

U.S.-CHINA ECONOMIC RELATIONS REVISITED

HEARING
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
ONE HUNDRED NINTH CONGRESS
SECOND SESSION

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MARCH 29, 2006
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Printed for the use of the Committee on Finance

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U.S. GOVERNMENT PRINTING OFFICE

33-886—PDF

WASHINGTON : 2006

For sale by the Superintendent of Documents, U.S. Government Printing Office
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U.S.-CHINA ECONOMIC RELATIONS REVISITED

WEDNESDAY, MARCH 29, 2006

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:08 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Charles E. Grassley (chairman of the committee) presiding.

Also present: Senators Hatch, Snowe, Thomas, Bunning, Baucus, Bingaman, and Lincoln.

OPENING STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S. SENATOR FROM IOWA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. Last June, our committee held a hearing in which we examined economic relations between the U.S. and China. Today's hearing provides an opportunity to follow up on those developments.

Looking ahead, I intend to continue this committee's focus on our trade and economic relations with China. We are committed to vigorous oversight on that relationship and what it means to the overall economic health and prosperity of our country.

Because our relationship with China is very important—China is already, as you know, our fourth-largest export market—our export growth to China far outpaces U.S. growth to the rest of the world. That is partly due to the fact that the United States and China have been the engines of the global economy in recent years.

Other major economies clearly need to do more, but the point is, we derive a great deal of benefit from our economic relationship with China. China also benefits. That should not be forgotten in this debate.

On the other hand, we also have some tensions with China. For example, our bilateral trade has become increasingly imbalanced in recent years. That is partly due to the fact that our trade deficit with other Asian countries has migrated, to some extent, to China.

But still it is an area of concern, and at some point the growth of our bilateral trade deficit will be neither politically nor economically sustainable. That raises the question of, what should our policy response be? As I said last June, we have to be thoughtful in our actions, and hopefully get it right. We cannot afford to act irrationally and get it wrong.

An important basis of developing our policy response is the extent to which China fulfills the obligations it assumed as a member of the WTO and as a major beneficiary of open trade.

We have currency exchange rate issues. Last July, China abandoned its currency pegged to the U.S. dollar. China announced that its exchange rate would become adjustable based on market supply and demand.

China also announced that its currency would be allowed to fluctuate by three-tenths of a percent on a daily basis against a basket of currencies. It is clear that the latter commitment is not being met. Since July, China's currency appreciated by about 1 percent relative to the U.S. dollar. Much of that movement came in the last few weeks; recently, in other words.

In addition to our growing bilateral trade imbalance, China ran a global trade surplus of over \$100 billion. These mounting trade imbalances indicate that China's currency should appreciate further, but something is impeding that adjustment.

So that is why Senator Baucus and I introduced, just yesterday, a bill to improve how we respond to the material currency imbalances. Our bill enhances U.S. engagement on this subject and it provides for meaningful consequences if countries fail to act. Cooperation is key if we're going to eliminate impediments to normal market adjustment exchange rates.

Moving on, another important issue is the enforcement of intellectual property rights. Last July, China committed to boosting its enforcement efforts in a number of ways, such as by ensuring that all levels of the Chinese government use legitimate software products.

This comes on top of China's pledge, in April of 2004, to, in their words, "significantly reduce infringement of intellectual property rights." Yet, estimated piracy in China is rampant, and continues to be. In addition, China accounted for almost 70 percent of counterfeit goods seized by U.S. Customs in fiscal year 2005.

So, in addition to the more fruitful engagement with China, we need to be prepared to assert our trade rights effectively. That is not to say the measure of our success is the number of cases that we might bring to the World Trade Organization. I focus, and I think we all ought to focus, on outcomes. If we can avoid lengthy litigation to settle disputes, that is so much the better.

The administration has achieved important successes taking that approach, but we also need to be prepared to litigate, if need be. That is why the bill that Senator Baucus and I introduced strengthens the administration's ability to enforce our rights under trade agreements, enhancing Congressional oversight of such efforts at the same time.

This hearing also gives us an opportunity to review our objectives for the planned meeting of the U.S.-China Joint Commission on Commerce and Trade and the planned visit to Washington, DC of the Chinese president.

We have a number of important issues to address, in addition to currency exchange rates and intellectual property. So, we are going to hear from the administration, and I look forward to that.

Now I am ready for Senator Baucus. Thank you. I did not thank Senator Baucus for his cooperation on the legislation. I did at the news conference yesterday, but I want to repeat it for the record, that this was something that was very easy to work on, and I thank you for your help.

**OPENING STATEMENT OF HON. MAX BAUCUS,
A U.S. SENATOR FROM MONTANA**

Senator BAUCUS. Thank you, Mr. Chairman. It is, frankly, not difficult at all, working with you. I very much appreciate your statesman-like sense in developing this bill, and I think it is a good piece of legislation.

Again, thank you for convening this hearing, because this is an important juncture in our relationship with China. I made my seventh trip to China this January. I met with Premier Wen Jiabao, Commerce Minister Bo, and other members of the senior leadership. I learned a lot, and I am eager to learn more today.

The book of Deuteronomy counsels, "When you make a promise, do not be slow to pay it. Be careful to do what you say you're going to do. Keep the promise you have made."

Promises are fundamental to human relationships. Just as much, promises form the foundation of international trade. America promises our trading partners to open our vast market.

In return, our partners promise America to open their markets to our exports. Promises are at the heart of U.S. trade policy. Members of Congress promise their constituents to defend their interests. The administration promises Congress to negotiate trade agreements consistent with the parameters in the law.

The administration promises to enforce these agreements vigorously. The administration promises to implement the trade laws that the Congress passes. The government promises all Americans to strive to make sure that trade works for them.

These promises reinforce the international trade system. We must make sure that promises made are promises kept. Is China keeping the promises that it made as part of its accession to the World Trade Organization? Is the administration keeping its promise to enforce China's trade obligations in U.S. trade law? The record on both accounts is mixed.

Let us start with China. When it joined the WTO, China made an extensive set of promises. China promised to reduce tariffs, to improve market access for services, to limit subsidies, and to protect and enforce intellectual property rights.

Many rush to criticize China, but many also overlook China's enormous efforts to keep these promises. China has implemented many of its WTO commitments on time, and some promises, like trading rights, China has implemented early. This deserves recognition.

In many key areas, however, China has not kept its promises. China maintains an unjustified WTO-inconsistent ban on U.S. beef, despite clear scientific evidence that our beef is safe. China has a team in Washington this week to address this issue, and they need to resolve it now.

China tolerates massive levels of piracy and counterfeiting of foreign products. China hides the subsidies that it provides to state-owned enterprises. China has not yet taken meaningful action to join the WTO agreement on government procurement. All evidence suggests that China continues to manipulate its exchange rate for competitive gain.

The administration has also made promises regarding China. They promised to enforce China's trade commitments and have

promised to defend U.S. trade law with respect to China. In some areas, the administration has kept its promises.

USTR has made progress working with China on standards affecting wireless communications devices, for example. The USTR successfully convinced China to rescind a WTO-inconsistent antidumping order on Kraft linerboard, which means a lot, I might say, to many hardworking people in that industry in my State of Montana.

Ambassador Portman's top-to-bottom review is an important step in focusing efforts on enforcing China's trade commitments, and I commend Ambassador Portman and the administration for that.

The administration, however, can do more. I hope that the bills that I have introduced with Senator Grassley yesterday, and with Senator Hatch last month, will help to focus the administration's enforcement efforts.

In other areas, the administration has failed to keep its promises. It has effectively nullified section 421 of the Trade Act. Congress purposely included that provision in the China PNTR bill. Congress intended for the administration to use that provision to limit harmful surges in Chinese imports to help our domestic industry adjust.

Four times, the International Trade Commission recommended that the President apply section 421 to counter the market disruption caused by Chinese imports, but in all four cases the President refused to act.

Those decisions are completely at odds with what Congress intended, and those decisions have led Americans to lose jobs. Companies have gone out of business as a consequence, American businesses, bankrupt. Broken promises by China and the administration have led us to a dangerous place in our trade relationship.

It is no wonder that Americans do not trust China on trade when it does not keep key commitments, and it is no wonder that Americans do not trust the administration on trade policy when the administration refuses to use U.S. law to defend Americans.

We need to get this relationship back on track. That is why I have worked so closely with Senator Grassley, Senator Hatch, and other members of this committee on responsible WTO-consistent legislation. That legislation will help make our trade policy work better. That legislation will address concerns that Americans have on currency and on trade enforcement.

So let us work to see that China keeps its promises, and let us ensure that the administration keeps its promises. Let us, thus, ensure that international trade can live up to the promise that it holds for better lives for all Americans.

The CHAIRMAN. Thank you, Senator Baucus.

Our first panel includes Ambassador Bhatia. He is Deputy U.S. Trade Representative, responsible for U.S. trade relations with East Asia, South Asia, Southeast Asia, and Africa.

The second panelist is Treasury Under Secretary Tim Adams, who is principal advisor to Secretary Snow on international economic issues, and that includes currency issues as well.

Third, Commerce Under Secretary for International Trade, Ambassador Frank Lavin, who oversees the International Import Ad-

ministration. We are very grateful because we know you had to adjust your schedule to be with us, and we thank you for doing that.

Do you have an order among yourselves? [No response] All right. Then I would suggest Bhatia, Lavin, and then Adams. Is that all right? Go ahead.

STATEMENT OF HON. KARAN K. BHATIA, DEPUTY U.S. TRADE REPRESENTATIVE, OFFICE OF THE U.S. TRADE REPRESENTATIVE, WASHINGTON, DC

Mr. BHATIA. Thank you very much, Mr. Chairman, Senator Baucus, and members of the Finance Committee. Thank you for giving me the opportunity to testify today.

I have prepared a more detailed statement that, with your permission, I would ask be submitted for the record, and I will just give you a synopsis version this morning orally.

[The prepared statement of Mr. Bhatia appears in the appendix.]

Mr. BHATIA. Today's hearing, I believe, is very timely. Last month, USTR issued the administration's top-to-bottom review of our trade relationship with China. This comprehensive review of our trade relationship, prepared after consultation with stakeholders and with Congress, is the first such review to have been undertaken since China's accession to the WTO, and contains various recommendations which we are in the process of implementing.

At the same time, we have been engaging China actively as we prepare for a meeting of the Joint Committee on Commerce and Trade, the JCCT, on April 11, and for President Hu's visit to the United States shortly thereafter.

In fact, Under Secretary Lavin and I just returned from meetings in Beijing at the end of last week where we were pressing China for more substantial progress in a number of areas.

Our assessment of our bilateral trade relationship with China, reflected in the top-to-bottom review, is that, while that relationship has benefitted both the United States and China and has witnessed a number of positive developments in recent years, it lacks equity, durability, and balance in the opportunities that it provides.

It has been more than 4 years since China joined the WTO, and we believe we are entering a new phase in the U.S.-China trade relationship. This new phase marks the end of China's transition period as a new participant in the WTO, and the beginning of a period in which China must act and be treated as a fully accountable participant in, and beneficiary of, the international trading system, one that must bear responsibility in its multilateral, its regional, and its bilateral trade relationships that is commensurate with its commercial heft and with the economic benefits that it has gained from participation in the global trading system.

Now, after 4 years of WTO membership, China has a track record, and in our view, it is decidedly mixed. The commitments that were easiest to fulfill have largely been fulfilled; those outstanding will require a more serious level of attention and focus.

In USTR's most recent report to Congress on China's WTO compliance, we highlighted our principal areas of concern, many of which we are pursuing with China as we approach the April 11 JCCT and the visit of President Hu.

First on our list of concerns is intellectual property protection and enforcement. While China has made improvements to its IPR laws and regulations, the lack of effective IPR enforcement remains an enormous challenge.

China committed to significantly reduce counterfeiting and piracy at the 2004 JCCT. Nearly 2 years have gone by, and that commitment has not been met.

Now we have seen China, under the leadership of Vice Premier Wu Yi, take a number of steps in an attempt to address this problem, and there is evidence that it remains focused on it.

For example, just over the past couple of days China announced actions to close and discipline 14 plants that produced pirated DVDs and CDs. We have been pushing China very hard in this area and look forward to getting a full report from China in the next few days on its recent actions.

This week, China also announced final regulations to transfer IPR cases from administrative authorities to criminal authorities, and draft regulations to transfer IPR cases from Customs authorities to criminal authorities, again, in response to vigorous U.S. pressure.

However, while these steps and others that China has taken are helpful, they have not resulted in significant reductions in piracy and counterfeiting levels.

We have also seen China continue to use an array of industrial policy tools to protect favored sectors and industries in the area of services. Concerns in many sectors remain, largely due to arbitrary and non-transparent policies, and China's use of entry threshold requirements that exceed international norms.

Their exceedingly high capitalization requirement for telecommunications services, for example, is a good example, and one which we think China should change as soon as possible.

Agriculture is a high priority of the administration's trade relations with China. And while China is one our farm sector's best customers, the record demonstrates that China does not always base its food safety decisions on science, as evidenced by its continued ban on U.S. beef. China needs to lift this ban.

And there are concerns in the area of transparency and rule of law, for example, that cut across sectors. In short, while China has a more open and competitive economy than 25 years ago and WTO accession has led to the removal of many trade barriers, there are still substantial barriers to trade that have yet to be dismantled, and they need to be.

These actions not only harm U.S. businesses, farmers and workers, they are also inconsistent with China's own best interests.

Now, the top-to-bottom review that we issued last month concludes that to effectively address these and other challenges going forward, U.S. trade resources and priorities with respect to China need to be readjusted.

First and foremost, the report calls for strengthening our current focus on China's WTO compliance and adherence to international norms, as China has transitioned to being a mature trading partner in the international system.

To improve our enforcement efforts, China has recently established the position of Chief Counsel for China Enforcement, and a

China Enforcement Task Force with a broad and aggressive mandate. The task force has already met and begun its work, and we expect to see it move forward quickly with a broad and aggressive agenda.

It will approach enforcement comprehensively by using WTO mechanisms short of dispute settlement, by seeking to ensure that China lives up to its bilateral commitments like those it has made in the JCCT, and by developing strategies for addressing trade problems that have so far been difficult to address, such as the Chinese government's excessive subsidization of a range of Chinese industries.

But it will also focus on issues where there is a need to enforce China's obligations through dispute settlement. We are already pursuing potential WTO cases on a number of fronts, and we will not hesitate to bring them if we believe that doing so is in the United States' best interests.

Indeed, in January of this year we were poised to bring a case challenging China's imposition of antidumping duties on our Kraft linerboard exports, as Senator Baucus referenced, when at the eleventh hour China reversed course and rescinded its improper duties.

We have made clear to China that using the WTO dispute settlement mechanism should not be viewed as a failure in our relationship, rather it is a sign of the maturity of that relationship.

In addition to strengthened enforcement, the top-to-bottom review outlines the following actions that we are in the process of taking to ensure meaningful progress on our priority objectives with respect to China: 1) expanding USTR's information assessment capabilities; 2) the creation of a senior advisory task force on China under the auspices of our Advisory Committee on Trade Policy and Negotiations, which will be co-chaired by John Engler, president of the National Association of Manufacturers, and Dr. Fisk Johnson, chairman of S.C. Johnson & Company; 3) expanding our trade negotiating capacity in Beijing; 4) increasing coordination with other trading partners, such as the EU and Japan, on China trade issues of common interest, such as enforcement of intellectual property rights and tariffs on automobiles and auto parts; 5) deepening our trade relations with other Asian economies through such mechanisms as bilateral FTAs with Malaysia and South Korea, and within regional forums to maintain and enhance our commercial relationships in the region; 6) increasing the effectiveness of high-level meetings with China's leaders, including through holding annual meetings of the JCCT; 7) strengthening the U.S.-China dialogue on important multilateral and bilateral issues that pose potential problems for the relationship, including China's participation in global institutions, market access and standards issues, subsidies and structural issues; 8) strengthening U.S. Government interagency coordination through more frequent and rigorous use of the TPRG mechanism; and, finally, 9) strengthening executive Congressional partnership through regular briefings for Congressional members and staff.

I would be happy to go into these in any greater detail that you desire. Mr. Chairman and members of the committee, thank you for providing me the opportunity to speak with you this morning.

The CHAIRMAN. Thank you.
Mr. Lavin?

**STATEMENT OF HON. FRANKLIN L. LAVIN, UNDER SECRETARY
OF COMMERCE FOR INTERNATIONAL TRADE, U.S. DEPARTMENT
OF COMMERCE, WASHINGTON, DC**

Mr. LAVIN. Thank you, Mr. Chairman, Senator Baucus, members of the committee. I am pleased to be with you today to share some thoughts on our economic relationship with China.

As Ambassador Bhatia noted, we just returned from China a few days ago. Secretary Gutierrez is there this week, all continuing discussions as a lead-up to this year's meeting of the Joint Commission on Commerce and Trade.

The relationship between the United States and China could well be the most important international economic relationship of our era, because the complexity of the relationship encompasses almost every major economic issue we face, such as competitiveness, trade balance, investment policy, and a relationship between economies of this size, as well as the fundamental differences of language, development levels, and political systems, which can present significant challenges, not the least of which are the trade barriers on China's side.

But as we wrestle with these challenges, we also need to keep the positives in mind: U.S. exports to China increased by over 20 percent in 2005, and, indeed, since China joined the WTO in 2001, U.S. exports to China have increased by some 118 percent, which is the highest 5-year percentage increase among our top export markets.

U.S. companies operating in China really report generally successful results, and we should also bear in mind that imports can bring advantages to the U.S. economy, as well as challenges.

But I want to focus on these challenges for a moment. When we look at the challenges in the U.S. market, the Department of Commerce, as the Chairman noted, takes the lead on trade remedy response.

We currently maintain 58 antidumping orders on imports from China, including consumer goods, steel products, agricultural products, seafood, and chemicals. These orders represent 22 percent of all current U.S. antidumping orders and affect some \$5 billion-plus in 2005 trade.

Regarding subsidies, we have stepped up our engagement of China through the JCCT. We have a Structural Issues Working Group, and we have launched a steel dialogue. Subsidies in China cover a wide range of issues, including industrial policies, China's banking sector, the role of state-owned enterprises, and China's continued use of price controls.

In the China market itself, we believe U.S. firms face a range of barriers and challenges. Intellectual property rights issues might be chief among them, as they include issues from software and entertainment piracy to fake pharmaceuticals and illegal knock-offs of famous brands' consumer goods.

As Commerce hosts the Patent & Trademark Office, as well as the International IPR Enforcement Coordinator, in addition to the International Trade Administration, we think we are able to bring

a distinctive combination of technical trade expertise to these issues.

If we move beyond the IPR issues, China has an array of non-tariff barriers, including government regulations, technical standards, non-market mechanisms, lack of transparency, and weak enforcement laws.

In fact, a complete list of trade barriers in China would be quite extensive and would include China's ban on U.S. beef, U.S. firms' inability to get 3-G service licenses, and Chinese barriers to U.S. telecom firms.

Furthermore, China is considering regulations that would be steps backward in areas such as direct marketing and express delivery. Also, as Senator Baucus noted, China has yet to honor its commitment to join the WTO government procurement agreement.

While we are trying to tackle these issues through the JCCT, we did finish a week of consultations. Some progress was made, but in my view, most of the major issues remain unresolved.

Beyond those discussions, the Commerce Department has a range of activity on the front lines every day in China to help U.S. companies compete in that market. China represents our largest single overseas presence. Our team there ranges from commercial specialists to patent and trademark experts.

We have four programs underway in China: developing market opportunities, business facilitation, problem-solving, and enforcement. Last year, we tallied in the thousands the number of U.S. companies that were helped through the various activities of trade promotion: IPR assistance, seminars, website call support, and so forth. With your permission, Senator, I have a written testimony that goes into detail on those points.

Ultimately, for the benefit of both our countries, open markets are essential. The most important step China can take if it wants to ensure continued access to the U.S. market would be to continue to increase market access for U.S. firms.

American companies, workers, and farmers can compete with anyone in the world, given a level playing field, and we will continue to work with our Chinese counterparts to achieve that goal.

Thank you, Mr. Chairman. I would be happy to take your questions.

The CHAIRMAN. Thank you very much.

[The prepared statement of Mr. Lavin appears in the appendix.]

The CHAIRMAN. Now, Mr. Adams?

STATEMENT OF HON. TIMOTHY D. ADAMS, UNDER SECRETARY OF TREASURY FOR INTERNATIONAL AFFAIRS, U.S. DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Mr. ADAMS. Thank you, Mr. Chairman, Senator Baucus, and other distinguished members of the committee. I am pleased to be with you here today to discuss the Department of Treasury's economic engagement with China.

As my colleagues have noted, the U.S. economic relationship with China may be the single most important economic relationship as the 21st century opens.

More than 25 years have passed since China began its transition to a market economy, and China has seen its standard of living

surge—in fact, it is almost unprecedented—with the transformation that this economy has experienced in such a short period of time.

China is now the world's fourth largest economy and the third largest trading nation. The United States has benefitted from China's growth. U.S. exports to China have grown at five times the rate of our exports to the rest of the world since China joined the WTO, and China has risen to our fourth largest export market. Moreover, China and the U.S. together have accounted for almost half of global growth since 2000.

China's rapid growth and the character of that growth also poses great challenges, not only for China, but for the rest of the world. China's overall current account surplus has risen sharply, from \$17 billion in 2001, to \$69 billion in 2004, and estimates for 2005 are something around \$150 billion, which would be close to 7 percent of China's GDP.

China's current account surplus is now a major component of global imbalances, and its continuation risks undermining support for the open trade policies which have contributed so much to its rapid development.

Secretary Snow and the entire Treasury team have been working on this relationship now for many years. Last fall, on his most recent trip to China, Secretary Snow articulated the three pillars of what China needs to do to support robust and sustainable economic growth.

These are: adopt a more market-based, flexible exchange rate; shift from investment- and export-oriented growth to a more consumption-based growth model; and reform and open up their financial sector, including their capital markets.

The Chinese have made some important achievements in these three pillars, but they have much work to do. Encouraging China to meet its responsibilities is a global task and has global implications. To that end, we have worked closely with our colleagues in the G-7, APEC, the IMF, and other formal and informal institutions to help bring about this change. There is a broad-based consensus on what China needs to do.

With this strategy in place, it is useful for me now just to take a couple of moments and maybe walk you through these three pillars.

The first one is exchange rate flexibility. Convincing China to move more rapidly to a more market-based, flexible exchange rate is our number-one priority. Exchange rate flexibility is, first and foremost, in China's interest.

Greater exchange rate flexibility will strengthen the ability of the Chinese monetary policy to help assure sustained growth and avoid the boom/bust cycles that we have seen certainly in the 1990s.

Greater ability to control domestic interest rates will also lead to more efficient financial intermediation and help avoid credit-fueled investment booms resulting in the build-up of non-performing loans.

The Chinese leadership has publicly committed to greater exchange rate flexibility. Our engagement with China on exchange rate policy is now not about whether, but about how quickly.

Premier Wen reaffirmed this commitment following the closing of the National People's Congress just a week or so ago, saying, "China will expand the foreign exchange market and will allow more flexibility and fluctuation of the currency."

China has made some progress in making its currency more flexible and market-determined, starting with the adoption of the new exchange rate mechanism last July 21st. This authorized inter-bank trading of currency. The trading bank is no longer the counterpart for every transaction.

China has also introduced new financial products that hedge against currency risks, which is important for their industry.

But to date, China's progress has been far too cautious. Since China began changing its exchange rate regime last July, its currency has appreciated by only 3.2 percent, and the day-to-day fluctuation has been severely constrained. In fact, it has failed to test the limits of its narrow intra-day trading bands that were established last July.

The Chinese government must allow market forces to play a much greater role in the determination of its currency's value. The obstacles are no longer technical. China could easily move more rapidly towards greater flexibility. It should do so now.

The second pillar of our strategy is achieving more balanced growth. The counterpart to China's high investment in its current account surplus is a savings rate of roughly 50 percent of GDP, the highest in the world.

Chinese households save 25 percent of their income, on average, mostly in the form of low-interest, low-earning bank deposits. Household savings reflected a weak social safety net, and limited access to financial instruments and insurance.

China's leaders recognize that achieving more balanced growth is central to current China policy. To spur consumption, China has placed strong emphasis on rural development in its most recent 5-year plan.

To boost disposable incomes of the rural poor, the government has recently decided to cut agriculture taxes and eliminate fees for rural primary education. It also plans to direct more capital and social spending to the rural sector.

Increasing the range of financial products available to households is also a critical component. Household savings could be reduced by insurance policies covering disability and catastrophic illness, and by the ability to finance education and other major expenses, and by making higher-return investment options available to households, including investment options overseas.

This brings me to the third pillar of our strategy, financial sector and capital market reform. Inefficient financial intermediation remains the Achilles heel of the Chinese economy. To help modernize China's financial system and capital markets, Treasury has identified a number of key priorities.

First, we believe it will be in China's best interests to allow more competition and market forces into the sector, in particular, by eliminating ownership caps on foreign states and expanding the scope of products that those institutions can offer. We are also pressing China to make substantial new commitments in financial services as an essential element of any Doha agreement.

Second, China's regulators and firms need to improve capacity for risk management. Third, China needs to improve opportunities for private companies to obtain finance so that capital can be channeled to its most productive uses.

In the corporate bond market, we have encouraged authorities to eliminate duplicative government approvals and to move to a more disclosure-based system. On the equity markets, we are arguing for an end to the moratorium on new listings and sales of domestic security companies to foreign investors. Finally, China needs to continue to privatize its state-owned enterprises.

Another important area of our engagement with China is protecting China's financial system from abuse. China must strengthen its draft anti-money laundering law, as it falls short in many key areas. We have been working very closely, bilaterally and multilaterally, with Chinese authorities on these issues.

Finally, let me address one of the stated concerns of some of the members of this committee regarding China's holdings of Treasury securities, and I will do that by just putting it in perspective. China's holdings are 3.2 percent of total public debt outstanding, and 6.6 percent of total debt outstanding held by non-U.S. Government institutions.

China has purchased around \$34 billion in Treasury securities in 2005. This is about 11 percent of what was issued or purchased. This is in the context of the extraordinarily deep and liquid Treasury market, where daily trading is about \$500 billion.

China holds only about \$470 billion, or 2 percent of the total of \$23 trillion in U.S. credit/debt securities, so its holdings are quite small relative to the stock.

In conclusion, China continues to undergo historic economic transformation. Developing a constructive and mutually beneficial economic relationship with China now is vitally important, since the decisions we take in the next few years will guide the U.S.-China economic relationship for a generation and the shape and pace of global growth for many years to come.

As a significant member and beneficiary of the international economy, China should make a greater contribution to sustaining strong global growth by reducing its large current account surplus and working to maintain global support for an open trade and investment system.

To put it simply, China must play by the rules of the system. Failure to do so entails consequences both for China, for the U.S., and for the global economy. It is important that we manage our relations in a way that preserves global growth and maintains an open trade and investment policy, which is a win-win proposition for China and for us.

The U.S. Treasury is committed to promoting a path of mutual prosperity and global leadership in our economic relations with China.

Thank you for this opportunity to appear before your committee today.

The CHAIRMAN. Thank you very much.

[The prepared statement of Mr. Adams appears in the appendix.]

The CHAIRMAN. After the Chairman and Ranking Member, we have it in this order: Hatch, Bunning, Bingaman, Lincoln, and

Thomas. And because we have a very distinguished second panel, and also because there is a vote at, I believe, a quarter to 12, I would ask members to stay within their 5 minutes, at least 5 minutes of asking your last question, so that we do not disregard our second panel, some of whom have come a long way.

Mr. Bhatia, what are our expectations, as you see them, regarding the upcoming trade policy review of China by the World Trade Organization, and specifically whether this process might spur needed reform in China?

Mr. BHATIA. Thank you, Mr. Chairman. Yes. We do have a trade policy review. The WTO actually has a trade policy review scheduled for China the end of the month of April.

This is an opportunity basically for member states, all of the WTO member states, to pose questions to China that will elicit responses about both what it has actually done to fulfill its commitments, and what it intends to do.

I should tell you that we anticipate this being a pretty thoroughgoing exercise. We just went through one ourselves over in Geneva, and I would note, emerged, I think, by consensus, with very strong marks, the United States as a whole, with respect to its policy.

China is going to have some very tough questions to answer. We have already posed more than 200 questions to the Chinese. Just to give you a sense, I think the United States got 600 questions in its TPR, and we always attract a fair number. So, it is going to be a pretty rigorous event for them.

The hope, I think, is that the question and answer period forces China both to focus on what it has accomplished, and what it has not accomplished. In that process, we will elicit both a greater understanding of what it intends to do to fulfill its obligations, but also perhaps some further commitments on their part to take some steps that we see as being important.

From our perspective, the multilateral arena is a very important one for China, to engage China in, as we seek to have them make the sort of reforms and changes that we are pushing for, in addition to the bilateral forum that we have been using through the JCCT.

The CHAIRMAN. All right.

Then, also for you, please provide us with some sort of summary of what progress USTR is making to enhance the degree to which U.S. trade policy is proactive and informed by comprehensive information on those economic trends and developments that we read about every day going on in China.

Mr. BHATIA. Again, I appreciate the question, Mr. Chairman. You are clearly referring to the part of our top-to-bottom review where we identified this as one of our higher priorities—indeed, one of our highest priorities.

Just by way of a sense of background, it was our sense that, as we move into this new phase of our trade relationship with China, it is critically important that we not be in a reactive mode, not reacting to issues that come up, the issue of today or yesterday, but that we be looking forward a month, a year, several years forward so that our trade policy is informed by such a longer-term view.

To that end, I would point out two things that we already have under way. The first is the hiring of more analysts within our

China office. We have already hired two. There are more China-focused folks on the way. They funnel into and feed, by the way, I should note, our Enforcement Working Group, so they will shape both our enforcement strategy, as well as our negotiation strategy.

Second, we are very cognizant that we do not have all the answers at USTR or in the U.S. Government, and that we need to get the benefit of the wisdom of many outside the government as well. To that end, we have set up a task force within our Advisory Committee on Trade Policy and Negotiations, our most senior-level advisory committee.

I mentioned this in my opening remarks, that we have asked John Engler and Dr. Johnson to co-chair that group. There will be others who will join that. The first meeting of that group is scheduled for the beginning part of April. So, we will be using that mechanism.

The CHAIRMAN. Thank you.

Secretary Adams, in my opening remarks I expressed my dissatisfaction with what I see: China failing to live up to its statements of last July on floating currency. I also feel sorry for them, because I think such a move would be very beneficial to them as well.

First, what are our expectations for meaningful currency reform in China? Second, could you describe the various costs to China of their delaying true currency reform?

Mr. ADAMS. Yes, Mr. Chairman. Thank you.

The CHAIRMAN. That is my last question.

Mr. ADAMS. Yes, Mr. Chairman. We continue to expect the Chinese to do what they said they are going to do. Senator Baucus talked about promises. I wrote down his Biblical reference. It is one I will pass along to my Chinese colleagues. We expect them to follow through on what they said they are going to do, and that means greater exchange rate flexibility over time. I do not think anyone expects a revolution to occur in a short period of time. I think your colleagues, Senator Schumer and Senator Graham, heard that firsthand; Senator Baucus, I am sure you heard it as well.

But we do want to see steady progress every single day. In fact, when I show up at the Treasury Department every morning, the first thing I look at is, what is the exchange rate between the yuan and the dollar. We watch it extremely closely.

But it is just one of three parts of our broader strategy, which are not ends in and of themselves, but means to bring about a more balanced relationship, to reduce risk to the global economy, to maximize growth, and to bring about the important adjustments that need to occur in the global economy.

Not undertaking greater exchange rate flexibility continues to keep them in a box where they do not have appropriate monetary policy instruments so that they can adequately deal with the boom/bust investment cycles we have seen in the past.

There is a tremendous amount of inefficient investment occurring in China. Investment, as a percentage of the GDP, is 40, 45 percent, one of the highest in the world. But they get very little for it. In fact, you would think with the growth rates of 9 percent, with the amount and quality of investments, they also should be grow-

ing much faster. So it gives them the appropriate tools to manage their economy much better.

The CHAIRMAN. All right.

Now, Senator Baucus?

Senator BAUCUS. Thank you, Mr. Chairman.

I would like to ask Ambassador Bhatia what the administration is doing, successfully, to encourage China to lift its ban on beef. As you well know, beef exports to China were growing at about 30 percent a year, until they were shut down a few years ago. The estimates are this is a several hundred million dollar industry in China.

We have given them all of the information they need, and it seems like they are just dragging their heels. I know, both from Premier Wen, and I asked Mr. Bo a couple of months ago, I got signals—at least what I thought were signals—that they would take care of that. So what needs to be done here?

Mr. BHATIA. Senator, as both Secretary Lavin and I mentioned, we just came back from a trip to China. The issue of beef entered prominently into our discussions there. It is a prominent issue in the JCCT coming up.

As you also know by that background, on my way to China I stopped in a number of other countries, including Japan.

Senator BAUCUS. Will this be lifted by the time of President Hu's visit?

Mr. BHATIA. All I can tell you is, we have made very, very clear to the Chinese that if it is not lifted, it is going to be a major topic.

Senator BAUCUS. I am glad you did that. But by the time the president is here, it will be a real problem. In fact, it would be in China's best interests, in my judgment, to lift that before his visit.

Mr. BHATIA. That point has been made quite clearly.

Senator BAUCUS. We did the same with the Korean president's visit here several years ago.

Mr. BHATIA. Yes.

Senator BAUCUS. Korea had very tough limitations on beef entering Korea. And I and others made it very clear when the Korean president was about to come to the United States that it would be a good idea to lift the ban, and they did.

Mr. BHATIA. Just so you know, there are technical discussions that have been going on with the Chinese, but, as you say, this has gone on far, far too long. There is no amount of technical information, beyond what we have already provided—

Senator BAUCUS. Thank you very much. That is very important.

I would like to turn now to section 421 safeguards, Ambassador Bhatia. Frankly, I am a little concerned that the administration has not followed up on recommendations by the International Trade Commission, and that is an understatement.

I understand that the industry has filed six petitions for relief. In how many cases has the ITC found market disruption and recommended relief?

Mr. BHATIA. In my understanding, sir, there were four decisions that went to the President.

Senator BAUCUS. Four, that is correct. Ambassador Lavin, of these four, in how many cases has the administration imposed relief recommended by the ITC?

Mr. LAVIN. The administration has not endorsed any of those four.

Senator BAUCUS. The answer is zero. That is correct.

Ambassador Bhatia, what was the President's rationale for refusing to grant relief in these instances, despite the ITC's findings?

Mr. BHATIA. Senator Baucus, I think when you are talking about the statute here, the 421 statute, in a nutshell, the statute, as you will recall, requires balancing, effectively, whether the safeguards—

Senator BAUCUS. The President said it was not in the national economic interest to do so.

Mr. BHATIA. Yes. When you measure the benefits and the costs of doing so, the costs of doing so are probably going to be over five times the benefits to be obtained.

Senator BAUCUS. Ambassador Lavin, what has happened to the that wire hanger industry since the President decided not to impose import relief in 2003?

Mr. LAVIN. The 2003 decision, sir?

Senator BAUCUS. Yes. What has happened to that wire hanger industry since the administration refused?

Mr. LAVIN. Sir, I do not have any data.

Senator BAUCUS. The answer is, all 15 U.S. plants producing wire hangers have shut down and thousands of jobs have been lost.

Ambassador Lavin, in December of 2005, the President again refused to impose relief in the most recent 421 case involving steel pipes. What has happened to that industry?

Mr. LAVIN. We have no information available.

Senator BAUCUS. That is revealing. I will tell you what happened. On March 24, the largest producer of this product announced that it would close its pipe-welding mill. This was due to the administration's failure to provide 421 relief.

Given the administration's nullification of Congressional intent, why would any industry in its right mind make use of any relief provided for under U.S. law, that is, section 421? Who wants to take a crack at that?

Mr. BHATIA. I am happy to start. First of all, Senator, I would venture to say that the administration's credentials in using trade remedies are very strong. You mentioned the steel case, for instance. One only need look back at the global safeguards that were put into place there.

The issue that we have here is the piece that's put before us. And I can speak personally with respect to the steel case because that is the one that has happened since I have been at the USTR. Again, let me point out a couple of other things.

Senator BAUCUS. I am sorry, Ambassador. My time is very tight here.

Mr. BHATIA. All right. In a nutshell—

Senator BAUCUS. In a very small nutshell.

Mr. BHATIA. All right. It requires a balancing between the two, the costs and the benefits. In this case, there was no question from the evidence that was provided by the ITC that the costs would be substantially greater to American consumers.

Second, the benefits, such as they were, would be diverted because you would have third-country providers, maybe 50 suppliers,

come in and fill up the back-fill. And lastly, I would point out that during the period at issue here, U.S. producers were in fact not only profitable, but in certain points in time hit record profitability. So, these are all case-by-case issues. I guess what I can tell you, sir, is that we stand committed to use 421 when the evidence before us demands it.

Senator BAUCUS. My time has expired. I will use about 10 seconds here. I hope that you develop good, solid, transparent metrics with respect to IPR infringement. If you can tell the committee also, what metrics are you using to determine the degree to which China has made up its commitment to enforce IPR.

The CHAIRMAN. Senator Hatch?

Senator HATCH. To all three of you, I appreciate the hard work that you are doing. I truly appreciate it.

The administration has information that intellectual property rights violations are occurring. In your written testimony, you make a distinction between so-called improvements in the Chinese government's piracy laws and their lack of enforcement. To me, what matters is the bottom line.

How many more software programs and records are being legitimately sold, or illegitimately sold? Has there been a significant increase in the number of copyright piracy criminal prosecutions? To me, these are statistics that matter. I have been over there. They have always said they are going to do something about it, but they never do.

I do not understand how you can say we are making progress, when the government itself continues to steal—the government itself continues to steal—American computer software.

Mr. BHATIA. Senator, all I can say is that we share, I think, a common belief. The U.S. Government, the administration, and you share a common belief that what matters here is the bottom line, that you can pass the regulations, you can pass the laws, but unless you have effective enforcement and evidence to show effective enforcement, it does not matter.

And indeed it would not matter not only simply from a trade perspective, but the Chinese themselves should care about this. It is critically important to them advancing up the economic ladder to more higher value-added products that they develop a vigorous IPR enforcement system.

