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US–China Economic Relations: The Next Stage

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In the past 30 years—and especially since China's entry into the World Trade Organization in 2001—trade and investment between the United States and China have dramatically expanded. Nonetheless, longstanding and increasingly pressing issues leave the full potential of the commercial relationship unfulfilled. Resolution of today's and tomorrow's economic disputes, as well as guidance toward a sustained, mutually beneficial commercial relationship, requires a more robust bilateral engagement.

Since China began in the late 1970s to open its economy to foreign investment, the commercial relationship has been a bridge between the two countries as political relations have fluctuated. From barely a trickle in the 1970s, two-way trade reached $244 billion in 2005. US foreign direct investment in China totaled $3 billion last year—nearly $52 billion cumulatively since 1979. The economic relationship has increased not only in size but also in scope and complexity as China has implemented economic reforms allowing international businesses greater access to its markets and as its own companies seek opportunities overseas.

Both countries benefit from these links. Trade and investment with China boost US economic growth by lowering prices, increasing productivity, and providing new export opportunities. In China, foreign investment creates jobs for the country's large numbers of un- and underemployed and has been a driving force in lifting millions out of poverty. The United States is also China's top export market.

Yet, despite many market openings and a steady pace of economic reform, American companies still encounter barriers in China as a result of unfinished market openings. Questions persist about whether US companies compete on a "level playing field" with Chinese competitors. Moreover, China still must complete core financial sector reforms to sustain its economic growth for the long term.

Existing commercial dialogues have been successful in resolving some bilateral trade and investment issues. But the commercial relationship has outgrown the mechanisms currently in place. Moreover, political concerns in both countries have arisen over the perceived negative effects of US-China economic ties. To advance and maintain a mutually advantageous economic relationship, China and the United States should elevate economic engagement to a more comprehensive level. Rather than just focusing on the immediate problems of today—which is a vital process that must continue—the two countries should establish a framework to identify the future path of economic cooperation and provide a context within which commercial disputes can be addressed.

BURGEONING TRADE

Economic relations between China and the United States were essentially nonexistent in 1973 when the US-China Business Council (at the time named the National Council for US-China Trade) was established. Today, the two countries are among each other's largest, most important, and most dynamic economic partners.

Business contact remained limited in the first decade after China began in the late 1970s to open itself to foreign trade and investment. In 1985, US exports to and imports from China were each only approximately $3.8 billion, according to US government statistics. US exports reached $12 billion

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China's Trade with the United States
(in billions of dollars)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
US Exports	11.8	12.0	12.8	14.3	13.1	16.3	19.2	22.1	28.4	34.7	41.8
US Imports	45.6	51.5	62.6	71.2	81.8	100.0	102.3	125.2	152.4	196.7	243.5
Total	57.4	63.5	75.4	85.5	94.9	116.3	121.5	147.3	180.8	231.4	285.3
Percentage Change	19.3	10.6	18.7	13.4	11.0	22.6	4.5	21.2	22.7	28.0	23.3
US Balance	-33.8	-39.5	-49.8	-56.9	-88.7	-83.7	-83.1	-103.1	-124.0	-162.0	-201.7

Source: US-China Business Council

by 1996 and then continued to grow to $42 billion by 2005. US imports from China leapt from $52 billion in 1996 to $244 billion in 2005. China today is the largest source of imports for the United States and the fourth-largest export market for American companies. (If sales to Hong Kong are included, it is the third-largest US export market, trailing only Canada and Mexico.)

Much of this explosive growth has occurred in the past few years. By introducing market openings and new investment opportunities for international businesses, China's entry into the World Trade Organization (WTO) in December 2001 accelerated trade between China and the United States. US exports to China increased by 81 percent in the first three years after China's WTO entry, compared with just 34 percent in the three years before China joined the WTO, according to US data. Similarly, US imports from China rose by 92 percent in the three years after China entered the WTO but by just 46 percent in the three previous years.

Investment in China by US companies also developed gradually in the 1980s and then accelerated. Between 1979 and 1989, US direct investment in China totaled just $1.7 billion, according to the Chinese Ministry of Commerce. As China continued economic reforms and opened up more sectors to foreign investment, US direct investment totaled $26 billion by 1999 and reached a cumulative $51 billion at the end of 2005.

FALLING BARRIERS

The growth in the quantity of bilateral trade and investment has been matched by the widening scope and increasing sophistication of US business in China. When China began to open to foreign investment in the late 1970s and the early 1980s, international companies faced hurdles in accomplishing even the most routine of business operations. Offices of international companies in China could hire local employees only through state-owned employment agencies. China's currency, the renminbi, could not be converted into other currencies, and China required foreign investors to "balance" their local and foreign currency needs through a combination of domestic and export sales. In addition, foreign companies faced high tariffs and a complex import licensing system that limited what they could import into China and how they could distribute those goods within China.

