries, have increasingly sought to develop new industrial groups in China. On a number of occasions, these groups have developed individual policies, not necessarily with the broad consensus of the Chinese government, that aim to encourage the development of industries in China in ways that challenge or disadvantage American companies and their workers:

- Promotion of National Champions

Certain Chinese companies, not necessarily state-owned companies, have in recent years found special favor as firms that may develop into distinctly Chinese multinational companies. The advantages conferred on these "national champions" vary, but the rationale for their promotion by parts of the Chinese government is straightforward. Chinese government officials, largely for reasons of national pride, favor the existence of Chinese national companies that operate on a world stage with a stature comparable to U.S., Japanese and European multinationals. When the interests of these companies compete with those of American companies, the Chinese companies are generally accorded a "patriotic"

advantage. An area of particular concern at this point is in green technology, which many Chinese officials perceive to be a competitive international commercial battleground that, given the dramatic scale of China's domestic market for wind and solar power in particular, Chinese companies will be uniquely poised to capture.

- Technology Certification for Procurement (the "Indigenous Innovation") Challenge

As discussed earlier, China's desire to move up the industrial value chain by improving its technology base is based on largely benign motivations. Whether intended to fulfill the Technology leg of the Four Modernizations, or to cope with the demographic challenge of China's aging workforce because of the "one child policy", a desire to build a more technologically advanced industrial base is not necessarily threatening to U.S. interests. The push in recent years, led by Chinese Premier Wen Jiabao, to develop a Chinese "indigenous innovation" capacity, on its face, is hardly something about which the United States has license to object.

However, since China's leadership opined on the broad parameters of an "indigenous innovation" push, Chinese industrial planners have actively developed operational policies that contradict the spirit of Chinese reform policies that led to China's accession to the WTO. These decisions unquestionably impact the ability of U.S. and other foreign companies to operate in the Chinese marketplace. In November 2009, a group of Chinese ministries collaborated on the development of a policy designed to provide advantages in China's procurement market to those companies that developed "indigenous innovations." The resulting policy circular set off a firestorm of criticism among the foreign business community in China, who argued variously that the policy would shut them out of the market, command their transfer of technology into the market, or require their collaboration with domestic Chinese players in the market. Although Chinese officials have been quick to suggest that the policy is not intended to disadvantage foreign players, the effect of the policy has, at a minimum, established

confusion at the direction of China's attitude toward foreign business operations. More specifically, the effort, if allowed to stand, would have posed fundamental challenges to the ability of U.S. and other foreign businesses to operate on equal footing with Chinese counterparts.³ The principle of "national treatment" – by which a WTO member accords no less advantageous a business environment to foreign businesses as it does its own – is, after all, a basic guarantee agreed to by China under its WTO accession agreement. The use of Chinese procurement laws to affect the policy was allowed by WTO rules because China is not a member of the WTO's Government Procurement Agreement, giving the country the ability to use its procurement market for the purposes set forth in the indigenous innovation policy. That China agreed on WTO accession to join the GPA "as soon as possible", yet used its lack of membership to adopt a policy counter to the GPA, suggests that the forces of reform that stood behind WTO accession are in full retreat.

- The Standards Trap

Technical standards are another area in which certain Chinese agencies have made an effort to carve out parts of the Chinese marketplace for domestic firms. In some cases citing security concerns, in some cases citing safety, Chinese agencies involved in commercial areas as diverse as agriculture to wireless encryption technology have been active in promoting China-only standards, frequently in collusion with domestic Chinese firms seeking market advantages. Some of these standards issues have become significant sources of friction in the relationship, such as the WLAN Authentication and Privacy Infrastructure (WAPI), a unique wireless encryption standard that Chinese regulators originally insisted be mandatory for all wireless equipment providers. That standard and its progeny, despite numerous high-level interventions at the Vice Premier and Secretary level, continue to percolate under the surface

³ At the meeting of the U.S.-China Strategic and Economic Dialogue this past May, China agreed to reduce the impact of the offending technology certification regulations. Whether those regulations or the spirit that motivated their creation are gone for good, or are just being held at bay, is uncertain.

of international trade relations. Numerous other standards in various stages of development, some seemingly created purely to confound the ability of American and other companies to compete with Chinese rival firms in the marketplace, will almost certainly prove to be a major source of commercial friction in the years to come.

Beyond the Bilateral : China's International FTA Push

In addition to the ongoing bilateral trade considerations that serve to challenge U.S. companies and their workers, China's activist international trade liberalization agenda is of undoubted concern to America's long-term competitiveness. Chinese efforts to build free trade links with Southeast Asia and other parts of the world are increasingly developing as competitive challenges to longstanding U.S. commercial advantages in these regions. China is winning hearts and minds in these parts of the world through conferring trade advantages. While the United States is obviously of two minds at present on the question of free trade, the failure to use a liberalizing trade agenda with Southeast Asia is increasingly acting to cede that part of the world to Chinese economic dominance. Without a more assertive international trade policy posture, including the goal of promoting Free Trade Agreements, the United States risks alienating itself as a commercial power, and reducing its overall influence in the region.

Combating the Challenges

Contrary to some suggestions that the U.S. trade agenda with China is occasionally captive to broader strategic considerations, in my experience the commercial relationship is appropriately treated separate and distinct from security and other matters involving China. The U.S. Trade Representative and Department of Commerce are active in pursuing enforcement cases against Chinese interests. USTR is quick to pull the trigger on WTO cases when winnable cases are presented. DOC is unflinching in applying American trade laws to protect American businesses and their workers from unfair trade

practices when the facts present a compelling reason to take legal action. The fact remains, however, that not every Chinese trade policy that disadvantages American businesses and their workers presents an actionable WTO or U.S. trade law case. Most often, the most difficult circumstances arise when a Chinese trade policy or practice is technically within the bounds of China's WTO commitments. Convincing Chinese officials to nonetheless reverse that policy or practice requires considerable skill. At a time when (a) Chinese officials are less-inclined to give credence to American arguments because of a perception that the American model is no longer appropriate to China's conditions; and (b) the ministries who favor market-oriented reform are short on political capital, the usual U.S. approach – that of engaging primarily with the Ministries of Commerce and Foreign Affairs to solve problems in the U.S. trade relationship – is unlikely to be particularly effective in solving the broadest range of challenges in the relationship.

In order to genuinely combat the challenges faced by American companies and their workers in the China market, the U.S. government and our companies will need to increase the sophistication of their approach to the marketplace. Too often, we approach China as if it were a monolith; a government with a top-down hierarchy that is best approached from the top down. In fact, the Chinese society is home to diverse constituencies that rarely are in lock-step consensus. Relying on any one or several ministries to expend political capital in the Chinese system in order to fix “an American problem” is not a long-term recipe for success. One thing that Americans need to get better at in China is understanding the array of forces in China that are aligned in favor and against a particular trade proposition, and working more closely with those forces that support an American position. China has come far in 30 years. It is now a complex business and policy environment with multiple interest groups commanding attention. The United States would do well to understand the complexity and diversity of this environment and begin developing alternative means for resolving problems in the environment that are not solely reliant on the strategies and tactics of years past.