United States Senate
Republican Policy Committee
Jon Kyl, Chairman

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Wishful Thinking, False Premises:

The Wisdom Behind – and Reality of – Granting Permanent Normal Trade Relations to China

Executive Summary

- The current economic relationship between the United States and People's Republic of China (PRC) is unsustainable. The PRC's nominally-communist policies have created global financial imbalances that harm American businesses and threaten both nations' future prosperity.

- The United States granted PNTR to the PRC with the understanding that China would liberalize its trade and macroeconomic policies, adopt the "rule of law," and allow political and democratic reforms to take root. Not only have these predictions not been borne out, there is growing evidence that China's robust economic growth since WTO-accession may actually be retarding the economic and political reforms on which the granting of PNTR was predicated.

- If current trends persist, China will be the world's largest exporter in seven years. This could be troubling for the United States: its trade deficit with China has grown by 25 percent in both years since China's WTO-accession; and the PRC continues to block U.S. agricultural products, subsidize exporters, engage in unfair capital controls, undervalue (and manipulate) its currency against the U.S. dollar, and avoid protecting intellectual property

- The suggestion that China could be reformed solely by the influence of the West has proven to be wishful thinking. Since joining the WTO, China arguably has ratcheted up its anti-democratic policies, both domestically and internationally.

- In December, the Bush Administration will have an opportunity to address China's unfair practices by raising concerns with Chinese Premier Wen Jiabao during his visit to Washington. The U.S. agenda should include reviewing China's record of trade abuse; requiring China to enter into a timetable for financial reforms; pressuring China to adopt political reforms; and holding it accountable for its weapons proliferation.

Introduction

It is becoming increasingly clear that unfair trade practices and currency manipulation by China are harming U.S. businesses and creating global trade imbalances. Congress voted to grant Permanent Normal Trade Relations (PNTR) status to China in 2000 [P.L. 106-286], removing the obstacles for China to join the World Trade Organization (WTO). Anticipated benefits of this decision for America included increased access to China's market for U.S. business and the expectation that economic engagement would serve as a catalyst for economic and political reform. The United States granted PNTR to the PRC with the understanding that China would liberalize its trade and macroeconomic policies, adopt the "rule of law," and allow political and democratic reforms to take root.

While there is little doubt that China's economic emergence provides immense benefits to American consumers, U.S. companies have not derived the great benefits that were assumed, and financial and macroeconomic liberalization has not occurred. Beijing continues to impose strict regulations on cross-border capital flows and investments, disregards its obligations to protect intellectual property, and coerces U.S. and foreign businesses in joint ventures. In addition, the democratic and political reforms that many suggested would result from increased economic interaction with the West have not materialized. As it turns out, it was wishful thinking that economic engagement alone would translate into a sea change in the political and macroeconomic situation in China.

Prior to final passage of PNTR for China, Senator Jon Kyl (R-AZ) stated: "China poses a special challenge for America, not merely because of its growing economy and increasingly capable military, but because the path of its evolution remains unknown. We need to be realistic in our dealings with China . . . ."[1] He suggested the United States ready itself to take steps to defend its economic and national security. Four years later, the *Washington Post* notes the significance of China's growing status in Asia: "China's rising status and influence present a challenge for the United States. After more than a half century as the dominant power in Asia, the United States has been forced to consider what the emergence of a rival means for its interests and how best to respond."[2]

In December, the Bush Administration will have an ideal opportunity to respond to China's emergence by raising American concerns with Chinese Premier Wen Jiabao during his visit to Washington. Correcting past U.S. policy deficiencies toward China should be part of the U.S. agenda. That agenda should include reviewing China's record of trade abuse; requiring China to enter into a timetable for financial reforms, including currency convertibility and a floating exchange rate; pressuring China to adopt political reforms; and holding China accountable for its weapons proliferation.

[1] Senator Jon Kyl (R-AZ), *Congressional Record*, September 18, 2000, S8645.
[2] Philip Pan, "China's Improving Image Challenges U.S. in Asia," *Washington Post*, November 15, 2003.

The Debate Over Granting PNTR for China

The WTO and Chinese Obligations

The WTO is a multinational organization whose agreements are negotiated and signed by a large majority of the world's trading nations and ratified by their governments. These agreements are the legal groundwork for international commerce and serve as contracts that provide member countries with important trade rights that can be defended in an international legal forum.[3]

The PRC first applied for membership in the WTO in July of 1986.[4] At that time, trade between the PRC and United States was conditioned by the Jackson-Vanik amendment (Title IV of the Trade Act of 1974), which requires governments of non-market (i.e., communist) economies to reach an annually-reviewed bilateral commercial agreement with the United States before normal trade relations could be extended.[5]

On April 8, 1999, the United States-China Bilateral Trade Agreement was finalized in Beijing, and President Clinton requested the legislation to grant PNTR the following year. The trade agreement required the PRC to reduce tariffs, eliminate export subsidies and quotas, and gradually open up service sectors, like distribution, telecommunications, insurance, and banking to full and unfettered foreign competition.[6]

The Economic Arguments for Granting PNTR to China

At the time of the PNTR vote, China's economy had been growing rapidly for 20 years following dictator Deng Xiaopeng's decision to ease price controls on agriculture and decentralize banking.[7] PNTR supporters argued that the Chinese leadership had successfully learned the lessons of Deng's reforms – capitalist economic institutions and integration into the world economy – and now would embrace more complete integration based on capitalist principles.[8] Thus, PNTR would provide American industry access to the burgeoning Chinese market, while assisting China's economic transformation from a communist, command-and-control system to a market-based economy.

Proponents of PNTR also contended that WTO accession would "be a key catalyst" for an "accelerated transition to free capital mobility in China."[9] This was important because the Communist Party retained strict macroeconomic control over the economy's overall direction even while the PRC allowed market incentives to begin taking hold on a microeconomic level.