Throughout the 1980s and 1990s, China adopted laws to establish regular processes for foreign companies to enter China. The government developed various legal forms for the establishment of foreign-invested enterprises, but most of these forms came with heavy restrictions. Gradually, international businesses were allowed to move beyond joint ventures and establish 100 percent foreign-owned companies and then other more flexible investment vehicles.

China's membership in the WTO spurred more dramatic reforms. Tariff reductions, the elimination of import licenses and quotas, and market openings mandated by the WTO have profoundly affected China's business environment. Of great importance was China's commitment to allow international businesses in China to import and distribute finished goods directly, instead of doing so through a state-owned entity. This reform, which is just being implemented, is allowing international companies to integrate their China operations more fully into their global networks and giving them more control over their supply chains.

Another indicator of the effect of these changes has been a shift in foreign investment toward 100 percent foreign-owned enterprises. For decades, the existence of high market-access barriers across many sectors and the importance of working with a local partner to navigate China's regulatory system made joint ventures often the only vehicle for foreign investment. In 1989, only 10 percent of foreign direct investment went to create businesses owned entirely by foreign investors. As China implemented reforms and its business climate became more rule-based, however, the opportunities for foreign investors to operate independent businesses in China grew. In 2005, more than two-thirds of all foreign direct investment went into 100 percent foreign-owned enterprises, according to China's Ministry of Commerce.

UNFINISHED REFORMS

While US-China Business Council surveys consistently show that American companies are optimistic about their business in China, they still confront obstacles. For example, China maintains explicit and implicit market-access barriers in a variety of industry sectors. Explicit barriers include tight limits on foreign ownership of local financial institutions and restrictions on foreign investment in so-called strategic sectors. International companies have encountered implicit market-access barriers in the form of what many executives believe are deliberate delays in license approvals and other regulatory procedures.

If the US trade deficit is a problem, it is not just with China but is global in nature.

Although China has implemented most of the market openings required by the WTO, some are still to come. Key among these is China's commitment to allow international banks by the end of 2006 to open branches throughout China and offer local currency banking services to Chinese individuals. International banks can currently offer local currency services in only a handful of China's largest cities and are limited to serving Chinese companies, foreign companies, and foreign individuals—not Chinese citizens.

Although the direct effect of this market opening is expected to be small, primarily because only a handful of international banks are likely to attempt to build major branch networks, the increased competition introduced by the broader presence of international banks could strengthen China's financial sector and thereby result in broad benefits for China's economy. These effects could be magnified by going beyond WTO commitments to allow foreign financial institutions to take majority stakes in existing domestic banks, securities houses, and insurance providers.

In many ways, financial sector liberalization is the core economic reform facing China. Investment, funded by high levels of household savings and reinvestment by domestic enterprises, currently fuels much of China's economic growth. A considerable amount of investment, however, is based on noncommercial criteria and flows to unproductive projects. Fundamental financial reforms could help rationalize this investment by redirecting its two main sources: savings and reinvestment.

China's high level of savings is in part a result of the absence of basic financial infrastructure, such as national pension, health insurance, or consumer credit systems. Pension, investment, insurance, and other products would reduce the need for such high savings and thereby make more household income available for consumption, creating an impetus for sustained economic growth. Similarly, Chinese companies reinvest a large proportion of their cash flow in new production facilities, even when confronting overcapacity, because they lack the financial investment options that more developed markets provide and generally do not pay shareholder dividends. Foreign financial firms can bring great expertise in these systems and products. Market openings in these and other financial areas would therefore accelerate the modernization of the sector.

Ultimately, financial reforms and strengthening the banking system will allow for removal of capital controls and enable China to adopt a fully market-driven exchange rate—a key political demand in Washington and a transition that China's economic policy makers want to make.