To that end, one of the things that we have been pushing them on, just as recently as last Friday, is getting the data. Get us the data that shows how many criminal cases, how many transfers of cases from administrative to criminal.

Senator HATCH. Are they cooperating in that?

Mr. BHATIA. Yes. They have been providing some of the data, and there is more that is allegedly coming.

Senator HATCH. And you think the data is reliable that they are providing?

Mr. BHATIA. That always remains an issue. I think what we have been trying to do is verify the data against what our experience is, what we are hearing from industry, what we are hearing from others who are following that.

Senator HATCH. Even if the distinction can be made, isn't Chinese criminal law not in compliance with the TRIPS agreement?

Mr. BHATIA. There are concerns as to whether there is compatibility. One of the areas that we have pointed the Chinese to, for instance, is the issue of thresholds in their criminal law that effectively preclude, it is our concern, effective criminal enforcement.

Senator HATCH. Do you believe that the Chinese law finally has reached the TRIPS threshold of criminalizing copyright piracy “on a commercial scale” or does China continue to use the ambiguous language “for the purpose of making a profit”?

Mr. BHATIA. Our position is that we believe that those criminal thresholds need to be changed, and we have made that quite clear to the Chinese.

Senator HATCH. All right.

Secretary Adams, we have heard that President Wu told President Bush that China “would unswervingly press ahead with reform in its exchange rate mechanisms.” Obviously, despite a small corrective action, this did not occur. In November of 2005, the Treasury stated that the PRC was not living up to the commitments regarding the manipulation of their currency.

Does the administration sense a trend here? Is this not just like the commitments that we have seen on intellectual property? First, the Chinese make a commitment, and then fail to live up to it. If China continues to have a lack of compliance on international standards regarding intellectual property protection, how can we trust them to adopt a market-based system?

Mr. ADAMS. Senator, that is a very good question. Indeed, they continue to say all the right things. They continue to repeat and repackage what we have been told, both publicly and privately.

When they do repackage it, they say it with greater emphasis. That is great, but it is time to stop talking the talk and walk the walk. We need to hold them accountable to what they said they were going to do.

They have done some things to build the financial infrastructure so that we can see greater exchange rate flexibility over time, so I do not want to deny that they have done some things that are important to bring about greater flexibility.

But we have not seen the kind of progress that we should be seeing and we want to see, and we are not going to rest until we do see it.

Senator HATCH. Ambassador Lavin, I just have a few seconds. But you just came back from a trip to China. As you know, in December of 2005, the Chinese completed their 15-month anti-piracy campaign. Yet, informed sources cannot point to any meaningful decrease of the widespread availability of pirated products. So what was the Chinese government’s explanation for this?

Mr. LAVIN. I think your analysis is correct, Senator, that there is very uneven performance within China, even when senior-level government officials launched these types of initiatives.

It is worth noting that one IPR initiative which has been very successful is that China has been able to stop any trademark violation of the Beijing Olympic logo. But that is quite clear evidence, as far as we are concerned, that China does have the capability to crack down on trademark and copyright infringement.

Senator HATCH. We know they have the capability. That is not the problem.

Mr. LAVIN. Yes, sir. But they do not have the political will.

Senator HATCH. Well, we have to go after them and really let them know, if they want to be in the world of nations, they have to act responsibly.

Mr. LAVIN. Absolutely.

Senator HATCH. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Now we go to Senator Bunning.

Senator BUNNING. Yes, Mr. Chairman. I have an opening statement I would like to have included in the record.

The CHAIRMAN. Yes. It will be included in the record.

[The prepared statement of Senator Bunning appears in the appendix.]

Senator BUNNING. All right.

Just for the information of our panel, we made a trip to China, six of the Senators did, in December; five members of the Trade Subcommittee of this committee, the Finance Committee.

If you wonder why you have a problem with China, their Trade Minister, and no one in their Trade Ministry, would meet with us. So if you talk about a disconnect and a non-enforcement and a misunderstanding to occur—they do not even know how our democracy works.

They think they can negotiate with you, the Trade Minister, the administration, and get trade policy done. They do not realize it has to come through this committee before it can become an agreement between China and the United States of America.

So you might start out with, in your conversations, since you are more successful than five members of the Trade Subcommittee were in December, of getting the Chinese's attention on certain trade issues. They sent number six or number seven in their line of command to meet with us, and he did not know what trade was all about.

First of all, I want to thank the USTR and the Commerce Department for their work that resulted in an agreement with China to limit U.S. imports of Chinese textiles and clothing. As you know, imports from China in these areas increased by 46 percent in just the first 8 months of last year. Some categories have seen growth in excess of 1,000 percent.

Could you please address what the impact of this agreement has been on our Chinese imports in this area?

Mr. BHATIA. I will go first, Senator. The evidence we have thus far—and again, this is the agreement, as you know, that was just concluded at the end of last year—is that the reaction has been quite positive, that effectively what the agreement did was, by removing the likelihood of safeguards coming in and going out, it created a more predictable environment, a more stable environment for U.S. importers, for U.S. producers, and for Chinese producers.

So the result thus far that we have seen, we have encountered, is that it is one of those occasions where working with the Chinese—and it was tough; I mean, it was seven negotiating sessions with the Chinese—

Senator BUNNING. Since we are limited to 5 minutes, would you please respond?

Mr. BHATIA. It has been positive.

Senator BUNNING. It has been positive?

Mr. BHATIA. Yes.

Senator BUNNING. That is all you can say? For both sides?

Mr. BHATIA. For both sides.

Senator BUNNING. All right.

What is the effect of this agreement on our domestic industry's ability to bring safeguard cases against the Chinese for textile and clothing categories that were not covered by the agreement? Not covered.

Mr. LAVIN. Senator, I do not think this decision prejudices subsequent cases. It was a broad agreement so it had broad coverage. But if there were matters that were not covered, we have to go back into that.

Senator BUNNING. In other words, if we find them violating other textiles, other imports, we can go back?

Mr. LAVIN. Outside this current agreement.

Senator BUNNING. All right.

There is great potential for increased exports to China. In one of Kentucky's premier products, bourbon, we have seen growth in our bourbon exports to China over the past couple of years. But a very dark cloud has been hanging over the market in the form of a product standard that is simply not consistent with international standards or practice and not based on sound science.

I appreciate the great support that the USTR and China have given this industry over the past 4 years as the industry has organized and participated in a series of scientific and technical changes with China's Ministry of Health and other agencies.

It is time to bring this all to a successful conclusion. Can you please advise whether the USTR plans to raise this matter in the coming meetings with the Chinese?

Mr. BHATIA. Senator, I am aware of the issue. It is the fusible oil issue, I believe, with respect to whiskey exports.

Senator BUNNING. Yes.

Mr. BHATIA. We have raised it with the Chinese. We have been dealing with them at the technical level. I can tell you that we will continue to raise it with the Chinese.

Senator BUNNING. There is a problem. All of a sudden, Scotch whiskey is the whiskey of choice in China.

Mr. BHATIA. Yes.

Senator BUNNING. If given an equal opportunity to compete, our bourbon and all the things that we manufacture in Kentucky would be, I think, very acceptable to the Chinese, without the technical and scientific hurdles that have been put up.

Mr. BHATIA. Yes, Senator. I am aware of that. I am aware of the fact that Scotch is apparently slightly different in terms of the fusible oil content. We have raised it, as I said, and we will continue to raise it.

Senator BUNNING. We also have a problem with wood, with furniture, with a lot of other things, not only on currency. But we do not seem to be getting results. We get a lot of talk. Mao Tse Tung used to have "talk, talk, talk, fight, fight, fight." That was his motto.

Now, it is “talk, talk, talk, trade a little, give a little, trade a little.” We are still not getting through to the basic Chinese government how we have to do our trade relations with that country.

My time has expired.

The CHAIRMAN. Thank you very much.

Now, Senator Bingaman?

Senator BINGAMAN. Thank you very much, Mr. Chairman, for having the hearing. Thank you all for being here.

On the currency issue, I appreciate the statement by Under Secretary Adams about the need for China to move more rapidly toward greater flexibility in its currency. There are some economists who have argued that instead of us constantly pushing for more flexibility, we really ought to just urge them to change the peg. Why does that not make sense?

Mr. ADAMS. Thank you, Senator. It is a very good question. That presupposes that we know what the new peg should be.

Senator BINGAMAN. Well, we know that the current peg substantially undervalues the yuan relative to the dollar, so any change would be a very positive thing, from our perspective. Right?

Mr. ADAMS. Yes, Senator. Any forward movement would be welcome. When they did put in a new regime last July and eliminated their 10-year former regime, we did applaud them for that move, and we will continue to applaud them as they move in the future.

Senator BINGAMAN. That is what got them the 3.2 percent change.

Mr. ADAMS. That is correct.

Senator BINGAMAN. Yes.

What options do we have? I have heard your statement, and I do not question your motivation a bit where you say we will not rest until they shape up.

What options do we have, what leverage do we have to bring about any change in their policy with regard to currency? Is this just something we jaw-bone about indefinitely?

I mean, one of the statements was “greater exchange rate flexibility over time.” I think our idea of “over time” is a few months. Their idea of “over time” may be a few decades. How do you actually cause action to occur?

Mr. ADAMS. Well, we have been very active in multilateral circles. The idea is to bring about a global consensus. We think that if we can move this discussion away from a bilateral conversation to a multilateral conversation using the informal and formal institutions, that the sheer weight of global opinion should bring to bear some change. If you listen to—

Senator BINGAMAN. How does that happen? It seems to me that a multilateral conversation is useful, I guess. But how does the weight of opinion affect the currency?

Mr. ADAMS. Well, it affects it in affecting the decision-makers’ decision about how quickly they allow change to occur. Now, I do think if you had at this table my counterpart of the head of the People’s Bank of China, Governor Zhou Xiaochuan, that he would tell you he agrees with everything we said, that if he were in charge or some of his colleagues were in charge, they would actually be moving more quickly. But it is a much more political deci-

sion. I think my colleague hit it correctly. There does not seem to be the political will to move more quickly.

Senator BINGAMAN. You indicated that the reserves, foreign currency reserves that the Chinese hold, are not significant compared to the overall dollars that are being held. Their foreign currency reserves are about \$853 billion now, expected to reach \$1 trillion by the end of 2006. That is not a concern to Treasury?

Mr. ADAMS. Senator, the numbers you cite are speculation about the most recent numbers. We have a number slightly below that. But there is no doubt which direction it is going.

Senator BINGAMAN. Slightly below the trillion?

Mr. ADAMS. It is slightly below the \$854 billion number you cited.

Senator BINGAMAN. Oh, I see.

Mr. ADAMS. Not much, but slightly. We have not seen a confirmation of their reported new numbers. It is quite likely they will crest above \$1 trillion later this year. It is an issue which we watch closely.

Senator BINGAMAN. You say it is likely it will crest above \$1 trillion?

Mr. ADAMS. If current trends continue, and one would be reasonable to expect that they would. We stay very engaged with them, all parts of Treasury, in trying to understand how they manage those reserves, their intention with managing those reserves. So far, we are comfortable with the way they have been managing them and the way they plan to manage them in the future.

Senator BINGAMAN. But is there any level of foreign currency reserves in dollars that would trigger a concern on our part? I mean, if it got to \$1.5 trillion or \$2 trillion? I mean, is there any point at which we actually take some action to impede or reduce the extent of the foreign currency reserves that they accumulate?

Mr. ADAMS. Well, the action we would like to see occur are the actions we have been talking about here, this three-part strategy, which they have embraced, to bring about greater balances so they do not accumulate reserves at the kind of pace that they have in the past.

But if there were a level, I would not want to offer that in an open setting because it does have serious market ramifications.

Senator BINGAMAN. My time is up, Mr. Chairman.

The CHAIRMAN. Thank you. Senator Lincoln, then Senator Snowe.

Senator Lincoln?

Senator LINCOLN. Thank you, Mr. Chairman. Once again, we very much appreciate you and Senator Baucus bringing us here together on such a critical issue for our Nation, workers, and our economy.

I would like to say a big major "ditto" to Senator Baucus. I join him in finding total frustration with the administration's insistence on not enforcing section 421, and I have spoken with you gentlemen on that on many occasions. We are grateful that you are here today to discuss this, and many other issues, with us.

I have four mills in my State that make steel pipe, and two of them have already had layoffs. As you know, as mentioned by Senator Baucus, last Friday on the 24th, one of the companies that has

a mill in my State shut down one of its pipe mills in Pennsylvania. So we are definitely suffering repercussions from the inaction that exists here.

Ambassador Bhatia, I know you mentioned, as Senator Baucus's time was closing, the same answer that we have gotten on several occasions when we have raised this issue, the administration's responses that we cannot reduce the pipe imports from China because 50 other countries export this product to the U.S., and yet China alone accounted for more pipe imports in 2005 than 43 of those countries put together.

So far, in 2006, China accounts for almost as many imports as all of those countries put together. So in terms of saying that there are other places that exist where all of this can also come from, I do not think that is as plausible a response as the workers in these facilities deserve.

The second reason for denying the relief that we continue to get is the cost to the U.S. consumer would be too great. But the two different ITC relief recommendations had estimated consumer costs ranging from as low as \$20 million to as high as \$69 million, and I think that works out somewhere between 7 cents to 23 cents per American. The same ITC report shows a loss of 400 jobs and \$20 million in wages to workers in this industry in 2005 alone.

I guess my question really is, how do you defend the decisions to put thousands of workers out of work just so the cost of pipe is slightly less? I mean, we have a good, solid industry there which we are going to be losing, as we have seen the loss of many other industries in this country.

I guess Secretary Adams is bringing up the political will. Where is the political will to get behind our workers and to use the types of redress that we have in our system to deal with what is occurring here?

Mr. BHATIA. Senator Lincoln, I appreciate the question. I tell you honestly that I—we—deeply share the concern that American workers in these industries have—any time an American worker loses a job in this, or in any other industry. Just to be clear, though, about some of the numbers that you mentioned.

First of all, our numbers indicate that there were on the order of 300 to 350 employees in the industry as a whole that lost jobs in this industry during the time period at issue. It fluctuated during that time, so at certain points it was higher than it had ever been, at other points it was lower.

Senator LINCOLN. Well, as I mentioned, that came from the ITC report.

Mr. BHATIA. Right.

Senator LINCOLN. I do not know why your numbers are different.

Mr. BHATIA. During that period of time, profits were—in fact, from one point, from 2003 to 2004, they increased by about \$100 million. They went from, I think it was, \$130 million to \$240 million, something along those lines. So you had a time when prices were increasing and, in fact, profitability was going up. So there were, clearly, things going on in this industry, I guess, is what I am pointing out.

Senator LINCOLN. Well, I guess my point is, they are continuing to go on in this industry. I mean, you dispute the number of jobs that were lost in 2005. How many people lost their job last week?

Mr. BHATIA. I am not disputing that there are changes going on in the industry. What I was trying to say is, what the 421 statute says to us at the end of the day is, you have to balance. You have to take the question of the negative impact of the safeguard, which requires you to basically look at the impact on the economy as a whole, which was measured at being on the order of—the numbers that you have provided sound correct, up into the neighborhood of \$80 million—versus what the benefits would be to the industry.

Senator LINCOLN. But that was an extreme, \$80 million.

Mr. BHATIA. Yes. Which would be on the order of \$4 million worth of benefit to \$18 million.

Finally, let me just come back to the point that you talked about before.

Senator LINCOLN. Do you still stand by those numbers?

Mr. BHATIA. Well, those are not my numbers. Those are ITC numbers.

Senator LINCOLN. But, I mean, in seeing what has happened. The ITC was not at \$4 million. I think they were somewhere between \$20 million as a low.

Mr. BHATIA. No. If I may, it depends on which remedy you want to go with. But under one remedy, the potential benefit could increase U.S. producers' income between \$4 million and \$8 million; in the others, it was between \$8 million and \$17 million. So it was a high of as much as \$17 million. The cost to the economy as a whole would range between \$18 million at the low end up to \$69 million at the high.

The CHAIRMAN. Senator?

Senator LINCOLN. My time has expired. I just have to say, if these are not the places to use the safeguards that exist, I do not know what is. I do not know what your impression or your intention is in this administration to implement those safeguards, or if you think there is a reason to implement safeguards.

But in my opinion, and in the opinion of those workers, our trade laws are the tools that we have and we should be using them, and particularly when you get the kind of recommendations of four out of six instances where the ITC recommends taking some action. I do not know how you respond to those workers, but I think there is more we could be doing.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator SNOWE?

Senator SNOWE. Thank you, Mr. Chairman.

I thank you all for being here today. I think that obviously you can sense a great deal of deep-seated frustration, because obviously we are not talking about a minor actor in the global arena.

Obviously China, being a major force, has certainly created some gargantuan distortions in the marketplace that are affecting so many of our companies and workers here in America. I think our patience is wearing thin.

Since their accession to the WTO back in December of 2001, we should have made greater progress to this point on so many of the

issues we are discussing here today. And I know it is not for lack of trying.

I think the question should be what we should be doing to ensure that we certainly are going to make sure that China is living up to its agreement and to the commitments that it made in its accession to the WTO.

Starting with the currency manipulation, Secretary Adams, one of the questions I wanted to ask you, I understand the semi-annual report will be issued in April. Is that correct?

Mr. ADAMS. Senator, it is due April 15. We are working toward that deadline. I might add that President Hu Jintao's visit, which is now scheduled for April 20, could influence the outcome of that report. So, therefore, it could be a few days late, taking into consideration that visit.

Senator SNOWE. Well, influencing in what respect? I think, particularly concerning the currency manipulation. Are you considering identifying China as a currency manipulator? I know the Treasury report failed to do so in November. Frankly, that might have been helpful to the whole process in expediting the situation, because clearly it is significantly under-valued. Taking the snail-paced approach is not helping.

It has been 4 years, almost 5 years since they became a member of the WTO. Here we are today, talking about major issues having a profound impact on our workers and our companies.

Mr. ADAMS. Senator, we are currently evaluating China and a number of other countries. We want to make sure that we are not just focused on China, but any country that is in violation of both the spirit and the letter of the law. We have not made that determination. We are in the process of making that determination, and we look forward to bringing that determination to you once the report is finished.

Senator SNOWE. Well, in light of the president's visit to the United States in April, I hope we will not miss the opportunity to designate them as such. I mean, that is my concern, that we are going to miss another opportunity and forego a chance to highlight and underscore a major issue that is having a significant impact on our ability to be globally competitive, not to mention other countries as well. So, if we miss this opportunity, then when is it, next November? That is the concern here.

I just want to send the message that, given the significant undervaluation of its currency, we really cannot afford to miss many opportunities because many people are losing their jobs. I think it is abundantly clear, and it certainly does reflect in our position and our posture with China, in the growing deficits and their growing surpluses.

Getting back to the question on the schedule, do you expect the report will come out before President Hu Jintao's visit?

Mr. BHATIA. Senator, we have not made a determination about the actual issuance date of the report. Again, we are working on it. We always endeavor to get our reports out on time, but the president's visit could influence the outcome of that report and therefore it may be a few days late.

Senator SNOWE. Ambassador Bhatia, I understand it may have already been created, the top-to-bottom review of the U.S.-China trade relations. Has that task force been created already?

Mr. BHATIA. The Enforcement Task Force has.

Senator SNOWE. It has been?

Mr. BHATIA. Yes.

Senator SNOWE. And when do you expect to have a report on the status of China's commitments as a member of the WTO?

Mr. BHATIA. The top-to-bottom review has come out. The Enforcement Task Force is sort of the group that will work on an ongoing basis. I think perhaps what you are referring to is the trade policy review mechanism that is going on through the WTO. That is scheduled to happen at the end of April of this year. That is what Chairman Grassley referred to.

Senator SNOWE. Well, obviously one of the huge issues that is certainly vexing in our relationship, certainly with companies and industries that have worked with China, is the intellectual property rights, piracy, thievery, whatever you want to call it. I mean, this is a major concern.

Frankly, we have not made any progress in this regard. In fact, the U.S. Chamber of Commerce issued its 2005 report on the U.S.-China Commercial Relationship, and I quote, "The IPR climate for our companies in China has not materially improved in 2005, and the infringers generally remain undeterred in the marketplace." I know, for example, one of my companies in the State of Maine has had to spend over \$1 million in legal fees, consulting, and so on just to try to thwart the piracy question, the piracy of what they make, having the Chinese appropriate that and obviously duplicate it. They are spending over a million dollars. This is not a huge company in our State. That is a problem.

That is obviously being replicated across America, and they are doing this in all spheres. I have been to China. I have seen some of the video stores. We have seen it all. That is the problem.

So what are we going to be doing to grapple with this problem and to assert our rights and to assert their commitments under the WTO? When can we expect any action on this question?

Mr. BHATIA. Senator, consistent with what we have laid out in the top-to-bottom review and elsewhere, I think there is going to have to be a multiple-pronged approach to this. Part of it is going to be continuing to work with them bilaterally to the extent possible.

Part of it is going to be pushing them in other forums, regional and multilateral. Part of it is going to have to be, where we believe it is appropriate, litigation in the WTO. I can tell you right now, IPR is one of the areas that we are working to prepare a case on.

Senator SNOWE. Thank you, Mr. Chairman. Thank you.

The CHAIRMAN. Senator Baucus?

Senator BAUCUS. I have a couple. On the last, IPR, this is getting to be a huge problem. I met with Madam Wu Yi a year ago or so and addressed my concern and she blew me off, very disrespectfully. That sent a signal to me of how seriously they are taking this. You know the problems. We are relying upon you, the administration, to solve this. That is your job. You are the USTR, you are the executive branch. You enforce the laws, as it says in the con-

stitution. We are dependent on you. We are asking a lot of tough questions to back you up, basically.

I believe firmly that no country altruistically, out of the goodness of its heart, ever lowers a trade barrier. They never do. The only language any country understands is leverage. So you are going to have to come up with leverage.

You are going to have to come up with some language that China, any country that has an unfairly high trade barrier, understands. That is your job. You know what leverage works and what does not work. You are going to have to find the leverage. Talk is not going to do it, in my judgment.

Second, I might ask you, Secretary Adams, about the legislation that Senator Grassley and I have introduced. The hope here, the thought is, that by changing the term “currency manipulation” to “fundamental currency misalignment,” that might help you. That is, the concern was that “manipulation” is a pejorative term, or might be pejorative in the eyes of some, but not in others’. But “misalignment” is more of a neutral word. The thought is that applying this objective test to “fundamental currency misalignment” might help Treasury make a determination that, yes, there is fundamental misalignment.

Again, the second part of the test is, fundamental misalignment adversely affects the economic interests of a country, the United States. There can be misalignment that may not have an adverse economic effect.

So could you tell us the degree to which this legislation might help you address misalignment with currencies generally, and I guess in some respects we are talking about China?

Mr. ADAMS. Yes, Senator. I have not seen the full scope of the legislation, but particularly with reference to the point of “manipulation,” indeed, it is. It is an emotive term. We have not cited anyone since the early 1990s.

There was a period in which we cited countries frequently, some 13 times between 1988 and 1994, but we have not since 1994. So because we have not employed it, the threshold becomes higher and higher.

Senator BAUCUS. Will this help you? Will this legislation help you?

Mr. ADAMS. Indeed it will, Senator. There is this view that somehow this term has taken on a life of its own, and whomever you name as a manipulator has to wear around a scarlet “M” and will be disgraced. We do not want to disgrace anyone, we want to solve the problem. So I think it is a very innovative and novel approach to helping.

Senator BAUCUS. I appreciate that.

What are your thoughts on the counter-argument that China often uses, namely, we cannot revalue because that will cause internal problems within our country, that we just cannot do that, or if we do we have to go ever-so slowly? What is the answer to that?

Mr. ADAMS. Senator, I think we do need to be somewhat sensitive to their own domestic political concerns. I do not want to sit here and defend the Chinese, and I am not going to. But they really do have two economies. They have a very urban, coastal-based economy which is beginning to become middle-class, and then they

have somewhere on the order of 700 or 800 million people who live in the rural sector—

Senator BAUCUS. Well, I have been out there. They are working at it, frankly. They are doing a lot.

Mr. ADAMS [continuing]. And some 200 million who live on less than \$2 a day, and some 100 million that simply roam or are migrating from rural to urban areas.

I think their concerns about rural development, the increasing inequity that exists between the urban and coastal areas and the interior rural areas is real.

Senator BAUCUS. Well, do they not need a little nudge to get them moving a lot more quickly, such as having a currency that is misaligned? Would that not help them do what they know they have to do?

Mr. ADAMS. I think they know what they need to do. I think for them it is a balancing act of trying to move as quickly as they can without creating political disruptions where the peasants are with the pitchforks—

Senator BAUCUS. My time is about to expire.

What about, sometimes people say, well, gee, if the renminbi were revalued, that would make Chinese products more expensive to the United States. We would not be buying as many Chinese products.

Would China therefore not have all the currency that it now gets from U.S. purchases of Chinese products, and therefore China would not be investing as much, say, in the Treasury markets in the United States? That would force the United States to increase interest rates. So, gee, if you ask for a currency revaluation, you are going to get higher interest rates. That is the argument.

What do you say about that?

Mr. ADAMS. I do not make much of that relationship. I think the interest rates are set in a global pool of savings and investment. Obviously China plays a part in that equation, but it is a very small part. I think we can see a greater flexibility and greater appreciation of currency without it having a deleterious impact on U.S. industries.

Senator BAUCUS. I appreciate that.

I just believe that there is an opportunity for China here to step up in the world arena. It is a real opportunity for China. It is an opportunity for China to show that it is part of the world community, responsibly, by revaluing, for example, by undertaking other actions that it knows it could and should take. It is going to be the largest economic power in a couple, three decades from now. There is an opportunity to be a very important, responsible political power as well.

I just hope that China is thinking along those lines. It is a message that I gave to Premier Wen and to others that I met there, and I know that they are thinking about it. But I just urge all of us to keep looking at enhancing the positive side, the economic opportunity side of all this too, while we are also pointing out some of the problems that exist. Thank you.

Thank you, Mr. Chairman, very much.

The CHAIRMAN. Thank you, panel. We appreciate it very much. I am going to move quickly to the next panel.

We have Joe Papovich, senior vice president international at the Recording Industry Association of America. Mr. Papovich will give his testimony and then leave right away, because he has obligations elsewhere. We understood that before he came. But he will respond to questions for the record.

We also have Ambassador Hormats, vice chairman at Goldman Sachs (International). Then we will hear from John Frisbie, president of the U.S.-China Business Council. Following that, Gary Joachim, vice president of the American Soybean Association. Then Dr. C. Fred Bergsten, a frequent appearer before this committee, director of the Institute of International Economics.

So we are going to start with you, Joe, because we know you have to go.

STATEMENT OF JOE PAPOVICH, SENIOR VICE PRESIDENT INTERNATIONAL, RECORDING INDUSTRY ASSOCIATION OF AMERICA, WASHINGTON, DC

Mr. PAPOVICH. Thank you, Mr. Chairman and Senator Baucus, for having this hearing today. I am Joe Papovich, senior vice president international of the Recording Industry Association of America.

Thank you for the opportunity to discuss the widespread piracy in China of the recordings of America's songwriters, performers, and record companies.

Our members' recordings are sold all over the world because American music is sought by consumers everywhere. These sales benefit our industry and add significantly to our Nation's current account balance.

Our Nation's welfare is reduced and everyone in the music industry suffers when foreign governments tolerate widespread piracy of our recordings. When it comes to pirating American sound recordings, China is one of the worst. This has been a point of conflict between our countries for years.

There are three problems. First, China is awash in pirated recordings because the penalties imposed on pirates by the Chinese government are simply not effective. Second, Internet piracy is growing rapidly in China, already undermining our future there. Third, my industry and other copyright industries face severe restrictions on our ability to do business in China.

It is difficult to significantly reduce piracy in China if the Chinese will not allow legitimate companies to expand their ability to make available legitimate products to Chinese consumers. China needs to abolish these restrictions.

Here are our recommendations. The Chinese government has often acknowledged that piracy is a major problem. However, they have consistently failed to take effective action.

Instead, they have relied on administrative actions, inspections, seizures, modest fines, and the suspension of business licenses. They do a fair amount of that. But these measures consistently fail to provide deterrence. They are a slap on the wrist to the pirates.

China's criminal enforcement authorities have been reluctant, but must become actively involved, in the fight against piracy in China, and they need to impose criminal deterrent remedies. Unless this occurs, we see little chance for improvement.

The U.S. Government, our executive branch, and Congress have been increasing pressure on China toward this end, and we are very grateful for this hearing to assist in this regard.

The U.S. Government and industry must continue to insist that China fully implement the commitments it made in the WTO and in the JCCT over the past 2 years, especially to significantly reduce piracy by imposing deterrent penalties.

If this does not occur, our industry is working with USTR to prepare the necessary elements of a possible WTO legal complaint against China. Of course, we hope that China will quickly take steps to address the inadequacies of the current flawed system such that litigation would be unnecessary.

However, we must be prepared to act if the Chinese continue to resist taking the actions necessary to comply with their international commitments on enforcement.

There is one possible bright light. Ambassador Bhatia referred to this in his testimony. In the last few days, we have received encouraging, but unconfirmed, reports that the Chinese government has closed six plants that were producing pirated CDs and DVDs and suspended production at an additional eight facilities.

We have been working closely with the U.S. Government over the past few months to achieve exactly this. The Chinese government has also announced the referral of 18 Internet piracy cases for criminal prosecution, and that is good news.

This hopefully signals a Chinese decision to begin more effectively and systematically dealing with the piracy problem. Such a development would be a testimony to the efforts of the U.S. Government, led by Ambassador Portman and Secretary Gutierrez.

Nevertheless, even if this proves true, we are a long way from the finish line—indeed, the finish line is a distant point in time—but we are hopefully headed in a direction in which it will become visible. We will need and count on your continued support.

We cannot force the Chinese government to act. All we can do is be clear that we will not accept practices that fail to meet international standards.

I wish to say a word while I have the floor about Russia, which is fast becoming the next China when it comes to blatant copyright piracy. Copyright pirates in Russia are producing millions of pirated sound recordings, movies, and other infringing products and exporting them all over the world, ruining our markets inside and outside of Russia.

We have a unique opportunity here as Russia hopes to join the WTO. The U.S. Government should not agree to this until Russia effectively addresses these problems, and I urge Congress to insist on this.

The U.S. Government must press China—and Russia—harder to strengthen their anti-piracy enforcement regimes. Unless the U.S. uses every option available to it, we will continue to face the same situation that we do today into the foreseeable future: overwhelmingly pirate markets and lost opportunities for U.S. companies and workers.

Thank you, Mr. Chairman.
The CHAIRMAN. Thank you.

[The prepared statement of Mr. Papovich appears in the appendix.]

The CHAIRMAN. The vote has started, so we will just stand in recess.

[Whereupon, at 11:45 a.m. the meeting was recessed, reconvening at 11:55 a.m.]

The CHAIRMAN. Robert, why do you not proceed?

STATEMENT OF HON. D. ROBERT HORMATS, VICE CHAIRMAN, GOLDMAN SACHS (INTERNATIONAL), GOLDMAN SACHS & CO., NEW YORK, NY

Mr. HORMATS. Thank you very much, Mr. Chairman. First of all, it is a pleasure to be back before this committee again. Second, let me just start out by commending you and Senator Baucus on the legislation which you have just introduced.

I think this is an enormously important step forward, for several reasons, one of which is, it is great to see the Chairman of the committee and the Ranking Democrat working together on a bipartisan basis with other members. I think bipartisanship has been the hallmark of U.S. trade policy, and for you to continue that trend is really in a great tradition. It is the best kind of governance on trade and other issues.

Second, I am very impressed that it is comprehensive. You have been asked to deal on the Hill, this committee, with a lot of bilateral agreements and very specific kinds of trade issues, but only dealing with part of the problem. This really is comprehensive, and I think that is an enormously important step, having a good dialogue on trade policy in its length and breadth.

Third, it brings in other countries, because there are a lot of other countries that have similar objectives to the United States, and working with them, I think, is particularly important in getting results.

Fourth, you have remedies in there. You have actual remedies for dealing with the kinds of issues that the bill focuses on, and therefore I think that is also important. So, by and large, I think this is an important step forward, and I commend you and your colleagues on this.

Second, I would like to talk a little bit, since there is a limited period of time, about a couple of issues where I think priority should be given. I completely agree about the importance of the exchange rate issue.

I think that the dialogue that has been held with China on this is extremely important. It is important in a bilateral sense, but it is more important in one sense, that if China raises its currency value, other Asian countries are likely to do so.

Since roughly 40 percent of our trade is with Asia, if you can get the Chinese renminbi and other currencies rising together, it really will have an impact. A lot of countries do not let their currency go up because they do not want to lose competitiveness vis-à-vis the Chinese. If the Chinese go up, it will have a broad benefit for the region.

The point, however, is that it is not likely the Chinese, who have done things in their reform program in a very gradual way, are going to do this as quickly or as dramatically as many might want.

That does not mean that there should not be a dialogue to encourage them to do this, because there are a lot of reasons for their doing it, domestic and international, but that is to say there should be, alongside that, other elements of our trade relationship.

There are several that I just want to touch on. One point is, when we deal with the Chinese, it is good to have allies in China. There are many people in China, many interest groups, who support the kind of things we are encouraging China to do, that are in their interest to do. For instance, intellectual property. There are a lot of Chinese companies that also support improving intellectual property protection. We ought to work with them as allies.

Telecom. Opening up of the telecom sector. That would be very helpful to rural China to have more cell phones and other kinds of phones; bringing new cell phone technology is in very important.

Improving the banking system is very important because it can improve the efficient utilization of capital to go into small, private-sector enterprises. As you well know, Mr. Chairman, small enterprises are big job creators in this country, and they can be in China. The problem is, they are not able to get capital as easily as they should. That is one area.

The second is energy. I think, unless we can work with the Chinese effectively on energy and cooperate—and they need a lot of things that we can provide, clean coal technology, for instance, biomass technology, a lot of things that can help them reduce dependence on imported oil, can be very helpful to our companies as well because we have very good energy technology.

Also, if we can do this, we help to avoid the kind of confrontations that are likely to occur if, instead of working together with the Chinese on energy, we are at odds with them on this. I think one thing I have put in my written testimony is to have a Cabinet-level committee on energy cooperation and to develop, as a result of President Hu's visit here, a U.S.-China energy partnership, which could bring in other countries like Japan, which also, as you know, has very positive technology.

These are the kinds of things that I think are extremely important in the overall relationship and I think could actually help considerably to build off the relationship that can help to deal with the big imbalances that are occurring, because there is a mutual benefit in the relationship we have had with the Chinese, but it is going to get more and more stressed, and there will be more and more friction, and there will be more and more frustration on the part of this committee, others on the Hill, and Americans, if this large imbalance remains or gets bigger.

Therefore, I think it is in the Chinese's interests to try to do something about it, as it is in our interests to put these kinds of items on the agenda, and a summit meeting of President Bush and President Hu is an important opportunity. I would say it is in the Chinese interest not to wait for that, but to do as much as they can prior to that visit in order to set the stage for positive dialogue.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

[The prepared statement of Mr. Hormats appears in the appendix.]

The CHAIRMAN. Mr. Frisbie?

**STATEMENT OF JOHN FRISBIE, PRESIDENT,
U.S.-CHINA BUSINESS COUNCIL, WASHINGTON, DC**

Mr. FRISBIE. Thank you, Chairman Grassley. I appreciate the opportunity to testify today.

The U.S.-China Business Council, as you may know, represents approximately 250 U.S. companies that are doing business in and with China. We are now in our 33rd year of existence.

Throughout our existence, we have pursued a balanced approach to our trade policy with China. This balanced approach recognizes the significant benefits that trade and investment with China have provided U.S. companies and the American economy. At the same time, we pursue resolution to the problem areas in our trading relationship.

My written statement lays out our views on today's topic in some detail. In my oral statement, I would just like to touch upon three items that I understand are of particular importance to the committee, and that is the USTR's top-to-bottom review, the currency issue, and the upcoming Joint Commission on Commerce and Trade meeting.

In regards to the top-to-bottom review, we welcome the findings and recommendations included in the USTR's report. As you are aware, the report proposed enhancing USTR's enforcement capabilities, increasing staff both in China and in Washington, and improving coordination with our other trading partners on China issues. All of these, in our view, would be helpful in addressing the concerns of the U.S. business community.

Based upon my 20 years of doing business with China, resolution of these problems is best pursued with the type of constructive engagement that USTR is proposing. We support the refocusing of their resources described in the report and anticipate tangible results and a stepped-up engagement effort.

On China's currency, this issue, more than any other, has certainly captured the attention of Congress and much of the public debate about China trade. As we noted in our testimony submitted last year, China should indeed adopt a more permanent exchange rate.

Our focus, we think, should be on encouraging China to undertake the broader financial sector reforms that will enable it to remove capital controls at some appropriate point in the future and allow those market forces to determine the value of the currency.

We understand Treasury is having this sort of dialogue in these broad reforms now, and we support that dialogue. In the meantime, China should move more quickly to allow market influences with trade flows to be reflected in the exchange rate.

This is a message that I delivered, by the way, in several meetings in Beijing in February when I was out there with Vice Minister Ran, including people back in China. Certainly last July's change is welcomed by all.

Movement since then to allow market influences a greater role in setting exchange rates has been slow, although I think, as noted earlier, the pace has picked up somewhat in the last month or so.

My meetings in Beijing, as well as the reading of Chinese language press when I was there in February, suggest that Chinese

economists and currency traders themselves anticipate gradual appreciation to continue over the balance of this year.

The third item I want to touch on is the JCCT meeting coming up on April 11th. That, in turn, comes in advance of President Hu's visit to Washington later on in the month.

China has done moderately well in following through on the commitments it has made as part of the JCCT process, but some issues remain unresolved. For us, two areas, we think, must be central in this year's meeting.

First and foremost is IPR enforcement, as has been talked about a lot today. This is the top problem cited most by our membership. Intellectual property piracy simply must not be tolerated. At the same time, we have to recognize that this far-reaching problem is not going to be solved overnight.