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[3] The WTO was formally known as the General Agreement on Tariffs and Trade (GATT) until January 1, 1995. Information on the WTO and its agreements available at: http://www.wto.org/.
[4] U.S. House of Representatives Committee Report 106-632.
[5] Vladimir N. Pregelj, "The Jackson-Vanik Amendment: A Survey," *Congressional Research Service Report for Congress 98-545 E*, August 22, 2003.
[6] House of Representatives Committee Report 106-632 lists the ten specific market-opening requirements.
[7] Professor Wing Thye Woo, "China: Facing up to WTO Membership," *Center for International Development at Harvard University*, December 4, 2000.
[8] Professor Woo.
[9] Fred Hu, Managing Director – Goldman Sachs, "China's WTO Accession as a Catalyst for Capital Account Liberalization," *Cato Journal*, Vol. 21, No. 1, Spring/Summer 2001.

In particular, the PRC was using the banking system to finance PRC-sanctioned projects and industries and was extending loans based on political, rather than financial, considerations.[10]

As a consequence, scarce capital was not allowed to flow to its most efficient use, few banks were profitable, and a large percentage of the banking system's assets were tied up in bad loans. Supporters of PNTR argued that increased trade with the rest of the world would "provide the outside stimulus needed" to bring about true liberalization of the sickly Chinese financial sector and deprive the Chinese Communist Party (CCP) of its ability to direct capital flows.[11] This would divest the CCP of its last lever on economic power and allow the cumulative effects of market decision-making to work.

PNTR and WTO accession were also necessary, supporters argued, to reduce the bilateral trade deficit. In 1999, the U.S. trade deficit with China was $68.7 billion.[12] By ensnaring China in the contractual obligations of the WTO, proponents argued, Chinese markets would be more open to U.S. goods, and the U.S. trade deficit would diminish as a result. Economist Desmond Wong, China Director for Ernst & Young, echoed the sentiments of many when he argued that the WTO accession would lead the U.S. trade deficit with China to "narrow and eventually reverse. . . within five years."[13]

Jerry Jasinowski, president of the National Association of Manufacturers, concurred: "[The Chinese] are hungry for the opportunity to buy more American products and could become one of our largest trading partners within just a few years. These exports will create hundreds of good-paying jobs for U.S. workers." Michael Rawding, Microsoft's regional director for China, was similarly sanguine about U.S. export opportunities: "By the end of next year, China will probably rank as the third largest market in the world for personal computers."[14]

Virtually all of the economic-based opposition to PNTR for China was provided by labor unions, including the United Auto Workers (UAW), AFL-CIO, and United Steel Workers of America (USWA). These organizations argued that increased trade with China would result in significant job losses as businesses shifted operations to take advantage of China's seemingly endless supply of cheap labor.

The Political Reform Arguments

The Clinton Administration was a leading proponent that economic engagement with the PRC would lead to widespread domestic political reforms. In testimony to the House Ways and Means Committee in May 2000, then-Treasury Secretary Lawrence Summers stated:

> "We are, however, convinced that we will have much more positive influence over China's behavior if we are actively engaged with China, rather than trying to isolate it. . . By learning to 'play by the rules,' both internationally and domestically, China will

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[10] Caroline Gordon and Joshua Harman, "A Study of Two Entrance Issues: The Banking System and Intellectual Property Rights in China," *Global Trade, Transportation, and Logistics Studies*, The University of Washington, May 24, 1999.
[11] Gordon and Harman.
[12] Foreign Trade Statistics, U.S. Census Bureau, available at: http://www.census.gov/foreign-trade/balance/c5700.html#1999.
[13] R.C. Longworth, "China Deal Doesn't Guarantee a Fix for Deficit," *Chicago Tribune*, July 5, 2000.
[14] Nathaniel Harrison, "US business leaders jubilant over PNTR," *AFP*, September 20, 2000.

> strengthen the rule of law, which will enable it to become a more reliable partner and a fairer society. It can even lay the groundwork for protection of core values in China, such as human rights, religious freedom, workers' rights and environmental protection."[15]

This optimistic view was not shared by all. Congress expressed concern that, for example, once China was granted PNTR, the United States would lose leverage over the PRC's human rights actions. In congressional testimony, Rep. Christopher Cox (R-CA) argued:

> "No matter where you stand on granting permanent normal trade relations to the PRC, one thing on which we can all agree is that the protection of human rights is an essential element of U.S. foreign policy. For the last 25 years, the Jackson-Vanik amendment has been an effective tool for promoting human rights abroad. . . . I'm here today because the Clinton-Gore administration's legislation throws out the human rights baby with the trade sanctions bath water. The administration's legislation . . . removes our primary mechanism for reviewing human rights in non-market economics."[16]

In addition to human rights concerns, Members expressed skepticism about whether China's economic integration would result in democracy and respect for the rule of law, and whether Beijing's entry into the WTO would have an effect on reducing the PRC's aggressive policies toward Taiwan.[17]

The Reality of Engaging China

The prediction that further economic integration would lead to liberalization of China's financial system and macroeconomic direction has not been borne out. Instead of developing into a free-market economy, the PRC has embarked on an export-driven, mercantilist development path, while continuing many of its pre-WTO, nominally-communist macroeconomic policies. Worse, it is becoming increasingly clear that the astounding success of the PRC's growth model has retarded liberalization. This is undoubtedly the most troubling lesson of China's WTO accession, and one which, if not addressed, will exacerbate global imbalances – and could have damaging consequences for the U.S. economy and beyond.