Other challenges cut across all business sectors. Chief among these is China's poor enforcement of intellectual property rights. China's government has taken steps toward improving the protection of intellectual property, including a plan announced in April 2006 to require the installation of licensed operating software on all computers manufactured in China before they leave the factory. China's central authorities recognize that strengthening intellectual property protections will bolster the country's efforts to develop its own innovative capability. Nevertheless, foreign companies continue to find it difficult to guard their intellectual property rights in China and cite this as a top prob-

Top US Exports to and Imports from China
(in millions of dollars)

Exports	2005
Electrical machinery and equipment	6,850.5
Power generation equipment	6,357.2
Air and spacecraft	4,381.5
Optics and medical equipment	2,396.7
Oil seeds and pleaginous fruits	2,289.3
Plastics and articles thereof	2,258.9
Inorganic and organic chemicals	1,961.6
Iron and steel	1,864.7
Cotton	1,411.3
Pulp and Paperboard	992.3
Imports	**2005**
Electrical machinery and equipment	53,009.7
Power generation equipment	52,732.7
Toys and games	19,140.7
Furniture	17,054.7
Apparel	16,807.9
Footwear and parts thereof	12,721.3
Iron and steel	7,414.8
Plastics and articles thereof	6,639.5
Leather and travel goods	6,258.8
Vehicles and parts other than rail	4,207.9

Source: US–China Business Council

lem affecting their operations. Improving intellectual property protection has been a key element of US government engagement with China since the 1990s. These efforts have succeeded in focusing the central government in Beijing on the problem, but enforcement throughout the country by local authorities remains problematic.

The low level of government transparency in China is another obstacle facing international companies. Although China's business regulators are far more open today than they were just five years ago, American and other foreign companies still often find themselves unable to comment on proposed rules that will affect their operations. Limited transparency also makes it difficult for observers to determine whether China's regulators are enforcing the law properly. In what may be a sign of progress, China's State Council recently issued a proclamation requiring government agencies to publish new regulations bearing on trade in the Ministry of Commerce's official gazette.

China's efforts to develop technical standards also give rise to some concerns. It is natural for China as a large and growing economy to play a more central role in establishing standards in everything from telecommunications to television technologies. What worries many international companies is that some parts of China's government seek to use standards to promote local companies and block competition. The possibility that China will mandate the use of unique standards within China also concerns companies.

Not all of the obstacles that foreign investors face to expanding their business in China are the result of Beijing's policies. For example, managers at international companies in China consistently cite challenges in retaining and attracting talented local managers as a top priority. China's pool of well-trained managers is without doubt the largest it has been at any time, but the breakneck pace of growth of China's economy has pushed the demand for these individuals well beyond the supply.

THE TRADE DEFICIT IN CONTEXT

Many observers assert that China's unfair trade practices, including an artificially weak exchange rate, are the cause of the US trade deficit with China. Much of this criticism of the US-China trade relationship, however, comes from those who look only at bilateral relations between the United States and China, ignoring the context of larger shifts in the global economy in which the rapid growth in trade and investment between the two countries has occurred. There is no doubt the US trade deficit with China—$202 billion in 2005—is large. But worldwide trade and investment trends indicate that America's trade deficit is increasingly global in nature and not caused solely by one region, let alone the result of specific Chinese policies.

Many commentators point out that the US trade deficit with China accounted for 26 percent of the total US trade deficit in 2005, according to US data. This figure, however, rose only modestly from 23 percent in 1996, even though in absolute terms the bilateral trade deficit has seen a hefty increase. Meanwhile, the share of the US trade deficit held by other major East Asian economies dropped over these same years from 42 percent to just 18 percent. This trend is the result of trade and investment flows between China and other East Asian economies. Investors from Hong Kong, Japan, South Korea, Singapore, and Taiwan provided more than half of the $60 billion of foreign direct investment that went to China in 2005, according to China's Ministry of Commerce. In 2004, these economies were the source of nearly 60 percent of foreign direct investment in China.

These investment flows reflect the integration of a greater East Asian economy. East Asian economies that previously supplied American consumers with most of their import demands are shifting or have already shifted much of the productive apparatus that focused on supplying the US market to China. In so doing, East Asian economies have in effect moved to China much of their trade surpluses with the United States, as evidenced by the dramatic decline over the past decade in the share of the US trade deficit held by East Asian economies other than China. In fact, the growth since 2003 in China's exports of electronics—which have in recent years been one of China's top two exports to the United States—has been largely a result of companies from other Asian economies shifting final assembly operations to China, according to a September 2005 study. What American consumers once bought from Japan, Taiwan, and South Korea, they now buy from China.

Just as trade and investment flows between China and the United States must be viewed in the context of an integrating East Asian economy, the economic relationship between East Asia and the United States must be viewed in a global context. As US trade with an integrated East Asia has shifted toward China as the final assembly point, the share of the US trade deficit held by all of East Asia—including China—has declined over the past decade from 65 percent in 1996 to 44 percent last year. The rest of the world's share of the US trade deficit increased correspondingly to 56 percent in 2005. If the US trade deficit is a problem, it is not just with China but is global in nature.