The key is, China needs to be able to show steady progress in reducing piracy. I think the challenge for us, in turn, is to identify specific measures for adoption in the JCCT process that, if implemented, will lead to such tangible progress. Last July's JCCT IPR-related measures were a good step in this direction, and I think we need to continue that approach in April of this year.

The second issue that the U.S.-China Business Council believes must be addressed in this year's JCCT is subsidies. If we are to seek a level playing field for U.S. companies operating in China, as well as for American companies facing Chinese competition at home and in other markets, we need to devote more effort and resources to better understand this aspect of China's economy.

China's WTO entry agreement required it to file a report on its subsidies upon accession in 2001. That deadline, of course, was missed. At the 2005 JCCT, China agreed to submit the report by the end of last year. It has still not been submitted. This report must be completed and submitted right away.

This report is not going to likely provide the details and complete picture needed, but it is a necessary first step to getting at this important aspect of a level playing field.

Apart from these two broad issues, we certainly hope the JCCT will successfully address other, more specific issues that USTR and Commerce are well aware of in terms of input from the business community, and we know they are discussing those actively with their PRC counterparts.

Let me conclude there. Thank you very much.

The CHAIRMAN. Thank you.

[The prepared statement of Mr. Frisbie appears in the appendix.]

The CHAIRMAN. Mr. Joachim?

**STATEMENT OF GARY JOACHIM, VICE PRESIDENT,
AMERICAN SOYBEAN ASSOCIATION, OWATONA, MN**

Mr. JOACHIM. Good afternoon, Mr. Chairman. I am Gary Joachim, a soybean and corn farmer from Owatona, MN. I currently serve as vice president of the American Soybean Association.

ASA represents 25,000 producer members on national issues important to U.S. soybean farmers. We appreciate your invitation to testify today on the current state of U.S.-China economic relations.

It is impossible to overstate the importance of China as a market for U.S. soybeans. In 1996, the U.S. sold \$414 million worth of soy-

beans to China, a significant market at the time. Last year, the value of our soybean exports reached \$3 billion. This is more than a seven-fold increase in a decade in which China emerged as the largest foreign buyer of U.S. soybeans.

The 405 million bushels exported to China in 2005 represented 40 percent of total U.S. exports, and 13.5 percent of last year's U.S. soybean crop. Prospects for continued growth in Chinese soybean imports are excellent.

China's population of 1.3 billion is close to leveling off, but its urban component has more than doubled since 1980. As per capita income has risen to \$1,300 a year, more Chinese consumers can afford a diet higher in protein and vegetable oil.

Annual consumption of protein meal is currently 30.9 pounds per capita, just 27 percent of the level we consume in the U.S. China's per capita consumption of vegetable oil is 15.7 pounds, or 44 percent of the U.S. level.

As demand continues to grow, China's inability to significantly expand their domestic production of soybeans and other oil-seeds and beans means that most of these requirements will come from imports. ASA has worked closely with this, and previous administrations, to increase access to this growing Chinese market through trade negotiations.

We have provided specific objectives to U.S. negotiators during talks on China's accession to the WTO, and strongly supported Congressional approval of this agreement.

As negotiations under the current Doha Round proceed, additional reductions in China's agricultural tariffs and expansion of its tariff rate quotas will be critically important to achieving a successful final agreement.

I would like to comment more specifically on the importance of improved access in China in the Doha negotiations. According to a preliminary analysis by the American Farm Bureau Federation, China will play a significant role in the final economic impact of a WTO agreement on global agricultural trade.

The analysis assumes that China will be subject to whatever market access commitments are required of developing countries, or a 40-percent reduction. It does not, however, take into account the possible exclusion of sensitive or special products from formula tariff reductions.

Based on these assumptions, the Farm Bureau analysis indicates China will account for between 35 and 40 percent of total agricultural trade gains from a new agreement.

This amount includes 85 to 90 percent of the increased global trade in soybeans and soybean oil, and 40 to 45 percent of the increased trade in soybean meal. China will also account for a substantial amount of the increase in trade of other agricultural commodities.

Given the high dependence for increased exports of key U.S. agricultural products on improved market access in China, it is critically important that China accept the same tariff reductions required of other developing countries.

We must also prevent key U.S. agricultural product exports, including livestock products, from being excluded from full tariff re-

ductions or tariff rate quota expansion through designation as “sensitive” or “special” products.

Unless China is a full participant, it is doubtful there could be enough expansion in trade in a final agreement to justify the concessions the U.S. has offered to make on reducing trade-distorting domestic support.

We are aware of concerns with China’s \$200 billion-plus trade surplus with the U.S. and proposals to impose a high punitive tariff on Chinese imports if China does not revalue its currency against the dollar.

As ASA indicated in testimony to this committee last June, we are concerned that higher tariffs on Chinese goods could trigger retaliation by China against U.S. imports. As an alternative for addressing the trade imbalance, we would encourage the committee to ensure that China undertakes full market access commitments in the Doha negotiations and that the number of agricultural commodities that can be designated as “sensitive” or “special” be extremely limited. If successful, this course of action would increase U.S. agricultural exports to China rather than causing them to be restricted.

As we also indicated in our June testimony, our industry’s trade relations have not been without difficulties. These problems have included uncertain and changing requirements on the imports of biotech soybeans and various restrictions based on the reported presence of diseases or fungicide residues.

While we have not experienced disruptions in the past 2 years, the potential for unexpected actions in the future remains a serious concern. However, we believe the relatively smooth course of our trade relations with China in recent years is due, in part, to the resolution of disputes through reinforcement of the mutual benefits of free and balanced trade rather than through public confrontation.

In closing, Mr. Chairman, China is a vital and growing market for U.S. agricultural sales. Including China as a full participant in the current WTO market access negotiations is critical to achieving a meaningful improvement in world trade and agricultural products. ASA urges the committee to focus on this priority as it addresses the current U.S.-China trade imbalance.

Thank you for the opportunity to appear today, and I will be happy to answer any questions.

The CHAIRMAN. Thank you.

[The prepared statement of Mr. Joachim appears in the appendix.]

The CHAIRMAN. Dr. Bergsten?

STATEMENT OF DR. C. FRED BERGSTEN, DIRECTOR, INSTITUTE OF INTERNATIONAL ECONOMICS, WASHINGTON, DC

Dr. BERGSTEN. Mr. Chairman, thank you very much for the invitation to appear before the committee again. Let me start by congratulating you and Senator Baucus on the legislation that you introduced yesterday.

Your Trade Enhancement Act will be a major improvement in U.S. law, particularly regarding the currency and foreign exchange

issues, and it ought to be adopted, even if there were no current problem with China.

It will no doubt help deal with the current problem with China, as I will indicate, but I applaud your initiative in any event. I hope you will pursue it as expeditiously as possible.

I also appreciate the opportunity to give you a copy of a new book on China that I have co-authored with colleagues at the Institute for International Economics and the Center for Strategic and International Studies, who did the security part.

We immodestly subtitled the book, "What the World Needs to Know Now About the Emerging Superpower." It is a very serious effort to do a factual analysis of what China means for the world that avoids a lot of the rhetoric, politics, and emotion in the current debate, and we hope it will be helpful to you and your colleagues in the Congress, as well as the public more broadly.

Let me make three points, and then I will be happy to answer any questions. I have given you a more elaborate analysis in my written statement.

The first point is that a change in China's currency policy, the exchange rate issue that has been discussed so much this morning, is by far the most important issue in U.S.-China economic relations. I do not mean to denigrate intellectual property rights or any of the other topics that have been discussed here.

But getting China to revalue the renminbi by, say, 20 percent, and getting the other Asian currencies to move up by a similar amount, which would be likely, would reduce the U.S. global current account deficit by \$60 billion to \$80 billion per year. So the payoff is huge.

Pursuing the issue is important to reduce our unsustainable international imbalance. It is important to bring China's huge surplus down, and it is clearly the number one issue.

Second, and really picking up on a point Senator Bingaman made, China's currency issue has to be regarded in two steps, over two time periods. It is well and good, as Under Secretary Adams says, that the Chinese should adopt a more flexible exchange rate—over the long run, they should.

The Chinese say they want to do it, and I think they will do it, but not until they reform their banking system sufficiently to avoid the risk of capital flight and destabilization from that more flexible exchange rate. Resolving their banking problem is going to take some time.

In the short run, therefore, what's needed is a one-step revaluation or series of revaluations of the currency or a managed upward float in which the Chinese push the renminbi up. But we should forget about any notion that they are going to have a freely floating exchange rate any time soon and that market forces will then push the renminbi up.

That is just not going to happen in light of their banking system. We need to focus instead in the short run, meaning several years, on more discrete, hopefully sizeable, and managed increases in the value of their currency.

They have demonstrated clearly they can manage an avoidance of a stronger value for the renminbi. They have intervened to the tune of \$20 billion per month for the last 3 years to do it. That is

where their almost \$1 trillion in foreign exchange reserves comes from.

They can also clearly manage it up by either revaluation or an upward float, if they wanted, and that should be the objective of U.S. policy. We must keep in mind that they need to do it not only quickly but also by a large amount.

Our calculation is that their currency, judged on a global basis, is undervalued by 20 to 40 percent. They need a big revaluation. They are obviously not going to do that overnight or in one step, but something moving in that direction decisively and with a major down payment soon is required.

The critical question, then, is how do we get them to do it? They obviously do not want to do it. It is equally obvious that the administration's quiet diplomacy has borne very little fruit, even when the pressure has been stepped up a little bit over the last 6 months or so.

We clearly need a new policy approach, and I would hook it, as several members have today, to the upcoming visit of President Hu Jintao in April.

One cardinal requirement, I would argue, is for the administration and Congress to adopt a unified, or at least consistent, position.

The administration has tended to be the "good cop," with quiet diplomacy, and the Congress has been the "bad cop," particularly your colleagues Senators Schumer and Graham, with their across-the-board tariff.

The Chinese have been able to exploit the difference between the administration and Congress, essentially counting on the administration to save them from Congress, and that bet has paid off so far. I think you have to get the two ends of Pennsylvania Avenue together.

I propose a four-part strategy. First, the administration should notify the Chinese right away that unless they make a significant down payment appreciation of at least 10 percent of their currency prior to the release of the U.S. Treasury's next semi-annual report, the Treasury will label China a currency manipulator under current law. It is absolutely clear that the manipulation has taken place for years. Treasury will lose all credibility if, once again, it fails to label China. But the administration should tell China right now that Treasury is going to label it a manipulator a month from now, or whenever the report comes out. This will give the Chinese a chance to head it off by making a serious down payment. I think there is a significant chance the Chinese would do that. They do not want to be named and shamed. They do not want this to disrupt the Hu visit. The Treasury should tell the Chinese that right now.

Second, Treasury should also tell its G-7 partners and the IMF that it is about to label China a manipulator and thus escalate this debate quite substantially. That will help bring the G-7 countries and even the IMF, which has been pretty recalcitrant on all this, into support for getting action on the issue.

We need to multilateralize the approach. But the IMF can say that the Treasury itself has not ever labeled China a manipulator, why are you asking us to do so at the IMF?

If the Treasury now indicates that it will label China a manipulator, then there is a good chance to galvanize the international community and the multilateral institutions that should be out in front on this. The United States cannot do it if it does not lead. But if it does, it can galvanize support. This would be step two in my strategy.

Third, the administration has to tell the Chinese that unless they move by an acceptable amount and at an acceptable speed to revalue the currency, the administration will no longer be able to oppose responsible Congressional initiatives to address the issue, particularly the bill that you, Mr. Chairman and Senator Baucus, have just introduced.

The Grassley-Baucus legislation, as you well know, would provide explicit sanctions against China, or any countries whose currencies are in fundamental misalignment, including some things the Chinese want: a larger quota at the IMF and revocation of their status as a non-market economy.

In the discussion with Under Secretary Adams, a couple of people raised the question, do you have the tools? I used to be in that job, Mr. Chairman. The administration does not have the tools.

Your legislation would give responsible tools to the administration, not like an across-the-board import surcharge, but responsible tools that the Chinese would not want to see deployed against them.

So this legislation is one that the administration, if it cannot support it, certainly should not oppose. The administration should let the Chinese know they are not going to save them from Grassley-Baucus.

Fourth and finally—I will not make the fifth point in my written statement here—the Congress should proceed with all due speed to pass Grassley-Baucus anyway. The currency sections of your new legislation are vastly superior to the 1988 law. They ought to be put into law as soon as possible, even if there were no current China problem.

But the administration can let China know, and China will see itself, that if it continues to fail to take adequate action on the currency front, passage of the bill will give the administration new tools, and will indeed insist that the administration use those tools to achieve the required currency correction.

So, if we can get the administration to itself recognize it has to label China now, tell the Chinese now so it could put them on notice, mobilize the multilateral community, and have your legislation coming as quickly as possible to provide the back-up, we would have a new strategy in this area that would bring some promise at long last of resolving the most central issue of U.S.-China economic relations today. Thank you.

The CHAIRMAN. Thank you very much.

[The prepared statement of Dr. Bergsten appears in the appendix.]

The CHAIRMAN. I would like to get four or five questions in in about 10 or 12 minutes, so if you could keep your answers short, I would appreciate it. You could expand in writing, if you would, if you need to go beyond that, because there are some meetings I have to go to.

Bob, one of the arguments against currency reform is that China's financial system is too shaky. Your view on that.

Mr. HORMATS. Thank you. I actually think that the financial system in China does really need reform. I think that one of the things they are in the process of doing, and Tim Adams mentioned this a little while ago, is trying to get their system better able to cope with the kind of changes that would be required were they to raise their currency. But I do not think that is a deterrent at this point to some revaluation of the currency.

I think that the two really go hand in hand. In one sense, they should be reforming their financial system. They should be doing a number of things to cushion the domestic economy from the kinds of changes that they regard as being difficult for them.

But it should not deter them from some adjustment right away. They have been, in fact, reforming their system for quite some time, so it is far better able to cope today than it would have been a year or two ago. So, I can see part of that argument being valid, but I do think there is an opportunity for them to raise the value of their currency without major disruption.

Moreover, the key point is that it creates the right incentives for doing what the Chinese want to do anyway, which is to shift a certain portion of their investment away from export-oriented products, more toward the domestic economy, and to shift a larger portion of their GDP away from an export focus to improving domestic living standards.

And to the extent they raise the value of the currency, they create the kind of investment incentives and the kind of incentives for shifting the economy away from too much dependence on exports to a lot more emphasis on domestic demand improvement and consumption improvement, which they need to deal with some of the instability that they have in central and western China, where people feel that their standard of living is not rising enough. Part of the currency shift would help in achieving that goal, so that would help stability.

The CHAIRMAN. Mr. Frisbie, China is using an industrial policy for their domestic industries. How much of an input do foreign companies like the ones you work with have as the government shapes those industrial policies, and how would you recommend that we approach this issue with China?

Mr. FRISBIE. I think it is a mixed record. On the positive side, we can look at things. For example, a current issue, China's anti-monopoly law that is being developed. They have issued several drafts of it publicly and they have allowed foreign companies to comment on it, as well as other organizations, and there have been changes in those drafts in response. So there are some positives to point to.

But on the other hand, a key part of industrial policy is the setting of standards. I think that we feel that process is still too opaque in China. Obviously it affects a broad variety of industries.

Which gets to another point I guess I would make, too. I mention we serve our membership regularly on their issues, and that IPR is the top one in our most recent survey.

But number three on that list is transparency. That has always been in the top 10. It has usually been lower, perhaps because

other issues were deemed to be more important. But it has moved up to be the third issue and it is consistently cited by companies operating in China. That is one that I think needs to be gotten at better.

This is also something that should be addressed, I think, certainly for the JCCT process and beyond, in terms of China doing a better job, perhaps along a *Federal Register* type system, to have drafts of laws, regulations, and so on be put out there for public comment.

The CHAIRMAN. Thank you.

Mr. Joachim, as a fellow farmer, I know that you raise a legitimate question when you express concern about, if we put additional tariffs on imports from China, then we might be retaliated against.

If that were the case, how credible is it that the Chinese would retaliate against exports of our soybeans? Could supplies from other countries compete with U.S. soybeans and take up the slack, which obviously would hurt American farmers?

Mr. JOACHIM. Mr. Chairman, that is probably, indeed, what would happen if the Chinese decided to retaliate against our agricultural exports. Obviously it would cause a disruption in trade, and of course that would mean lower prices not only for our farmers, but actually for everybody who grows soybeans in the world. There is a reason we sell so much of our crop to China: we have transportation advantages that the South Americans do not have.

The CHAIRMAN. Dr. Bergsten, what policy should we pursue to help foster domestic demand-based economic growth in China versus export-led growth?

Dr. BERGSTEN. We address this topic at great length in our new book, Mr. Chairman. There is a very natural set of policies. As China has deregulated and privatized its state-owned enterprises, a lot of the benefits previously provided to the citizenry by the state-owned enterprises have disappeared: health care, free education, pensions, etc.

So now less than 20 percent of the Chinese population has any health insurance or any pensions at all. In rural areas, until very recently, the Chinese had to pay for primary education.

China, thus, has an enormous opportunity to respond to its social problems, which have led to a lot of disruption in the countryside, by increasing government programs for health care, pensions, and education, all of which, in economic terms, mean spending on domestic demand, thus giving China a big, new jolt of growth, simultaneously meeting priority social needs and shifting growth from the export side to the domestic demand side. In short, it is a win-win set of policy changes. The Chinese are aware of it. They are moving, but very slowly, in that direction.

They need to consciously phase in those new domestic social spending programs in parallel with phasing in the needed rise in the value of their currency and therefore the reduction of their trade surplus. Done properly, the two things will intersect and mesh very nicely. They can keep 8, 9, 10 percent growth but alter the composition in ways that are desirable both domestically and internationally.

Mr. HORMATS. And I think they are in the process of doing it, but it is slower, and the resource allocation required is probably greater than they budgeted so far. But they know they need to do it, because there are lots of social pressures in China.

There are lots of demonstrations, violent demonstrations, against income inequality and against the number of the kinds of issues that we are talking about: health insurance, education, taxation. They have to do this, particularly in rural China. That will help. They know they have to accelerate the process for their own good reasons, but it helps us also.

Dr. BERGSTEN. Since Mr. Hormats has added a word to my answer, could I add a word to the question you asked him at the start about the effect of greater exchange rate flexibility on their banking system, and vice versa?

The CHAIRMAN. Yes.

Dr. BERGSTEN. The distinction between the kinds of exchange rate change is very important. A theoretically pure floating exchange rate, which also means getting rid of all capital controls, would pose a big risk for the Chinese financial system because, under that approach, a lot of capital flight could occur. People who are worried about Chinese banks could move money out, and the Chinese economy could be at risk. The Chinese know that, and therefore they are not going to do it.

By contrast, one-step revaluations of the currency will permit them to keep the fixed exchange rate within very narrow margins and keep the capital controls. Doing so would have no discernibly negative effect on their banking system at all.

That is a major reason, in addition to the need for a speedy, large change in the currency relationship, to do it that way and stop harping on greater flexibility, which I am afraid the U.S. Government, the world, and the IMF have done, thus giving the Chinese an easy out for the last 3 years. The debate needs to focus on what could be done practically and in large amount in the short run.

Mr. HORMATS. I agree with that. They are not going to let their currency float freely for a very long time.

The CHAIRMAN. Thank you all very much. The hearing is completed. Thank you all for coming.

[Whereupon, at 12:30 p.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

U.S. TREASURY DEPARTMENT OFFICE OF PUBLIC AFFAIRS

STATEMENT OF
UNDER SECRETARY FOR INTERNATIONAL AFFAIRS TIMOTHY D. ADAMS
BEFORE THE SENATE FINANCE COMMITTEE
U.S.-CHINA ECONOMIC RELATIONSHIP REVISITED

Mr. Chairman and distinguished members of the Committee, I am pleased to be with you today to discuss Treasury's economic engagement with China, what we have achieved and the critical work to be done. The U.S. relationship with China may be the single most important economic relationship of the 21st century. Underlying Treasury's engagement is the fundamental belief that a broad, mature, candid, and constructive relationship with China will bring results that are good for the American people. When Secretary Snow traveled to China last fall, he articulated the three pillars of what China needs to do to contribute to sustained global growth and eliminate distortions and imbalances. These are: (1) adopt a more market-based, flexible exchange rate; (2) shift from investment- and export-oriented growth to a more consumption-based economy; and (3) reform and open up China's financial sector, including its capital markets. Implementing these reforms will promote an orderly reduction of global imbalances and lead to sustained and less volatile Chinese growth to the benefit of its own population and the global economy.

The Chinese have made some important achievements on these three pillars, but they still have much to do. Today I would like to describe those areas where greater efforts are needed. The best place to begin is by discussing more broadly U.S. economic relations with China.

China's Importance

Almost 20 years have passed since China began its transition to a market economy, and China has seen its standard of living surge. It has gone from maintaining an autarkic trade policy to subscribing to the WTO principles of open and fair trade, and from being a minor player in global trade to a major player in the global economy. China is now the world's 4th largest economy and the 3rd largest trading nation. The United States has benefited from China's growth: U.S. exports to China have grown at five times the rate of our exports to the rest of the world since China joined the WTO. Growth in exports to China has exceeded 20 percent over the last three years and China has risen to our fourth largest export market.

Variations in China's growth rate now have a significant impact on the global economy and a major impact on markets for steel, oil, copper and a variety of other products. Moreover, the U.S. and China together have accounted for almost half of global growth since 2000. A prosperous and secure China that meets its international obligations and is fully integrated and engaged in the global economy and

global economic institutions is in our interest, and in China's interest. It presents enormous opportunities for U.S. workers and firms.

Economic Challenges

China's rapid growth and the character of that growth also pose challenges – for China and for the rest of the world. While China's growth has been rapid, it has depended too heavily on investment growth and increasingly on net exports.

Net Exports and the Current Account

Opening the Chinese economy to trade was a major factor in the development toward a market economy in China and the acceleration of Chinese growth. Chinese imports have grown rapidly along with Chinese exports, so that increases in the trade surplus have until recently made only a small contribution to Chinese growth. But the last two years have seen a dramatic increase in China's global trade surplus – from \$25 billion in 2003 to \$102 billion in 2005. Net exports accounted for 12 percent of real GDP growth in 2004. China's overall current account surplus has also risen sharply, from \$17 billion in 2001 to \$69 billion in 2004, and estimates for 2005 are near \$150 billion, or almost 7 percent of China's GDP. China's current account surplus is now a major component of global imbalances, and its continuation risks undermining support for the open trade policies which have contributed so much to China's development. China is now simply too large to rely on export-led growth to pick up the slack when other sources of growth falter.

Investment

The dependence of Chinese growth on investment is even more striking. In each of the years since 2001, investment has accounted for more than 60 percent of GDP growth. Even with the new, revised GDP figures, China's investment is over 40 percent of GDP – significantly higher than other East Asian countries – and that share is still climbing. The result is an economy that has been skewed too heavily towards investment, much of it with little return.

Overall productivity growth has fallen since the early 1990s, and increased capital and labor input, rather than greater productivity, now accounts for the bulk of China's growth. The heavy dependence of growth on investment raises risks to the Chinese and global economy. China has a long history of credit-fueled cycles of investment-led booms and busts. To sustain rapid and stable growth in the future, China will need more selective and more productive investment. Given China's current size and integration into the global economy, the next Chinese downturn will have a global impact, and affect U.S. jobs and prosperity.

Treasury's Intensive Engagement with China

Treasury is in frequent and substantive consultations with the Chinese government on exchange rate and financial market reform issues. Secretary Snow and Finance Minister Jin convened the 17th Joint Economic Committee (JEC) meeting last October in Beijing, which covered a wide array of economic policy, financial sector, and capital markets issues. Over the past few years, we have broadened the JEC to include a range of senior Chinese and U.S. financial officials, including the National Development and Reform Commission (NDRC), and China's chief financial regulators. Treasury also conducted the first meeting of the Sino-U.S. Financial Sector Working Group, which brings together U.S. and Chinese financial regulators at a more technical level. We will host the next session in April.

In 2005, Secretary Snow dispatched a high-level envoy to conduct quiet and meaningful talks on the three pillars of our strategy, with special focus on exchange rate flexibility. Next month, Treasury's financial attaché, Dave Loevinger, will take up residence in Beijing. Getting more representatives on the ground, where they can advocate for U.S. interests, is part of Secretary Snow's initiative to place Treasury staff in the largest and fastest growing emerging markets, and is included in the President's FY 2007 budget request.

Two years ago, Secretary Snow launched a Technical Cooperation Program (TCP) to help the Chinese authorities overcome the technical obstacles they had identified to greater exchange rate flexibility. Treasury has hosted a number of exchanges, including training on developing and regulating financial futures markets.

Encouraging China to meet its responsibilities is a global task as it has global implications. To leverage our own efforts, we have enlisted support from China's major trading partners particularly through the G-7, APEC, and the IMF.

We believe the most effective way to promote change in China, including on the exchange rate, is by working in cooperation with our Chinese counterparts. There are several bills in Congress that would close our markets to Chinese goods if China does not move more on its exchange rate. We do not support those isolationist approaches. They would damage our economy and not achieve our shared goals.

In addition, we are reviewing the legislation Chairman Grassley and Senator Baucus introduced yesterday and look forward to providing our views on that legislation once our review is complete. With this strategy in place, it is useful to take stock now of how China has responded to the three pillars: greater exchange rate flexibility, balanced growth, and reform of China's financial sector.

Three Priority Issues

I. Exchange Rate Policy: Encouraging China to move more rapidly to a more market-based, flexible exchange rate regime is Treasury's number one priority. Exchange rate flexibility is in China's interest. Greater exchange rate flexibility will strengthen the ability of Chinese monetary policy to help assure sustained growth, avoiding the boom-bust cycles that have characterized Chinese growth to date. Greater ability to control domestic interest rates will also lead to more efficient financial intermediation, and help avoid credit-fueled investment booms and resulting buildups of non-performing loans. As China's transition to a market economy proceeds, command-and-control tools will lose their effectiveness, and interest rates and other price mechanisms will become more important. The price signals that come from a flexible exchange rate will be a critical part of readjusting China's economy to produce more balanced and sustainable growth. Finally, a more flexible Chinese exchange rate will help address global imbalances, particularly as it is likely to allow other Asian economies to adopt more flexible exchange rate regimes.

The Chinese leadership has publicly committed to greater exchange rate flexibility. Despite internal criticism on the pace of market reforms in China, Premier Wen reaffirmed this commitment in his press conference following the closing of the National People's Congress on March 14, saying China "will expand the foreign exchange market and allow more flexibility and fluctuation of the currency."

Our engagement with China on exchange rate policy is not now about "whether" but about "how quickly." China has made some progress in making its currency more flexible and market-determined, starting with the adoption of its new exchange rate mechanism last July. It has gradually allowed more movement and flexibility. It has authorized inter-bank trading of currency and more participants in the

foreign exchange market. China has also introduced new financial products to hedge against currency risk, and strengthened its banks and its supervision of the financial system.

But to date China's progress has been far too cautious. Since China began changing its exchange rate last July, the RMB has appreciated by only 3.2 percent and the day-to-day fluctuation has been severely constrained. It has also failed to test the limits of the current narrow intra-day trading bands. That said, the RMB continues to be much more stable against the dollar than it is against a trade-weighted basket of the Yen, the euro, and the dollar (the renminbi's nominal effective exchange rate appreciated by around 9 percent in 2005). This tight control over the exchange rate prevents the market incentive needed to develop liquidity and hedging instruments. And China continues to accumulate foreign exchange reserves at an excessive pace. China's foreign exchange reserves are almost 600 percent of its short-term debt in 2004, while economists consider 100 percent coverage prudent. As a result neither China, nor the global economy, has reaped the benefits of a more flexible exchange rate. The Chinese government must allow market forces to play a much greater role in the determination of the RMB's value. The obstacles are no longer technical; China could easily move more rapidly towards greater flexibility. It should do so now.

II. Rebalancing Growth Towards More Domestic Demand: In addition to greater exchange rate flexibility, sustaining rapid and steady growth in the Chinese economy without the buildup of a large external imbalance will require a more balanced pattern of Chinese growth, with a much greater role for consumption, which is an estimated 47 percent of GDP under China's revised GDP statistics, compared to over 60 percent for India, 57 percent for Japan in the 1960s, and 67 percent for Korea in the 1970s, all periods of rapid growth in those economies.

The counterpart to China's high investment and its current account surplus is a savings rate of roughly 50 percent of GDP, which may be the highest in the world. One World Bank study estimated that China's savings rate was 10 percent of GDP higher than one would predict from China's economic and demographic characteristics. Chinese households save 25 percent of their income, on average, mostly in the form of low interest-earning bank deposits. Household saving reflects a weak social safety net and limited access to financing and insurance; households need high savings in the event of serious illness, disability, or to pay for children's education. The "iron rice bowl" of cradle to grave wages and benefits is gone and a modern social safety net has not yet been erected. Chinese state and private firms also save heavily – and invest the earnings they have rather than paying out dividends.

China's leaders recognize the importance of lowering the savings rate and boosting domestic demand, and achieving more balanced growth is central to current Chinese policy. To spur domestic demand, China has placed strong emphasis on consumption and rural development in its most recent Five-Year Plan. To boost disposable incomes of the rural poor, the government has recently decided to cut agricultural taxes and eliminate fees for rural primary education. It also plans to direct more capital and social spending to the rural sector.

There are a number of additional steps that China could take to lower savings and boost domestic demand. Policies to encourage China's state-owned enterprises to pay some of their earnings as dividends would reduce their savings and their inefficient investment, and could contribute to greater social welfare expenditure or reduced taxes. Strengthening and increasing enrollments in public pension and health insurance systems, particularly in rural areas, are also important steps.

Increasing the range of financial products available to households is also a critical component. Household saving could be reduced by insurance policies covering disability and catastrophic illness, by the ability to finance education and other major expenses, and by making higher return investment options available to households, including those overseas.

III. Financial Sector Reform: This brings me to the third pillar of our strategy – financial sector and capital markets reform. Inefficient financial intermediation remains the Achilles heel of the Chinese economy. China’s financial institutions were built as an appendage to the planning system, their funds still go primarily to state-owned enterprises. The large amount of non-performing loans reflects the failures of the planning system.

There has been notable progress on banking reform. In the last 18 months, foreign strategic investors – including U.S. institutions such as Bank of America and Citigroup – have invested more than \$17 billion in Chinese banks. In addition, international institutional investors invested around \$11 billion in the Hong Kong IPOs of two of China’s five largest banks. On the regulatory front, China has been tightening its risk classification system for bank loans, deregulating bank lending rates, and developing financial-sector infrastructure, such as the nationwide credit bureau launched in January and a deposit insurance system expected later this year.

China has also undertaken a number of steps to develop its capital markets. Reforms to reduce the overhang of non-tradable (predominantly government-owned) shares are moving forward. China expanded the Qualified Foreign Institutional Investor (QFII) program to allow more access for foreign investors to companies listed on local stock exchanges and has also launched a separate program to allow large, long-term strategic investors to purchase local shares above and beyond the QFII program. U.S. securities companies are also benefiting from Chinese equity offerings overseas. In 2005, Chinese companies raised more than \$25 billion in equity in Hong Kong alone, and U.S. securities companies (such as Morgan Stanley, Merrill Lynch, Goldman Sachs, and JP Morgan) were the lead arrangers for 44 percent of those issuances. Assuming underwriting fees of between 3 percent and 5 percent, U.S. securities companies earned between \$335 million and \$560 million in revenue from leading these Chinese equity offerings.

Despite this progress, much needs to be done to improve China’s financial markets. China’s stock markets are still too often viewed as a way to keep inefficient state enterprises afloat rather than as a way to channel capital to the most competitive firms and sectors and a way to transfer control to more productive owners. Deeper bond markets would reduce corporate reliance on state-controlled lenders and more active derivatives trading would allow firms to better manage risk. On the banking side, the state dominates: government entities own all but one Chinese bank, and the central government’s “Big 4” banks account for more than half of financial sector assets. This pervasive state involvement has led to inefficient allocation of resources and a large build-up of non-performing assets.

To help modernize China’s financial system and capital markets, Treasury has identified a number of priorities. First, we believe it would be in China’s best interest to allow more competition and market forces into the sector, in particular, by eliminating ownership caps on foreign stakes and expanding the scope of products they can offer.

Second, China’s regulators and firms need to improve capacity for risk management. This involves better accounting and financial reporting, and institutions such as an effective nationwide credit bureau accessible to all financial services providers (including foreign banks and other non-bank financial companies). An essential component of this effort will be to establish a consolidated supervision framework for financial institutions in China.

Third, China needs to improve opportunities for private companies to obtain finance so that capital can be channeled to its most productive and efficient uses and support more balanced growth. In the corporate bond market, we have encouraged the authorities to eliminate duplicative government approvals and move to a more disclosure-based system. Such a system will require professional

institutional investors and independent, credible credit rating agencies. On the equity market side, we are arguing for an end to the moratoriums on new listings and sales of domestic securities companies to foreign investors. Finally, China needs to continue to privatize its extensive portfolio of state-owned enterprises.

We are also pressing China to make substantial new commitments in financial services as an essential element of any Doha agreement. China can open its financial system to competition by improving its WTO offer to allow 100 percent foreign ownership of subsidiaries, whether by new investment or acquisition, and allowing them to perform a full range of securities and asset management services. China's plan to open completely the banking sector to foreign participation by the end of 2006 is a key WTO commitment and something that Treasury will watch closely to ensure that regulatory impediments do not undermine China's meeting its commitment.

Another important area of engagement with China is protecting China's financial system from abuse. Overall, the U.S. has been favorably impressed by the political commitment to anti-money laundering and countering the financing of terrorism (AML/CFT) issues demonstrated by Chinese authorities. The U.S. is working in cooperation with the Chinese financial authorities to update their current legal provisions and improve regulations in their financial sector to combat money laundering and terrorist financing. These continued efforts will help reduce fraud and tax evasion, and help improve Chinese banks' access to other markets. We have been working closely – bilaterally and multilaterally – with the Chinese authorities on these issues in order to ensure that China joins the global community in adopting and implementing the international standards to combat money laundering and terrorist financing. China must strengthen its draft AML law, as it falls short in some key areas, such as its definitions of money laundering offences and rules for financial institutions to identify the beneficial owners of accounts.

Finally, let me address the concern of some members of this committee regarding China's holdings of Treasury securities. Chinese holdings are 3.2 percent of the \$8.2 trillion in total public debt outstanding, or 6.6 percent of the \$4.0 trillion in total privately held public debt outstanding. China has purchased around \$34 billion in Treasury securities in 2005. This is in the context of the extraordinarily deep and liquid Treasury market where daily turnover exceeds \$500 billion. China holds only about \$470 billion, or 2 percent, of a total of \$23 trillion in U.S. credit market debt securities.

Conclusion

China continues to undergo a historic economic transformation. Developing a constructive and mutually-beneficial economic relationship with China now is vitally important since the decisions we take in the next few years will guide the U.S.-China relationship over the next generation – and the shape and pace of global growth for years to come. As a significant member and beneficiary of the international economy, China should make a greater contribution to sustaining strong global growth by reducing its large current account surplus and working to maintain global support for open trade and investment. To put it simply, China must play by the rules of the system. Failure to do so entails consequences both for China and for the global economy. It is important that we manage our relations in a way that preserves global growth and maintains an open trade and investment policy, which is a “win-win” proposition for both economies. The U.S. Treasury is committed to promoting a path of mutual prosperity and global leadership in our economic relations with China.

Thank you for this opportunity to appear before the Committee. I am happy to take your questions.

**Questions for the Record From Hon. Timothy D. Adams
U.S. Senate Committee on Finance
Hearing on “U.S.-China Economic Relations Revisited”
March 29, 2006**

QUESTIONS FROM SENATOR GRASSLEY

QUESTION 1

In your testimony you note that “China is simply too large to rely on export-led growth.” Based on your interactions with the Chinese, do they appreciate that as well? To what extent is China willing to change its policies accordingly?

The Chinese authorities have indicated that they intend to shift the pattern of growth from one largely based on investment and exports to one led more by consumption. Most notably, the recent 11th Five Year Plan states that China’s future growth will be based on the expansion of domestic demand, particularly consumption, as a major driving force.

Premier Wen Jiabao reiterated this position, stating that increasing rural development could promote consumption. Premier Wen has stressed that the country must “pay more attention to social equity and social stability so that all people can enjoy the fruits of reform and development.” China will direct more fiscal spending to rural areas by reducing agricultural taxes and fees, building infrastructure and improving social services (including eliminating basic education fees and improving the affordability and quality of health care).

Central Bank Governor Zhou Xiaochuan recently outlined a five-part plan to reduce China’s current account surplus by expanding domestic demand, accelerating social safety net reform, allowing greater exchange rate flexibility, widening market access to foreign firms and lowering trade barriers.

Based on these public statements and my private conversations with senior government officials, I am persuaded that the Chinese government is making a concerted effort to re-balance the composition of China’s growth.

QUESTION 2

Does the current legal framework, which dates back to 1988, constrain you in pushing for exchange rate flexibility in Asia?

More flexible exchange rates in some emerging Asian economies would assist global adjustment processes generally, and the resolution of current global imbalances in particular. The Treasury has worked hard to make progress in this area. The 1988 Omnibus Trade and Competitiveness Act (the “Act”) is a less than perfect tool for

achieving these goals, and its focus on designating countries as currency manipulators has become so politically charged as to be very difficult to use in practice.

Much has changed in the global economy over the past 15 years, since Congress passed the Act, to render old concepts and definitions of less practical use. Many economies have liberalized and removed restrictions on capital account transactions with a corresponding sharp increase in the flow of funds internationally. The volume of capital account transactions now substantially dwarfs the volume of transactions involving trade in goods and services. In addition, asset and financial markets are much more internationally driven today than they were in 1988. Treasury has been sensitive to these evolutionary developments in the international financial system when conducting its analysis of exchange rates and when preparing its reports to Congress.

There are instances in which an exchange rate regime creates significant problems within the international monetary system that changes should be made in the regime. Because such situations exist in a number of emerging Asian economies, Treasury has made great efforts to convince officials responsible for those economies to institute greater exchange rate flexibility outside and inside the framework established by the Act.

QUESTION FROM SENATOR BUNNING

QUESTION 1

Mr. Adams, does it appear that there is speculation in Chinese currency? If so, what impacts is that having on the Chinese and the world economy and how would that speculative money react if the Chinese were to revalue its currency?