The Chinese Economy

China's economic performance over the past 10 years has been nothing short of astonishing. Its Gross Domestic Product (GDP) has increased by an average of 8 percent annually, and this growth has accelerated since WTO accession. According to estimates from investment bank UBS, the PRC's GDP is on pace to grow by more than 11 percent this year – an all-time recorded high for that nation.[18] This growth has been fueled by exports, which have increased by an average of 17.3 percent annually over the past decade,[19] and have grown by

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[15] Testimony by Treasury Secretary Lawrence Summers before the House Ways and Means Committee, May 3, 2000.
[16] Rep. Christopher Cox (R-CA), prepared statement before the House International Relations Committee, May 10, 2000.
[17] See Statement by Senator Jon Kyl (R-AZ) on Final Senate Passage of H.R. 4444, September 18, 2000.
[18] Richard McGregor, "Chinese Economy on Pace for 11 Percent Economic Growth," *Financial Times*, October 9, 2003.
[19] Martin Wolf, "The World Must Learn to Live With a Wide-Awake China," *Financial Times*, November 12, 2003.

about 30 percent since WTO accession.[20] China is the fourth-largest exporter in the world, and, if current trends continue, will become the world's largest exporter within seven years.[21]

Unfortunately, China's rapid growth has not been accompanied by the reforms explicitly required by its WTO commitments, nor by those implied by its rapidly growing share of world commerce. While the United States had little choice but to tolerate the PRC's stifling controls over cross-border capital movements, its sickly banking sector, and refusal to deal seriously with trade obligations when China was a closed, relatively small economy, that no longer can be the case because of China's WTO commitments and increasing share of world commerce.[22]

As the world's largest importer and what the International Monetary Fund calls the "sole engine of global demand growth,"[23] the United States has been greatly impacted by China's development. After declining by a small amount in 2000 (the year before China's WTO accession), the U.S. bilateral trade deficit with China grew from $83.1 billion in 2001 to $103 billion in 2002 (a 24 percent increase) and is expected to worsen by 25 percent to 30 percent in 2003.[24] A large bilateral deficit may not be a problem per se , but it raises a red flag about why the deficit exists, which should cause policymakers to scrutinize the trade relationship.

<u>Specific Trade Issues</u>

China's record thus far on WTO compliance is mixed. It has failed to meet some current obligations, and does not appear to be on track to meet those required in later years. For instance, the PRC does not enforce intellectual property protections as is currently required of it in the bilateral agreements of 1992 and 1995, and disregards its obligations under the Trade-Related Aspects of Intellectual Property Rights (TRIPS) portion of the WTO.[25] The PRC is so inadequate in its intellectual property enforcement that illegal commerce in pharmaceuticals and pirated CDs and DVDs cost American businesses up to $25 billion annually.[26] Since intellectual property is of increasing importance to the U.S. economy in general, and its exports in particular, failure to treat PRC contraventions seriously could worsen our already large trade deficits and harm the domestic economy.

The PRC also: uses a series of complex and arbitrary regulations to intentionally delay and impede the delivery of U.S. agriculture products (particularly soybeans); provides domestic companies with a 17-percent tax rebate for exporters, which is similar in nature to the U.S.'s FSC/ETI tax provision for which the WTO authorized $4 billion in sanctions against the United States;[27] and is subject to twice as many Commerce Department anti-dumping investigations as any other nation.[28]

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[20] Richard McGregor, "Chinese Economy on Pace for 11 Percent Economic Growth," *Financial Times*, October 9, 2003.
[21] Wolf.
[22] Martin Wolf, "China Must Adapt," *Financial Times*, November 19, 2003.
[23] The International Monetary Fund, *World Economic Outlook*, September 2003.
[24] Edward Alden, Jeremy Grant, and Victor Mallett, "Opportunity or threat? The US struggles to solve the puzzle of its trade with China," *Financial Times*, October 4, 2003.
[25] US Trade Representative, *2003 Special 301 Report (Intellectual Property)*.
[26] Tkacik.
[27] Ben Kwok, "Beijing Under Fire in Chips War," *South China Morning Post*, October 30, 2003.
[28] Department of Commerce Release, November 1, 2003.

Although these issues require attention and continued pressure, it is evident that the PRC's nominally-communist macroeconomic, monetary, and regulatory policies have the greatest impact on the Sino-U.S. economic relationship. China is supposed to fully liberalize its financial sector to full foreign competition by 2007, but based on where China currently lies on the continuum between a Communist state-banking regime and full liberalization, it is difficult to see how China can meet this deadline.

Chinese Financial Controls

While the PRC allows currency trades to settle international transactions for goods and services, it maintains stifling controls on the movement of capital across its border.[29] For example: no foreign investor may purchase financial assets denominated in Chinese currency or make any other portfolio investment in China; no domestic entity may issue securities abroad; and no domestic entity can purchase foreign currency for any purpose other than to complete a PRC-approved transaction.[30]

These controls are intended to prevent the flight of capital out of China, insulate domestic banks from competition, and to condition the type of foreign investment that comes into China.[31] For example, while China's capital controls prevent nearly all foreign portfolio investments,[32] the PRC welcomes certain types of Foreign Direct Investment (FDI) in plant, equipment, and other fixed assets.[33] According to the Organization for Cooperation and Development, China has attracted $135.3 billion in FDI since 2000.[34] In 2002, China surpassed the U.S. as the world's top destination for FDI with $52.7 billion and is expected to exceed that figure this year.[35]

The net effect of preventing foreign investors from making anything but fixed investments in production capacity is that foreigners are unable to pull money out of China in the event of an unwelcome political or economic development. In this way, capital controls turn investors into strong advocates for the interests of the PRC in their home countries, as they have no choice but to support the regime to which their fortunes are tied. It also leaves businesses operating in China with little recourse when the Chinese businesses with which they are forced to collaborate "siphon off" proprietary technology and trade secrets.[36]

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[29] Phillip Day and Karby Leggett, "Beijing, Yuan Hold Firm as Speculation Grows," *The Asian Wall Street Journal*, September 26, 2003.

[30] International Monetary Fund, *Annual Report on Exchange Arrangements and Exchange Transactions*, September 9, 2002. In the past year, the PRC has allowed for some foreign purchases of equity stakes in state-owned enterprises in the context of the PRC's reorganization rules, which attempt to use foreign funds to prop up these enterprises, see: Michael Moser, "Traditional Barriers are Starting to Fall Away," *Financial Times*, September 24, 2003.