BENEFITS FOR BOTH

Despite many claims to the contrary, trade and investment between China and the United States benefit both countries. In the United States, the increase in trade and investment with China that came with China's entry into the WTO is predicted to boost gross domestic product by 0.7 percent and lower prices by 0.8 percent by 2010, according to research by Oxford Economics published this January by the China Business Forum. This translates into an annual increase of $500 in real household disposable income in 2005—a figure projected to grow to $1,000 by 2010.

Many who worry about the impact of the economic relationship on the United States express concerns about the state of American manufacturing and the resulting effects on employment. While trade and investment with China certainly put pressure on some segments of the US economy, the shift in US employment from manufacturing to services has been a decades-long process and one that was in full swing well before China emerged as an international economic factor.

Moreover, the increase in trade and investment with China since it joined the WTO has made some US manufacturers more competitive by making available high-quality components at low prices and by encouraging them to increase their productivity to compete on a global stage. In fact, these trends will by 2010 increase US manufacturers' annual growth in productivity by 0.3 percent, according to Oxford Economics. The United States remains the world's largest manufacturer, responsible for 20 percent of global manufacturing output—about the same proportion as 10 years ago. Although growing rapidly, China's share of global manufacturing output is just 8 percent.

Nevertheless, the expansion of trade with China since 2001 has affected American manufacturing employment. Oxford Economics estimates that this expansion will have contributed to the loss of 500,000 manufacturing jobs by 2010. While clearly significant to those directly affected, this number must be viewed in context: over the past year, the American economy on average created 4.8 million and shed 4.5 million jobs each month. Moreover, the dynamism of the US economy generally ensures that positions lost in the manufacturing sector are replaced by new ones in the service sector. Government policies should focus on keeping the American economy competitive and facilitating the transition for those affected by these shifts.

In China, though the data are less detailed, the positive effects of trade and investment are even more evident. At the broadest level, China's economic growth, spurred by reforms that began in the 1980s and continue to this day, is on its own responsible for 75 percent of the reduction in global poverty that has occurred in the past two decades, according to the World Bank. China's middle class, nonexistent 30 years ago, is large and growing quickly. China's National Bureau of Statistics put the middle class at 75 million in 2005 and predicted it would expand to 170 million by 2010.

International trade and investment are important causes of this growing prosperity. Not only do international companies employ millions of Chinese individuals who would otherwise be contributing less than their full productivity to the country's economy; international businesses also help keep China committed to the market policies that have led to its stunning growth.

POLITICAL GRUMBLINGS

Based on legitimate concerns as well as on misunderstandings and exaggerations, some political figures in both countries have expressed discontent with aspects of the economic relationship between China and the United States. A mistaken belief that the relationship with China is on its own causing the mounting US trade deficit and the loss of large numbers of jobs drives much of the political concern in the United States. On top of this consternation is a belief that somehow China does not "play fair."

Foremost among the aggravations for the past several years has been China's exchange rate policy. Critics say China deliberately "manipulates" the value of the renminbi in order to boost its exports. The issue is brought to the fore every six months when the US Treasury Department releases its report on international exchange rates and identifies countries that manipulate their currencies. The most recent report, released in May, was criticized because Treasury again refrained from labeling China a "currency manipulator." A bill introduced by US Senators Charles Schumer, a Democrat from New York, and Lindsey Graham, a Republican from South Carolina, would impose tariffs of 27.5 percent on all imports from China unless Beijing revalues its currency by a similar amount. Many analysts believe this legislative cudgel would be counterproductive: China is unlikely to respond to such a heavy-handed threat, while US consumers would in effect be hit by a 27.5 percent tax.

Moreover, most analysts agree that the effect of China's exchange rate policy on the US trade balance is overstated. Any production that becomes unprofitable in China because of an exchange rate appreciation is likely to move back to other Asian economies rather than to the United States. Beijing should nonetheless more quickly allow its exchange rate to fluctuate in response to trade and capital flows. Ultimately, China needs to adopt the banking and financial reforms discussed earlier to move to a fully market-determined exchange rate.

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Chinese investment in the United States has also elicited political responses. Most prominent was the explosion of dissent on Capitol Hill when China National Offshore Oil Corporation (CNOOC) proposed to buy the oil company Unocal in the summer of 2005. The House of Representatives approved a proposal to block the deal. Although this did not become law, Congress would likely have approved a measure to prevent the transaction had CNOOC not withdrawn its bid. Chinese computer manufacturer Lenovo's purchase of IBM's personal computer business raised minimal concerns at the time of the transaction in early 2005, yet lawmakers recently forced the State Department to abandon plans to use computers that it intended to purchase from Lenovo (though built in former IBM facilities in North Carolina and Mexico) on its classified network.