Despite China's capital controls, at various times it has experienced large inflows of funds on speculation of an appreciation of the RMB. These flows probably peaked in late 2004 and early 2005, when there was market anticipation of a near-term RMB appreciation (which occurred in July 2005). Though portfolio capital flows into China slowed markedly after July 2005, currency speculation remains a significant concern for China. Large capital inflows complicate China's conduct of monetary policy by creating excess liquidity at a time when the authorities are trying to rein in money growth. Large capital inflows also distort the capital allocation process in the Chinese economy, encouraging over-investment, risky lending, and speculation in real estate markets. These inflows also make it more difficult to develop prudent lending policies among China's commercial banks. Speculative funds flow in anticipation of future gains. Once those gains are realized, or once the odds of future gains diminish, then speculators take their money out. Moving the Chinese currency to a more market oriented system, where the prospect of gains and losses on the RMB are more evenly divided, will reduce the incentives for speculators to make one-way bets on the movement of the RMB.

QUESTIONS FROM SENATOR BAUCUS**QUESTION 1**

You have been a vocal critic of the IMF. You have called for reforms and you have called for vigorous IMF oversight.

(a) What is your vision of a reformed IMF?

The IMF has an important role to play in promoting growth and international financial stability in its member countries and the global economy as a whole. The Administration believes that refocusing on this core mission of international financial stability would benefit both the United States and the global economy. The 2006 National Security Strategy states:

“For the IMF, we will seek to refocus it on its core mission: This means strengthening the IMF’s ability to monitor the financial system to prevent crises before they happen. If crises occur, the IMF’s response must reinforce each country’s responsibility for its own economic choices. A refocused IMF will strengthen market institutions and market discipline over financial decisions, helping to promote a stable and prosperous global economy. By doing so, over time markets and the private sector can supplant the need for the IMF to perform in its current role.”

Consistent with this vision, the Administration has been pursuing four areas of reform in order to achieve this.

First, the IMF should carry out strong surveillance of exchange rates. The IMF – the only institution with a mandate to assure a smoothly functioning international monetary system – should be able to reach judgments about the sustainability of exchange rate policies and whether a member’s exchange rate policies are damaging to the international system; the IMF should be able to do that consistently across the membership. The IMF should be not only a trusted advisor to each of its members but the protector of the system as a whole.

- In *bilateral* surveillance, the Fund – with its wealth of expertise and experience across the globe – should identify exchange rate policies that are inconsistent with domestic conditions or the international system and advocate change. The Managing Director should hold consultations with members that have improper exchange rate policies. Regular use of the special consultations mechanism would lessen the perceived stigma associated with special consultations, and encourage better compliance with IMF principles for exchange rate policies.
- Better *multilateral* exchange rate analysis would facilitate identification of exchange rate policies that damage other members or pose a risk to the international financial system.

A second issue is crisis prevention, and particularly public debt sustainability in emerging markets. Domestic debt markets in many emerging market economies have expanded rapidly over recent years. While the IMF has traditionally looked at external debt, it should deepen its traditional focus on fiscal policy by increasing efforts to help countries improve their debt structures and management.

The third issue is crisis resolution. It will never be possible to prevent all crises, and the next crisis will likely differ from previous crises in unexpected ways. The IMF's crisis resolution framework is a mix of policy adjustment, official finance, and private finance. On policy adjustment, there will inevitably be a tough judgment call on what is both necessary and politically feasible. On official finance, the Administration won agreement on a new framework for large-scale IMF lending to provide increased predictability for markets, and there is now widespread adoption of collective action clauses in sovereign debt. On private finance, country authorities, private creditors and the official sector will continue to face the difficult task of discerning when a country's debts have become truly unsustainable. We have promoted steps such as the inclusion of collective action clauses in sovereign bond contracts in an effort to make the restructuring process more orderly.

Fourth, in low-income countries a reformed IMF must eschew the role of a development institution, and instead provide short-term financing in response to an actual balance of payments need. The Fund will be tightly focused on helping countries assess the macroeconomic impact of actual/plausible aid inflows and on improving fiscal and monetary management so that aid and domestic resources are invested wisely. With the recent implementation of 100 percent debt relief, the creation of a non-lending Policy Support Instrument, and the Shocks Facility of the Poverty Reduction and Growth Facility, and continued work by the IMF and World Bank on a framework to assure that debt is not rebuilt to unsustainable levels, the IMF is realistically poised to achieve this new role in low-income countries.

(b) What is the role of Asia, and what kind of actor would Asia be in that reformed IMF?

The governance structure of the IMF needs to evolve to reflect the growing weight of emerging markets – particularly but not exclusively in emerging Asia. This should be represented in an increase in quota for the most under-weight members (whose share in global GDP is much larger than their respective share of the IMF vote). The Executive Board should also better represent the relative importance of the fast growing emerging market countries. A strong and effective IMF that is relevant and responsive to all its shareholders will be better placed to promote growth and stability – an undertaking of key interest to the United States which itself represents over one-third of the world economy.

Increased weight brings increased responsibilities. Greater representation for Asia requires respecting the “rules of the road” of a market-based international financial system and assuming greater responsibility for the stewardship of the system. This means that authorities need to implement appropriate, sustainable exchange rate policies; consider the interests of the countries in whose currencies they intervene; and avoid

manipulating exchange rates to prevent balance of payments adjustment. In particular, countries with a fixed exchange rate and a current account surplus should limit sterilization of the foreign exchange interventions required to fix the value of their currency or otherwise obstruct real exchange rate adjustment to the surplus. It also means emerging economies with chronic current account surpluses need to play a more active role in reducing global imbalances by adopting policies that allow for greater exchange rate flexibility and promote sustained increases in domestic consumption in part by accelerating the pace of financial sector reform.

(c) What is the surveillance role of the Managing Director in such an IMF?

As the head of an institution with a central role in the international system – the only institution with a mandate to assure a smoothly functioning international monetary system – the Managing Director (MD) plays a significant role in international surveillance, policy dialogue and direction, and crisis response. The surveillance role involves prioritization of staff efforts in monitoring developments, maintaining the quality and independence of Fund analysis, communicating policy recommendations, and coordinating international policy responses. Two specific examples of surveillance policymaking in a reformed IMF include:

- The MD would have a key role in making proposals to the Executive Board to clarify IMF involvement in exchange rate issues. MD Rodrigo de Rato has called for updating “guidance on the treatment of exchange rate regimes, the notion of disequilibrium in a world of capital mobility and floating exchange rates, and the procedures for monitoring by the Fund.” By taking this forward, the MD would provide a sharper tool for the Fund to identify exchange rate practices which violate IMF principles, and hence justify a special consultation.
- The MD would engage in consultations more regularly. The MD would undertake intensified consultations with individual members whenever an Article IV review raises serious questions about the compatibility of a member’s exchange rate policy with IMF principles or the country’s domestic policies, or when the exchange rate regime otherwise appears unsustainable. The MD should also use his authority to bring together decision makers in the systemically important countries for small group meetings to improve dialogue on addressing imbalances when they are unsustainable or may cause damage to the system as a whole.

The most critical surveillance role of the Managing Director remains overseeing that *implementation* is consistent with the spirit of the reforms.

QUESTION 2

The undervaluation of China’s currency is critical, but it is only one piece of the puzzle. China’s neighbors are also intervening in their currency markets—or using less obvious tactics—to keep their currencies undervalued to remain competitive with China.

I have always said that China must move to bring its currency in line with market forces, but so must its neighbors. What is your regional strategy to assure not just China, but the entire region play fair?

Greater exchange rate flexibility for large economies in East Asia has been a consistent objective of this Administration, and is a critical component of our engagement with Asian counterparts, both bilaterally and multilaterally. We have, through a series of APEC discussions and communiqués, moved that organization towards encouraging greater exchange rate flexibility among its members. The Asian Development Bank has also advocated greater exchange rate flexibility for China and other of its members. The G-7 Finance Ministers, of which Japan is a member and in whose meetings China has begun to participate, has consistently stressed the importance of greater exchange rate flexibility for large economies that lack such flexibility.

For many of the economies in the East Asian region, cost competitiveness vis-a-vis other economies in the region – particularly with respect to China – is a very important consideration. For that reason, greater exchange rate flexibility in China is a lynchpin for greater regional exchange rate flexibility. Our efforts to bring about greater Chinese exchange rate flexibility are therefore instrumental in bringing about greater flexibility in the region.

THE U.S. TRADE DEFICIT AND CHINA

Statement by
C. Fred Bergsten
Director, Institute for International Economics¹

Before the Hearing on
US-CHINA ECONOMIC RELATIONS REVISITED

Committee on Finance
United States Senate

March 29, 2006

The Centrality of the Currency Issue

The US global merchandise trade and current account deficits hit annual rates of \$900 billion in the fourth quarter of 2005. This amounted to 7 per cent of our GDP, twice the previous record of the middle 1980s (as a result of which the dollar declined by 50 per cent over the three-year period 1985-87). The deficits could reach annual rates of \$1 trillion within the next year or so.

China's global current account surplus soared to about \$150 billion in 2005, about 7 per cent of its GDP. China has become the second largest surplus country in the world, slightly behind Japan and far ahead of all others. Its foreign exchange reserves have recently passed Japan's to become the largest in the world and will probably reach \$1 trillion by the end of 2006 (compared with \$38 billion for the United States).

¹ Dr. Bergsten has been Director of the Institute for International Economics since its creation in 1981. He was previously Assistant Secretary of the Treasury for International Affairs (1977-81) and Assistant for International Economic Affairs to the National Security Council (1969-71). He is co-author of the new book *China: The Balance Sheet: What the World Needs to Know Now About the Emerging Superpower*, prepared jointly by the Center for Strategic and International Studies and the Institute for International Economics and published by Public Affairs Press.

China's role in the global imbalances is even greater than these numbers might suggest. A substantial increase in the value of the Chinese currency, the renminbi, is essential to reduce the imbalances but China has blocked any significant RMB rise by intervening massively in the foreign exchange markets, buying \$15-20 billion per month for several years to keep market pressures from pushing its currency up. China apparently sees its currency undervaluation policy as an off-budget export and job subsidy that, at least to date, has avoided effective international sanction.

By keeping its own currency undervalued, China has also deterred most other Asian countries, from Japan to India, from letting their currencies rise against the dollar for fear of losing competitive position against China. Hence China's currency policy has taken virtually all of Asia out of the international adjustment process. This is critical because Asia accounts for about half the global surpluses that are the counterparts of the US current account deficit, has accumulated the great bulk of the increase in global reserves in recent years, enjoys the world's fastest rates of economic growth so can "afford" trade adjustment better than other regions, and is essential to the needed correction of the exchange rate of the dollar because it makes up about 40 per cent of the dollar's trade-weighted index.

These global imbalances are unsustainable for both international financial and US domestic political reasons. On the international side, the United States must now attract almost \$7 billion of capital from the rest of the world every working day to finance our current account deficit and our own foreign investment outflows. Even a modest reduction of this inflow, let alone its cessation or a selloff from the \$12 trillion of dollar claims on the United States now held around the world, would initiate a precipitous

decline in the dollar. Especially under the present circumstances of nearly full employment and capacity utilization in the United States, this could in turn sharply push up US inflation and interest rates, severely affecting the housing and equity markets and potentially triggering a recession.

The domestic unsustainability derives from the historical reality that dollar overvaluation, and the huge and rising trade deficits that it produces, are the most accurate leading indicators of protectionist trade policies in the United States. Such overvaluation alters the domestic politics of US trade policy, adding to the number of industries seeking relief from imports and dampening the ability of exporting industries to mount effective countervailing pressures. It was trade policy pressures of this type that prompted drastic policy reversals by the Reagan Administration, to drive the dollar down by 50 per cent via the Plaza Agreement in the middle 1980s, and by the Nixon Administration, to impose an import surcharge and take the dollar off gold to achieve the cumulative 20 per cent devaluation of the early 1970s. The escalation of protectionist pressures against China at present, despite the strength of the US economy and the low level of unemployment, is the latest evidence of this relationship between currency values and trade policies. Continued failure to correct the currency misalignments could have a devastating impact on the global trading system.

It is thus essential to reduce the US and China imbalances by substantial amounts in an orderly manner. The goal of US adjustment should be to cut its global current account deficit to about 3 per cent of GDP, less than half the present level, at which point the ratio of US foreign debt to GDP would stabilize. China's goal, accepted at least in

principle by its political leadership, should be to eliminate its global current account surplus and stop the buildup of foreign exchange reserves.

The United States should take the lead in addressing the imbalances by developing a credible program to convert its present, and especially foreseeable, budget deficits into modest surpluses as were in place as recently as the early years of this decade. Whether or not the United States effectively addresses its budget problem however, large changes in exchange rates are essential component of the global correction. A change in China's currency policy, in both the short and longer runs, is thus by far the most important issue in US-China economic relations.

In the short run, an increase of 20-40 per cent in the value of the RMB (and parallel appreciations of other key Asian currencies) is an essential component of an orderly correction of the global imbalances.² Such a sizeable change could be phased in over two or three years to ease the transitional impact on China.³ It could be accomplished either by a series of step-level revaluations, like the 2.1 per cent change of last July only much larger and with a substantial initial "down payment" of at least 10 per cent, or by a steady upward managed float of the RMB.⁴ An increase of 20 per cent in the RMB and other Asian currencies would reduce the US global current account deficit by \$60-80 billion per year.

² I have studiously refrained from mentioning the very large Chinese bilateral trade surplus with the United States, which should not be a focus of policy because of the multilateral nature of international trade and payments. Attached is a summary of the analysis of the bilateral imbalance from our new book *China: The Balance Sheet* that explains its causes and how it relates to the two countries' global payments positions.

³ See Morris Goldstein and Nicholas Lardy, *A New Way to Deal with the Renminbi*, *Financial Times*, January 20, 2006.

⁴ To offset the impact on its domestic economy of the resulting decline in its external surplus, China should simultaneously phase in increases in domestic demand through higher government spending on health care, pensions and education. Such new government programs are already needed for purely internal reasons because of the internal unrest in China that has resulted from the reform of state-owned enterprises that provided these benefits in previous times. See Chapter 2 of *China: The Balance Sheet*.

Over the longer run, China should adopt a more flexible exchange rate that will respond primarily to market forces. These forces would clearly have pushed the RMB to much higher levels by now in the absence of China's official intervention. There is some justification, however, for China's fears that an abrupt move to a freely floating exchange rate now, particularly if accompanied by abolition of their controls on financial outflows, could trigger capital flight and jeopardize their economy in view of the fragility of their banking system. Full-scale reform of China's exchange rate system will have to await completion of the reform of its banking system, which will take at least several more years. Hence the adoption of a flexible exchange rate regime in China, which is essential to avoid re-creation of the current imbalances in the future, can be only the second stage of the resolution of the currency problem.⁵

A US Strategy for China's Currency

It is obvious that China is extremely reluctant to make the needed changes in its currency policy. It is equally obvious that US efforts on the issue over the past three years, whether the earlier "quiet diplomacy" approach or the commendably more aggressive stance of the past six months or so, have borne little fruit. A new US policy approach needs to be adopted with considerable urgency in light of the upcoming visit of President Hu Jintao of China to Washington on April 20-21.

One cardinal requirement is for the Administration and Congress to adopt a unified, or at least consistent, position. To date, there has been something of "good cop (Administration) – "bad cop" (Congress, e.g., the threat of the Schumer-Graham legislation) bifurcation between the two branches. China has exploited these differences,

⁵ This two-step approach was initially proposed in Morris Goldstein and Nicholas Lardy, *Two-Stage Currency Reform for China*, *Financial Times*, September 12, 2003.

essentially counting on the Administration to protect it from the Congress – a bet that, to date, has paid off.

I would therefore suggest a new five-part strategy for US policy on the currency issue:

1. It is clear that China has aggressively blocked appreciation of the RMB through its massive intervention in the currency markets and that the Treasury Department will lose all credibility if it fails to carry out the requirements of current law to label China as a “currency manipulator.” The Administration should therefore notify the Chinese immediately that, if China fails to make a significant “down payment” appreciation of at least 10 per cent prior to the release of the Treasury Department’s next semi-annual report on currency issues in a month or so, it will be labeled a “manipulator.” This would trigger an explicit US negotiation with China on the currency issue.
2. The Administration should also immediately notify its G-7 partners and the IMF that it plans to make such a designation, in the absence of major preventive action by China, with the goal of galvanizing a much broader multilateral effort on the issue and reducing its confrontational bilateral character. The Europeans and Japan have a major incentive to join the United States because their currencies will rise much more sharply when the dollar experiences its next large decline if China (and other Asians) continue to block their own adjustment.
3. The Administration should also notify the Chinese that, absent acceptable correction in the RMB, it will be unable to oppose responsible Congressional initiatives to address the issue such as the legislation just introduced by Senators

Grassley and Baucus. That legislation would provide explicit sanctions against China (or other countries whose currencies are in “fundamental misalignment,” a far superior criterion to “currency manipulation”) including blockage of a larger Chinese quota at the International Monetary Fund⁶ and ineligibility for revocation of its status as a “nonmarket economy,” both of which the Chinese fervently desire.

4. The Congress should proceed with all due speed to pass the new Grassley-Baucus bill, whose currency sections are a highly desirable replacement for the similar sections of the Omnibus Trade and Competitiveness Act of 1988 in any event. If China continues to fail to cooperate, passage of the bill should be accelerated to provide the Administration with new tools to promote an acceptable outcome to the currency issue or to respond appropriately in the absence thereof.
5. If the first four steps in the strategy fail to produce the necessary results in the near future, Congress should pass the Schumer-Graham legislation to impose an across-the-board surcharge on imports from China. Such a step would be highly regrettable but must be envisaged as a last resort if all else fails to resolve the issue.

⁶ It would be highly desirable to increase the quotas, i.e. voting shares, of China and some other countries in the IMF to reflect their sharply increased role in the world economy as recommended in Edwin M. Truman, *A Strategy for IMF Reform* (Institute for International Economics, February 2006). However, this should be done only for countries that are living up to their obligations under the IMF Articles of Agreement, including the obligations to avoid “competitive undervaluation of their currencies” and “large, protracted, one-way intervention in the exchange markets.” The United States can block any increase in IMF quotas because they require a super majority of 85 per cent and the United States has about 17 per cent of all Fund votes.

CHINA'S TRADE SURPLUS WITH THE UNITED STATES

Background

China has run a bilateral trade surplus with the United States since the late 1980s. These surpluses increased steadily in the 1990s and China became the largest single source of the U.S. global deficit in 2003. In 2005, the U.S. bilateral trade deficit with China exceeded \$200 billion – over one fourth of its total imbalance. U.S. imports from China are now almost six times as large as U.S. exports to China so its future exports would have to grow almost six times as fast as its imports grow just to keep the bilateral imbalance from increasing further.

Bilateral imbalances should not be a focus of national policies because of the multilateral nature of international trade. The China-U.S. bilateral position, however, reflects both countries' large worldwide imbalances. The United States is by far the world's largest deficit and debtor country, and its global current account deficit hit an annual rate of \$900 billion in the final quarter of 2005 (7 percent of GDP). China's global current account surplus, after averaging only 1.6 percent of its GDP during 1993-2002, soared to about \$150 billion (almost 7 percent of GDP) in 2005. These global disequilibria are a major source of concern: they could lead at virtually any time to a large and disorderly fall in the exchange rate of the dollar, pushing up U.S. inflation and interest rates with very negative effects on the U.S. and world economies, and/or to a sharp outbreak of trade protectionism in the Congress.

Why Is China's Surplus So Large?

1. Chinese officials frequently assert that the imbalance would be much smaller if the United States would approve more high technology exports to China.

However, the Department of Commerce rejected only \$12.5 million in potential sales in FY2005 and it returned applications, including for incompleteness, of only \$550 million more. Approval of all these licenses would have cut the bilateral deficit by only 0.3 percent.

2. A common explanation, especially in the United States, is that China blocks access to its market for U.S. (and other foreign) products. But the effective tariff ratio in China, import tariff revenue collected as a share of the value of imports, was only 2.2 percent in 2004. Even China's average level of announced tariffs, at 10.4 percent in 2004, is among the lowest of any developing country. China eliminated all import licensing requirements and virtually all import quotas by 2005.

More broadly, China's ratio of imports to GDP has soared from 5 percent in 1978 to 30 percent in 2005. By that measure, China is now twice as open to trade as the United States and three times as open as Japan. China has in fact been the most rapidly growing market for U.S. exports for the last 15 years: during 2000-2005, for example, U.S. exports to China grew by 160 percent while its exports to the rest of the world rose by only 10 percent. China needs to further open its

markets for a number of products but its import regime does not explain much of the imbalance.

3. Another explanation for the imbalance is that the United States (and other high income countries) cannot compete with China's low-wage labor, which earns only about one thirtieth that of its American counterparts. However, Chinese productivity is also only about one thirtieth that of the United States. Moreover, wages account for only 5 percent of the total cost of producing semiconductors and no more than 20 percent of the costs for apparel. More broadly, many developing countries have lower wages than China but are not large exporters and the United States, with wages among the highest of any country, is the world's second largest exporter. "Low wages" cannot explain the large trade imbalance.

4. The most persuasive explanation of the growing bilateral deficit is the increasing role of China as the final assembler in Asia-wide production networks. Over the past two decades, the production process for a growing range of manufactured goods has become increasingly disaggregated on a geographical basis. Each country serves as the location for the portion of the process in which it has the strongest comparative advantage. Higher-income, more technologically advanced countries like the United States have come to specialize in producing high value-added parts and components. China, with its large pool of workers available for unskilled labor-intensive operations, has increasingly become the location of

choice for the final assembly of a broad range of goods, especially electronic and information technology products.

Goods that are assembled from imported parts and components now account for about 55 percent of China's total exports and about 65 percent of the goods China exports to the United States. When these goods are exported from China to the United States, their entire value is counted by U.S. Customs as imports from China. On average, however, about two-thirds of the value of these so-called "processed exports" in fact originate outside China, mostly in other Asian countries.

China's rise as the point of final assembly of a broad range of manufactured goods is reflected in the sharp decline over the past two decades in the share of the U.S. bilateral trade imbalance that originates in other Asian countries (especially Hong Kong, Taiwan, Korea and Japan). As these countries have moved manufacturing capacity to China – and, in the case of Japanese autos, to the United States – the share of the U.S. trade deficit that they account for has fallen by two-thirds, from more than 50 percent in 1985 to only 16 percent in 2004, while China's share has risen from nothing to about one quarter. The United States must understand that it will continue to run a sizable bilateral deficit with China, as recorded in the conventional statistics, largely because of the growing internationalization of production with China as the final assembly point for many products.

5. This structural source of China's burgeoning trade surpluses, especially its global imbalance, has been intensified in recent years by the growing undervaluation of China's currency, the renminbi (RMB). This issue has become a central point of debate between the two countries and is addressed in a separate one-pager.

It is clear that the average exchange rate of the RMB is now undervalued by 20-40 percent (and that its bilateral rate against the dollar is undervalued by even more). China has intervened massively in the foreign exchange markets for several years to keep the RMB from rising in value, resisting market pressures for a much stronger currency, by selling RMB for dollars. As a result, its foreign exchange reserves are rising rapidly toward \$1 trillion, by far the largest in the world. By maintaining its dollar peg as the dollar declined against most other currencies over the past few years, the RMB has in fact recorded a cumulative depreciation that has made China even more competitive. Its minor currency reform of July 2005 had no appreciable impact on the situation. A revaluation of the RMB by 20 percent, if accompanied by an equal appreciation of the other major Asian currencies, should reduce the U.S. global current account deficit by \$60-80 billion per year.

QUESTIONS FOR THE RECORD FROM DR. C. FRED BERGSTEN

**United States Senate
Committee on Finance**

**Hearing on “U.S.-China Economic Relations Revisited”
March 29, 2006**

QUESTIONS FROM SENATOR BAUCUS

Question 1

You have laid out clear steps that the administration must take toward China. However, the problem that I have seen with China is that any small step in the right direction is viewed as “progress.”

Unfortunately, this puts us in the position of continually applauding progress, while always falling short of our ultimate goal. I think we need better ways to measure progress.

If you were to return to this witness panel one year from now, how would you measure a successful year in U.S.-China relations? What would be the metrics of better U.S. policy, and better engagement, toward China?

Answer

I totally agree that China has taken very modest, if any, steps in the directions that I would view as “progress” on these issues. I also fully agree that we need better ways to measure progress.

My own metric, in the hypothetical return to the witness panel a year from now, would be the adoption of policy measures by both countries that promise substantial reductions in their global trade imbalances. This should include a program of credible budget consolidation in the United States. From the Chinese side, it should include at least two major elements: a rise of at least 10 percent in the value of the exchange rate, with the credible promise of further increases that would bring the total to 20-40 percent over 2-3 years and a shift in the determinants of economic growth to much greater reliance on domestic demand (especially private consumption) rather than further expansion of the trade surplus. It will take several years for such policy steps to translate into recorded improvements in the two countries’ international positions, but I would hope that decisive steps in those directions would be adopted over the next 12 months (or preferably much sooner).

Question 2

Whether one agrees or disagrees with our economic policies toward China, it is difficult to deny that the global economy remains dangerously out of balance. At some point, it will return to equilibrium. The question is, how and how fast this adjustment will occur.

What must happen for an orderly adjustment to the global economy? What are the odds that this adjustment really will be a “soft” rather than a “hard” landing?

Answer

There is certainly a risk of a “hard landing” of the world economy, but I believe that the probability of a “soft landing” is considerably greater for three reasons.

First, the U.S. economy is fundamentally quite strong. Productivity growth is rapid and is likely to remain robust. Monetary policy is credible and conducted skillfully. There is no incentive for capital flight out of the United States.

Second, the other major industrial economies (Europe and Japan) are not doing nearly as well. Both are picking up, but neither is likely to experience impressive growth over the next few years. Hence there is little prospect of a substantial shift of capital into the euro or the yen, the only currencies with sufficiently large financial markets to generate strong depreciations of the dollar.

Third, even if these economic judgments are incorrect, the G-7 could and surely would intervene aggressively in the foreign exchange markets to limit the pace of any precipitous dollar decline. They would not try to stop such an adjustment, but both the United States and the creditor countries would have a major incentive to avoid a free fall of the dollar. Some observers doubt that they would be able to do so, but it must be remembered that the surplus countries would be selling their own currencies, which they can create without limit, so I believe that such a “smoothing” strategy (and hence a “soft landing”) would be quite feasible.

Question 3

We are in uncharted waters. Our current account deficits keep breaking records. Foreign debt levels are unlike those of any major modern industrialized country. The sheer size and potential of the Chinese market is unprecedented.

I think that when we face an unknown future, we should look back to put things in context. Given your experience, how do our challenges today compare to those of the past? More importantly, how does our response to those challenges compare?

Answer

There are two historical parallels with the huge current account imbalances that we face today.

The more recent was the initial onset of large U.S. deficits during the first half of the 1980s, which reached a peak in 1987. The result on that occasion was a massive outbreak of trade protectionism, including a series of voluntary export restraint agreements imposed on Japan and a threat of draconian congressional action by 1985. The second Reagan administration, led by Secretary of the Treasury James Baker, responded by launching the Plaza Agreement in September 1985 to drive the dollar down by 50 percent. As a result, the congressional pressures subsided substantially and the U.S. current account deficit was virtually eliminated by 1990-91.

The other precedent was in 1971, when President Nixon and Secretary of the Treasury, John Connolly, took the dollar off gold and imposed a 15-percent import surcharge in order to negotiate a substantial devaluation (which turned out to exceed 20 percent in two stages). The immediate trigger was again a risk of substantial protectionism in the Congress, as reflected in the Mills bill in 1970 and the proposed Burke-Hartke legislation in 1971.

In both cases, there was some threat of a reduction in willing foreign financing for the U.S. external deficits. The immediate and more apparent trigger, however, was the threat of protectionist action in the Congress that could have disrupted the global trading system. In both cases, the Republican administration of the day reversed its policy from the prior "benign neglect" to the adoption of aggressive steps to both deal with the substance of the issue and reassert control from the Congress. I believe that similar actions are required to deal with similar problems that we face today.

**PREPARED TESTIMONY OF
DEPUTY UNITED STATES TRADE REPRESENTATIVE
KARAN K. BHATIA
BEFORE THE
COMMITTEE ON FINANCE
OF THE
UNITED STATES SENATE
March 29, 2006**

Introduction

Chairman Grassley, Senator Baucus and members of the Finance Committee, I appreciate the opportunity to testify today on issues surrounding the U.S.-China trade relationship. This is a subject of considerable importance and a matter of great priority for the Administration and the Office of the United States Trade Representative (USTR), in our capacity as the lead agency with responsibilities for U.S. trade policy.

The specific focus that you have given to today's hearing – "U.S.-China Economic Relations Revisited" – fits in with the Administration's thinking. As you know, at Ambassador Portman's direction, USTR recently led an interagency "top-to-bottom" review of U.S. trade policy with China. When Ambassador Portman took over as the United States Trade Representative, he felt strongly that it was time to revisit how the United States approached its trade relationship with China. Having completed the review, our view is that U.S.-China trade relations are entering a new phase in which greater accountability on China's part and greater enforcement on the Administration's part are needed.

This will be an important month. I returned from China over the weekend, where Under Secretary Lavin and I conducted talks with our Chinese counterparts to prepare for the next meeting of the Joint Commission on Commerce and Trade (JCCT) scheduled to take place in Washington on April 11th. Nine days later, on April 20th, President Hu Jintao will meet with President Bush.

We enter this period firm in our belief that, while our bilateral trade relationship has been largely beneficial for both the United States and China, it is not sufficiently balanced in the opportunities it provides. As a result, though our overall goals and objectives remain the same, some recalibration in the way we respond to problems is required. We have a complicated task as we seek to achieve the dual objectives of solving specific, immediate problems – resorting to more muscular enforcement mechanisms where necessary – and encouraging the long-term transformation of China into a more rules-based, open economy. We believe that the key to achieving those objectives is treating China as a fully accountable stakeholder in the international trading system and insisting that China play a constructive role commensurate with its commercial heft and the enormous benefits that it has gained from its participation in the global trading system.

A New Phase in U.S.-China Trade Relations

Thirty years ago, China was a nation mostly closed to international commerce. Today, it is the world's third largest trading power. China's emergence over this period as a major international player has not only redefined the global trading system, but also has had far-reaching economic and political impact on China, the United States, East Asia and the world.

The trade relationship between the United States and China has become increasingly central to the economies of both our countries. China's economy has been growing at roughly 10 percent per year for more than two decades, and its growth has been closely tied to the open trade and investment regimes of the major economies of the world. Exports account for 40 percent of China's GDP, and China has depended on the growth of its export sector to spur modernization of its economy and to support improved standards of living. According to Chinese data, the United States market has been the direct recipient of 22 percent of China's phenomenal export growth over the last twenty years.

The United States has also derived benefits from the trade relationship. U.S. consumers now have access to a wider variety of less costly goods, and low-cost consumer and industrial goods from China have helped spur U.S. economic growth while keeping a check on inflation. Access to Chinese inputs have helped make U.S. companies more competitive in the global economy. Since 2001, when China joined the World Trade Organization (WTO), U.S. exports to China have grown five times faster than they have to the rest of the world, and China has gone from being the ninth to the fourth biggest export market for the United States. U.S. exports to China increased by an impressive 21 percent in 2005, building on 22 percent growth in 2004 and making China our fastest growing export market among our major trading partners.

Together, the United States and China have accounted for roughly half of the economic growth globally in the past four years. Market forces continue to drive broader and deeper economic ties between our two countries.

At the same time, the enormous scope and scale of the changes that have occurred in China's trading posture and in our bilateral trade relationship pose continual challenges. As China's economy and our bilateral trade have grown, our trade relationship has become enormously complex. Features of this relationship – the size of China's consumer base and labor force, for example, or the increasing sophistication of Chinese production – can be both encouraging and a cause for concern at the same time. The relationship lends itself neither to simplistic characterizations nor to simple policy prescriptions.

Overall, despite many positive developments, there is concern that the U.S.-China trade relationship lacks balance in opportunity, as well as equity and durability, with China's focus on export growth and developing domestic industries not being matched by a comparable focus on fulfilling market opening commitments or on the protection of intellectual property rights (IPR) and internationally recognized labor rights.

In our “top-to-bottom” review, the Administration examined the United States’ trade relationship with China over the years and concluded that the United States is now entering an important new phase in its relationship with China. We view it as the third phase in that relationship.

The first phase began in 1986 when the United States formally acknowledged China’s goals to modernize and integrate itself into the global marketplace by commencing negotiations for China to become a party to the General Agreement on Tariffs and Trade (GATT), or as it was subsequently renamed, the World Trade Organization. That phase lasted for 15 years and was focused on identifying and negotiating the kinds of commitments China needed to make in order to gain admission to the WTO. Great strides were made during that first phase in modernizing and strengthening our bilateral trade relationship. Building on the measures already implemented as part of this reform program, China was in a position to take on new commitments as part of its accession agreement to join the WTO. Under their WTO accession agreement, China committed to lower trade barriers in virtually every sector, adopt intellectual property protections, and adopt special rules to address subsidies and other forms of state ownership and control of economic resources.

The second phase began in December 2001, when China joined the WTO. While its accession agreement called on China to implement a large number of commitments immediately as a condition of membership, China was also allowed to implement many other, often significant commitments over a period of years – including not only scheduled reductions in tariff rates, but also the elimination of numerous non-tariff barriers and expansions in market access for a variety of service sectors. During this transition period, U.S. trade policy towards China was largely focused on ensuring that China implemented these specific commitments, and our view of China’s performance as a trading partner was largely based on how fully and timely it implemented them. Spurred on by our relentless vigilance and engagement, China made progress in implementing many of its commitments. For example, China lowered its tariffs on the goods of greatest value to the U.S. economy from an average of 25 percent to an average of 7 percent, while removing or reducing numerous non-tariff barriers such as quotas and licensing requirements. China also followed through on its important commitments to make trading rights available to foreign enterprises and individuals, and to allow foreign suppliers to engage in distribution within China. In addition, China created new opportunities for many foreign companies in a range of service sectors.

It has now been more than four years since China joined the WTO, and as our “top-to-bottom” review report concluded, we are entering a new – third – phase in the U.S.-China trade relationship. China’s transition period as a new participant in the international trading system – and, in particular, the WTO – must now come to a close, and China must act and be treated as a fully accountable participant in and beneficiary of the international trading system. Like any stakeholder, China must find a way to pursue its own self-interest while also adhering to, and helping to shape, the policies and institutions that undergird its own growing prosperity and the prosperity of its trading partners.

Challenges in the Relationship

After four years of WTO membership, China has a track record as a WTO member, and that track record is decidedly mixed. The commitments that were easiest to fulfill have largely been fulfilled, and those still outstanding will require a more serious level of bilateral and multilateral focus and attention.

In USTR's annual Report to Congress on China's WTO Compliance issued in December 2005, we provided a detailed assessment of China's first four years of WTO membership. We concluded that China has not yet fully embraced the key WTO principles of market access, non-discrimination and national treatment, nor has China fully institutionalized market mechanisms and made its trade regime predictable and transparent. While China has made some important progress in implementing specific commitments from its accession agreement, we found that it continued to use an array of industrial policy tools in 2005 to promote or protect favored sectors and industries, and these tools at times collide with China's ongoing WTO obligations. We also catalogued specific WTO compliance problems that we are encountering, while highlighting certain areas that continue to generate the most significant problems, including inadequate enforcement of laws, particularly in the area of intellectual property rights, and problems associated with industrial policies, restrictions on market access for services, non-tariff barriers affecting trade in agriculture, and an overall lack of transparency in the regulatory environment.

On April 19 and 21, WTO Members will meet in Geneva to conduct the first Trade Policy Review (TPR) of China. WTO rules require that the four Members with the largest share of world trade be reviewed every two years, with less frequent reviews of other Members. The WTO Secretariat prepared a nearly 300-page report on China's trade policy regime, noting China's many reforms and the multitude of challenges that it still faces. The report projects that China will need to create over 100 million jobs in the next decade as it continues to restructure its economy, especially its agriculture sector and state-owned enterprises. This will present major challenges for China, and could have a significant impact on other Members. The Report also notes the need for policy realignments to prevent misallocation of resources and overinvestment in certain sectors. The United States has submitted more than 200 questions in connection with China's TPR, and in accordance with WTO rules, we look forward to receiving written responses from China. This TPR provides an important opportunity for the United States and other WTO members to seek an accounting from China with respect to trade practices of concern to us. China participated actively in the TPR conducted of the United States just last week, and we are looking forward to engaging with China during its review.

We are also facing challenges in our bilateral trade relationship with China, and we are working actively to address them. As noted above, I have just returned from China, where we discussed a number of issues that we hope to resolve at the upcoming meeting of the JCCT, as well as issues discussed at the last JCCT meeting in July 2005 where we have not seen the progress we had anticipated.

In the area of intellectual property rights, while China has made noticeable improvements to its framework of laws and regulations, the lack of effective IPR enforcement remains an enormous challenge. At the JCCT in 2004, China committed to significantly reduce counterfeiting and piracy. Nearly two years have gone by and the results demonstrate isolated --

but not significant -- progress. For example, U.S. trademark owners have met with some promising early successes in a campaign to impose liability on the landlords of markets that are notorious for selling fakes, such as the Silk Market in Beijing. At the same time, there are troubling signs. In 2005, for instance, the share of IPR infringing goods seized by U.S. Customs originating in China increased to 69 percent from 64 percent in 2004, despite China's declaration at the 2005 JCCT that exportation is a criminal offense. Moreover, China has not yet met its 2005 JCCT commitment to issue regulations on transferring IPR cases from customs officials to criminal prosecutors. This may help to explain why we have not seen prosecutions of exporters of counterfeit and pirated goods.