[31] Markus Rodlauer, Assistant Director, International Monetary Fund, "China-Europe Relations After China's Entry Into the WTO," November 19, 2001. Available at: http://www.imf.org/external/country/chn/rr/111901.pdf.

[32] Portfolio investments are direct purchases of stocks, bonds, and other financial assets.

[33] Foreign Direct Investment is investment in factories, businesses, and fixed assets. It is sunk into ownership of companies and property and is difficult to pull out from a country, as opposed to portfolio investments.

[34] OECD, *Trends and Recent Developments in Foreign Direct Investments*, June 2003. Figures available at: http://www.oecd.org/dataoecd/52/11/2958722.pdf

[35] The Organization for Economic Cooperation and Development, *Investment Policy Review of China — Progress and Reform Challenges*, March 7, 2003.

[36] John J. Tkacik, Jr., "The U.S. Must Face Up to China's Trade Challenges," *Backgrounder No. 1698*, The Heritage Foundation, October 23, 2003.

Most sectors of the Chinese economy are open to FDI, but the PRC imposes regulations requiring foreigners to team with domestic partners, often providing incentives for FDI that produce products for export, involve technology transfers, and minimize outflows of royalty payments for intellectual property.[37] Since foreigners are limited to investments that are export-oriented and involve the transfer of technology, it is not surprising that 65 percent of the growth in exports of the past decade has come from businesses in partnership with foreign investors.[38]

Implications of Capital Controls

The PRC argues that these controls must remain in place to "ring-fence" its domestic financial system until it has been restructured.[39] This is because of the sickly state of Chinese banking, where political, rather than financial, considerations have driven lending for the past 20 years. Were controls suddenly lifted, the PRC argues, a mass capital exodus would result, destabilizing the entire region.[40]

But instead of confronting the ambitious reforms required to return its banks to solvency,[41] the evidence suggests that dubious lending is on the rise. According to recent estimates, non-performing loans[42] comprise a greater percentage of total bank lending – 50 percent (or $525 billion) – than they did in 2000,[43] when an estimated 35 percent of the Chinese banking system's loans were non-performing.[44]

While the PRC refuses to lift capital controls until its banking system is solvent, the regime is equally reluctant to restructure its banking system to reach this goal. This is because most of the non-performing loans are extended to loss-making and inefficient state-owned enterprises, which comprise all but a small portion of the Chinese economy (and most of its employees). It is likely that a string of bankruptcies and social unrest would result if these state-owned businesses' access to credit were immediately conditioned on their ability to repay.

Export Growth Delays Banking Reform

The PRC thus far has been able to avoid dealing with these banking problems, thanks to an overall trade surplus, huge inflows of foreign investment into the country, and its strict controls on capital outflows. The combination of these elements has allowed China to

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[37] Rodlauer.
[38] Stephen Roach, "The Hypocrisy of Bashing China," *Financial Times*, August 7, 2003.
[39] Claire Innes, "US Adopts More Diplomatic Approach in Exchange Rate Row," *World Market Analysis*, World Market Research Centre, October 31, 2003.
[40] Claire Innes, October 31, 2003.
[41] The People's Bank of China (PBoC) has twice attempted to deal with this problem, but both times its efforts have proven inconsequential. In 1998, the People's Bank of China (PboC) injected $32.6 billion into the four large, state-owned banks, but the effect was ephemeral as the cash injection simply allowed the banks to continue their bad-lending practices. A year later, the PBoC attempted a more ambitious bail-out package by taking $169 billion of bad loans off of the banks' books and rolling them into four affiliated Asset Management Companies, which presumably would be responsible for disposing of the assets. A vast majority of the non-performing loans are still owned by the Asset Management Companies, and the government is now considering a plan to sell $9 billion in bad assets still on the banks' balance sheets to international investors and hedge funds. Daniel Bogler, "Third Time Lucky for China's Bank Bail-Out," *Financial Times*, November 3, 2003.
[42] Loans are labeled non-performing when interest payments are not made and the principal cannot be repaid in full.
[43] James Kynge and Edward Luce, "China's sprint for modernization leaves India panting in its trail," *Financial Times*, September 22, 2003.
[44] Ronald McKinnon, "China's Financial Policies Upon Ascension to the WTO," *Perspectives*, Volume 2, No. 1, August 31, 2000.

accumulate vast foreign currency reserves, which have expanded the domestic money supply and led to rapid credit growth. With credit expanding so rapidly, the PRC continues to avoid reform by rolling-over bad debts as they come due with new, equally dubious loans.[45]

In the first nine months of this year, China's money supply has grown by 20 percent. This has led to a 25-percent increase in bank lending over the same period,[46] much of which has been directed towards state-owned businesses and export sectors.[47] According to the People's Bank of China (PBoC), China's August loan growth was up 24 percent, measured on a year-on-year basis, and new loans are running at nearly 40 percent as a percentage of GDP.[48]

China's extremely high savings rate exacerbates the situation because capital controls prevent funds from leaving the domestic financial system. According to economists Nicholas Lardy and Morris Goldstein of the Institute for International Economics, China's stock of household savings is equal to about 100 percent of GDP.[49] With a frail financial system that lacks the capital markets necessary to transform savings into productive investments, the only outlet for this pent-up savings has been financing of exports, which have grown by 33.4 percent this year, and will continue to grow rapidly until the PRC opens other channels for the investment of domestic savings.[50]

The Currency Peg

With such rapid growth, controls on capital outflows, trade surpluses, and vast amounts of foreign investment, the Chinese currency, the Yuan Renminbi (RMB), would be expected to rise in value to achieve purchasing-power parity with China's trading partners. Since 1994, this expected adjustment has not been allowed to occur because the PRC has pegged the value of its currency at 8.28 Yuan to 1 U.S. dollar. By preventing such an appreciation, the PRC has prevented a change in relative prices that would make Chinese exports more expensive and lead to an adjustment in international terms of trade.