These incidents, which legislators perceive to have potentially grave national security consequences, have prompted Congress to consider revising the procedure by which the government reviews foreign investment in the United States. The attempt by Dubai Ports World to acquire the rights to operate certain US port terminals earlier this year accelerated these moves. Many economists and business leaders are concerned that some of the new proposals, if implemented, will chill the investment climate while doing little to address legitimate security concerns.

Although political skepticism of the US-China economic relationship is more pronounced in the United States, it exists in China, too. This has been most evident recently in reported opposition to foreign investment in some sectors. In recent months, some Chinese officials and commentators have criticized decisions by China's main domestic banks to sell minority stakes to foreign investors, saying that domestic investors should be given privileges and that foreign banks were allowed to purchase their shares at too low a price. Some analysts have speculated that these complaints have stalled plans advanced by some of China's economic officials to open the financial sector further to foreign competition. Similarly, China's State Council in June issued rules printed in state-owned business media that capital equipment manufacturers cannot sell stakes to foreign investors without government approval—a move that may pose challenges for the bid by US-based Carlyle Group for China's Xugong Group Construction Machinery Company.

Whether these incidents are isolated or are part of a trend presaging a broader reexamination of the role of foreign investment in China remains unclear. While it is certain that some quarters in China's officialdom would advocate greater control over foreign investment in key domestic companies, it is equally clear that others would not. Indeed, Prime Minister Wen Jiabao said after the March 2006 meeting of China's National People's Congress that the country should "consistently and unswervingly press ahead with reform and opening up." A June article in the official *People's Daily* newspaper strongly endorsed this view.

A NEW FRAMEWORK?

The ramifications of these political concerns on economic links should not be exaggerated, but they cannot be ignored. The best way to address these concerns is to lay out a path for progress on the difficult and fundamental commercial issues that remain unresolved. Maintenance of a successful economic relationship requires high-level commitment in both countries to do just that.

Recent bilateral exchanges have produced the more measured results anticipated by sober analysts. In April, US President George W. Bush and Chinese President Hu Jintao affirmed their commitment to advance "win-win" solutions to commercial concerns. Earlier that month, US and Chinese trade officials met in Washington for the Joint Commission on Commerce and Trade, which serves as the principal venue for bilateral trade negotiations. The 2006 meeting resulted in incremental steps forward on many of the issues that continue to hinder American companies in China. A separate dialogue, the US-China Joint Economic Committee, last occurred in October 2005, in Beijing. At that meeting, then-Secretary of the Treasury John Snow urged China to implement broad financial sector reforms.

While these and other smaller forums have over time resolved some of the frictions that arise in the economic relationship, they are mainly reactive—seeking to resolve the market access hurdles that American businesses report to US trade officials. In addition, lasting for only one day and occurring only once each year, these meetings are too limited and too infrequent to tackle the full range of trade and investment issues that are a natural result of the tremendous growth in the commercial relationship that has occurred since these channels were established. These discussions are vital, but something more is needed.

Officials from the United States and China should establish a comprehensive framework laying out common economic objectives to help guide the development of the commercial relationship between what will soon be the two largest economies in the world. Disputes and issues could then be tackled within this framework, without threatening to derail this critical economic relationship. In many ways, such a framework could be considered a commercial and economic version of the dialogue on strategic issues established by former US Deputy Secretary of State Robert Zoellick and Chinese Deputy Minister of Foreign Affairs Dai Bingguo.

A comprehensive framework would aid US and Chinese policy makers to better understand each other's economic agendas. This, no doubt, would help them see how the two economies complement each other and where proactive steps are needed to ease friction. Reforming and strengthening China's financial sector with the assistance of international companies is a clear example of a mutually advantageous project on which such a dialogue could focus. With China's global economic impact growing quickly, many of China's economic policies that will be of most interest to the United States are in time likely to be unrelated to the market access barriers that the current bilateral framework is structured to address.

The new framework must also address the concerns of China as well as those of the United States. While Washington should not offer concessions to secure China's commitment to implement its international or bilateral obligations, it would be wise to highlight for China the benefits of its continuing embrace of an open economy. These should include a greater role in international economic policy making and, when China meets the criteria established in US law, recognition by Washington as a market economy, a move that would change the way China is treated in trade remedy actions and also carry important symbolism. By establishing such a framework, China and the United States would create the means to sustain and expand the substantial benefits both countries enjoy from their economic relationship in the decades to come. ■