In other IPR areas we have also not seen significant progress. For example, while the use of pirated software on Chinese government computers has declined since China's 2004 and 2005 JCCT commitments to ban illegal software in government offices, we have not seen clear evidence that the problem has been resolved. There is also widespread software piracy outside the government in China, which China has begun to take steps to confront. We would like to continue working with China to achieve success in these areas. Similarly, given the widespread availability of pirated movie DVDs and music CDs in stores and on streets across China, we have urged China to remedy this problem once and for all through permanent plant closures, criminal prosecutions and on-going monitoring and enforcement. China agreed to step up criminal enforcement, but we have seen only a very small increase in the number of criminal copyright cases. We stand ready to cooperate toward this end. The Internet is another means that has also been used extensively in China and elsewhere for IPR-infringing purposes. China agreed at the JCCT last year to submit the legislative package necessary to join the WIPO Internet Treaties to its National People's Congress in June of this year. We have worked with and will continue working with China on the details of this very important package.

Last year, USTR concluded an out-of-cycle review under the Special 301 provisions of U.S. trade law, and elevated China to the Special 301 "Priority Watch" list. We set forth a comprehensive strategy for addressing China's ineffective IPR enforcement regime, including the possible use of WTO mechanisms, as appropriate. In October 2005, the United States submitted a transparency request to China under Article 63.3 of the WTO Agreement on Trade-Related Aspects of Intellectual Property rights. The U.S. request, made in conjunction with similar requests by Japan and Switzerland, seeks detailed information from China on its IPR enforcement efforts over the last four years. China has provided the United States with some information, but not a complete response. We will release our Special 301 Report this year according to the deadlines Congress has established.

We have also seen China increasingly resort to industrial policies that limit market access by non-Chinese origin goods or services or rely on government resources to support increased exports. The objectives of these policies are to protect less-competitive domestic industries and support the development of Chinese industries higher up the economic value chain than those industries that currently make up China's labor-intensive base. In 2005, examples of these industrial policies were readily evident. They included the issuance of regulations on auto parts tariffs that discourage the use of imported parts, the telecommunications regulator's interference in commercial negotiations over licenses with IPR holders in the area of 3G standards, the pursuit of unique national standards in many high technology areas that could lead to the

extraction of technology or intellectual property from foreign rights-holders, draft government procurement regulations mandating purchases of Chinese-produced software, a new steel industrial policy that calls for the state's management of nearly every major aspect of China's steel industry, continuing export restrictions on coke, removal of provisions addressing certain government monopolies from the current draft of the anti-monopoly law, and excessive government subsidization benefiting a range of domestic industries in China. We believe that such policies not only harm U.S. and third-country competitors, they redound to China's detriment as well. Moreover, some of these policies appear to conflict with China's WTO commitments. We are taking a hard look at them and will not hesitate to take action at the WTO if such action appears warranted.

In the area of services, concerns in many sectors remain, largely due to arbitrary and non-transparent policies, delays in the issuance of regulatory measures, and China's use of entry threshold requirements that exceed international norms. Indeed, Chinese regulatory authorities continue to pose obstacles to the efforts of U.S. providers of distribution, express delivery, direct selling, franchising, insurance, construction and engineering, telecommunications and other services to achieve their full market potential in China.

Agriculture is a high priority of the Administration's trade relations with China. While China is one of our farm sector's best customers, the record demonstrates that China does not always base its food safety decisions on science, as evidenced by its continued ban on U.S. beef. Last year, the United States and China initialed a Memorandum of Understanding to facilitate cooperation on animal and plant health safety issues. However, agricultural trade with China remains among the least transparent and predictable of the world's major markets. Capricious practices by Chinese customs and quarantine officials can delay or halt shipments of agricultural products into China, while sanitary and phytosanitary standards with questionable scientific bases and a generally opaque regulatory regime frequently bedevil traders in agricultural commodities.

Transparency concerns cut across sectors, as China's various regulatory regimes continue to suffer from systemic opacity, frustrating efforts of foreign – and domestic – businesses to achieve the potential benefits of China's WTO accession. Although China has taken steps to improve transparency across a wide range of national and provincial regulatory authorities, particularly at the Ministry of Commerce, many other ministries and agencies have made less than impressive efforts to improve their transparency. U.S., Chinese and other participants in commercial activities across China would benefit greatly if China fully adhered to its WTO commitment to maintain an official journal dedicated to the publication of all trade-related measures, and provided ample opportunity for prior public comment before such measures became effective.

Overall, while China has a more open and competitive economy than 25 years ago, and China's WTO accession has led to the removal of many trade barriers, there are still substantial barriers to trade that have yet to be dismantled. If China is to complete the implementation of its WTO commitments and institutionalize market-oriented reforms, it will need to eliminate mechanisms that allow government officials to intervene in the Chinese economy in a manner that is inconsistent with market principles. Despite its remarkable transformation over the past

quarter century, China continues to suffer from its command economy legacy. As a result, Chinese economic policy-making often operates in a way that prevents U.S. businesses from achieving their full potential in the China market. As U.S. expectations shift from the establishment of basic regulations and implementation of specific WTO commitments to measurable improvements in market access for U.S. products and services, there will be decreasing tolerance for Chinese efforts to protect domestic industries. JCCT meetings have provided bilateral opportunities to discuss and find solutions for many issues of particular importance in U.S.-China trade relations. We value the open, productive, problem-solving approach China has taken at the 2004 and 2005 JCCT meetings, and hope that the JCCT will continue to function as a meaningful forum for the resolution of trade frictions.

Readjusting U.S. Trade Resources and Priorities

The report on our “top-to-bottom” review of the U.S.-China trade relationship recognizes the many ongoing challenges, and opportunities, presented by China’s emergence as a major international player. Because of the nature of the challenges, and because it is time to insist that China be held accountable as would any mature partner and responsible stakeholder in the international trading system, the report recommends that U.S. trade resources and priorities be readjusted in a number of ways.

First and foremost, the report calls for strengthening the United States’ current focus on China’s WTO compliance and adherence to international norms. The report also urges that more focus be put on ensuring that the bilateral trade relationship offers more balanced opportunities and is equitable and durable. The report also cites a need for U.S. trade policymaking to be more proactive and informed by more comprehensive information regarding China’s economic trends and developments, with stronger coordination within the Executive branch and between the Executive and Congressional branches. The report further highlights the need for China to participate more fully in the global trading system as a responsible trading partner, and for the United States to remain an active and influential economic and trading power in the Asia Pacific region.

The report goes on to identify six key China trade objectives as we move forward. They include:

1. **Participation**: Integrate China more fully as a responsible stakeholder into the global rules-based system of international trade and secure its support for efforts to further open world markets.
2. **Implementation and Compliance**: Monitor China’s adherence to international and bilateral trade obligations and secure full implementation and compliance.
3. **Enforcement of U.S. Trade Laws**: Ensure that U.S. trade remedy and other import laws are enforced fully and transparently, so that Chinese imports are fairly traded, and U.S. and Chinese products are able to compete in the U.S. market on a level playing field.

4. **Further Market Access and Reform:** Beyond what is granted under China's current commitments, secure further access to the Chinese market and greater economic reforms in China to ensure that U.S. companies and workers can compete on a level playing field.
5. **Export Promotion:** Pursue effective U.S. export promotion efforts with special attention to areas of particular U.S. export growth potential in China.
6. **Proactive Identification and Resolution of Trade Problems:** Identify mid- and long-term challenges that the trade relationship may encounter, and seek proactively to address those challenges.

In the report, USTR lays out a series of actions that will help ensure that the United States is positioned to achieve these objectives. First, USTR will seek to enhance its trade enforcement capacity, along with its capability to obtain and process comprehensive, forward-looking information about the U.S.-China trade relationship. We will also seek to expand our trade resources in Beijing and strengthen interagency coordination and the Executive-Congressional partnership on China trade. In addition, we seek to strengthen, expand and increase the effectiveness of the U.S.-China dialogue on China's needed structural economic reforms and numerous specific issues, such as standards and SPS issues, China's subsidies practices, financial services, telecommunications services, labor, environmental protection, and transparency and the rule of law, among other issues. The Administration recognizes as well the importance of increasing coordination with other trading partners in pursuing these issues and – as evidenced by its coordination with European and Asian partners on IPR and auto parts issues – is already vigorously pursuing such coordination.

Engaging China

Bilateral Engagement

Through sustained and constructive engagement, the United States has contributed greatly to China's integration into the global economy – to the benefit of both countries. Indeed, more has been done by the United States to promote and facilitate China's integration into the rules-based international trading system than has been done by any other nation in the world, and the United States will continue to engage China as it continues its transformation. We continue to believe that U.S. interests are best pursued by ensuring that China complies with the applicable international trade rules and through further opening of the Chinese market, not by closure of U.S. markets.

To ensure that the economic benefits of the U.S.-China trade relationship are protected, and the potential gains are achieved, we must demonstrate that we can cooperate effectively to resolve bilateral issues. Such cooperation was evidenced last year, when the United States and China reached an agreement on textiles, adding much-needed predictability to bilateral trade, to the benefit of producers and consumers. We will continue to seek to work constructively with China, to resolve bilateral challenges and to develop a U.S.-China relationship that has greater equity, durability, and balance of opportunities.

Regional Engagement

Looking beyond the bilateral issues, China can also take actions that demonstrate it is prepared to play a role as a responsible stakeholder in the international economic system commensurate with its commercial heft and with the benefit it has obtained from that system. China should work closely with its partners in regional fora, such as APEC. China needs to play a constructive role in ensuring that the conditions for safe, secure and efficient trade prevail in the region. As both a driver and beneficiary of economic growth in the Asia Pacific region, China has a great incentive in joining with other regional economies to open markets, promote trade security, and build the infrastructure needed to ensure that trade can flow smoothly. It also has powerful incentives to address proactively threats – such as disease and pollution – that do not recognize national borders, but that could have enormously damaging effects on trade – to say nothing of human welfare – if left unaddressed.

It bears mentioning that the United States is also actively seeking to broaden its trade relations with countries in the region. Whether through free trade agreements (concluded with Singapore and being pursued with Korea, Malaysia, and Thailand), bilateral WTO accession agreements (Vietnam, Cambodia and Laos), or other trade-enhancing arrangements, USTR is working actively to strengthen and deepen U.S. trade relations in East Asia. These efforts will ensure that we maintain durable and balanced ties in the region as a whole, to the benefit of those countries and the United States.

Multilateral Engagement

Multilaterally, China can strengthen the WTO by opening its markets beyond the specific requirements of its accession agreements, and by playing a more active and positive role in the Doha Round negotiations, which are at a critical juncture. China has gained much from its membership and participation in the international trading system, and it stands to lose much if that system is weakened or atrophies. As it takes its place as one of the larger WTO members, China should be expected to provide leadership in advancing the rules-based system and a global framework for fair and free trade in the context of the WTO. At the most basic level, that means advancing meaningful offers and requests in the WTO negotiations, especially in the areas of agriculture and services. It also means fully embracing and complying with the letter and spirit of the obligations it has already undertaken.

Enforcement

The Administration will not hesitate, when appropriate, to use all tools at its disposal to ensure that China lives up to its commitments, including dispute settlement at the WTO or the use of trade remedies within our own legal system. In January of this year, we were poised to bring a case against China for its treatment of our kraft linerboard exports. Aware of our intent, China, at the eleventh hour, reversed course and rescinded its improper antidumping duties. We will continue to hold China accountable. That is our responsibility to the workers, farmers and businesses here in the United States.

Utilizing these tools should not be viewed as a failure in our bilateral relationship. If our two countries have a dispute and use legal channels to resolve it, it is not a sign of an adversarial relationship but rather a sign of a mature one. Disputes between the United States and Europe, for example, have not obscured the benefits of our billion-dollar-a-day trade relationship. Rather, knowing that litigation is a real option tends to have the benefit of focusing minds on viable solutions.

To give some perspective on this issue, the European Communities (EC) has been sued 63 times and the United States 86 times since the WTO entered into force in 1995. Interestingly, the United States and the EC have tracked each other closely over the years in terms of the number of cases, with the number declining for both in recent years. Since 2001, the U.S. and EU have each brought exactly 16 cases. Other WTO members have been very active as well. For example, Brazil has brought 22 WTO cases, 16 of them since 2000. In that same period, Korea has brought 10 WTO cases.

In many ways, China has been an anomaly in terms of its isolation from the WTO dispute settlement process. Despite its growing economic presence, China has been the defendant in exactly one WTO case, brought by the United States. Now that China's transition period as a new WTO member is drawing to an end, we should expect China to be more active in the dispute settlement mechanism, both as a complainant and a defendant.

We have recently announced the establishment of a China Enforcement Task Force at USTR, as promised in our "top-to-bottom" review of the U.S.-China trade relationship. The task force is being co-chaired by a new Acting Chief Counsel for China Enforcement and a Deputy Assistant United States Trade Representative, who bring to the table extensive experience in WTO litigation and U.S.-China trade negotiations. They are joined on the task force by veteran USTR staffers, including specialists in intellectual property rights, industrial policies, agriculture, services, investment, WTO affairs and textiles.

The task force has already met and begun its work, and we expect to see it move forward quickly with a broad and aggressive agenda. The task force has begun focusing on issues where there is a need to enforce China's WTO obligations through dispute settlement. But, it will also approach enforcement in a more comprehensive manner, by using WTO mechanisms short of dispute settlement more effectively, by seeking to ensure that China lives up to the bilateral commitments that it has made, for example, in the JCCT context, and by developing strategies for addressing trade problems such as the Chinese government's excessive subsidization of a range of Chinese industries.

We have also established a Task Force on China under our Advisory Committee on Trade Policy and Negotiations. This Task Force – which will consist of ACTPN members and be co-chaired by Governor John Engler, President of the National Association of Manufacturers, and Dr. Fisk Johnson, Chairman of S.C. Johnson & Company – will provide senior-level counsel to USTR on strategic issues in the U.S.-China trade relationship.

Conclusion

Mr. Chairman and members of the Committee, thank you for providing me with the opportunity to testify. I look forward to your questions.

**RESPONSES TO QUESTIONS FOR THE RECORD
FROM HON. KARAN K. BHATIA**

**United States Senate
Committee on Finance**

**Hearing on
“U.S.-China Economic Relations Revisited”
March 29, 2006**

QUESTIONS FROM SENATOR GRASSLEY

QUESTION 1

How would you characterize China’s engagement thus far in the Doha Round negotiations of the World Trade Organization?

What does China stand to gain in these negotiations? Are there areas where we can work together to prod these negotiations forward?

ANSWER:

China is now the world’s third largest trading nation and will have to make significant contributions to make the DDA a success. While China has at times played a constructive role in advancing the negotiations, it has not been consistently engaged in moving the process forward. As one of the biggest beneficiaries of the WTO system, China must make ambitious offers in all of the key areas of the negotiations. We have actively engaged China both in Geneva, and in our bilateral discussions, to urge China to play a leadership role in the Doha negotiations. At the Asia Pacific Economic Cooperation forum meetings last year, we agreed, together with China, to call for an ambitious tariff reduction formula on Non-Agricultural Market Access (NAMA), starting with the Swiss formula. We will continue our efforts to work with China to press forward in all areas of the negotiations.

QUESTION 2

When can we expect that China will submit its subsidies report to the World Trade Organization, which was due at the end of 2005?

ANSWER

After the U.S. repeatedly raised this issue (including in March 2006 meetings I conducted in Beijing), China submitted its WTO subsidies notification on April 11 and we have been carefully

reviewing the document. China's subsidies notification appears to be a good first effort, but there also appear to be some significant omissions both in terms of estimates for the value of specific subsidies and of the types of subsidies included in the notification. We recently began to address the substance of China's subsidies notification at the WTO in connection with China's Trade Policy Review.

QUESTIONS FROM SENATOR BUNNING**QUESTION 1**

Ambassador Bhatia, in an area of particular concern to the Kentucky economy, the Chinese have emerged as major competitors in wood products manufacturing. They have already taken over furniture production which displaced thousands of U.S. workers.

U.S. hardwood manufacturers are forced to compete with a huge Chinese wood processing industry where their sources of supply are highly suspect - possibly illegally felled timber from Russia and Southeast Asia. Chinese environmental regulations are also suspect.

What is USTR doing to help U.S. hardwood producers compete on a level playing field with their legally-sourced, environmentally-managed American hardwoods?

ANSWER:

The Administration has aggressively worked to ensure a level playing field for U.S. hardwood manufacturers as well as the entire forest and paper industry. As you pointed out, China's wood products sector has emerged as a chief competitor to the U.S. wood products industry. A range of industries, including the forest and paper industry, have expressed concerns to us about the problems that Chinese government subsidization creates for them. China's lack of transparency presents enormous challenges in trying to compile comprehensive information about the various types of financial support that China provides to its domestic industries. This month, China submitted its first subsidies notification since joining the WTO in December 2001. We are currently evaluating that document.

To the extent that we are able to develop information on particular subsidies, we have been raising our questions and concerns at the WTO. For example, in October 2004, the United States submitted questions about a number of subsidy programs, including potentially prohibited subsidies, in a WTO filing under Article 25.8 of the Subsidies Agreement, although to date China has not directly responded to any of those questions. We have also regularly used the China Transitional Review Mechanism (TRM) meetings at the WTO to express our concerns and seek further information.

In regard to environmental regulations, there has been much news in recent months of China's efforts to enhance environmental protection and of its new emphasis on the management of natural resources. We are watching those changes carefully, both to ensure that barriers to U.S. products are not erected, and to determine how such measures affect the competitiveness of U.S. industries.

Finally, the Administration is also working to stem the problem of illegal timber that may be a source for Chinese producers. Specifically, the United States commenced negotiations this month with Indonesia on a Memorandum of Understanding combating illegal logging, and we

are working to get Singapore and Malaysia more involved in efforts to stem illegal logging, shipments of illegal harvested timber, and transshipment of products of illegal logging.

QUESTION 2

Ambassador Bhatia, about six weeks ago, a USTR official was quoted as saying that “we may be running out of options” other than a WTO case when it comes to China’s lack of protection of intellectual property rights. This comes after the less-than-cooperative response of the Chinese to our article 63 request that they provide more data on their IPR enforcement cases.

What type of response will the administration need to see from the Chinese in the upcoming JCCT meeting in order for it to make sense to postpone the filing of a WTO case?

ANSWER:

USTR and Commerce co-lead the Joint Commission on Commerce and Trade (JCCT) with China. On April 11, we held the third “elevated” JCCT meeting, at which we made measured progress on stepping up IPR enforcement efforts in China. Some of the key IPR results included actions by China against plants that produce pirated optical disks; new rules issued by the Chinese government that require computers to be pre-installed with licensed operating system software; an agreement on cooperation to combat pirated goods displayed at trade fairs in China; and a commitment to intensify efforts to eliminate infringing products at major consumer markets in China, such as Silk Alley in Beijing. We also agreed that China would cooperate by stepping up its domestic IPR law enforcement efforts, increase customs cooperation and provide China with additional technical assistance to fully implement the WIPO Internet Treaties.

In addition, immediately after the JCCT, Under Secretary of Commerce Jon Dudas and I proposed to our Chinese counterpart a fourth meeting in June of the JCCT IPR Working Group. Since its creation in 2004, the Working Group has met three times, including last November. These discussions have produced concrete outcomes. For example, China agreed at the 2005 JCCT – and the relevant Chinese court subsequently confirmed – that it would apply its 2004 judicial interpretation on criminal IPR infringements to sound recordings. Moreover, customs experts are currently working out the details for cooperating on enforcement and for exchanging information on seizure statistics. China is concerned, as it should be, that 69 percent of U.S. Customs’ seizures of IPR-infringing goods originate from Chinese facilities. We will work closely with China on actions it should take to significantly lower this figure.

Notwithstanding our progress at the JCCT and in the JCCT IPR Working Group, we continue to believe that China’s IPR enforcement regime is inadequate, and we therefore continue to prepare for WTO dispute settlement. In our recent meetings, we have made it clear to Chinese leaders privately, and - as you note – have also indicated publicly, that China’s continued failure to significantly reduce counterfeiting and piracy may leave us with no option other than WTO dispute settlement. Ambassador Portman has instructed our General Counsel to actively prepare for WTO dispute settlement with China on IPR. As part of this effort, Ambassador Portman and I have met with IPR-sensitive industries to discuss working with us to develop the data we will

need to win a WTO case. In addition, in late February/early March, our General Counsel led a USTR team to China to meet with individual companies and their legal and brand protection advisors to make sure we understand the evolving IPR protection environment experienced by our companies on the ground in China.

In October 2005 we submitted a request to China under Article 63 of the TRIPS Agreement seeking detailed information on China's IPR enforcement cases since 2001. We also sought cooperation from several other trading partners, leading Japan and Switzerland to submit their own transparency requests to China simultaneously with ours. You are correct to note that China's initial response to our request was troubling. Thereafter, China invited us to consult with them in early March, and we held a full day of constructive meetings, at which we obtained some new statistical information about criminal IPR cases and conviction rates, and discussed ways in which China will work toward greater transparency. We appreciate this progress, but do not consider that China has provided a full response to our request and will continue to seek a more complete response.

QUESTION 3

Ambassador Bhatia, I would like to address China's WTO accession commitments. Specifically, the US-China Commission reports that the Chinese are frustrating the intent of the transitional review mechanism which was meant to be an annual review of China's compliance with its WTO obligations. Is it the view of the administration that China is complying with its TRM obligations?

ANSWER:

The Transitional Review Mechanism (TRM) is an annual review of China's WTO compliance efforts that takes place before 16 WTO committees and councils every Fall. The United States was a principal champion during the negotiations leading to China's accession for the carefully-crafted TRM. The TRM was intended as a forum in which the WTO could fully focus on the complex legal and economic transition required of China in its efforts to fulfill its WTO commitments. It was not, of course, intended as a dispute resolution mechanism or a substitute for other WTO enforcement procedures. When operating as intended, the TRM should fulfill two principal purposes. First, it can and has served as an information-gathering tool, helping WTO members learn more about China's policies and practices and informing WTO members' strategies to pursue enforcement of China's WTO implementation. Second, the TRM allows WTO members to supplement ongoing bilateral efforts aimed at pressing WTO concerns by raising them in a formal multilateral setting, setting the stage for more robust WTO enforcement action if necessary.

The United States has been by far the most active WTO member during the annual TRM process. Officials from USTR's China Office, at times accompanied by China experts from other U.S. agencies, regularly participate in the great majority of the TRM meetings. Moreover, the U.S. officials often hold side meetings with the Chinese delegates in order to further emphasize U.S. concerns. In addition to participating in TRM meetings, the United States uses the regular committee and council meeting process throughout the year to raise concerns

regarding China's policies and practices when warranted.

The TRM could be enhanced were China to provide advance written responses as opposed to only oral responses and were China to take a more cooperative attitude generally in working with other members on the TRM. However, as a supplement to regular committee and council meetings and ongoing fact-finding conducted by USTR and the Departments of State, Commerce, Agriculture and Treasury in particular, the TRM has been a useful means of gathering information on China's WTO implementation, and an effective means of conveying U.S. concerns about specific WTO implementation matters in China. This latter use of the TRM has been especially effective in communicating U.S. priorities with respect to concerns over China's WTO implementation. Indeed, U.S. interaction with China at the TRM has been an important predicate for later, more forceful interaction aimed at enforcing China's implementation of its WTO commitments, including use of WTO dispute settlement and other procedures.

Additionally, preliminary feedback from the 2006 Trade Policy Review of China, which occurred on April 19 and 21, suggests that the TPR process will be another important and valuable tool to obtain information from China. In the 2006 TPR, the United States submitted over 200 questions, cutting across all sectors of our trading relationship with China. The number of questions posed by the United States far exceeded those of any other WTO member during the China TPR review.

QUESTIONS FROM SENATOR BAUCUS**QUESTION 1**

One of the most important outcomes of last year's JCCT was China's promise to use legal software in all government offices by the end of 2005 and in all enterprises by the end of 2006. I understand that China believes to have implemented this commitment. But all indications that I have seen suggest otherwise. What is your assessment?

What are you doing to develop some kind of transparent monitoring mechanism, or even ongoing audits of Chinese government offices and state-owned firms, that will enable USTR to keep track of whether such offices are actually using legal software?

ANSWER – See combined answer after Question 2

QUESTION 2

China also made a 2005 JCCT commitment to ensure that enterprises, including state-owned enterprises, use legally licensed software. In terms of enforcement, what requirements is China placing on Chinese enterprises and on computer makers, and are you satisfied that China is living up to this commitment?

ANSWER:

China has taken steps to reduce government and enterprise use of unlicensed software, but its efforts have not fully addressed these piracy problems. Government and enterprise software piracy were key issues at this year's JCCT. This was also the case, as you note, at the 2004 and 2005 JCCTs.

USTR has raised software piracy issues at meetings of the JCCT IPR Working Group and at meetings with key officials of China's National Copyright Administration (NCA). We are also in regular contact with concerned U.S. industries, led by the Business Software Alliance (BSA).

In late March, just prior to the JCCT, China issued two notices that impose important software pre-installation requirements for which we and the U.S. software industry had been pressing. The first notice requires that government agencies purchase only computers pre-loaded with legal operating system software. The second requires that all computers manufactured in or imported into China be pre-installed with legal operating system software. The Ministry of Information and Industry (MII) will also monitor compliance annually through a reporting mechanism.

China also informed us at the JCCT that its national steering group for the promotion of legal software in enterprises will issue procedures at the end of April on the use of licensed software by large enterprises, including state-owned enterprises. The steering group was formed in late February to begin the process of complying with China's 2005 JCCT commitment on enterprise

legalization. The group is led by NCA and MII, and other agencies including the Ministry of Commerce, the Ministry of Finance, the State-owned Assets Supervision Administration of the State Council, the China Banking Regulatory Commission, the China Securities Regulatory Commission and the China Insurance Regulatory Commission. We are encouraged that a wide array of agencies, including many with responsibility for regulating state-owned enterprises, are participating in this important effort. We will be examining announcements and results carefully.

We have also pressed China to adopt software asset management systems for government agencies and for enterprises, including state-owned enterprises. As part of our preparations for this year's JCCT, we proposed a government software asset management program to China's Ministry of Commerce and NCA. BSA proposed an enterprise software asset management program to NCA. At the JCCT, Vice Premier Wu Yi agreed that China would discuss these proposals with us at the JCCT IPR Working Group. Undersecretary of Commerce Jon Dudas and I have written to our Chinese counterpart to begin planning for the next meeting of the JCCT IPR Working Group.

We are pleased that China has taken specific steps to address government and enterprise software piracy. However, it is also clear, particularly with respect to the use of licensed software by governments at all levels, that China's actions thus far fall short of its commitment of full government legalization by the end of 2005. Many additional steps will also be needed to ensure that enterprises use only licensed software, consistent with the government's pledge to do so by the end of 2006.

QUESTION 3

Please provide a detailed accounting on China's compliance with the commitments it made at the July 2005 JCCT, including, but not limited to the following questions:

- (a) Has China faithfully implemented its promise to increase the number of criminal prosecutions for IPR violations relative to the number of total IPR cases?
- (b) Has China reduced exports of infringing goods?
- (c) Has China ensured the use of legal software in central, provincial, and local government offices?
- (d) Has China accelerated its efforts to join the WTO Government Procurement Agreement?
- (e) Has China fulfilled its WTO requirements in the area of distribution services?

ANSWER:

(a)

Since last July, USTR and other agencies have continued to work with the Chinese government to ensure implementation of the IPR commitments made at the 2005 JCCT. On March 14, China announced a broad Action Plan to improve IPR enforcement, including

steps in the areas of enforcement, legislation and education. Although the action plan provides few details, we are hopeful that it will provide an overarching leadership framework within which China will build on some of the steps taken over the past year. Those steps include:

-- Establishing a leading IPR criminal enforcement group within the Ministry of Public Security to ensure nationwide enforcement.

--Clarifying the application of China's Criminal Law to recorded music and other audio-video products.

-- Issuing four new regulations to provide for the transfer of cases from administrative authorities to criminal authorities. These include mechanisms for cross-regional coordination between administrative and law enforcement authorities, for transfer of case leads and evidence among relevant agencies throughout the Chinese government, and for supervision of transfers by the Supreme People's Procuratorate.

Unfortunately, to date, there has been no sign of a significant shift in emphasis toward criminal enforcement. China's reported absolute numbers of criminal cases have risen, but China has not publicized corresponding administrative statistics that would reveal any shift relative to the total number of IPR administrative cases. On the contrary, according to a trademark industry submission, officials of China's State Administration for Industry and Commerce recently indicated that the number of trademark cases transferred to the police during 2005 was expected to be less than 0.3% of the total. Rights-holders have continued to express dissatisfaction with the number and substance of investigations, prosecutions, and convictions last year by local police. USTR will continue to monitor China's compliance with its 2006 set of commitments to ensure it leads to significant increases in criminal prosecutions for IPR violations relative to the total number of IPR administrative cases.

(b)

This is a high priority area for USTR, as the U.S. Government continues to see increases in China's share of IPR infringing goods seized at our own borders. According to data from U.S. Customs and Border Protection, the share of IPR infringing product seizures of Chinese origin at the U.S. border increased to 69 percent in 2005 from 63 percent in 2004, while the total value of the IPR infringing goods from China decreased to 63.9 million in 2005 from \$87.2 million in 2004. Since the July 2005 JCCT, China has taken steps, outlined in its 2006 IPR Action Plan, to reduce the export of infringing goods from China. On March 28, China's Ministry of Public Security and General Administration of Customs issued provisional regulations to ensure timely transfer of cases for criminal investigation, with the goal of reducing infringing exports by increasing criminal prosecution.

(c)

Since the July 2005 JCCT, China has begun to take steps to ensure the use of legal software in government offices throughout the country. The Chinese government reported in 2006 the completion of its national audit of central, provincial and local government offices to ensure their use of legal software and has pledged it will continue to monitor government offices in the future.

Despite China's ongoing efforts, the U.S. software industry reports that, based on data through the end of 2005, it has not seen a corresponding increase in sales that would confirm China's government software legalization efforts. As a result of U.S. government requests, China agreed at the April 11, 2006 JCCT to discuss U.S. proposals regarding government and enterprise software asset management in the JCCT IPR Working Group. The Chinese government also issued a notice requiring the pre-loading of legal operating system software on all computers produced in or imported into China, as well as a notice requiring government agencies to purchase computers with pre-loaded operating system software. In line with these requirements, several Chinese computer manufacturers have recently signed agreements to purchase U.S. operating system software. In addition, China has launched initiatives to ensure the legalization of software used in Chinese enterprises -- measures that were included in China's 2006 IPR Action Plan. USTR will continue to work with U.S. industry to confirm that government and enterprise computers in China use only legal software.

(d)

Since the 2005 JCCT, China has taken steps to accelerate its accession to the WTO Government Procurement Agreement (GPA). In February 2006, USTR and the Department of Commerce held technical discussions with the Ministry of Finance and Ministry of Commerce on GPA accession. At the 2006 JCCT, China further committed to commence formal negotiations to join the GPA by submitting its Appendix I GPA offer of coverage no later than December 2007. In the interim, China will continue technical consultations with the United States, and will also consult with other WTO members.

(e)

Fulfilling WTO and prior JCCT commitments, China has taken the following steps to ensure that U.S. products can be freely distributed in China: (1) clearing a large backlog of distribution license applications; (2) preparing a "how to" guide for businesses seeking to acquire distribution rights, expanding on the guidelines announced in April 2005; and (3) confirming that all enterprises in China, including those located in bonded zones, can acquire licenses to distribute goods throughout China. USTR will continue to work with U.S. industry in China to ensure that companies can apply for and receive distribution rights in China in a timely and non-discriminatory manner.

QUESTION 4

China has used a range of industrial policies to limit access of foreign companies to China's market. China is presently drafting new rules and laws including an anti-monopoly law, patent law, and rules on procurement and treatment of intellectual property in standards that could discriminate against foreign companies' products and that could result in confiscation of underlying intellectual property rights. What is the Administration's strategy to address this?

ANSWER:

China has, in certain sectors, adopted industrial policies that limit market access by non-Chinese origin goods or services or that rely on government resources to support increased exports. The objectives of these policies appear to be to protect less competitive domestic industries and support the development of Chinese industries higher up the economic value chain than those industries that currently make up China's labor-intensive base. In 2005, examples of these industrial policies were readily evident in each of the four areas mentioned in your question, i.e. standards, intellectual property, government procurement, and anti-monopoly law.

We have raised concerns about China's telecommunications regulator's interference in commercial negotiations over licenses with IPR holders in the area of 3G standards, the pursuit of unique national standards in a number of high technology areas that could lead to the extraction of technology or intellectual property from foreign rights-holders, and draft government procurement regulations mandating purchases of Chinese-produced software.

Regarding China's anti-monopoly law (AML), USTR is particularly concerned by China's decision late last year to remove provisions in the draft of the law that would prevent provincial and local governments from abusing their administrative powers to hamper intra-China trade. The interstate commerce clause of the U.S. Constitution has worked well in this country to address similar issues dealing with trade within the United States, and we believe that similar requirements in China would enhance trade for both Chinese and foreign companies. It is also important that China's AML apply to state-owned enterprises. We are looking very intensively at this draft law, which could have far-reaching consequences for a broad cross-section of U.S. industry.

Our strategy for addressing all of these concerns is reflected in USTR's February 2006 Top-to-Bottom review of U.S.-China trade relations. First, we identified each of the items in your question as priorities. Next, as I outlined in my testimony, we are focusing resources on these areas in a number of ways, including by expanding our enforcement capacity in USTR, increasing our information resources, working closely with other trading partners, and pursuing a number of other approaches identified in the report.

QUESTION 5

Ambassador Portman made a number of promises in his top-to-bottom review on steps USTR will take to increase enforcement of China's trade commitments. Please report your progress in implementing those commitments, including but not limited to:

- (a) Has USTR designated a Chief Counsel for China Trade Enforcement?
- (b) Has USTR established a China Enforcement Task Force?
- (c) Has USTR added personnel to USTR's China office?

- (d) Has the administration beefed up our trade enforcement capacity in our embassy in Beijing?
- (e) What steps is USTR taking to better coordinate China trade enforcement with our trading partners?
- (f) How does USTR plan to strengthen the Executive-Congressional partnership on China trade?

- (a) Has USTR designated a Chief Counsel for China Trade Enforcement?

ANSWER

Yes. Stephen Kho, of our General Counsel's office, was named Acting Chief Counsel for China Trade Enforcement on March 28, 2006.

- (b) Has USTR established a China Enforcement Task Force?

ANSWER

Yes. On March 28, 2006, USTR announced the formation of the China Enforcement Task Force within USTR, following through on a commitment made in the Top-to-Bottom review of U.S.-China trade policy unveiled by Ambassador Portman on February 14, 2006.

The task force will be co-chaired by Stephen Kho, who is serving as the Acting Chief Counsel for China Enforcement, and Terry McCartin, now the Deputy Assistant United States Trade Representative for China Enforcement. They are joined on the task force by veteran USTR staffers specializing in intellectual property rights, industrial policies, agriculture, services, investment, WTO affairs and textiles, among others.

- (c) Has USTR added personnel to USTR's China office?

ANSWER

Yes. On March 13, Eric Altbach joined the office as Deputy Assistant USTR for China. Eric had served as Director for Asian Economic Affairs at the National Security Council since March 2004. On April 3, Amy Celico joined as Senior Director for China Affairs. Amy had been the Deputy Director of the Office of the Chinese Economic Area of the International Trade Administration at the Commerce Department since July of 2004.

- (d) Has the administration beefed up our trade enforcement capacity in our embassy in Beijing?

ANSWER

USTR is working with the State Department to complete preparations to post a senior USTR official in Beijing and is reviewing candidates for the position.

- (e) What steps is USTR taking to better coordinate China trade enforcement with our trading partners?

ANSWER

USTR is increasing its efforts to coordinate with major trading partners in our enforcement efforts with respect to China. As a result of close consultations, on March 29, the United States joined with the European Union to initiate a WTO case against China on its tariff treatment of auto parts. This is an important issue. China issued regulations that discourage auto manufacturers in China from using imported auto parts in the assembly of vehicles, essentially creating local content requirements. After consultations with Canada, it too has filed a request for consultations. In addition to our international cooperation on the auto parts case, we have also been working closely with the EU and Japan and other trading partners in reviewing China's intellectual property enforcement regime. In October 2005 we submitted a request to China under Article 63 of the TRIPS Agreement seeking detailed information on China's IPR enforcement cases since 2001. We also sought cooperation from several other trading partners, leading Japan and Switzerland to submit their own transparency requests to China simultaneously with ours. We continue to look for other opportunities to consult and cooperate with our trading partners to ensure that China abides by its WTO commitments.

- (f) How does USTR plan to strengthen the Executive-Congressional partnership on China trade?

ANSWER

In the run-up to the April 11 meeting of Joint Commission on Commerce and Trade, USTR initiated a program of regular briefings for Congressional members and staff to update them on progress in pursuing the objectives outlined in the Top to Bottom Review and to gain Congressional views on the key trade priorities we should address. On March 30, Ambassador Portman and I met with the members of the House U.S.-China working group. On March 29, I, together with Under Secretary Lavin of the Commerce Department and Under Secretary Adams from Treasury, testified before the Finance Committee. Following the JCCT, USTR has conducted several briefings for staff of Senate Finance, House Ways and Means, and other Congressional committees to give a detailed readout of JCCT outcomes and discuss next steps on implementation of Chinese commitments. We look forward to continuing these consultations.

QUESTION 6

I am very concerned about China's foot-dragging in joining the WTO Government Procurement Agreement. Has the administration set a deadline for China's accession to the GPA? If not, why not?

In the interim, what are you doing to ensure that China conducts its procurements in a transparent manner and does not discriminate against U.S. suppliers?

What are you doing to monitor China's implementation of its procurement law to be sure that China does not interpret it in a discriminatory manner?

ANSWER:

At the April 11, 2006 meeting of the Joint Commission on Commerce and Trade, China agreed to begin the process of acceding to the WTO Government Procurement Agreement (GPA) by submitting its market access offer no later than the end of December 2007. We had strongly urged that China set a date certain for making its GPA offer, and view this as an important commitment by China. We are pleased that China has taken this step, and have let our Chinese counterparts know that we are seeking the submission of their GPA offer as far in advance of December 2007 as possible.

We held technical consultations with Chinese Ministry of Finance and Ministry of Commerce officials in late February 2006, per China's 2005 JCCT commitment. We emphasized the importance of China's respect for the principles of transparency and non-discrimination during the period leading up to China's GPA accession, and made clear that we would have serious concerns over procurement policies that favor Chinese companies. We specifically expressed concern about a notice stating that China would establish a list of proprietary domestic products from which government agencies would need to procure, and will follow all developments regarding this notice very closely.