The currency peg played a valuable role when many of China's neighbors experienced significant currency devaluations in 1997 and 1998; however, as China's role in world commerce has grown, so too has the intervention required to maintain the peg. Under its capital control regime, when a Chinese exporter sells its wares abroad, it fills out an invoice with the PBoC to convert its foreign currency (typically dollars) earnings into Yuan. Essentially, the PBoC prints Yuan, which can only be used in China and is not convertible into another currency, to purchase the declared foreign currency. This dollar-buying operation now runs at $600 million a day.[51] It has led China's cumulative foreign reserve holdings to climb to an astounding ***$383.9 billion*** by the end of October – an amount that is roughly equal to 12 percent of U.S. publicly-held debt.[52]

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[45] McKinnon. Kynge and Luce.
[46] Francis Scotland, "Why China Should Not Revalue," *Financial Times*, October 3, 2003.
[47] Innes, November 12, 2003.
[48] PBoC quoted in Daniel Bogler, "China's Bubbling Banks," *Financial Times*, September 29, 2003.
[49] Nicolas Lardy and Morris Goldstein, "A Modest Proposal for China's Renminbi," *Financial Times*, August 26, 2003.
[50] Fang Xinghai, Deputy Chief Executive of the Shanghai Stock Exchange, "China's Exchange Rate is the Wrong Target," *Financial Times*, August 18, 2003.
[51] Claire Innes, "US Adopts More Diplomatic Approach in Exchange Rate Row," *World Market Analysis*, World Market Research Centre, October 31, 2003.
[52] *China Economic Review*, China: Foreign Exchange Reserves, November 5, 2003.

PBoC uses the dollars it gets from this transaction to purchase dollar-denominated securities, typically Treasury bonds or bonds carrying an implicit federal guarantee, like those issued by Fannie Mae and Freddie Mac.[53] This significant additional demand for U.S. government debt has the effect of lowering U.S. interest rates, which makes federal deficits less expensive to finance. Were China to suddenly stop buying dollars or begin to sell its significant stockpile, however, long-term U.S. interest rates would rise.[54]

But the peg also creates a monetary union between the United States and the PRC that forces China to "import" Federal Reserve monetary policy, which is currently highly stimulative.[55] Thus, it serves to further stimulate the aforementioned explosion in credit and lending. As UBS' Jonathan Anderson has said, "The [PBoC] can either slow down the economy or cool off external Yuan pressures - but not both."[56] As long as these conditions persist, the cycle of increased exports begetting increased foreign currency reserves begetting increased credit growth begetting increased exports, will continue.

International Consequences of China's Practices

Pursuant to its WTO-entry conditions, the PRC is supposed to open its financial-services sector to full foreign competition by 2007. This deadline requires the PRC to clean up its banking system by that date to avoid a collapse of domestic banking or huge budget deficits to assume the banks' non-performing loans. As economist Ronald McKinnon cautioned in 2000:

> "Admitting foreign banks, which are not so encumbered, to bid for RMB deposits would not be fair competition. In the inter-bank market (and even at retail if deposit interest ceilings are abolished), foreign banks could bid away deposits from even well-behaved domestic banks that are encumbered [with non-performing loans]. Most importantly, this would undermine the government's fiscal position as its ability to extract policy loans from the banks at low interest rates erodes."[57]

Now, more than three years after this cautionary note was issued, the fundamental problems of the banking system remain. Estimates suggest that less than 1 percent of the country's $2.4 trillion in deposits are held in foreign banks, a violation of the spirit of the WTO agreement if not its letter.[58] The PRC has a perverse incentive in that the longer it continues to drag its feet with financial reform, the longer it can credibly argue that its capital controls must remain in place.

While removal of capital controls and liberalization of the exchange rate remains an eventual goal, the PRC has pursued a policy of "gradual reform," which entails making enough concessions to placate trading partners (usually involving highly-publicized purchases, like

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[53] The Latest Fed data indicate that foreign central banks own $799 billion in UST securities and $202 billion in Agency debt (predominately Fannie Mae and Freddie Mac). http://www.federalreserve.gov/releases/h41/Current/H41.TXT
[54] Chen Zhao, "The Fed is in a Dangerous Game with China," *Financial Times*, July 31, 2003.
[55] Paul McCulley, "Our Currency, But Your Problem," *Fed Focus*, Pacific Investment Management Company (PIMCO), October 2003.
[56] *China Economic Review*, "China: Credit Tightening Risks Currency Pressures," November 5, 2003.
[57] McKinnon.
[58] James Areddy and Karby Leggett, "China Regulator Imposes Penalty on Wachovia," *The Wall Street Journal*, October 31, 2003.

aircraft)[59] without making the tough decisions required to transform into a genuine market economy. As Moises Naim writes, "The Chinese model of gradual economic deregulation coupled with slow political change does not make the fine-tuning of economic reforms any easier. In fact its 'gradualism' has increasingly been used to justify a reform paralysis,"[60] which has already created severe imbalances that will only worsen as true reform continues to be avoided.

The Harsh Economic Reality

Yet the PRC's actions persist and FDI into China continues unabated. This breathes truth to recent analysis of the U.S.-Sino relationship published in the *Financial Times*:

> Supporters of U.S. engagement with China have long argued that ensnaring the communist nation in a web of economic ties with the US would force Beijing to curb its hostility towards Washington. But the effect has been at least as strong the other way: the U.S. economy is now so enmeshed with China that the growing threats to get tough on the country will almost certainly prove hollow.[61]

The False Premise of Political Reform

The suggestion that China could be reformed solely by the civilizing influence of the West has proven to be wishful thinking. Since joining the WTO, the PRC has neither embraced nor undertaken meaningful political reform. In fact, it can be argued that China has ratcheted up its anti-democratic policies, both domestically and internationally, most likely due to its recognition that access to its market causes trading partners to turn a blind eye toward its undemocratic and often belligerent behavior.