One of the major successes of the 2005 JCCT was China's agreement to postpone issuing draft regulations that would have excluded most U.S. software manufacturers from the Chinese government procurement market by requiring Chinese government agencies to purchase domestic software products and services with only limited exceptions. To date, China has stood by its commitment and has not implemented these draft regulations.

QUESTION 7

Last year, Senator Grassley and I – as well as many of my colleagues – expressed concern over non-transparent subsidies provided by the Chinese government to CNOOC in the context of its failed takeover bid for Unocal.

These subsidies – whether in the form of preferential loans or direct payments – are a real issue. We don't know the magnitude of the subsidies that China provides its firms. This lack of transparency makes all such subsidies appear suspect.

Under both its WTO accession and JCCT commitments, China was supposed to notify such subsidies to the WTO. Why has China not done so?

What are you doing to ensure that China fulfils this commitment in the immediate future? Are you contemplating specific enforcement action to ensure that it does so?

ANSWER:

A range of industries have expressed concerns to us about the problems that Chinese government subsidization creates for them. China's lack of transparency presents enormous challenges in trying to develop comprehensive information about the various types of financial support that China provides to its domestic industries.

After the U.S. repeatedly raised this issue (including in March 2006 meetings I conducted in Beijing), China submitted its WTO subsidies notification on April 11 and we have been carefully reviewing the document. China's subsidies notification appears to be a good first effort, but there also appear to be some significant omissions both in terms of estimates for the value of specific subsidies and of the types of subsidies included in the notification. We recently began to address the substance of China's subsidies notification at the WTO in connection with China's Trade Policy Review.

QUESTIONS FROM SENATOR KERRY**QUESTION 1**

I understand that software piracy in China remains an enormous problem. I have heard estimates that overall software piracy rates in China are at 88%. At the July 2005 JCCT meeting, the Chinese Government agreed to complete its software legalization program to ensure that all central, provincial and local government offices are using only legally licensed software. Has this program been fully implemented? What additional measures will the Administration seek to address this issue going forward to ensure only legal software is used?

I understand that China also agreed at last July's JCCT to extend software legalization beyond the government enterprises, including state-owned enterprises, in 2006. How is this going? What other efforts are underway in China to monitor and enforce against software piracy? What additional measures does the Administration seek?

ANSWER:

China has taken steps to reduce government and enterprise use of unlicensed software, but their efforts have not fully addressed these piracy problems. Government and enterprise software piracy were key issues at the April 2006 JCCT. This was also the case, as you note, at the 2004 and 2005 JCCTs.

USTR has raised software piracy issues at meetings of the JCCT IPR Working Group and at meetings with key officials of China's National Copyright Administration (NCA). We are also in regular contact with concerned U.S. industries, led by the Business Software Alliance (BSA).

In late March, just prior to the JCCT, China issued two notices that impose important software pre-installation requirements for which we and the U.S. software industry had been pressing. The first notice requires that government agencies purchase only computers pre-loaded with legal operating system software. The second requires that all computers manufactured in or imported into China be pre-installed with legal operating system software. The Ministry of Information and Industry (MII) will also monitor compliance annually through a reporting mechanism.

China also informed us at the 2006 JCCT that its national steering group for the promotion of legal software in enterprises will issue procedures at the end of April on the use of licensed software by large enterprises, including state-owned enterprises. The steering group was formed in late February to begin the process of complying with China's 2005 JCCT commitment on enterprise legalization. The group is led by NCA and MII, and other agencies including the Ministry of Commerce, the Ministry of Finance, the State-owned Assets Supervision Administration of the State Council, the China Banking Regulatory Commission, the China Securities Regulatory Commission and the China Insurance Regulatory Commission. We are encouraged that a wide array of agencies, including many with responsibility for regulating state-

owned enterprises, are participating in this important effort. We will be examining announcements and results carefully.

We have also pressed China to adopt software asset management systems for government agencies and for enterprises, including state-owned enterprises. As part of our preparations for the April 2006 JCCT, we proposed a government software asset management program to China's Ministry of Commerce and NCA. BSA proposed an enterprise software asset management program to NCA. At the JCCT on April 11, Vice Premier Wu Yi agreed that China would discuss these proposals with us at the JCCT IPR Working Group. Undersecretary of Commerce Jon Dudas and I have written to our Chinese counterpart to begin planning for the next meeting of the JCCT IPR Working Group.

We are pleased that China has taken specific steps to address government and enterprise software piracy. However, it is also clear, particularly with respect to the use of licensed software by governments at all levels, that China's actions thus far fall short of its commitment of full government legalization by the end of 2005. Many additional steps will also be needed to ensure that enterprises use only licensed software, consistent with the government's pledge to do so by the end of 2006.

QUESTION 2

Last year, China issued draft procurement regulations that would have severely limited access of foreign software makers to China's government market. They later agreed, in the JCCT, to delay such regulations and to accelerate its efforts to join the WTO GPA. What is the status? The government is China's largest single purchaser of goods and services; do U.S. companies have adequate legal protection against discrimination in China's government procurement practices?

ANSWER:

In April 2005, China's Ministry of Finance (MOF), Ministry of Information Industry (MII), and State Council Information Office (SCITO) released draft regulations that would have required Chinese Government agencies to purchase "domestic" software products and services with only limited exceptions, effectively excluding most U.S. software companies from bidding on such government purchases. One of the major successes of the 2005 JCCT meeting in Beijing was China's agreement to postpone issuing these procurement regulations. To date, China has stood by its commitment and has not implemented these draft regulations.

China is not yet a signatory to the World Trade Organization (WTO) Government Procurement Agreement (GPA), so it is not bound by any agreement to provide a level playing field for the purchase of U.S. goods or services by the Chinese government. Nevertheless, although China is not a signatory to the WTO Agreement on Government Procurement (GPA), Beijing agreed to become an observer to the GPA upon accession and initiate negotiations for membership as soon as possible as part of its WTO accession commitments in 2001, according to Paragraphs 339 and 341 of China's Working Party Report. Until joining the GPA, Beijing also agreed that all government entities at the central and sub-national level, as well as any of its public entities other

than those engaged in exclusively commercial activities, would conduct their procurement in a transparent manner, and provide all foreign suppliers with equal opportunity to participate in that procurement pursuant to the principle of MFN treatment. This commitment means that if a procurement is open to foreign suppliers, all foreign suppliers would be provided with equal opportunity to participate in that procurement, e.g., through the bidding process.

Recognizing the importance of this issue for US companies, we have continued to press China to begin negotiations to join the GPA. These efforts were successful. At the April 11, 2006 JCCT session China agreed to commence its accession to the GPA with the submission of a market access offer by the end of December 2007.

We will continue our technical consultations with China as it prepares to begin its negotiations to join the GPA. We will also continue to engage with them on specific government procurement-related issues as they arise.

QUESTION 3

We have heard examples of the use of discriminatory procurement and technology standards policies to limit access of foreign companies in the Chinese market. I understand that China is now drafting a new patent law, new anti-monopoly law and new rules on standards. Could you provide, based on your best information, a summary of the provisions in these laws? Could these new laws be used to confiscate the intellectual property of foreign companies? If yes, under what circumstances? What is the Administration doing to ensure that China's innovation and industrial policies do not result in exclusion of U.S. companies from China's market or harm to intellectual property rights?

ANSWER:

China is increasingly resorting to industrial policies that limit market access by non-Chinese origin goods or services or that rely on government resources to support increased exports. The objectives of these policies are to protect less competitive domestic industries and support the development of Chinese industries higher up the economic value chain than those industries that currently make up China's labor-intensive base. In 2005, examples of these industrial policies were readily evident in each of the four areas mentioned in your question, i.e. standards, intellectual property, government procurement, and anti-monopoly law.

Specifically, we have raised concerns about China's telecommunications regulator's interference in commercial negotiations over licenses with IPR holders in the area of 3G standards, the pursuit of unique national standards in a number of high technology areas that could lead to the extraction of technology or intellectual property from foreign rights-holders, and draft government procurement regulations mandating purchases of Chinese-produced software.

Regarding China's anti-monopoly law (AML), USTR is particularly concerned by China's decision late last year China to remove provisions in the draft of the law that would prevent government monopolies from hampering intra-China trade. The interstate commerce clause of

the U.S. Constitution has worked well in this country to address similar issues dealing with trade within the United States, and we believe that similar requirements in China would enhance trade for both Chinese and foreign companies. It is also important that China's AML apply to state-owned enterprises, and China has not been clear that its law will apply with equal force to these entities. We are looking very intensively at this draft law, which could have far-reaching consequences for a broad cross-section of U.S. industry.

Our strategy for addressing all of these concerns is reflected in USTR's February 2006 top-to-bottom review of U.S.-China trade relations. First, we identified each of the items in your questions as priorities. Next, as I outlined in my testimony, we are focusing resources on these areas in a number of ways, including by expanding our enforcement capacity in USTR, increasing our information resources, working closely with other trading partners, and employing the many other tactics we identify in the report.

STATEMENT FOR SENATOR BUNNING
SENATE COMMITTEE ON FINANCE
U.S.-China Economic Relations Revisited
29 March 2006

Thank you, Mr. Chairman. I would like to welcome our guests to the committee.

This issue of American-Chinese trade relations is one that has troubled me for a long time.

In 1993, I stood on the floor of the U.S. House of Representatives arguing against the granting of Most Favored Nation status to China. Our trade deficit with China at that time was \$18 billion dollars. Currently, it is about \$200 billion.

We in the U.S.—possibly as a result of our youth as a country—tend to view important international matters with a short, 2- to 5-year timeframe. The Chinese, by contrast, have a time horizon of 1,000 years. This difference has obvious implications for the future dominance of the world economy.

Since China joined the WTO, to say that its record on living up to its obligations is “mixed” is being generous. For starters, they have been violating the WTO prohibition on export subsidies and the IMF rules against currency manipulation. Furthermore, the record of the Chinese on the protection of intellectual property rights is practically non-existent.

While other countries are taking steps toward cracking down on folks who steal the creativity and innovation of others, the Chinese are making little, if any, progress. In fact, they are acting as a haven for crooks that have been driven out of other countries by tougher law enforcement. Suspicions of their complicity in this illegal conduct are reinforced by their patent refusal to respond to our Article 63 request in October for information on their IPR enforcement.

The Chinese are acting to frustrate the transitional review mechanism which is the annual review of its compliance with its WTO obligations—a requirement of its WTO accession. They are refusing to open up their government procurement procedures. They are putting up non-tariff barriers, such as putting in place unique technology standards, right and left.

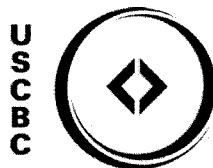
I could go on for hours reciting examples of the lack of good faith on the part of the Chinese government. I'm sure we will hear many more examples during the hearing today. This dismal list of the failure of the Chinese to live up to the commitments it has made should come as no surprise to anyone who has followed how the Chinese have behaved over the years.

I was recently in China with a number of my Senate colleagues. Our ability to gather useful information on that visit was frustrated by the fact that we were unable to meet with many Chinese government officials—including the trade minister. Such a refusal to meet with a group of United States senators shows a blatant misunderstanding of the functioning of the U.S. system of government.

Perhaps the Chinese government feels that they need only deal with the administration in trade and other important matters—obviously, that is not the way this democracy functions.

I have a number of questions, and I am looking forward to hearing your responses.

Thank you.



THE US-CHINA BUSINESS COUNCIL
 美 中 贸 易 全 国 委 员 会

US-CHINA ECONOMIC RELATIONS REVISITED

**Statement to the Senate Committee on Finance
 March 29, 2006**

**John Frisbie
 President, the US-China Business Council**

Chairman Grassley, Senator Baucus, other members of the Senate Finance Committee: My name is John Frisbie. I am President of the US-China Business Council, which represents approximately 250 US companies doing business in and with China. Thank you for this opportunity to provide you with our members' perspective on the state of US-China economic relations.

Introduction

The US-China Business Council (USCBC) favors a balanced approach to our trade policy toward China. This involves recognizing the significant benefits trade and investment with China have provided US companies and the American economy, while also understanding the challenges experienced by some sectors. A balanced approach also requires addressing the barriers still faced by US companies doing business with China, while expanding the opportunities created by the opening of China's economy.

These themes were addressed in our written statement submitted for last June's Senate Finance Committee hearing on China. Since then, China and Hong Kong combined have become our third-largest export market, passing Japan and trailing only our free-trade-area neighbors, Canada and Mexico. Moreover, China continues to be the fastest growing of our top fifteen export markets. Our exports to China have grown 150 percent over the past five years since China joined the World Trade Organization (WTO); the second fastest growing major market for American products during that time was Belgium, with a cumulative growth of 33 percent.

At home, US trade and investment with China will by 2010 result in an annual 0.7 percent increase in US gross domestic product and an annual 0.8 percent decrease in US prices—the combined effect of which will be an annual increase of up to \$1,000 in real disposable income per US household.¹ At the same time, however, it must be acknowledged that China's expanding role in the international economy has likely contributed to the decades-long shift in US

¹ Erik Britton, Christopher T. Mark, Sr. *The China Effect: Assessing the Impact of Trade and Investment with China on the United States*. Washington, DC: China Business Forum, 2006. pp. 8 – 9. <<http://www.chinabusinessforum.org/pdf/the-china-effect.pdf>>.

employment from manufacturing to service sectors, even as our manufacturing output continues to rise.

Most of the USCBC's approximately 250 member companies are focused primarily on either exporting to, or manufacturing and selling in, China. This focus is reflected in the annual survey results of our membership regarding its China business. For USCBC member companies, the top concerns include improving the protection of intellectual property rights (IPR); fully utilizing newly granted distribution rights; increasing government transparency; finding and retaining local management staff; lowering market access barriers in various service sectors; and ensuring that Chinese technical, safety, and health standards do not hinder US companies' ability to sell in China. With the exception of IPR, companies using China as an export platform would not be concerned with these issues.

Before going further, it is important to understand the global dynamics of trade and investment affecting the US-China economic relationship. Increases in the US trade deficit with China are generally not the result of specific Chinese policies. Rather, they mainly reflect the ballooning US global trade deficit and shifts in patterns of trade and investment within Asia. Over the last ten years, China's share of the total US trade deficit remained fairly constant, increasing from 23 percent to 26 percent (even though it has grown significantly in real terms). During the same period, the rest of East Asia's share of our global trade deficit declined significantly, from 42 to 18 percent. Why has this happened? During that period, East Asian economies invested heavily in China, thereby shifting much of their manufacturing capacity—and therefore their trade surpluses with the United States—to China.

Furthermore, when taken as a whole, China and East Asia's share of the US global trade deficit actually has dropped from 67 percent to 44 percent over ten years. In contrast, our trade deficit with the rest of the world has grown across the board and now makes up 56 percent of our global trade deficit. Some of this increase is from petroleum imports. But even when the effects of petroleum are stripped out the growth of the US trade deficit with East Asia including China (\$225 billion) is roughly matched by the growth in our trade deficit with the rest of the world (\$205 billion) during this time. The US economy may have a trade deficit problem, but if so its causes extend beyond simply our trade with China.

On this basis, I would like to turn to key developments since last June's Senate Finance Committee hearing on China.

USTR's Top-To-Bottom Review

The USCBC welcomed the findings and recommendations of the Office of the US Trade Representative's (USTR) "top-to-bottom" review of US trade policy toward China released in February of this year. As the Committee is aware, the report proposed enhancing USTR's enforcement capabilities, increasing staff both in China and in Washington, and improving coordination with our other trading partners on China issues—all of which we believe are essential to addressing the concerns of the US business community.

The review demonstrates USTR's commitment to working on the key issues in our trading relationship and it highlights the balanced approach we describe above. While China is our

fastest growing major export market and our commercial relationship with China is vital to the strength of the US economy, we also must take steps to resolve problems in that relationship.

USCBC member companies, like most businesses operating in China, agree that these key issues must be addressed. IPR protection and enforcement remain inadequate. China's regulatory process still remains too opaque. Market access for foreign companies operating in China remains inconsistent. China's financial sector reforms are unfinished.

Resolution of these problems is best pursued through the type of constructive engagement that USTR described in the top-to-bottom review. We support the refocusing of resources and anticipate tangible results from stepped-up engagement.

China's Currency

One issue more than any other has captured the attention of Congress and much of the American public: the exchange rate between the US dollar and the Chinese yuan. Many say that China's government keeps the value of its currency artificially low in order to boost its exports and that this is the main cause of the bilateral trade deficit between China and the United States.

As we noted in our submitted testimony last year, China should indeed adopt a market-determined exchange rate. Toward this end, our focus should be on encouraging China to undertake the broader financial sector reforms that will enable China to remove capital controls at the appropriate time and allow market forces to determine fully the value of its currency. These include opening the financial sector to more private companies, introducing more financial market products such as currency futures, requiring greater commercial accountability from existing financial sector companies, and, of course, allowing more foreign participation in China's capital and credit markets. We understand that the Treasury Department has made these reforms a central part of its engagement with China's government and we fully support this dialogue.

In the meantime, China should move more quickly to allow market influences from trade flows to be reflected in the exchange rate between the dollar and the yuan. Last July's change in China's currency policy was welcomed by all. Movement since then to allow market influences a greater role in setting the exchange rate has been slow, although the pace has increased during the past month. Many economists and the local press in China expect gradual appreciation to continue for the balance of this year.

It should be noted, however, that the effect of China's exchange rate policy on bilateral trade is likely overstated. USCBC member companies generally do not cite the exchange rate as a key business issue affecting their competitiveness in China. Many are concerned, though, about potential repercussions should the political dispute between the two countries over the exchange rate worsen. More broadly, recent research indicates that even a 25 percent revaluation of the yuan against the dollar—far greater than expected—would decrease the total US trade deficit, which was \$766 billion in 2005, by \$20 billion.²

Even so, any benefit China gains from an undervalued currency—even if its actual impact on the US economy is not great—should be addressed. The best way to eliminate any such unfair

² Ibid, p. 8.

advantage is to continue to push for greater market influences to be reflected in the exchange rate now, and for broader financial reforms that will lead to the removal of capital controls at the appropriate time and a truly market based currency in the future.

Joint Commission on Commerce and Trade

As the members of this committee are aware, the Joint Commission on Commerce and Trade (JCCT) will meet on April 11, 2006 in advance of PRC President Hu Jintao's visit to the United States later in the month.

Before I note some of the issues that the USCBC's members hope will be addressed at this year's meeting, I want to highlight a concern about the process in general. The JCCT originally was created as a means to promote commercial opportunities. In recent years, the JCCT has focused solely on resolving trade problems.

There are, of course, many more issues of concern between our two countries than can be resolved in a single annual meeting. As one would expect, negotiators on both sides frequently begin to plan for the JCCT several months in advance with extensive lists of possible topics that may be included in the final JCCT agenda. As the list of issues is reduced to a manageable number, unresolved issues are put aside until the next opportunity for resolution—frequently, the following year's JCCT.

Given the breadth of the issues, US government and industry need to see engagement with the PRC in the areas of concern on a more regular basis. The current, irregular, schedule of the JCCT and its limited scope of coverage are not adequate to make continued, meaningful progress. For instance, issues affecting US media companies are, for the most part, outside of the portfolio of China's JCCT team. A mechanism for broader and more frequent engagement is necessary if we hope to resolve the irritants in our economic relationship with China.

Until such a mechanism is established, however, the JCCT remains the best means to achieve progress on the greatest number of issues. China has done moderately well in following through on the commitments it has made as part of the JCCT process, though some issues remain unresolved.

Two areas that the USCBC believes must be central in this year's meeting should be highlighted. First and foremost is IPR enforcement, the top problem cited by our membership in our most recent survey. USCBC continues to regularly lobby the PRC government on the need for improved IPR enforcement. We will be submitting recommended regulatory changes directly to the PRC government this spring. And we are providing American companies with "best practice" tools so that they can do the maximum to reduce their exposure in a difficult environment.

Intellectual property piracy simply cannot be tolerated. At the same time, this far-reaching problem will not be solved overnight. The key is for China to show steady progress in reducing piracy—that effective steps are being made toward the goal. The challenge for us is to identify specific measures for adoption in the JCCT process that, if implemented, would lead to such tangible progress. Last July's JCCT IPR measures were a good step in this direction; we need to continue this approach in April. And, China needs to bring greater transparency to its enforcement efforts so that all can assess if progress is being made.

China published just recently its 2006 IPR Work Plan. The plan suggests that many of the July 2005 JCCT actions are being implemented and additional measures are being taken. We encourage USTR and the Department of Commerce to evaluate this plan's effectiveness and identify additional specific measures that could be incorporated in this year's JCCT that would encourage further progress on IPR enforcement in China. We hope these measures would include China's favorable response to the request for case information under Article 63.3, which would bring more transparency to the enforcement effort.

A second issue that the USCBC believes must be addressed in this year's JCCT is subsidies. If we are to seek a level playing field for US companies operating in China, as well as for American companies facing Chinese competition at home and in other markets, we need to devote more effort and resources to better understanding this aspect of China's economy. While China's economy continues to evolve, it is transitioning from a state-run, command economy that directly subsidized much activity in the past. There may be remnants of the old system still in place that are benefiting Chinese companies at the expense of foreign competitors.

China's WTO accession required it to file a report on its subsidies upon accession in December 2001. That deadline was missed. At the 2005 JCCT, China agreed to submit the report by the end of the year. It still has not been submitted. The report must be completed and submitted now. It will not likely provide the detail or complete picture needed, but it is a necessary first step to getting at this important aspect of the level playing field.

Beyond these issues, we hope the JCCT will successfully address other issues, such as: establishing a start date for negotiations on China's accession to the WTO Government Procurement Agreement; resolving the auto parts customs classification issue; addressing several air express delivery concerns with China's draft Postal Law; and allowing direct selling companies to practice their internationally accepted model in China. We also hope to see progress on several other issues that USTR and the Department of Commerce are discussing with their PRC counterparts.

A Bigger Framework?

The USCBC hopes that President Hu's visit will provide additional incentive for resolution of bilateral concerns. The main goal for the United States, however, should be to reinforce at the highest level China's continued commitment to implement fully its WTO obligations and to participate in the global economy as a mature trading partner.

One of China's goals is recognition by the United States as a market economy. US law clearly lays out the criteria for market economy status, one of which is the extent to which a country's currency is convertible into other currencies. Given the need for tangible progress on that and other issues, it may be time to provide China with a clearer roadmap of how to meet those criteria. As further encouragement, perhaps we should also consider the steps China could take to become a member of what would then become the "G9." Setting positive, mutually beneficial goals and outcomes may help facilitate progress in China on the reforms and market openings needed to get there, including resolution of issues adversely affecting American companies and the American economy.

Conclusion

Since the Senate Finance Committee hearing on China last June, we have seen progress in a number of important areas:

- A JCCT meeting took place in July, at which several specific IPR-related measures were included. China has enacted several of those measures. China announced a 2006 IPR Work Plan in March that incorporates many of these measures, plus additional actions.
- Other, non-IPR measures agreed to at last July's JCCT have also been implemented, including a meeting under the US-China Insurance Dialogue in December to address regulatory issues; a meeting of the Information Technology Working Group in January to work on capitalization requirements and other issues; and a delay in issuing regulations on PRC government procurement of software.
- China revised its currency policy in July, along with a 2.1% revaluation of the exchange rate, and has allowed the yuan to appreciate slowly since then.
- US exports grew 20% last year, making China our fourth-largest export market, or third largest when combined with Hong Kong.
- USTR released its top-to-bottom review of China trade policy, offering a comprehensive approach to addressing trade concerns.

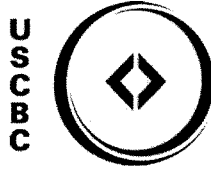
However, we also need to see more progress in some of these same as well as other areas:

- IPR protection is still a significant problem for US (and other foreign and Chinese) companies. While the IPR problem cannot be solved overnight, we have to see progress toward reaching that goal, with more transparency needed from China in its enforcement effort.
- China should allow market influences to be reflected in its exchange rate at a faster pace. We should keep in mind that broader financial reforms and market openings are also needed to get to the eventual goal of a fully market-based exchange rate.
- The bilateral trade deficit grew to just over \$200 billion in 2005. While our bilateral trade balance needs to be put into the context of our shifting trade pattern with East Asia as a whole and with the rapid growth in our trade deficit with the world, we nonetheless need to make a more fact-based assessment of the "level playing field," including subsidies that may give Chinese enterprises an unfair competitive advantage. On our side, we need to boost our exports by continuing to engage the PRC on removing market barriers and by devoting more resources to helping American companies—especially small- and medium-sized enterprises—enter and succeed in the China market.
- Insurance licensing, telecommunications capitalization requirements, and government software procurement questions remain, despite the limited progress noted above. Further attention to these issues is required to ensure progress continues to be made.
- China needs to start accession negotiations to the WTO Government Procurement Agreement by the middle of this year; allow direct selling firms market access based on internationally accepted practices; ensure that its standards setting process does not exclude foreign competition; and engage in meaningful discussions with the US government to eliminate or reduce numerous other market access barriers.

In closing, we feel it is important to comment on the call for protectionist policies from some

quarters in response to the challenges of trade. As noted in our statement submitted to the Senate Finance Committee last June, the US-China Business Council is very much aware that the benefits and costs of international trade do not distribute to all Americans evenly. We recognize that some sectors of our economy struggle with the challenges brought by trade with China and the rest of the world. We must also remember, however, that our large global trade deficit is not caused solely or, perhaps, even mainly by Chinese policies.

In addition, the benefits of trade, in the form of substantial exports, a lower cost of living, and less inflation, are large and clearly outweigh the challenges. Business and government should work to guarantee that all Americans have the opportunity to enjoy these benefits. Part of this work requires us to press China to abide by its international trade agreements and to enforce our trade remedy laws to ensure a level playing field, but jeopardizing the US economy with tariffs or other protectionist measures is not an acceptable way to inform China that it must change some of its policies. Rather, we should also focus on policies to correct a trade deficit that has grown remarkably with all regions—not just China—such as reducing our large fiscal deficit and enhancing the competitiveness of our economy.



THE US-CHINA BUSINESS COUNCIL

美中贸易全国委员会

AN INTRODUCTION TO THE US-CHINA BUSINESS COUNCIL

The United States-China Business Council, Inc. is a private, non-profit, non-partisan, member-supported organization. It is the principal organization of US corporations engaged in business relations with the People's Republic of China. Founded in 1973 as the National Council for US-China Trade, the Council originally served the early efforts of United States business in China in the absence of formal diplomatic relations between the two nations. With the massive growth of US-China economic engagement since the end of the 1970s, the Council has continued to assist firms entering the field for the first time, but increasingly the bulk of its work has served the interests and needs of US firms with well-established commercial relationships in China. Headquartered in Washington, DC, the Council also serves its corporate members from field offices in Beijing and Shanghai.

The Council provides extensive, tailored Business Advisory Services on a wide range of business interests and concerns to individual member companies. Its meetings and programs, in the United States, China and Hong Kong, provide both broad-gauge and highly business-relevant information, and offer companies the chance to share ideas and experiences as well.

The Council continues to play a central role in analysis and advocacy of key policy issues of significance not only to US businesses but also to the future of US-China relations. The Council's activities in support of government policies conducive to expanded US-China commercial and economic ties include educational meetings with Members of Congress and Congressional staff, and frequent testimony on behalf of the US business community in Congressional or other venues. The Council also works to enhance media and public understanding of complex issues in US-China relations, appearing frequently on major broadcasts and providing accurate statistical and analytical information to media representatives.

The Council's numerous publications include the leading US periodical on China trade, the *China Business Review*, the members' weekly electronic newsletter, *China Market Intelligence*, two web sites, www.uschina.org and www.chinabusinessreview.com, and numerous focused studies on topics of current business interest.

The Council serves as a valued and economical complement to the intensive in-house efforts that US companies devote to business development in China. Council membership in 2006 currently stands at approximately 250 firms, and continues to strengthen in response both to China's economic growth and to the many challenges and complexities US firms face in the Chinese environment. Among the Council's members are many of the largest and best known US corporations, but smaller companies and service firms make up a substantial portion of the overall membership as well.

The Council is governed by a Board of Directors composed of distinguished corporate leaders. The Council's current chairman is Michael L. Eskew, Chairman and Chief Executive Officer of UPS. Since November 1, 2004, the Council's president has been John Frisbie.

The US-China Business Council has long served as a respected host for senior visitors from China and from the United States government. In recent years, the Council has been honored to receive His Excellency President Hu Jintao; Premier Wen Jiabao; former President Jiang Zemin; former Premier Zhu Rongji; and other distinguished Chinese guests from central and provincial government entities. Recent American public figures to meet with Council members have included Commerce Secretary Carlos M. Gutierrez; former US Trade Representative Robert B. Zoellick; US Ambassador to China Clark "Sandy" Randt; key figures from the United States Congress; and numerous specialists on US-China affairs from various agencies of the Executive Branch of government.

January 2006

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SHANGHAI

John Frisbie
US-China Business Council
Responses to Questions for the Record

1. If you were to become the United States Trade Representative today, what would be your top three priorities for your China policy? What would be your goals and how quickly do you think you could achieve them?

As the US Trade Representative, I would place a priority on three broad goals.

First, I would focus on ensuring that US exports to China continue the impressive growth of the past few years. China is by far the fastest growing major export market for US goods. Continued export growth requires that the US government pay diligent attention to China's implementation of its World Trade Organization (WTO) commitments and assist US companies that are seeking to export to China.

Second, I would encourage China to prosecute intellectual property rights (IPR) violations aggressively at the national, provincial, and municipal level. China's recently released 2006 IPR Protection Action Plan describes many new enforcement strategies and reporting and education initiatives for all levels of government. Confirmed implementation of the Action Plan, many elements of which should occur in 2006, would be one of my top goals for improving IPR protection in China. I would give particular attention to ensuring that China establishes the national database of IPR enforcement cases promised in the Action Plan to improve transparency on this issue.

Finally, I would focus on ensuring China's full implementation of its WTO and Joint Commission on Commerce and Trade (JCCT) commitments. China's record in this regard is mixed. US-China Business Council member companies almost unanimously found China to have done a "fair" or "good" job in complying with its WTO commitments in 2005. The Council's monitoring of China's implementation of commitments it made at the 2004 and 2005 JCCT sessions demonstrates that it has adopted policies to meet the bulk of these commitments. Even so, some issues remain outstanding—and meeting "most" commitments does not satisfy the need for China to meet all of its WTO and JCCT commitments fully and on schedule.

2. Looking ahead at 2007, what will be the metrics for a successful year in US-China ties? How will you measure success? What could the balance sheet look like?

When assessing whether 2006 has been successful for bilateral commercial relations, the US-China Business Council will look at the extent to which China's government has:

- Implemented commitments scheduled to be phased-in by December 11, 2006 in its World Trade Organization entry agreement,¹ including:
 - Removing remaining restrictions on where and with whom foreign banks may engage in local currency business;
 - Lifting most remaining restrictions on foreign-owned wholesalers and retailers;
 - Allowing wholly foreign-owned enterprises to engage in architectural, engineering, integrated engineering, and urban planning services;
 - Broadening the range of products wholly foreign-owned insurers may sell to Chinese customers; and
 - Expanding the number of cities open to joint-venture telecommunications service providers.
- Implemented commitments made at the April 2006 US-China Joint Commission on Commerce and Trade, including:
 - Implementing its IPR commitments, including agreeing on a means to assess compliance with use of legal software on all government and state-owned enterprise computers;
 - Initiating discussions to reduce capitalization requirements for telecommunications; and
 - Meaningfully engaging in the technical consultations to prepare for joining the Government Procurement Agreement.
- Adopted and implemented policies likely to result in better enforcement of intellectual property rights;
- Increased the role of market influences in determining its exchange rate; and
- Introduced reforms to open the financial sector to more domestic and foreign private companies and allowed the introduction of new financial products.

In the United States, the Council will look to the extent to which:

- The administration and the Congress remain committed to pursuing resolutions to bilateral commercial disputes through engagement and mechanisms consistent with US obligations as a WTO member; and
- US trade officials focus their efforts on effective strategies to expand the market access of US companies.

¹ China has already moved toward implementing some of its 2006 WTO commitments:

- China has allowed foreign banks to engage in local currency business in a number of cities ahead of the WTO schedule.
- China has partially implemented its commitments on wholly foreign-owned architectural, engineering, integrated engineering and urban planning services. Urban planning enterprises have been allowed since May 2003; draft rules for the other types of firms were issued in late 2005 for comment but have not yet been finalized and implemented.

3. We need to work together to make our relationship with China work. Sometimes, that means the government helping American companies and workers. Other times, it means American companies helping the government, so that we can ultimately help enforce international trade laws.

In China, I understand that some US companies have been reluctant to help USTR for fear of retribution by the Chinese. In other words, US companies may be reluctant to give adequate information on to USTR, for fear of losing valuable market share in China.

Is there any truth to this kind of scenario? Do American companies feel hamstrung, wanting on one hand to help enforce trade laws, but fearing Chinese retribution on the other?

Reports of US companies fearing retaliation in China if they support USTR trade actions appear to be exaggerated, even though some companies may indeed feel this way. In fact, US companies in the past have shown their support for USTR actions, such as the semiconductor value-added tax and the kraft linerboard cases.

Much of this criticism has focused on company strategies regarding intellectual property rights (IPR). IPR, however, is a broad term that encompasses many distinct concerns. IPR issues range from copyrights to trademarks to patents to trade secrets, and solutions to problems in each of these areas differ widely. Companies view the IPR problem differently depending on their industry and the nature of their problem. A movie company sees the problem differently from a pharmaceutical company, and both have a different view than an industrial company. The severity of the problem is different for each sector, the policy redress is different, and importantly, the actions companies support are different in each of these areas. In the end, a more focused approach to the IPR problem in China—one that accounts for the different problems and solutions—is the most productive way to achieve advancement for American companies on this issue.

When a US company operating in China—or any country—encounters a barrier it believes to violate WTO or bilateral agreements, it must decide what strategy is the most effective way to reach a satisfactory outcome. The options range from directly approaching the appropriate regulator(s) in China, to working through trade associations, to requesting the assistance of the USTR or other US government agencies, to seeking possible WTO actions. Companies must retain the flexibility to determine the appropriate course of action, including both private means of redress and the intervention of the US government, to resolve market access hurdles.

Testimony of Robert D. Hormats
Vice Chairman Goldman Sachs (International)
Before the Committee on Finance
United States Senate
March 29, 2006

U.S. – CHINA ECONOMIC RELATIONS REVISITED

Mr. Chairman and members of the Senate Finance Committee,

It is a great pleasure for me to appear before this Committee once again. I welcome the opportunity to discuss U.S.–China relations — particularly in advance of the important visit of President Hu to this country in mid-April.

I can recall the first discussion I had with this committee on the subject of U.S.-PRC relations in the early 1970s, when we were just beginning to normalize ties. At the time, I was a staff member for economic policy on Henry Kissinger's NSC Staff and was asked to come up to the Committee to brief members on our nascent economic opening with China prior to President Nixon's trip. We used small economic steps to signal the Chinese that we were interested in normalization of relations. The first signal we sent was to permit American citizens to bring in to the U.S. \$100 worth of Chinese products — so long as they were not purchased in China. That was roughly 30 years ago — and at the time it was considered a major step and was very controversial here.

How far our relationship has come since then — and how dramatically our trade and investment flows have expanded! It is easy to forget how remarkable the changes in China have been — and that hundreds of millions of people in that country are now far better off as the result of China's reforms. It is also easy to forget just how much China's economy has opened since that time and how beneficial to the U.S. and the rest of the world the surge in Chinese prosperity has been! So as we focus on the problems that our two countries face in their economic relationship today, it is also useful to put them in perspective — and recall the enormous progress that has been made.

Adjustment to the rising economic, financial and political power of China poses a number of challenges. The economic rise of China has had a profound and pervasive impact on the U.S. economy and the global economy — in trade, commodity markets, the oil market, finance and manufacturing. China has risen to the position of a world economic power more rapidly than any other country in history (although it is worth recalling that China was the biggest economy in the world roughly 200 years ago, so this is really a "comeback" rather than something new).

The U.S. and other nations have been faced with the need to adjust at a very rapid pace to the opportunities and competitive challenges that China's rising economic power poses. And Chinese officials are faced with a similar need to adjust to the fact that international economic power carries with it international responsibilities. It is worth noting that this is not the first time

the established power structure in the world has been faced with the challenge of a rising new power: Germany in the late 1880s, the United States in the early 1900s, post-war Japan in the 1970s, and now China in the early 21st Century.

There are those in our government and country who see China as a long-term security threat and a near and long-term economic threat; if we treat our relationship with China based on the assumption that this is inevitable, we will in fact be contributing to that outcome. If, instead, we attempt to develop bilateral and multilateral policy and institutional linkages that serve our mutual interests by enhancing China's efforts to sustain growth and job creation while enabling U.S. companies to benefit from the growing opportunities in China, and by ensuring that China plays by the market based international rules that the U.S. and its other major trading partners adhere to, then tensions can be better managed and the prospect of a win-win relationship can be improved.

One key U.S. objective must be to find ways for our citizens to benefit further from the opportunities afforded by China's growth while also ensuring that China uses its growing economic influence, in cooperation with the U.S. and other major economic powers, to shape a more balanced and open trading and financial system that all sides perceive as fair, and that provides an opportunity for market forces to work smoothly and without excessive government intervention.

NEGOTIATING AND WORKING WITH CHINA

Before I get to the heart of my testimony, I thought that it would be useful to reflect on a few personal experiences I have had in working with, and negotiating with, Chinese officials for over 30 years, and share a few points emerging from that which might be relevant today.

BE CANDID IN ASSERTING U.S. INTERESTS AND OBJECTIVES, BUT AVOID PUBLIC LECTURES — Candor in personal and professional relationships vis-à-vis China is essential; the Chinese typically are very candid with us and we show them respect and get better results if we are candid with them. If we have concerns or issues, we should by all means raise them clearly and assertively with their officials and leaders. They do it, and so should we. But there is a difference between forcefully raising concerns in public — and certainly in the form of public lectures — and doing so in private conversations and negotiations. Public criticism and lectures have been demonstrably ineffective in persuading senior Chinese leaders to alter policy. The recent National Strategy Report, for instance, states that China “must” do this or “must” do that. Quite apart from the merits of the substance, that tone is unlikely to produce results. Typically, private negotiations and pressure — in which points can be strongly, but less highhandedly made, in support of U.S. interest — have worked a lot better.

STRATEGIC COHERENCE AND POLICY PRIORITIZATION — U.S. policy toward China is not likely to achieve significant results if it lacks strategic coherence. Every agency cannot achieve everything it wants at the same time. The laundry list approach has rarely worked. An absence of prioritization — and one central figure or agency in the administration to convey those priorities — weakens the U.S. position. Nor can the U.S. conduct an effective policy by responding to every U.S. domestic pressure group that wants the U.S. government to take some sort of action against China or obtain China's agreement to its desired objective. A long-term strategy that focuses on the priorities that are most central to America's national interests will work far better than pursuing the issue du jour or raising a lot of issues all at once without making clear our priorities.

DON'T EXAGGERATE CHINA'S IMPACT — China accounts for 15% of U.S. imports and imports overall are 14% of GDP, implying that Chinese imports are equivalent to 2% of U.S. GDP. And, as a recent report by the China Business Forum notes, "While the bilateral trade imbalance with China has been rising dramatically in absolute terms, China's share of the overall U.S. current account deficit has remained fairly constant, at around 20 percent for more than a decade." This is because U.S. trade and current account deficits are increasing with almost all regions of the world as well — not just China. Indeed, "the increase in China's share of U.S. imports from 2000 through 2004 was offset by declining shares of other East Asian exporters, reflecting a profound shift in production patterns by Asian and other multinational firms operating in the region." Moreover, while it is also true that although trade with China has resulted in a loss of output in a number of manufacturing sectors, it has boosted output in a number of other sectors; the impact on job displacement is also focused heavily on the manufacturing sector — and it is important to find ways to assist people thus displaced and to ensure that those job losses are more than offset by job gains in other sectors.

However, the criticism that Chinese imports are responsible for large scale job loss in this country is misplaced. First, the U.S. has been losing manufacturing jobs for decades, well before the increase in trade with China even began. In addition, the U.S. economy typically is subject to a very high churn rate as companies down size or close, new companies start and older ones add more employees. This churn began during the time of Alexander Hamilton — and is natural in a dynamic market economy. It has speeded up recently as the result of rapid technological change and the rise in import competition as well as the need to shift human and capital resources to activities that produce higher returns. But the U.S. economy is now creating more jobs than are lost. In any case, the effect of trade with China in employment in the US is relatively small compared to the effect resulting from domestic technological change and the normal flux in our economy.

This is not meant to suggest that U.S. policy makers should be complacent or indifferent about the plight of people who are displaced. Indeed I am deeply concerned that we as a nation are not sufficiently aware of the growing difficulties of low and middle income workers who face concerns about job insecurity due to foreign competition and technological change, health insurance insecurity, doubts about the future of social security, social and similar factors. Means should be found to address their concerns, or we will end up with a very divided society with some seeing trade and technological progress as their friend and others seeing them as their enemies.

RECOGNIZE THE DIFFICULT NATURE OF CHINA'S DOMESTIC CHALLENGES — We must recognize that China faces enormous internal challenges — a 150-200 million person floating work force, terrible environmental problems (due in part to the stripping of land, inadequate water supplies and the extensive use of coal), great income disparities, especially between rural and urban China, the need to create a lot of jobs in order to preserve social stability, and the lack of a broad scale social security and healthcare system etc. Putting U.S. requests and negotiating objectives relating to economic policy reform in a context that recognizes these challenges, and framing our requests and objectives in such a way that the Chinese government sees the benefits of these measures in helping to address these pressing domestic issues (or at least demonstrates an awareness of them) has a better chance of succeeding than failing to make this connection. For example, working with the large numbers of Chinese who are developing intellectual property of their own — and will be able to create needed domestic jobs using their intellectual property — can enhance the chances of obtaining more meaningful reform in this area. Putting requests for banking reform in the context of shifting more resources

to the private sector, which will in turn enable it to create more jobs, also makes good negotiating sense.

USE INTERNATIONAL INSTITUTIONS TO SHARE RESPONSIBILITY AMONG STAKEHOLDERS IN THE GLOBAL ECONOMY — Chinese authorities have demonstrated a strong interest in working with and in multilateral institutions — and have joined virtually every international institution for which they are eligible. China is far more open to trade and foreign investment than were Japan and South Korea at similar stages of their development. This active global engagement should be welcomed by the U.S. — and these institutional arrangements should be utilized by the U.S. — as a way to encourage China to assume the responsibilities that a large economy has to the world economy as it derives benefits from the trade and investment relations it enjoys in the world economy. Even those institutions, such as the East Asian Summit, which the U.S. is not a part of, can provide constructive fora for integrating China into the global economic system. The U.S. should also strengthen groups such as APEC, which bridge the Pacific and can provide a useful forum for discussion and consensus building. Bringing China into the G-8 is also a worthwhile idea — and in my judgment overdue. And the two countries should work together to successfully conclude the Doha Round — the success of which is extremely important to both nations.

THINK TWICE ABOUT THE IMPACT THAT MEASURES BEING PROPOSED VIS-À-VIS CHINA WILL HAVE ON THE U.S. — Attempting to isolate China or impose barriers around the U.S. to punish China or to compel policy changes is likely to be harmful to our own economy, as well as to China's economy. The U.S. and Chinese economies are closely linked by trade, investment ties, company supply chain linkages and capital flows. This is not to argue that we should not assert our interests and be prepared to use international trade rules and our domestic laws and sources of trade relief when warranted. It is to warn that heavy handed uses of blunt instruments could do great damage to millions of American consumers, home buyers who depend on low mortgage interest rates, businesses and jobs that depend on increased sales in China and growth opportunities in China, our capital markets and many other parts of our economy and society.

Legislative actions that may initially look appealing might end up doing a lot of damage to the US economy. Beware of the boomerang affect in trade policy. We have seen it all too frequently. The US is, after all, the nation with the greatest economic, political and strategic interest in an open and rules-based global economic system; we should steer clear of measures which damage that system.

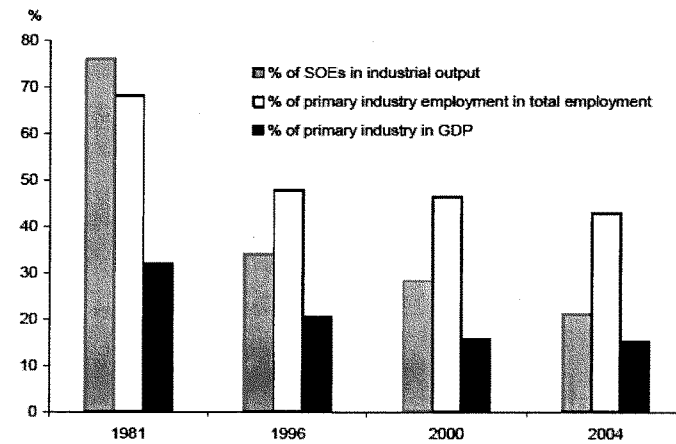
REMAIN ACTIVELY ENGAGED IN ASIA — Many of the initiatives China currently is taking are moving in the direction of making it the centerpiece of an economically integrated Asia. It is not likely that other Asians would want this to occur to the exclusion of the U.S.; indeed virtually all other Asian nations would not want to marginalize the U.S. for economic, political and security reasons. But there are strong feelings in much of the region that the U.S. is so preoccupied with Iraq and the War on Terrorism that it is neglecting the Asian development, trade, financial and economic agenda, or at least is not very enthusiastic about it. President Bush has emphasized his support for an annual summit with ASEAN. That is a good idea. We need to build on that and many other regional and international groupings to demonstrate commitment and staying power in the Asian region.

A BRIEF LOOK AT CHINA'S ECONOMIC TRANSFORMATION

China's extraordinary growth performance over the last three decades has been underpinned by two historical transformations in that country — from an agrarian to an industrial society, and from a central-planned to a market-based economy.

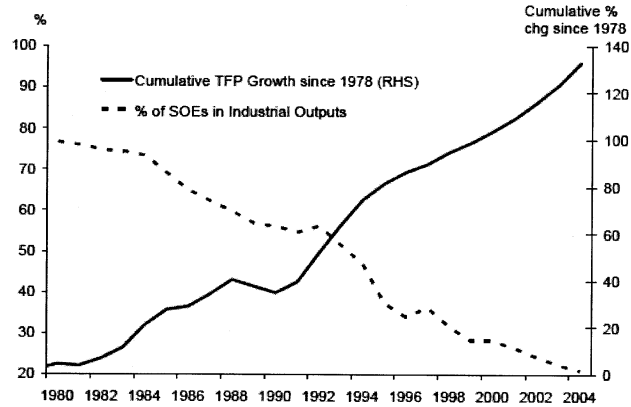
It is the unique path China has chosen for the second transformation that has distinguished its story from any other growth experience the world has witnessed before. A sharp and sustained increase in productivity post 1978 has been the driving force behind China's fast growth, and it has benefited from a unique "reform dividend" originating from policy efforts that have gradually but consistently scaled back the government's role as a central planner.

Twin transformation in China: declining roles of the SOEs and the agricultural sector



Source: CEIC, Goldman Sachs Research estimates.

**Extraordinary improvement in economic efficiency
coincident with the decline of SOE's share in the economy**



Source: CEIC, Goldman Sachs Research estimates.

Therefore, the real epic China story is not about how an inefficient economy could continue to grow so fast, but rather how China could have gradually but consistently reduced the inefficiencies in the system. Reforms that have progressively given greater rein to market forces in resource allocation are at the heart of China's success. Of equal importance is the leadership's pragmatism in executing these changes.


Foreseeing further sizable gains in "reform dividends" from China's WTO membership-related changes, the next several years could be a "sweet spot" of growth and efficiency improvement. Looking beyond the medium term, when China's per capita annual income will likely cross the \$3,000 mark, however, there are fewer certainties, and greater challenges.

The challenges are primarily in the areas of heretofore "postponed," but very much needed internal social and economic reforms. For example, a high priority for the Chinese government is to narrow the growing income and wealth disparities between rural and urban China, and between coastal China and central and western China, that have developed over the last ten years. Such disparities have been a key factor precipitating outbreaks of serious rural unrest and violent incidents. The government of President Hu and Prime Minister Wen is attempting to address these disparities by focusing on rural development, eliminating rural taxes, improving the security of land tenure, moving production westward, building more infrastructure in central and western China and protecting the interests of rural farmers, the unemployed and migrant or floating workers. These have attained a high level of urgency and priority in recent months as rural discontent rises.

THE GLOBAL ADJUSTMENT PROCESS

These internal macro-economic shifts will, over the medium term, help reduce the U.S.–China imbalance. The Chinese economy is more robust than the earlier statistics suggested: it is larger and growing faster than most observers have thought. Recent figures released by the PRC indicate that the average real GDP growth rates for China in the past 27 years is 9.6%. Never before has an economy achieved such high growth rates for such a long period of time, including the Asian Tigers. The size of the Chinese economy, even measured in current U.S. dollar (USD) terms, is likely to have surpassed that of Britain and leapt to be the fourth largest economy in the world by the end of 2005.

As noted, the key driver for China's extraordinary growth performance in the past three decades has been productivity growth, generated by sustained structural reforms; such productivity growth is likely to continue as long as reforms continue. And indeed 8%-10% real growth per annum could be the norm for China in the next few years if, as anticipated, China steps up its efforts to deregulate and open up further its economy to fulfill its WTO membership-related commitments. Recent data also show a healthier picture of domestic demand balances between investment and consumption.



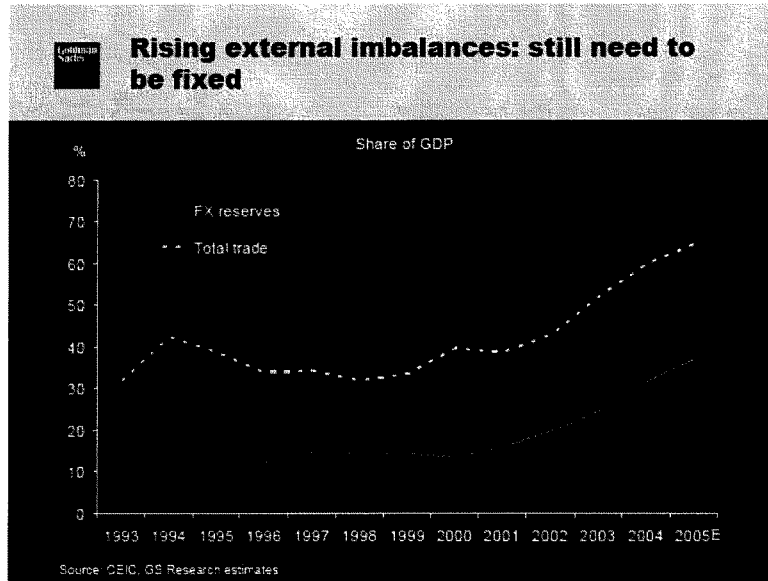
China: no landing

Summary Indicators
(percentage change, unless otherwise indicated)

	2004	2005E	2006E	2007E
REAL SECTOR				
GDP by expenditure (at 1990 prices)				
GDP	10.1	9.9	9.6	9.1
Private consumption	6.6	9.3	9.8	9.9
Fixed investment	12.1	10.6	10.0	9.0
Domestic demand	8.5	7.6	9.0	9.2
Net exports (contribution to growth)	2.0	3.1	1.4	0.6
Exports (G&S)	25.3	24.9	15.0	10.2
Imports (G&S)	22.1	20.6	14.5	10.8
Memo:				
CPI inflation (period average)	3.9	1.8	2.2	2.0
Current account balance (as % of GDP)	3.6	7.0	6.2	4.9

Source: Bloomberg, CEIC, GS Research estimates.

However, despite such shifts, recently released data point to continued large external imbalances for the Chinese economy. Such imbalances have been rising in the last few years.



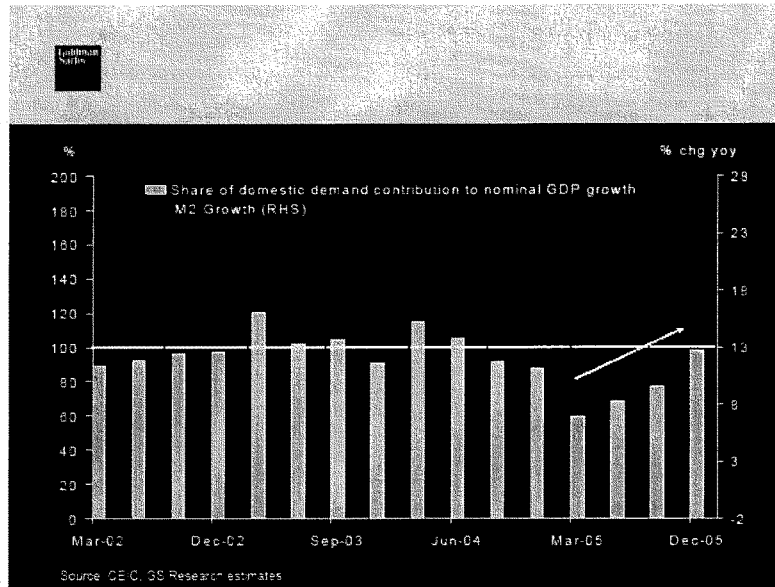
The good news is the macro policy setting in China has switched to address the external imbalance since mid-2005, with an initial revaluation of 2.1% to the CNY in July. More importantly, monetary, fiscal, and sectoral policies have shifted towards strengthening domestic demand. The newly-announced 11th Five-Year Plan has also established the promotion of domestic demand and the encouragement of investment focused on the domestic market as key policy objectives for the government in the next five years.

This macro policy shift is in stark contrast to the policy stance in 2004, which had a tightening bias against domestic demand and favored keeping the RMB peg. Recent policy adjustments — assuming they are sustained and strengthened — will help the economy, which remains robust and responsive to policy stimulus, to adjust on the right path, and thereby significantly reduce China's macro risks and gradually reduce its export dependence.

February imports posted strong growth. Imports grew by 29.6% year on year (yoy) in February, compared with 25.4% yoy in January. On a seasonally-adjusted; quarter-on-quarter (qoq) annualized basis, imports growth was 30.6%, up from 25.9% in January. Meanwhile, exports growth came in at 22.3% yoy in February, compared with 28.1% yoy in January. On a seasonally-adjusted; sequential basis, exports growth was 33.3% qoq annualized.

The trade surplus narrowed. Stronger growth in imports led the February trade surplus to fall significantly to USD2.5 billion.

Combined January-February data also show robust growth of 25.4% and 27.4% for exports and imports respectively. Our economists expect the strength in China's exports to be sustained amid strong global demand momentum. They also expect firm domestic demand to translate into stronger import demand. And these two months certainly cannot yet be taken as a trend.



CURRENT ISSUES

In keeping with the point I made at the outset about setting priorities, I would like to focus on a few key economic issues affecting U.S.–PRC relations.

ENERGY

The issue of energy presents a major geo-political and a geo-economic challenge. **Unless the U.S. and China can agree on a framework for energy cooperation, a series of mutually damaging confrontations is virtually inevitable.** To avert this, and turn a source of current tension and potential conflict, into a focal point for cooperation, President Bush and President Hu should establish a **U.S.–China Energy Partnership supported by a high level Joint Cabinet Committee.** I suggested this idea to several officials in the Administration and to the China Economic and Security Review Commission last fall — and I believe that the time is right to launch it during the coming summit.

Some observers have insisted that clashes between the U.S. and China over energy are inevitable. Chinese companies are buying oil properties and concluding long-term supply contracts around the world; some Americans fear these will divert supplies from the U.S. and international markets. A few of China's deals are in countries such as Venezuela, Iran and Sudan, with which the U.S. has strained or no relations. China's surge in oil demand is seen by some as a reason for higher prices. And China's increased coal production concerns U.S. environmentalists.

But the fact is that **the U.S. and China have many common interests in the energy area and thus many reasons to cooperate on energy.**

- The U.S. is the world's biggest oil importer. China is the world's fastest growing oil importer. High prices and supply instability harm both nations. Recent price increases primarily reflect sluggish world investment in production and refining, which both nations have an interest in correcting.
- Chinese, like Americans, are concerned about their environment; China faces enormous environmental problems, as anyone who has visited Beijing during the winter has experienced first hand. U.S. companies have great expertise in clean energy technology; their clean coal technology can be especially important to China, which has enormous coal reserves.
- The U.S. and China have a similar interest in open sea lanes for oil.
- Both nations also desire a secure business and legal environment for their energy investments in emerging economies as well as stable and growing supplies from world exporters.

At their coming meeting, Presidents Bush and Hu can begin this partnership by agreeing to cooperate in several areas:

- **A Joint Business-Government Commission on Clean Coal Technology;** that could help China develop and utilize its coal in an environmentally friendly way, boost U.S. exports of technology and equipment and help address global warming.

- Joint research on alternative fuels, which should also include representatives of Japan, would draw on the best talent in these three countries, could lead to breakthroughs in, or broader dissemination of, 0hybrid or non carbon-based technologies.
- Strengthen U.S.-China cooperation in the context of the International Energy Agency — a group of oil importing countries that seeks to minimize supply and price disruption. The U.S. should encourage China to join the IEA.
- Consultations with one another, and with other regional nations, to maintain open sea lanes; that could reassure China that the U.S. will not use its naval power to leverage China on oil.
- Strengthen established regional groups that include China, the U.S. and other Asian nations to address environmental and energy supply issues in the region.

Helping China to increase domestic energy output would slow the growth of its import dependence. The recent U.S.-India nuclear agreement had a similar purpose. Both would help to reduce imbalances in the global oil market and reduce upward price pressures. And cooperating on broader energy issues can produce greater stability in global energy markets and in the overall U.S.-China relationship. The alternative — frequent confrontation — benefits no one.

THE CURRENT ACCOUNT IMBALANCE

There has been a great deal of focus on the exchange rate between the dollar and the Chinese RMB. There are a number of good points to be made in favor of an RMB appreciation. But it is important not to raise hopes too high that it will happen soon or be dramatic. And, as former Federal Reserve Board Chairman noted before this committee in June, 2005, "some observers mistakenly believe that a marked increase in the exchange value of the Chinese RMB relative to the U.S. dollar would significantly increase manufacturing activity and jobs in the United States. I am aware of no credible evidence that supports this conclusion." He went on to say that "an increase in the exchange rate of the RMB relative to the dollar would likely redirect trade within Asia, reversing to some extent the patterns that have emerged during this decade."

Although I believe that an RMB revaluation is appropriate, I am inclined to agree with the central thesis of this analysis — but the key point to focus on is the word "significant." Dr. Greenspan might be correct that the impact would not significantly increase manufacturing activity and jobs in the U.S., but it would help on both fronts and it is desirable for other reasons as well. Secretary Snow and Undersecretary Adams have made good arguments as to why this is so.

But we need to have realistic assumptions. Secretary Gutierrez recently warned Beijing against "gradualism" in responding to U.S. complaints; but the entire history of Chinese reforms over the last 30 years has been based on "gradualism" — to avoid big disruptions and big mistakes. So on the currency issue, U.S. expectations should bear this in mind — even as we push for greater flexibility in the exchange rate. U.S. officials should encourage a steady appreciation of the RMB, but it is highly unlikely to be a sharp or rapid appreciation. And we can urge a widening of the current 0.3% trading band — but not harbor unrealistic hopes that it will widen dramatically.

Nonetheless, the topic is a useful one to discuss with Chinese authorities at high levels. I note that Undersecretary Adams recently has had productive discussions in Beijing on this topic and that Senators Schumer and Graham had useful discussions in their visit.

THE IMPACT OF A FURTHER RMB MOVE

One of the benefits of an RMB appreciation from China's perspective is that it would improve domestic monetary policy management. Currency undervaluation continues to fuel a high level of liquidity creation, encourage overinvestment in traded goods sectors and, though inflation has not yet become a serious issue, risks triggering medium-term price pressures. A substantial (e.g. 5-10%) appreciation in China's real exchange rate over time could reduce the economy's aggregate trade surplus — and put China's economy on a more balanced domestic footing. Appreciation would also reduce the growing commodity price bill. And its negative impact on overall Chinese growth likely would be small.

The key impact for the U.S. of an RMB revaluation will come from a broader strengthening in Asian currencies, which, including China, make up 40% of the U.S. trade weighted dollar. Asian central banks and governments have been reluctant to allow their currencies to appreciate against the RMB, placing the burden of global adjustment on non-Asian economies. A change in Asian exchange rates would contribute to the process of global trade rebalancing.

For the U.S., the main transmission of an RMB appreciation would come from the impact of a decline in the dollar against this larger basket of currencies. An RMB revaluation would likely produce upward pressure on the yen, Taiwan dollar and Korean won. Some of that appreciation may already have occurred, with these three currencies already seeing some appreciation pressure fueled in part by anticipation of an RMB move. According to our analysis, a 5% decline in the U.S. Dollar trade-weighted index would boost U.S. GDP growth by 0.25%, largely through trade balance improvement. On inflation, the first-order effects would probably be quite small. Such a decline would lift U.S. inflation by only 0.1-0.2%.

U.S. bond markets would likely react negatively to the news of a CNY revaluation. The prospect of stronger and more balanced growth together with a rise in import price pressure would likely be a recipe for higher yields. As importantly, a substantial revaluation of the RMB and other Asian currencies is likely to see their central banks reduce purchases of U.S. Dollars for their currency reserves. The scale of any impact on global yields resulting from revaluation of the RMB or other currencies will be modest, however.

OTHER ASPECTS OF REFORM AND ADJUSTMENT

It is worth noting that an undervalued currency alone is not a prime reason for China's or any other nation's surge in exports. More importantly, China offers attractive investment environment that encourages massive investment, particularly foreign investment, in export oriented goods. Foreign companies produce over half of China's exports and have accounted for roughly two thirds of its export growth over the last ten years. A higher exchange rate can diminish the incentive of foreign and domestic companies to produce for export — but China will be a powerful exporter even with such changes.

So while addressing the currency revaluation issue, I suggest we will make more progress if we focus on encouragement of the kinds of domestic reforms that 1) would

further open the Chinese economy to imports of goods and services, 2) continue to boost and broaden internal consumer demand for goods and services in China, and 3) reduce the growth of investment in export-oriented products in favor of investment in products and services for the domestic market.

In some of these areas we might do better to move the dialogue from a bilateral to a multilateral framework to do so we should **take full advantage of the soon to be released WTO Trade Policy Review of China**. This argues the benefits of liberalization of the services sector — which could produce a lot more jobs in China as big manufacturing companies cut their workforces. And it recommends improving enforcement of intellectual property protection — which will increase the comfort level of foreign and domestic investors in high technology products. The report is also likely to reinforce the conclusion that the Chinese government has already come to — that it would be wise to deemphasize attracting investment in export-oriented, capita intensive manufacturing, and instead give higher priority to removing impediments to the expansion of investment in domestically-oriented sectors.

In this context, domestic financial reforms also would help to reduce imbalances. Improving the stock and bond markets would enable capital to go to its most efficient uses; that would avoid the continued buildup of excess production capacity in some key sectors; that excess capacity encourages companies to seek markets abroad and to compete at very low prices to secure those markets. I look at the exchange rate adjustment issue as potentially supporting this change, by reducing the incentive to export — and withdrawing an artificial inducement to do so — and increasing the incentive to invest in products that will be consumed at home.

In addition, the more efficient allocation of capital would help to ensure the continuation of China's growth and job creation. That efficiency depends on the correct pricing of risk through a dynamic and well regulated bank loan market and transparent and efficient capital markets. Foreign firms can act as catalysts for the development of China's capital markets; foreign institutions can bring in expertise, good practices and technological capabilities. Liberalizing ownership rules, improving the Qualified Foreign Institutional Investor Program, reducing capitalization requirements and similar measures all would be constructive.

USTR's PHASE THREE AGENDA

The Top-to-Bottom Review conducted by USTR, and recently released, contains a number of very thoughtful suggestions for moving forward in what the Report calls Phase 3 of our trade relations with China. Ambassador Portman and his colleagues have done a very thorough and thoughtful job in preparing this Report. I believe the recommendations the Report makes provide a sound framework for progress. I particularly commend the focus on encouraging further regulatory reform and strengthening the joint efforts between the two countries to address issues in that area. I also agree with the emphasis on effectively using the JCCT and APEC as well as increasing coordination with our other trading partners. I also support the emphasis on developing a "coordinated U.S. government interagency focus on specific priority trade goals." A strong roll for USTR as point agency is imperative — to sort out competing priorities in the trade community and to coordinate them within the cabinet and White House so there is greater focus on the key U.S. objectives and avoidance of the helter-skelter approach that dilutes the focus of U.S. policy.

WHAT THE U.S. CAN DO AT HOME

Insisting that China make a number of changes to boost market access and reduce the bilateral trade imbalance is altogether appropriate. But there is much that can be done in this country to reduce our trade and current account imbalances as well. As long as the U.S. has a very low household savings rate and a very large budget deficit we are going to have a very big current account deficit — the only question will be who it will be with. It does strike me as wise to address these imbalances at home as well. While that topic is beyond the scope of this particular hearing, it is an area in which this Committee has a distinguished history of leadership. If the current account imbalance we have with China were to be eliminated tomorrow, the overall U.S. current account deficit would still be exactly the same as long as the gap between domestic saving and domestic investment in this country is unchanged. Our dependence on foreign capital would also be unchanged.

I thank the Committee for inviting me to appear and look forward to your questions.

**RESPONSES TO QUESTIONS FOR THE RECORD FROM
HON. D. ROBERT HORMATS**

**United States Senate
Committee on Finance**

**Hearing on
“U.S.-China Economic Relations Revisited”
March 29, 2006**

QUESTIONS FROM SENATOR BAUCUS

Question 1

China has been a large recipient of foreign direct investment for some decades, but it has only begun to make investments abroad. To date, these have been state-owned companies looking to secure key natural resources, or “leap-frogging” into world consumer markets by acquiring established brands.

How do you see China’s investment strategy developing in coming years and decades? What effect will this have on financial markets and consumer markets? In light of reactions to the attempted acquisition of Unocal and Maytag, what effect do you think that increased Chinese investment will have on U.S. public opinion?

Response to Question 1

I think that China will become an increasingly significant investor in the U.S. and elsewhere in coming years. Raw materials and energy will be two sectors in which the Chinese will continue to invest. And there will be continued efforts to buy companies with established brands. But there is likely to be greater interest in purchasing companies with new and innovative technologies as well as those with proven distribution capabilities, so that Chinese products can be sold in greater amounts through Chinese-owned distribution channels, which will provide higher value added to Chinese companies.

The Chinese are increasingly concerned about a public backlash in the U.S. regarding Chinese acquisitions of U.S. companies. They are likely to be very cautious in future investment decisions. That is likely to mean that they will avoid investments that are too high-profile or in industries considered very sensitive. But as they pursue such a policy, we should also be aware that they will use a national security argument to resist some kinds of U.S. investment in China—or some of the regulatory changes the U.S. seeks to broaden the scope of U.S. business in China.

Question 2

Can you expand on your view of the importance of savings, its effect on the budget deficit, and its overall impact on the current account deficit? To what extent do Federal budget deficits drive current account deficits? How does foreign central bank lending affect U.S. interest rates?

Response to Question 2

There are three categories of savings: government, household and corporate. The government saves when it has a surplus; now it is a big borrower. The household sector is saving very little, and during some quarters it has recorded negative savings. And the corporate sector has been a slight saver in the last few years, but is not a net borrower. All told, the amount of U.S. savings is considerably less than the amount of U.S. investment—and the difference has to be made up by attracting savings from the rest of the world, which the U.S. is doing to the tune of nearly 7% of our GDP (roughly \$3 billion every business day). It is possible to have a large current account deficit when we have a big budget surplus, as occurred a few years ago. But that can only happen if other parts of the economy experience big savings shortfalls.

There is a big controversy about how much foreign central bank policies affect interest rates in the U.S. The Fed does not believe this impact is significant. In fact, long-term interest rates fell last year even as central bank intervention in currency markets slowed considerably, meaning that this was not a determinative factor. The key determinant of interest rates here are inflationary expectations and Federal Reserve policy.

**Statement by Gary Joachim, Vice President
American Soybean Association**

before the

**Committee on Finance
United States Senate**

on

U.S.-China Economic Relations

March 29, 2006

Good morning, Mr. Chairman and Members of the Committee. I am Gary Joachim, a soybean and corn farmer from Owatonna, Minnesota. I currently serve as Vice President of the American Soybean Association. ASA represents 25,000 producer members on national issues important to all U.S. soybean farmers. We appreciate your invitation to testify today on the current state of U.S.-China economic relations.

It is impossible to overstate the importance of China as a market for U.S. soybeans. In 1996, the U.S. sold \$414 million worth of soybeans to China – a significant market at that time. Last year, the value of our soybean exports reached a record of nearly \$3.0 billion. This represents more than a seven-fold increase in a decade in which China emerged as the largest foreign buyer of U.S. soybeans. The 405 million bushels we exported to China in 2005 represented 40 percent of total U.S. soybean exports, and 13.5 percent of last year's U.S. soybean harvest.

Prospects for continued growth in Chinese soybean imports are excellent. China's total population of 1.3 billion is close to leveling off, but its urban component has more than doubled since 1980, from 20 to 42 percent of the total population. As urban per capita income has risen to \$1,300 per year, more Chinese consumers can afford a diet higher in protein and vegetable oil. Annual consumption of protein meal, including livestock products, is currently 30.9 pounds per capita, just 27 percent of the protein we consume in the U.S. China's per capita consumption of vegetable oil is 15.7 pounds per year, or 44 percent of our level of consumption. As protein and vegetable oil demand continue to grow, China's inability to significantly expand domestic production of soybeans and

other oilseeds and feeds means that most of these requirements will be met through imports.

ASA has worked closely with this and previous Administrations to increase access to this growing Chinese market through trade negotiations. We provided specific objectives to U.S. negotiators during talks on China's accession to the World Trade Organization, and strongly supported Congressional approval of this agreement. As negotiations under the current Doha Round proceed, additional reductions in China's agricultural tariffs and expansion of its tariff-rate-quotas (TRQs) will be critically important to achieving a successful final agreement.

I would like to comment more specifically on the importance of improved market access in China in the Doha negotiations. According to preliminary analysis by the American Farm Bureau Federation, China will play a significant role in the final economic impact of a WTO agreement on global agricultural trade. The analysis assumes that China will be subject to whatever market access commitments are required of developing countries. It also does not take into account the possible exclusion of Sensitive or Special Products from formula tariff reductions.

Based on these assumptions, the Farm Bureau analysis indicates that China will account for between 35 and 40 percent of total world agricultural trade gains from a new WTO agreement. This amount includes 85-90 percent of increased global trade in soybeans and soybean oil, and 40-45 percent of the trade gain for soybean meal. China also will account for a substantial amount of the increase in world trade for other agricultural commodities: wheat (85-90 percent), corn (60-65 percent), barley (50-55 percent), poultry (45-50 percent), and beef (35-40 percent).

Given the high dependence of increased exports of key U.S. agricultural products on improved market access in China, it is critically important that China accept the same tariff reductions required of other developing countries. We must also prevent key U.S. agricultural product exports, including livestock products, from being excluded from full tariff reductions or TRQ expansion through designation as Sensitive or Special Products. Unless China is a full participant in the market access negotiations, it is doubtful there can be enough expansion in trade in a final agreement to justify the concessions the U.S. has offered to make on reducing trade-distorting domestic support.

ASA is aware of concerns with China's \$200 billion-plus trade surplus with the U.S., and of proposals to impose a high punitive tariff on Chinese imports if China does not revalue its currency against the Dollar. As we indicated in testimony to the Committee last June, we are concerned that higher tariffs on Chinese goods could trigger retaliation by China against U.S. imports. As an alternative for addressing the trade imbalance, we would encourage the Committee to ensure that China undertakes full market access commitments in the Doha negotiations, and that the number of agricultural commodities that can be designated as Sensitive or Special Products be extremely limited. If successful, this course of action would increase U.S. agricultural exports to China, rather than causing them to be further restricted.

As we also indicated in our June testimony, our industry's trade relations with China have not been without difficulties. These problems have included uncertain and changing requirements on imports of biotech soybeans, and various restrictions based on the reported presence of diseases or fungicide residues in soybean shipments. While we have not experienced these disruptions in the past two years, the potential for unexpected actions in the future remains a serious concern. However, we believe the relatively smooth course of our trade relations with China in recent years is due, in part, to the resolution of disputes through reinforcement of the mutual benefits of free and balanced trade, rather than through public confrontation.

In closing, Mr. Chairman, China is a vital and growing market for U.S. agricultural sales. Including China as a full participant in the current WTO market access negotiations is critical to achieving a meaningful improvement in world trade in agricultural products. ASA urges the Committee to focus on this priority as it addresses the current U.S.-China trade imbalance.

Thank you again for the opportunity to appear today. I will be happy to answer any questions.

Under Secretary of Commerce for International Trade Administration
Franklin L. Lavin
U.S. Senate Committee on Finance
U.S.-China Economic Relations Revisited
March 29, 2006

Mr. Chairman, Senator Baucus, Members of the Committee, I am pleased to be with you today to share some thoughts on the United States' economic relationship with China. I returned from Beijing a few days ago. Secretary Gutierrez is in China this week, continuing as a lead-up to this year's meeting of the Joint Commission on Commerce and Trade.

I would like to offer some general comments on U.S.-China economic relations, and then discuss particular issues in the U.S. market and in the China market. Finally, I would like to review programs the Department of Commerce is managing to deal with these issues. First some general points.

The relationship between the United States and China is one of the most important international economic relationships of our era. The complexity of the relationship encompasses almost every major economic issue we face, such as competitiveness, the trade balance, and investment policy. Additionally, the size and the dynamism of the two economies ensure that even seemingly minor policy decisions can ripple across the oceans. If we add to these challenges the more fundamental differences of language, culture, levels of development, and political systems, it should be no surprise that Sino-American economic relations are frequently viewed negatively by Americans. Indeed, there are many problems and challenges in the relationship, not the least of which are trade barriers on China's side.

I. Positives should not be lost

But even as we wrestle with these challenges, we need to keep the positives in mind: China is one of our fastest growing export markets; U.S. exports to China increased by over 20 percent in 2005. Indeed, U.S. exports to China have increased by 118 percent – the highest five-year percentage increase among our top export markets. According to industry surveys, U.S. companies in China are generally successful and report solid sales in the China market. We should also bear in mind that our imports from China bring advantages to the U.S. economy and consumers, as well as challenges.

II. Challenges in the U.S. Market

There are many wide-ranging challenges in the relationship as well, and they can be divided into those in the U.S. market and those in the China market. In the U.S. market, concerns center on unfair competition from Chinese imports because of dumping, subsidies, or China's exchange rate. I will leave the exchange rate questions to my

colleague from the Treasury Department, but let me offer some comments on subsidies and dumping.

At Commerce we are committed to vigorously combating these unfair trade practices. We currently maintain 58 anti-dumping orders on imports from China, including consumer goods, steel products, agricultural products, seafood, and chemicals. These orders represent 22 percent of all current U.S. antidumping orders. The estimated value of trade affected in 2005 by these orders was more than \$5.25 billion.

We believe that this tough-minded approach to enforcement led to successful textile negotiations with the Chinese last year. We will continue to use all our tools aggressively when needed.

Regarding subsidies, the United States has stepped up its engagement with China through the JCCT Structural Issues Working Group and the newly established Steel Dialogue. Subsidy concerns cover a wide variety of programs, including industrial policies, the role of state-owned enterprises, and China's continued use of price controls. Transparency remains a major obstacle to identifying and measuring subsidies in China, a difficulty furthered by China's continuing failure to provide its annual subsidy notification to the WTO. I am pleased to report, however, that China informed us last week that they did intend to meet this WTO commitment later this spring.

III. Challenges in China

Perhaps more significant than challenges in the U.S. market, U.S. companies face challenges doing business within China. Though tariffs have come down, China retains an array of non-tariff barriers, among them the use of regulations, technical standards and non-market mechanisms that hurt American companies. Other challenges include, China's government procurement policy, its lack of transparency, and the weak enforcement of laws.