Domestic Repression

According to the State Department's most recent report on human rights practices, "Citizens lacked both the freedom to peacefully express opposition to the party-led political system and the right to change their national leaders or form of government."[62] Furthermore, Freedom House has written, "since 1998, courts have sentenced more than 30 leaders of a would-be opposition group, the China Democracy Party, to prison terms of up to 13 years on subversion and other charges."[63]

Rule of law does not exist in China. The U.S. State Department found that while the PRC's constitution provides for an independent judiciary, in fact, the judiciary was not independent, the judicial system lacked due process, and that authorities routinely violated legal protections in the cases of political dissidents and religious leaders and adherents.

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[59] Guy De Jonquieres and James Kynge, "China Urged to Move Faster on Imports," *Financial Times*, October 29, 2003.
[60] Moises Naim, "Only a miracle can save China from itself," *Financial Times*, September 15, 2003
[61] Edward Alden, Jeremy Grant, and Victor Mallett, "Opportunity or threat? The US struggles to solve the puzzle of its Trade with China," *Financial Times*, October 4, 2003.
[62] U.S. Department of State, Country Reports on Human Rights Practices, 2003.
[63] Freedom House, *World's Most Repressive Regimes*, 2003.

In Freedom House's most recent survey on "Freedom of the Press" throughout the world, the organization found that Beijing "sharply restricts press freedom." The Chinese government also harshly practices Internet censorship as a part of denying the Chinese people access to information and news from outside of China. PRC authorities legally restrict and penalize access to any information on the Internet considered "subversive" or "critical" of the state, including web sites of dissident groups and "some major foreign news organizations, such as Voice of America, the *Washington Post*, the *New York Times,* and the BBC." Dozens of Chinese citizens have been jailed for using the Internet and email to discuss or promote political ideas.

International Belligerence

Internationally – and with specific regard to Hong Kong and Taiwan – the PRC has not abandoned its aggressive intentions as a result of joining the WTO. Beijing continues to impose more direct rule on Hong Kong (which was handed back to it by Great Britain in 1997). Most notably, Beijing has attempted to impose its own draconian media and human rights restrictions on Hong Kong by having the province adopt Article 23 to its Basic Law. Article 23 legislation would have penalized individuals and groups who display and distribute publications critical of China's communist government, and it would have allowed people or groups who work for change in government policy to be susceptible to charges of "sedition," "subversion," and "treason," subjecting them to severe penalties, including life imprisonment or execution. In July, after outcries from media and nongovernmental organizations – and the passage of a U.S. House resolution – the PRC dropped (at least for now) its crusade to have Hong Kong adopt Article 23.

Unfortunately, international outcries have done little, if anything, to alter the PRC's bellicose attitude toward Taiwan, America's long-standing democratic ally which China views as a "renegade province." As recently as November 20, 2003, Beijing threatened to militarily attack Taiwan. The Communist regime has spent billions of dollars to build up and modernize its military in preparation for retaking Taiwan by force and countering any U.S. intervention on Taiwan's behalf. According to the most recent report of the U.S. China Economic and Security Review Commission, China's military has been instructed to have viable military options to accomplish this objective by 2005-2007.[64]

Beijing also actively pursues policies aimed at diplomatically isolating Taiwan from international organizations where state sovereignty is not a prerequisite for membership, most notably from the U.N.'s World Health Organization. For more than six years, the PRC has actively sought to deny Taiwan the opportunity to be allowed to join the WHO as an observer.

In 2000, the PRC agreed to allow Taiwan to join the World Trade Organization (WTO) with the condition that Taiwan enter as "Chinese Taipei." It should be noted, however, that the PRC did not want Taiwan to join as a separate customs territory, Chinese Taipei, even though it had originally agreed to such an arrangement. At the last minute, the PRC tried to insist that Taiwan join as a customs territory of China. However, due to bold U.S. leadership – and pressure from 31 Senators who wrote to President Clinton on July 27, 2000 asking him to clarify whether he believed that Taiwan's entry into the WTO remained a committed goal of his Administration — Taiwan was able to enter the WTO as Chinese Taipei.[65]

[64] Report to Congress of the U.S.-China Security Review Commission, July 2002, http://www.uscc.gov/anrp02.htm
[65] Letter to President Clinton from Sen. Jon Kyl and 30 other Senators, 7/27/2000.

U.S.-PRC Relations

During the past 10 years – while the United States has increased trade relations and military-to-military exchanges with the PRC, as well as provided considerable emergency medical and disaster relief – Beijing has continued to engage in acts that gravely threaten U.S. security and national interests. These acts included engaging in military espionage against the United States;[66] diplomatically and militarily isolating and threatening Taiwan;[67] building up and modernizing its military to counter the United States,[68] supplying rogue regimes with WMD and ballistic missile materials;[69] and committing widespread human rights abuses against its people as well as against foreigners (including permanent U.S. residents such as Yang Jianli) in the country despite an ongoing U.S.-China human rights dialogue.[70]

China's aggressive intentions and undemocratic policies have accompanied a serious military modernization effort. According to the Congressional Research Service, during the past decade, China has become the developing world's leading weapons importer, with purchases totaling some $17.8 billion in U.S. dollars since 1995.[71]

Technology purchases from the United States have also played a role in China's modernization efforts. Over the past five years, there have been an alarming number of cases reported in the press and uncovered during congressional inquiries that illustrate how China has exploited loose U.S. export controls to acquire sensitive U.S. technology. [72] In some instances, this technology has been used to improve China's military capabilities. For example, during the 1990's, Beijing diverted U.S.-built high performance computers for unlawful military applications, using them to design, model, test, and maintain advanced nuclear weapons.[73]

In other instances, entities in China have retransferred sensitive U.S. technology to third countries. One Chinese firm, Huawei Technologies, purchased sensitive "dual-use" technology like high-powered computers and telecommunications equipment from the United States, and provided Saddam Hussein with technology and know-how to improve Iraq's air defense system before Operation Iraqi Freedom.[74]

In addition, the U.S. Commerce Department has stated that Chinese companies are refusing to allow "end-use" inspections on U.S. sensitive technologies to determine whether these goods are being sold or diverted for military purposes. The United States conducts such end-use verification visits "without problem" in over 85 countries, according to the Commerce

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[66] See the 1999 report of the "United States House of Representatives Select Committee on U.S. National Security and Military/Commercial Concerns with the People's Republic of China," http://www.house.gov/coxreport.
[67] See 1979 Taiwan Relations Act, as well as Public Laws 106-137, 107-10, and 107-158.
[68] See Department of Defense, Annual Report on the Military Power of the People's Republic of China, July 2003.
[69] See National Intelligence Council's December 2001 report on "Foreign Missile Developments and the Ballistic Missile Threat Through 2015;" and CIA's 2002 "Unclassified Report to Congress on the Acquisition of Technology Relating to Weapons of Mass Destruction and Advanced Conventional Munitions, 1 January Through 30 June 2002."
[70] See annual U.S. Department of State Human Rights reports, www.state.gov.
[71] Congressional Research Service, "Conventional Arms Transfers to Developing Nations, 1995-2002," September 2003.
[72] See Cox Report
[73] See Cox Report
[74] Prepared testimony of Gary Milhollin before the House Armed Services Committee, September 19, 2002.

Department; however, it has "difficulty" in China, due to government restrictions. China bought $2.8 billion worth of dual-use goods in 2002, which is a five-fold increase from 2001. [75]

Beijing's actions clearly run counter to U.S. national security interests. Yet many continue to argue that economic engagement will somehow solve the myriad problems in our relationship and result in China's political enlightenment. Small gestures, like the release of one political prisoner, are touted as signs of Beijing's willingness to reform.

Some have cited Chinese "help" in dealing with North Korea as evidence that China has changed its ways and that it seeks commonality of interests with the United States. Yet no one is able to provide concrete examples of this assistance. For decades, the PRC has remained North Korea's lifeline, supplying it with financial and energy assistance. The United States must recognize the delusion in expecting Beijing to view North Korea's abandonment of its nuclear program as in China's own interest. Only if it comes to believe Japan will proceed with development of its nuclear deterrent, would China see a need to pressure its ally North Korea to stop its nuclear program. There is no evidence that China believes it is in its national interest for North Korea to abandon its nuclear policies and become a responsible player on the international stage.

Solution: Exert America's Leverage on the PRC

Keeping in mind that economic engagement with China has failed to produce the economic and political reforms for which some had assumed, it is time to reassess the U.S.-China relationship in the context of broader U.S. strategic objectives. Neither blind acceptance of China's failure to abide by internationally accepted norms of behavior, nor rewarding that country with the economic and technological capabilities it needs for continuation of communist control and modernization of its military, are in the interests of the United States. These two nations do not share common values or common goals, and cooperation between the governments therefore needs to be carefully assessed. As Ellen Bork wrote in a recent *Washington Post* column, "Perhaps the Bush Administration believes that other interests are served by subordinating democracy to concerns such as Iraq, terrorism, and North Korea. But that cooperation is usually exaggerated, and in fact, China serves its own interest in every case."[76]

Until now, Washington has excused Beijing's irresponsible behavior and failed to apply pressure on Beijing to change. For example, on November 5, Secretary Powell stated that "as China participates more actively in world affairs, we will extend our welcome. ***We will also expect China to accept world standards*** in trade and proliferation and human rights, and openness and transparency in business and information" (emphasis added).[77] The United States should not be satisfied that China *might eventually* accept international standards and norms of behavior; upon signing international treaties and conventions and organizations, Beijing is *required immediately*—not at a time of its choosing—to honor the terms and obligations of those agreements.

[75] *Washington Times*, "China Blocks Checks," October 17, 2003.
[76] Ellen Bork, "No Exceptions for Democracy in China," *Washington Post*, November 15, 2003.
[77] Remarks by Secretary of State Colin Powell at a conference on U.S.-China relations, November 5, 2003.

Moreover, Beijing should be reminded that, if it expects to be treated as a respected member of the international community, it must behave accordingly. In that regard, it needs to honor its commitments under the WTO, abide by its international and bilateral commitments, and respect the rights of its own people, as well as its neighbors, including Taiwan. The United States should back its words with action by working with the international community to enforce WTO standards and by enforcing U.S. laws, such as statutes requiring sanctions for weapons proliferation, which would hold China accountable for its behavior.

Between diplomacy and war, there are a number of options a nation has to advance and protect its national interests, including trade leverage, sanctions, and publicly highlighting and condemning a country's failure to honor its commitments. In using these tools, the Administration and Congress should consider the following:

Economic Options

Over the past decade, China has simply grown too large in terms of world trade to continue on its mercantilist development path. It is time for the deregulation that served China so well in microeconomic transactions to spread to macroeconomic and monetary policy. China must take real action to correct its banking problem, liberalize its financial regulations to allow capital to flow more freely, and adhere to its WTO commitments to full liberalization of its financial services sector. China must respect intellectual property rights and meet both the letter and spirit of its international trade commitments.

All indications suggest that the intoxicating growth China has enjoyed since WTO-accession has given the PRC the false impression that it can delay true reform or engage in half-hearted measures. The Bush Administration must make it clear to Beijing that continuation of the current path threatens to create imbalances so large that the prosperity of both nations could be imperiled. Specifically, the Administration should:

- **Direct the United States Trade Representative to file a formal complaint against the PRC for flouting its obligations under the Trade-Related Aspects of Intellectual Property Rights (TRIPS) portion of the WTO.** According to the USTR's *2003 Special 301 Report*, only Ukraine ranks behind China in terms of disregard for intellectual property protection. [78] As the USTR explains, China's "Intellectual property rights problems run the gamut, from rampant piracy of film and other entertainment products, to sophisticated software and semiconductor products, to counterfeiting of consumer goods, electrical equipment, automotive parts and pharmaceuticals."[79] Given intellectual property's increased importance to the U.S. economy in general, and our exports in particular, this can no longer be tolerated.

- **Use U.S. participation in the "Transitional Review Mechanism" (TRM) to demand progress on financial reforms.** Rather than completing the implementation of its WTO commitments prior to membership, China gained WTO entry in exchange for participating in an annual eight-year, multilateral review of its WTO compliance with a

[78] US Trade Representative, *2003 Special 301 Report (Intellectual Property)*
[79] Statement by Deputy Assistant U.S. Trade Representative Charles W. Freeman to the Congressional-Executive Commission on China, "China Not Fulfilling All WTO Commitments," September 24, 2003.

final review in the tenth year.[80] At the time of WTO-accession, the TRM was supposed to have "unprecedented scope and authority" to investigate Chinese compliance efforts and make recommendations.[81] The U.S. must use this annual review process, in conjunction with like-minded WTO members, to explain to the Chinese that if verifiable progress is not made on banking reform, dispute settlement proceedings will begin at the earliest possible juncture. The amount the U.S. should seek to recover from any dispute settlement should include not only the losses stemming from a lack of access to the Chinese financial services industry, but also the costs of the capital and currency controls the Chinese use to "ring-fence" their financial sector.

- **Direct the USTR and Commerce Department to review the "Safeguard Mechanisms" at our disposal and apply them where appropriate.** China's WTO agreement allows WTO members to take unilateral action against China "to prevent injury that U.S. or other WTO members' industries and workers might experience based on unfair trade practices or import surges."[82] The U.S. recently used this tool in response to explosive growth in certain textile markets,[83] and may be able to apply it in other areas to compel Beijing to take its international obligations more seriously.

Diplomatic and Security-Related Options

In addition to addressing economic concerns, the Bush Administration must state to Beijing that continuation of past behavior and refusal to undertake political reform will have serious consequences. Actions Washington should undertake include the following:

- **Publicly and privately highlight China's refusal to honor international obligations and norms of behavior, as well as the democratic and human rights abuses committed by Beijing.** Such actions could include introducing a resolution of condemnation of the PRC at the United Nation's annual Human Rights Convention in Geneva. Washington should demand immediate action from Beijing to demonstrate its

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[80] The United States entered into the "Transitional Review Mechanism" (TRM) framework as part of the U.S.-China Bilateral Trade Agreement of 1999. The TRM requires China to provide detailed information on its implementation efforts and gives all WTO members the opportunity to raise questions about how China is complying with its specific commitments before 14 WTO subcommittees. These subcommittees report to the WTO's General Council, the administrative body of the WTO, which conducts an overall review each year and issues recommendations in December. If China does not adopt these recommendations, a member nation may start a dispute-settlement proceeding with the presumption of success. Once the review in year ten is completed, the General Council must decide, based on the recommendations of its members, whether or not to provide the PRC with full-fledged and unconditional WTO membership. If the PRC has failed to transition to an open economy at that point, the U.S. can petition the WTO General Council to continue the TRM, impose sanctions, or invoke Article XIII of the WTO charter, which allows the U.S. to declare unilaterally that the terms of WTO trade do not apply between the U.S. and the PRC. Were the PRC's non-compliance to be particularly egregious, the U.S. could petition the General Council to revoke the PRC's membership, but such action would require unanimity among WTO members. The United States is the only country to date to invoke Article XIII and has done so five times since 1995.

[81] United States Trade Representative, "China's Accession to the WTO," available at: http://www.ustr.gov/regions/china-hk-mongolia-taiwan/accession.shtml

[82] *China's Protocol of Accession* (available at www.wto.org) provides unilateral safeguards for: anti-dumping violations for the first 15 years of China's membership; rapid import growth from specific Chinese industries for the first 12 years of China's WTO membership; and a special textiles safeguard that covers all clothing merchandise for the first seven years of China's WTO membership.

[83] The U.S. used this tool in November to impose quotas to limit import growth of certain textiles from China to 7.5 percent a year, after such growth exceeded 60 percent in 2002 and in the first nine months of 2003. "U.S. Announces Limits on Apparel Imports From China," *Bloomberg News*, November 18, 2003.

understanding of America's resolve, such as requiring that China become a responsible party in the bilateral human rights dialogue by releasing individuals imprisoned for using the Internet and those advocating pro-democracy and religious-tolerant views.

- **Suspend high-level military-to-military contacts between the U.S. and China until Beijing drops its hostile policies.** Given the PRC's record of military espionage against the United States, as well as its determination in modernizing its military and developing asymmetric weapons and strategies to counter U.S. military force, senior officer-to-officer exchanges and U.S. naval ships making Chinese port calls should be suspended.

- **State that the PRC government must allow the U.S. to verify that U.S. technology exports are not being diverted to military uses (or to third parties); without this verification, Chinese entities WILL NOT receive sensitive U.S. exports.** The Bush Administration should proactively state that no sensitive technologies will be exported until end-use inspections resume.

- **Continue to respond to Chinese WMD-related proliferation and/or diversion of U.S. technology exploits with sanctions that have teeth.** The Bush Administration should be praised for its actions earlier this year to levy sanctions with million-dollar penalties against two Chinese firms, NORINCO and CMEC, and other Chinese companies that transferred sensitive missile-related technologies to Iran and other restricted countries. Washington should state that the PRC government must halt the proliferation of missile-related materials and undertake enhanced and full enforcement of its export-controls laws or else Chinese companies will face additional and enhanced sanctions and penalties.

Conclusion

The U.S. government must abandon the false premise that economic engagement alone will bring about democratic and free market reform in China. Instead, the U.S. must insist on full and complete compliance with all WTO obligations and apply all available diplomatic and economic measures to ensure that the PRC is not allowed to threaten U.S. strategic interests and flout its international responsibilities.

Secretary of State Colin Powell recently stated that "the United States sees an even greater need to shape a relationship with China that is defined by our mutual interests, not by areas of disagreement."[84] However, it is the areas of disagreement that need addressing as they impact greatly on U.S. economic and security interests. Without addressing these issues, no positive relationship can—or should—develop between the United States and China.

[84] Remarks by Secretary of State Colin Powell at a conference on U.S.-China relations, November 5, 2003.