We find these practices somewhat paradoxical because the Chinese people also lose by these distortions. For example, China's leaders tell us they are concerned about lagging development in China's rural areas. U.S. telecommunications firms could provide investment and services in these areas, but Chinese regulations effectively prohibit this. Similarly, these areas are typically underserved by the modern retail sector. U.S. direct sales firms are eager to expand in China, yet China's regulations dramatically limit their ability to operate in China. U.S. express delivery firms have been central to China's export success, but China is considering regulations that would restrict their ability to compete. Meanwhile, China's leaders tell us they are dedicated to tackling corruption. Participating in the WTO Government Procurement Agreement would improve transparency in government procurement. Despite this China has yet to honor its commitment to join the GPA, declining even to start negotiations.

A complete list of trade barriers in China would be quite extensive, but it is worth highlighting the following of critical concern. China's ban on U.S. beef makes it one of

the few major markets to remain closed. U.S. firms want to offer 3G services in China but cannot get licenses to do so.

And the issue of intellectual property rights enforcement remains front and center, though China has expanded its efforts to protect IPR. Industry estimates that nine out of every ten copies of software installed on PCs in China are pirated, representing a loss to the U.S. software industry of about \$3.6 billion a year. 19 of 20 film DVDs sold in China are pirated, costing U.S. companies \$280 million a year.

On the Chinese side, Vice Premier Wu Yi has personally committed to overseeing IPR efforts in China, and her attention has improved the government's focus on this issue. China recently posted an IPR Ombudsman to Washington to work with U.S. companies to resolve their IPR issues. China has also committed to accede to the World Intellectual Property Organization Internet Treaties, which would bring China's copyright laws into the digital era.

And yet, we need to see more tangible progress. We are looking for China to increase the number of criminal prosecutions for IPR violations. We want China's cooperation in cleaning up the illegal street markets of pirated goods. We want them to stop the "trademark squatting" in which U.S. companies find their well-established marks registered and/or used by unauthorized entities. We want them to cooperate in worldwide programs that "fingerprint" optical discs so that pirated material can be traced to the manufacturers that produce such material.

We are attempting to address all of these issues through the US-China Joint Commission on Commerce and Trade (JCCT). Established in 1983, the JCCT is a government-to-government consultative mechanism that provides a forum to resolve trade concerns and promote bilateral commercial opportunities. The 17th JCCT session, co-chaired by Secretary of Commerce Gutierrez and United States Trade Representative Portman and China's Vice Premier Wu Yi, is scheduled to take place on April 11 in Washington. It was the preparatory work for the JCCT that took me to China last week along with my USTR counterpart Ambassador Bhatia. Although some progress was made, most of the major issues we would like to address through this process remain unresolved.

IV. What Commerce Is Doing

Beyond the JCCT, the Department is engaged on the front lines to ensure that American companies, workers and farmers compete and win in the Chinese market. Our China team is our largest overseas presence, with a staff of 115. Though our personnel range from commercial specialists to patent and trademark experts, Commerce programs can be grouped into four broad areas—developing market opportunities; business facilitation; problem-solving; and enforcement.

A. Developing Market Opportunities

We provide a range of "front end" services to U.S. companies in areas such as export counseling, customized market research, qualified international contacts and trade leads,

and trade events. Commerce also provides grants to assist in U.S. industry market expansion efforts overseas.

- The Commerce *Gold Key Program* helps U.S. companies find a buyer, partner, agent or distributor. In FY 2005, 103 companies participated in this program in China.
- In response to a 2004 Congressional mandate, Commerce has opened fourteen *American Trading Centers* in fourteen key cities where the U.S. Government (USG) had no previous commercial presence. Through this initiative U.S. firms can compete for major local infrastructure projects and sell directly to Chinese importers with help from targeted market research, counseling, introductions, and representation at trade shows.
- In 2005, Commerce's China-based officers recorded 202 *Export Successes* related to China, with a value of \$6.9 billion dollars.
- In 2005, the Department participated in 36 major *trade shows in China*, and China-based staff supported 68 trade missions in China (including ten led by U.S. governors).
- The Commerce Department is currently funding 12 ongoing *Market Development Cooperator Programs* in operation in China, through which we partner with industry on market expansion projects. Areas of focus for current projects include environmental products, e-commerce, architecture and engineering, energy, standards, and education.

B. Business Facilitation

Commerce runs a range of outreach programs across the U.S.: road shows, websites, and a hotline. Through these programs, Commerce assists companies of all sizes on how to enter the China market and where to turn for federal resources and assistance.

- *China Business Information Center*: The China Business Information Center (CBIC) consists of a public-information phone line and a website (<http://www.export.gov/china>) which brings together China-related information to enable U.S. exporters to promote products and services, understand Chinese laws and customs, obtain market research, and generally take basic steps to enter the Chinese market. There have been over 73,000 website "hits" since the program went on line in September 2004.
- The Department works with industry associations and local governments on a series of *Doing Business in China seminars* targeting small-and-medium-sized enterprises (SMEs) around the country. In 2005, Commerce hosted 114 outreach events, attended by 7,480 participants.
- The Commerce *Advocacy Center* serves as a central USG point of contact through which U.S. companies can access government resources and request advocacy in competing for international government tenders. To date in FY 2006, USG advocacy has already successfully assisted American companies in winning tenders in China worth more than \$5.3 billion, with more than \$3.6 billion in U.S. export content.
- To assist U.S. companies (particularly SMEs) to protect their intellectual property rights, Commerce assisted in the development of a *StopFakes.gov* website that provides up-to-date information on protecting and enforcing IPR at home and abroad, including information on registration, border enforcement, and criminal enforcement. A Commerce hotline, 1-866-999-HALT, allows U.S. exporters to submit requests for assistance.

C. Problem-Solving

When U.S. companies encounter problems in China, Commerce staff is available to provide on-the-ground assistance to resolve the issue. When problems are specific to IPR issues, Commerce has also developed industry partnerships to link businesses with lawyers with China expertise and a program with the Chinese Government to ensure that specific IPR cases are passed to relevant Chinese agencies to be resolved.

- The Commerce *Trade Agreements Compliance Program* helps U.S. companies to resolve problems without having to resort to formal dispute settlement proceedings. Through this program, Commerce has investigated nearly 150 market access or compliance cases involving China. These cases have dealt with transparency issues, duplicative testing requirements, tariffs, import licensing, customs/customs valuation, market restrictions and policy changes.
- Commerce is posting three *Intellectual Property Attaches* at our Embassy in Beijing and Consulate in Guangzhou to work with the Chinese government to ensure that China is living up to its IPR commitments and assist American businesses in protecting their IPR in China.
- The Commerce *Trade Facilitation Office* at U.S. Embassy Beijing hosts industry-specific IPR roundtables in China with U.S. companies based in China to discuss the protection and enforcement of IPR in China, and how the U.S. Government and the private sector can work cooperatively to address the industry's specific IPR issues.
- In 2004, Commerce worked with the USG interagency to establish an *IPR Case Referral Mechanism*, which facilitates the submission of individual U.S.-company IPR cases through China's Ministry of Commerce (MOFCOM) to relevant Chinese government ministries.
- *SME China IPR Advisory Program*: The Department of Commerce, along with the American Bar Association, the National Association of Manufacturers, and the American Chamber of Commerce in China, established this program so that American SMEs can request a free, one-hour consultation with a volunteer attorney experienced in both IPR issues and the China market to learn how to protect and enforce rights such as trademarks, patents or copyrights in China.

D. Enforcement

By law, the Commerce Department enforces the fair trade rights of U.S. companies and runs a number of China-specific initiatives to carry out this responsibility.

- Commerce officials in Beijing facilitate anti-dumping investigations to help ensure the information provided to the Department is accurate and complete, and that the Department reaches correct results. As noted above, the current 58 anti-dumping orders on imports from China have a value of more than \$5.25 billion.
- Commerce maintains an office to help SMEs navigate the unfair trade laws and it also maintains a subsidies tracking office to help U.S. companies identify actions by foreign governments that unfairly aid their competitors and distort the market.
- Commerce has overseen the creation of the U.S. Embassy *China IPR toolkit*, available at Stopfakes.gov, to guide businesses through steps to secure and enforce their rights in China.

- Commerce established a *Trade Fair Enforcement Program* with China's Ministry of Commerce to allow U.S. companies to formally file IPR complaints at China's major trade fairs and improve the Chinese Government's enforcement efforts at these major trade events.

V. Closing

I want to emphasize in closing these challenges and opportunities are real. I am proud of the work that Commerce Department officers are doing on the front lines for U.S. companies to ensure China is an open market for their products and services. It is our pleasure to work with Members of Congress on constituent's requests for assistance to enter the China market or solve problems there.

Ultimately, for the mutual benefit of both our countries, open markets are essential. To guarantee that support is sustainable, the Chinese Government must increase market access for U.S. firms and live up to its international trade commitments. American companies, workers and farmers can compete with anyone in the world, given a level playing field. We will continue to work with our Chinese counterparts to achieve this goal.

QUESTIONS FOR THE RECORD
Under Secretary of Commerce for International Trade
Franklin L. Lavin

United States Senate
Committee on Finance

Hearing on
“U.S.-China Economic Relations Revisited”
March 29, 2006

Senator Grassley – Question 1

The Chinese made a number of commitments during the 2004 and 2005 meetings of the Joint Commission on Commerce and Trade on protecting intellectual property rights. So far, however, there doesn't appear to be much improvement.

How effective are these meetings for resolving issues like intellectual property rights? Do you have ideas on other mechanisms that can complement these annual meetings to have a great impact?

Answer

The protection and enforcement of intellectual property rights (IPR) is a top priority for the Administration in our relationship with China. The annual meetings of the Joint Commission on Commerce and Trade (JCCT) are an important part of our efforts. Over the past few years the Chinese Government has committed at the JCCT to lowering the threshold for criminal prosecution of IPR violators; facilitating the transfer of cases from administrative agencies to criminal investigators; enhancing coordination within the national police on IPR enforcement; undertaking enhanced efforts to combat production of illegal optical disks in China; requiring the pre-loading of legal operating systems on all personal computers made in or imported into China, and a range of other actions. In this year's JCCT, China further committed to creating 50 “IPR Compliant Reporting centers”, continuing to shut down optical disc plants, establishing specialized civil intellectual property courts across China, and increased transparency in court procedures and verdicts, among others.

Despite these important commitments, we have not yet seen a significant decrease in infringing activities in China, our ultimate goal. However, our efforts through the JCCT have resulted in solid progress in specific areas of interest to U.S. companies, e.g., the requirement for pre-loading of legal software on personal computers. Further, our efforts have significantly increased the priority and resources the Chinese Government is applying to the enforcement of IPR. This provides a good foundation for further efforts going forward.

In addition to the annual JCCT meeting, we pursue a wide range of efforts on IPR issues with China. These include meetings over the course of the year of the JCCT IPR Working Group, at which U.S. and Chinese experts hold technical discussions on IPR issues. Mechanisms other than the JCCT that the Administration is employing to resolve IPR issues included making technical assistance programs available to Chinese IP officials to ensure that they have the skills needed to help China meet its IPR commitments. In addition, law enforcement officials within

the Department of Justice, the Federal Bureau of Investigation and the Department of Homeland Security are working closely with Chinese law enforcement officers to improve coordination of actions against cross-border infringing activities. We also address IPR enforcement issues with China in a multilateral setting, such as through meetings of the World Trade Organization TRIPS Council in Geneva.

Finally, the Department of Commerce provides programs to educate U.S. companies on protecting and enforcing their IPR in China. These include free seminars in cities across the United States, a new series of online seminars, and the "China IPR Advisory Program," which provides U.S. companies with free, one-hour consultations with an experienced IPR attorney.

Senator Grassley - Question 2

The President's 2006 Export Promotion Strategy points to specific goals of certain EU member countries such as France, Britain, and Germany, to increase exports by small businesses to China over the next five years.

Does the United States have a comparable strategy?

Answer

The U.S. Commercial Service (CS) has a strategy to promote exports by small and medium-sized enterprises (SMEs) that is second to none. The United States has a different approach that seeks to maximize our reach to American businesses to help them achieve commercial success. One specific difference concerns technical assistance. As mentioned in the *President's Export Strategy*, European governments broadly define "technical assistance" to include substantial financial grants, donation of equipment, funding of pilot projects, and orientation visits at the expense of the receiving foreign government. Compared to other G-8 countries, the United States offers a more robust and coordinated strategy to assist U.S. companies focus on concluding export transactions. The U.S. Government also offers trade financing through the Export-Import Bank and project feasibility study grants through the U.S. Trade and Development Agency. As a matter of U.S. trade policy, the approach and sums of money involved are significantly different compared to the EU. Our strategy has three components which, applied to our operations in China, will be described in more detail in the response to the following question.

1. Provide Information to Explore the Market. The China Business Information Center is a virtual network of U.S. federal government resources that are combined to enable SMEs to easily obtain trade-related information on China. The initiative includes a comprehensive website on China that is packed with practical trade-related information; a call center that SMEs can contact to quickly obtain answers to their questions from China experts; and an outreach program that has hosted over 158 seminars since it was launched in 2004.

2. Offer Customized Services. Once firms learn about the opportunities and challenges the China market presents, CS offers over 20 services that provide practical solutions to the challenges of obtaining market research, screening prospective distributors, staging single-company promotion events, or addressing market access issues. In addition, CS China has developed a trade event program that features a U.S. Pavilion at trade shows that track with

industries that have been identified by the CS as best export prospects. CS China also hosted 68 trade missions last year.

3. Match Chinese Buyers with U.S. Exporters. Through the American Trading Centers initiative, the U.S. Commercial Service has expanded its scope of service in China from five offices, located in the U.S. Embassy and four U.S. Consulates, to fourteen largely untapped and economically robust cities that present enormous opportunities. Through these programs, CS can assist SMEs in identifying market niches that are right for them, while also servicing companies that have strong market prospects in large urban areas.

What are we doing to help our small and medium-sized enterprises compete in export markets like China? Is there more the government should be doing?

Answer

The U.S. Commercial Service (CS) is helping American SMEs export to China in a number of ways. Last year alone CS offices, attached to the U.S. Embassy and four consulates in China, helped American SMEs participate in 36 major trade shows, and hosted 68 trade missions to China, including ten governor-led delegations.

CS also created a network of American Trading Centers in 14 Chinese cities with strong markets but that had previously been difficult for American SMEs to access. Partnering with the China Council for the Promotion of International Trade (CCPIT -- a non-profit trade promotion organization with a presence throughout China), CS now helps U.S. firms compete for major local infrastructure projects and sell directly to Chinese importers through counseling, business matchmaking, targeted market research, and trade show support in Chongqing, Dalian, Hangzhou, Harbin, Kunming, Nanjing, Ningbo, Qingdao, Shenzhen, Tianjin, Wuhan, Xiamen, Xi'an and Zhuhai.

CS created the China Business Information Center (CBIC), a Congressionally mandated initiative, that brings together trade-related information on China that is available from various agencies of the federal government to help U.S. exporters promote products and services, understand Chinese laws and customs, obtain market research, and take steps to enter the Chinese market. CBIC consists of: (1) a comprehensive website, (2) a toll-free public-information telephone line to contact CS's China specialists, and (3) outreach events held throughout the United States, with 158 events held since September 2004. The website includes country information and industry-specific market research reports, exporting tips, export leads, trade events, and links to other resources.

CS is also organizing "China Road Show Conferences" which will take place May 15-24, 2006, in Houston, Texas, Washington, D.C., and Cleveland, Ohio. Commercial officers and locally-engaged staff from CS posts in China will discuss the risks, challenges, and opportunities in the Chinese market, as well as entry strategies in China's information technologies, environmental protection, infrastructure, and medical equipment and healthcare industries.

CS and CCPIT are jointly exploring working with American trade and business associations to help U.S. exporters more economically and more efficiently penetrate China's markets through an American Product Showcase (APS). An APS would be a business incubator facility where

American SMEs could display products, receive professional support services, develop business contacts, and lease temporary office space.

CS has concentrated more resources on China than any other market in the world, yet the volume of interest and need for support in China is so great that on some occasions clients may be placed on waiting lists for basic export promotion services such as the popular Gold Key business matchmaking program.

Senator Grassley - Question 3

In 2005, the Secretary of State announced a global repositioning of overseas personnel designed to match our diplomatic resources with our foreign policy goals.

Are there any plans for the Department of Commerce to undertake a similar review to ensure that our foreign commercial service resources are allocated most effectively?

Answer

Even before the State Department announced its global repositioning program, the U.S. Commercial Service (CS) conducted a rightsizing review to ensure that resources are allocated most effectively. This rightsizing initiative will allow CS to adapt to the changing global marketplace including the Internet, growing trade in services, and new trade opportunities, and to implement the President's Management Agenda. The rightsizing initiative will also guide CS in the difficult process of selecting offices that must be closed or reduced in order to remain within the funding available to CS. Our rightsizing efforts over the next three to five years will:

- refocus the location and mix of overseas staff to provide the support U.S. businesses need most in each market;
- improve the ability to reach U.S. businesses both domestically and overseas through the use of technology and strategic partnerships;
- identify and close offices whose costs, including security costs, are no longer justified by their relative importance or performance; and
- close offices and reduce staffing levels to operate within available resources.

CS is committed to adjusting its locations based on new global opportunities. We are constantly evaluating the best ways and the best places to serve our clients, and we are in the process of adapting our operations accordingly. Maintaining strong and effective export assistance programs for small- and medium-sized companies continues to be a top priority.

Senator Bunning - Question 1

Mr. Lavin, I'm curious to hear your views on China's trading relations with other countries.

Under the terms of their WTO accession, China is scheduled to be treated as a "non-market economy" until 2016. China has obviously been pressuring a number of countries to recognize it as a "market economy" – so far, I know that Argentina, Brazil, Singapore, Thailand, Australia and New Zealand – and about 20 or so other countries as well – have agreed to grant them this status.

Can you comment on your knowledge of how this recognition could impact Chinese trading relations with and Chinese foreign investment in these countries?

Do you feel that there could be any impact on the trading relationship of the United States with these countries as a result of their decision to recognize China as a "market economy"?

Answer

Article 15 of China's protocol of accession to the WTO generally allows WTO Members to apply alternative methodologies in antidumping and countervailing duty actions concerning exports from China – in other words, treat China as a "non-market economy" – through 2016. Under this provision, the non-market designation may be rescinded in part or in whole prior to 2016 if China clearly demonstrates that a specific industry or its economy as a whole, respectively, meets market conditions as specified under the laws of the particular Member.

This aspect of China's accession to the WTO affects only antidumping and countervailing duty actions and has no direct application to any other aspect of trade with China. Of the approximately 50 countries that have officially recognized China as a market economy, only a handful have ever conducted an antidumping investigation of goods from China – most have never conducted any antidumping or countervailing duty actions at all. As such, there is little direct impact on China's or our trade with these countries by those countries treating China as a market economy.

Senator Baucus – Question 1

Why is China so successful in stopping piracy in Beijing 2008 Olympic merchandise, but such a failure in other areas?

Why is there such a lack of commitment to enforcing intellectual property rights in any meaningful way?

Do you see this as a double standard?

Answer

Reports from China suggest that, for now, China has been successful in combating piracy of products using the Beijing Olympic logo. This seems to reflect the high priority attached to this effort by the Chinese Government and the fact that their efforts require control over only a relative small number of products. China still has a long way to go before it is applying the same level of priority and effort to protecting the full range of intellectual property, across the country, as it does to these items. These efforts are complicated by resistance of local authorities to strictly enforcing central government rules on the protection of IPR for reasons that include local economic pressures (i.e., job creation by factories producing infringing products), corruption, lack of skilled personnel, and other factors.

We believe that China should apply the same level of priority and effort to protecting the full range of intellectual property, across the country, as it does to Beijing Olympic logo items. We continue to work aggressively toward this goal through the annual meeting of the Joint Commission on Commerce and Trade (JCCT) and through a range of other activities throughout the course of the year, including law enforcement cooperation, capacity building programs, and direct approaches to the Chinese Government on specific issues. We have been making progress in raising the level of focus and resources in China applied to protecting and enforcing intellectual property rights and will continue our energetic efforts in this area.

Senator Kerry – Question 1

I understand that software piracy in China remains an enormous problem. I have heard estimates that overall software piracy rates in China are at 88%. At the July 2005 JCCT meeting, the Chinese Government agreed to complete its software legalization program to ensure that all central, provincial and local government offices are using only legally licensed software. Has this program been fully implemented? What additional measure will the Administration seek to address this issue going forward to ensure only legal software is used?

I understand that China also agreed at last July's JCCT to extend software legalization beyond the government enterprise, including state-owned enterprises, in 2006. How is this going?

Answer

The Chinese Government has said that it has completed the effort to ensure the legalization of all software used in Chinese Government agencies at the central, provincial, and local levels. However, the U.S. software industry reports that it has not seen the increases in sales they would expect if this effort had been accomplished thoroughly. In light of this situation, we have continued to engage the Chinese to find ways to ensure the legalization process is successful. Most recently, during the preparations for the JCCT meetings on April 11, 2006, China issued directives requiring that all personal computers manufactured or imported into China pre-load legal operating systems and that all government agencies must buy only personal computers with pre-loaded software. We consider these significant steps forward in helping support the software legalization effort. In addition, at the JCCT, the Chinese government agreed to undertake discussions with us on the possibility of using software asset management systems to help monitor and ensure the use of legal software.

On February 23, China launched its effort to implement software legalization in all enterprises, including state-owned enterprises. It is too early to judge the results of that effort, which will continue throughout this calendar year. However, we have been pleased to see the focus and energy that has been applied so far on this issue. We also note that the directive requiring pre-loading of legal operating systems on all personal computers made in or imported into China, discussed above, will also contribute to the effort to ensure the use of legal software in Chinese enterprises.

We will continue to work aggressively to ensure that China's efforts on legalization of software in government and enterprises are carried out successfully.

Senator Kerry – Question 2

Last year, China issued draft procurement regulations that would have severely limited access of foreign software makers to China's government market. They later agreed, in the JCCT, to delay such regulations and to accelerate its efforts to join the WTO GPA. What is the status? The government is China's largest single purchaser of goods and services; do U.S. companies have adequate legal protections against discrimination in China's government procurement practices?

Answer

In April 2005, China's Ministry of Finance (MOF), Ministry of Information Industry (MII), and State Council Informatization Office (SCITO) released draft regulations that would have required Chinese government agencies to purchase "domestic" software products and services with only limited exceptions, effectively excluding most U.S. software manufacturers. One of the major successes of the 2005 JCCT meetings in Beijing was China's agreement to postpone issuing these procurement regulations. To date, China has stood by its commitment and has not implemented these regulations.

China is not a signatory to the World Trade Organization (WTO) Agreement on Government Procurement (GPA), and is not bound by any other agreement to provide a level playing field for the purchase of U.S. goods or services by the government. Recognizing the importance of this issue for U.S. companies, we have continued to press China to begin negotiations to join the GPA. These efforts have been successful. At the April 11 JCCT meetings, China agreed to submit its Appendix I GPA offer of coverage by no later than the end of 2007.

We will continue our technical consultations with China as it prepares to begin its negotiations. We will also continue to engage with China on specific government procurement-related issues as they arise.

Senator Kerry – Question 3

We have heard examples of the use of discriminatory procurement and technology standards policies to limit access of foreign companies in the Chinese market. I understand that China is now drafting a new patent law, new anti-monopoly law and new rules on standards. Could you provide, based on your best information, a summary of the provisions in these laws? Could these new laws be used to confiscate the intellectual property of foreign companies? If yes, under what circumstances? What is the Administration doing to ensure that China's innovation and industrial policies do not result in exclusion of U.S. companies from China's market or harm to intellectual property rights?

Answer

We are concerned about the possibility that new policies on technical standards, IPR, and anti-monopoly could have a negative impact on U.S. companies' market access in China and on the protection of their intellectual property. For now, however, the new policies remain in draft form. We are engaging intensively with the Chinese Government to help ensure that when finalized, these policies will promote transparency, competition, and a level playing field for Chinese and foreign companies. In addition, as specific issues arise, we continue to press the Chinese Government to ensure that our companies are not disadvantaged. This includes our successful efforts to postpone the implementation of the Wired Authentication and Privacy Infrastructure (WAPI) encryption standard and a proposed regulation requiring government procurement of domestic software, and our insistence that all of the 3G wireless telecommunications standards get equal treatment. Finally, we have made efforts to explain to broader audiences in China why industrial planning and heavy government intervention are not conducive to China's own goals of promoting innovation and ensuring long-term, stable

economic growth. This was a theme of several presentations by Secretary Gutierrez during his most recent trip to China.

Regarding the current status of the draft proposals:

Anti-monopoly law: The version of the draft law that the Department has seen from 2005 would govern conduct that adversely affects competition within China. Generally speaking, the draft law restricts anti-competitive agreements that are harmful to the market. The draft law further restricts companies having a dominant position in the market place from abusing that position to harm domestic competition. The draft law contains a provision establishing its applicability to abuses of intellectual property rights that restrict or eliminate competition.

Patent policy: The Department has also reviewed an informal translation of tentative Provisions for Patent Issues Relating to National Standards. According to the draft, if a recommended standard does involve a patent, the Standardization Administration of China (SAC) shall only proceed with developing the standard if the patent holder presents written certification that it shall grant any interested party a license free of charge or on a reasonable and non-discriminatory basis; otherwise the SAC shall return the standard to committee for further development.

Testimony of Joseph S. Papovich
Senior Vice President International
Before the
The Senate Finance Committee
On
U.S.-China Economic Relations Revisited
March 29, 2006

America's song writers, performing artists and recording companies have a long history of working with the Congress and the Administration to protect and defend our uniquely successful sector of the U.S. economy. As a participant in and representative of this industry, I very much appreciate the efforts of this Committee, the rest of the Congress and the dedicated officials within the various Executive Branch agencies who have worked closely with our industry.

The importance of the U.S. recording industry, and intellectual property protection, to the U.S. economy

A critically important aspect of our nation's competitive strength lies in the creation of knowledge-intensive intellectual property-based goods and services. This is one of those economic activities that Americans do better than others. The "core" U.S. industries that rely on copyright protection account for more than six per cent of US GDP.¹ The foreign sales and exports of these industries are nearly \$90 billion, an amount greater than almost any other U.S. industry sector, including automobiles and auto parts, agriculture and aircraft.

International markets are vital to America's creative talent and record companies. Exports and other foreign sales account for over fifty percent of the revenues of the US record industry. This strong export base sustains American jobs.

In this respect, the protection of our intellectual property rights abroad is essential to promoting America's competitive advantages in world commerce. The sale of our recordings abroad makes a major contribution to America's current account balances. Each and every sale of a pirated product abroad that substitutes for the sale of a legitimate American product increases our current account deficit. As our trade deficit has soared, Congress should consider more closely the relationship between our widening trade and current account deficits and copyright piracy and to take steps to enable us to more effectively protect our intellectual property rights and to sell our products at home and abroad.

¹ These industries include recording, music, motion pictures, book and newspaper publishing, computer software (including business and entertainment software) and radio and television broadcasting.

The Effect of Music Piracy

Music is the world's universal form of communication. It touches every person of every culture on the globe to the tune of \$34 billion annually. America's record companies—small and large—create employment for thousands of people, including composers, singers, musicians, producers, sound engineers, record promoters and retail salespersons, to name only a few.

The piracy of music is almost as old as the music industry itself, but historically it was difficult for the criminal to reproduce copies with the quality of the real thing. Now with the advent of digital recordings, computers and high-speed internet access, criminals can reproduce perfect copies of any recording. There is massive manufacture and traffic of illegal CDs, both in the form of molded CDs that are produced in factories, and increasingly pirated CD-R's produced on blank optical discs by computer CD-R burners.

The illegal music trade is feeding the profits of international organized crime syndicates who are involved in drugs, money-laundering and other criminal activities. Music piracy is costing governments hundreds of millions of dollars in tax revenues.

The battle against intellectual property theft must be unrelenting. Digital technology and internet piracy have greatly exacerbated our problems. Our country must employ every tool at its disposal, including the critically important leverage provided by international trade agreements.

The Problem in China

America's creative industries are under attack, especially in China where high levels of piracy in conjunction with market access barriers plague our industry.

Last year, the record industry lost over \$200 million in China to pirate sales. Eighty-five percent of the sound recordings sold in China were pirated. This means an astounding 17 of every 20 sound recordings sold in China are sold by pirates.

Demand for American musical recordings in China is enormous, as evidenced by the massive piracy of our products across China. The result has been a colossal lost opportunity for American writers, performers and record producers to benefit from the fast growing Chinese society and economy. Here's why:

1. *China is swamped with pirated recordings because the penalties imposed on pirates are not effective. Chinese pirates also export pirated versions of American recordings all over the world. Chinese authorities might raid one of these manufacturing facilities, a warehouse or a retail store and seize the pirate product—and they seize millions—but the resulting penalty, if any, is almost always just a small fine. Pirates are entrepreneurs who see such raids and seizures as a cost of doing business—a “slap on the wrist”—and the occasional interruptions are built into their*

business model. The penalties do not deter, punish or in any way incapacitate the thieves.

We believe there are around 90 optical disc plants in China, which operate nearly 1,400 optical disc-making lines, with a total disc capacity of a staggering 4.8 billion discs per year. Most production lines are interchangeable, switching easily between audio CD, VCD, DVD, and even CD-R or DVD-R production.

Unfortunately, a considerable amount of China's production is destined for export. In 2005, infringing product from China was found in nearly every major market in the world, including Germany, Italy, Australia, Norway, Belgium, Canada, Mexico,² the United States, Russia, the United Kingdom, the Netherlands, Israel, Paraguay, Lithuania, Singapore, Taiwan, the Philippines, Indonesia, Vietnam, Hong Kong, Malaysia, Thailand, Chile, and South Africa. Known shipments and seizures around the world are only the tip of the iceberg of the total exports of pirate optical discs from China. That China's factories have once again returned to large-scale exporting, after enforcement efforts in the late 1990s largely eradicated such pirate exports, is extremely disappointing

2. *Internet piracy is growing rapidly in China. China has over 100 million internet users and 600,000 websites, only 8,000 of which were legally registered. Many websites offer the unauthorized downloading of music files, some for a financial charge, others for free. Certain China-based ISPs have become online "warehouses" for international pirate syndicates. Many of the legal deficiencies that enable physical piracy to flourish in China plague the on-line environment as well.*

The Internet penetration rate per capita and per household in China is still relatively small. However, the sheer numbers of broadband lines (reported to be 35 million as of September 2005), and the rapid rise of mobile applications, makes China one of the world's largest potential markets in terms of digital delivery of copyright content, and unfortunately, one of the world's largest emerging digital piracy problems. The Chinese publication "Economic Daily" reported that as of the end of 2005, 64 million Chinese accessed the Internet via broadband connections.

Hundreds of websites emanating from China now offer streams, downloads or links to unauthorized files of copyright materials (music, films, software, and books). Disturbingly, there are many Bit Torrent (BT) sites based in China now (BT is a recent P2P architecture which allows for faster file sharing due to the way users cooperate in uploading and downloading pirate content simultaneously). There are at least four "eMule/eDonkey" servers; at least seven specialized "MP3 search engines" which offer deep links to thousands of infringing song files for instant downloads or streaming; and at

² The Mexican Association of Gift Producers (AMFAR) reported that during 2005 holidays, nearly 80% of traded merchandise was imported from China through illegal means. *AMFAR: 80% of Chinese merchandise, illegal*, Corporate Mexico, January 18, 2006.

least eight China-based peer-to-peer (P2P) services (including Kuro China, whose Taiwanese affiliate has been found guilty in a criminal court in Taiwan).

The largest MP3 search engine is Baidu, the subject of two civil lawsuits in 2005; it lost one in September 2005 but has appealed.³ Baidu, as well as Yahoo!CN provide independent MP3 search functionality that produces indexes, and even deep links to, infringing files, thereby directly inducing and facilitating the misappropriation of American intellectual property. Senator Hatch has written to the Chinese Ambassador expressing his great concern that the Chinese Government would permit these activities to take place. To the best of our knowledge, he has not had a response, and this erosion of a promising digital marketplace continues.

Most of the pirate websites in China generate income through advertising, so they are profit-making ventures even though copyrighted materials are provided for free. At least three of the P2P services (including Kuro China) charge subscription fees. Unfortunately, the availability and use of these services, spurred by the rapid growth of broadband technologies in China, indicate that Internet piracy will be one of the greatest challenges industry and the Chinese Government must face.

Most unfortunately, enforcement against Internet piracy in China in 2005 was made more difficult by recent Chinese government decisions. In 2003 and 2004, thousands of “takedown” notices were sent by the recording industry to Chinese ISPs and content providers, and the takedown rate of these ISPs was relatively high.⁴ However, the April 2005 “Administrative Measures on Protecting Copyright on the Internet made such takedowns more difficult and compliance by ISPs fell precipitously in 2005.”⁵ The Administrative Measures appear not to allow e-mail notices and require that the notices include, for each infringing site, evidence of all infringements and proof of copyright ownership for each book, song or film infringed, among other things. The ISPs thus ignored notices that do not meet this unrealistically burdensome standard.⁶

As discussed below, the State Council is expected soon to issue new Internet regulations which would reportedly replace these Administrative Measures. The most recent draft would lessen the notice requirements. However, there are other concerns with the draft Regulations which need to be addressed prior to its issuance (including provisions on protection of technical protection measures, the scope of limitations on liability of ISPs, and the form of the notices to be sent to ISPs).

³ On September 16, 2005, the People's Court of Haidian District in Beijing reportedly ordered Baidu to pay RMB68,000 (US\$8,400) to mainland music company Shanghai Busheng Music Culture Media for unauthorized downloads of 46 songs. Baidu has reportedly appealed the ruling.

⁴ The recording industry achieved takedowns of three China-based servers, of at least seven international sites (Supermusic, Crazymp3, 21century-mp3, Mp3explosion, Easym3s, Realalbums, and Finestmp3s), infringing music files hosted on large Chinese portals like Wanwa, Hitmusic, Sohu, and 9sky (9sky has since become a licensed music site, as have four other sites), and 17 “eDonkey” servers based in China.

⁵ From September to November 2005, the takedown rate by ISPs was as low as 25%.

⁶ Administrative Measures on Protecting Copyright on the Internet, issued by the National Copyright Administration of China (NCAC) and the Ministry of Information Industry (MII), effective April 30, 2005.

Record Industry Takedown Rate of Suspected Infringing Websites in China			
	Number of notices	Number of sites	Takedown rate
2003	1320	2509	29%
2004	2632	7170	61%
2005	1778	4711	40%

Internet piracy in China is also infecting neighboring markets. For example, of 154 pirate websites found in Taiwan in 2002, the recording industry in Taiwan found that 102 (66%) were located in China. In 2005, the number of pirate websites in Taiwan grew to 469, of which 393 were reported to be located in China, or almost 84%.

3. *On top of the blatant piracy of our products, the record industry faces severe restrictions its ability to do business in China. Frankly speaking, it will be very difficult to ever significantly reduce piracy in China if the Chinese will not let our companies expand their ability to sell legitimate products to Chinese consumers. China must abolish these restrictions.*

The Chinese Government does not allow foreign sound recording producers, motion picture companies (for theatrical and home video, DVD, etc. distribution), or entertainment software publishers to enter the Chinese market except as a partner in a minority-share (up to 49%) joint venture with a Chinese company.

Record companies are prevented from developing talent in China and from getting legitimate product quickly to market. The fact that U.S. record companies cannot “publish” or release a recording without permission of a state owned company, and cannot manufacture, distribute or engage in retailing of their products makes it extraordinarily difficult for legitimate companies to participate effectively. U.S. record companies are skilled at and desirous of developing, creating, producing, distributing and promoting sound recordings worldwide.⁷ The universal experience of nations in which the international record companies do business is that local artists have expanded opportunities to have their music recorded and distributed widely. The in-country presence of U.S. companies also has brought jobs and expertise in a wide variety of areas. China should permit U.S. (and other foreign) sound recording producers to engage in:

- the integrated production, publishing and marketing of sound recordings.
- replicating, distributing, and retailing sound recordings (at present, these activities must be performed by other companies, which segments industry activity and drives up costs; even Chinese sound recording producers may not engage in these

⁷ The work of these companies encompasses a wide range of activities, including developing and investing in state of the art recording, mastering and engineering facilities; identifying and training talented singers, songwriters, composers, and musicians; promoting and advertising acts and recordings; establishing efficient and competitive distribution systems to take products from recording studio to replicator to wholesalers to retailer; and using global arrangements and distribution services to release products in markets outside the local market. U.S. record companies have long sought to bring these skills to China to develop and record Chinese artists for the Chinese market and for export.

activities, meaning all musicians, including Chinese, who record in China operate at a competitive disadvantage with those recording music outside China).

- production, publication and marketing their own recordings in China and direct importation of finished products (at present, a U.S. company must (1) license a Chinese company to produce the recordings in China or (2) import finished sound recording carriers (CDs) through the China National Publications Import and Export Control (CNPIEC)).

China should also permit foreign-owned record companies to release sound recordings in China.

The Criminal Enforcement System Remains Non-Deterrent

Despite China's promise in the JCCT to increase the number of criminal prosecutions for copyright piracy, little has yet been done. The current criminal system in China continues to operate ineffectively and without deterrence.⁸ Moreover, there are legal problems with respect to what acts constitute crimes, and what proof meets the criminal thresholds (including, *inter alia*, how to measure harm to meet the thresholds) that make it essentially impossible for copyright owners to obtain deterrent enforcement.

Further, there is not one Ministry that takes responsibility for criminal copyright enforcement, including the raid, arrest, seizure, and transfer of a case file for prosecution. Retailers, distributors, warehouse owners, and even pirate producers know that administrative raids will rarely be transferred for criminal prosecution, so they operate for the most part in the open without fear of effective enforcement action, much less effective criminal enforcement. Repeat offenders often pay insignificant administrative fines and disregard administrative orders to cease their infringing activities. Unless criminal prosecutions are brought, piracy will remain pervasive in China as mere administrative actions have long been proved to be without a deterrent effect on pirates and counterfeiters.

The U.S. copyright industry has repeatedly emphasized the importance of addressing the current absence of criminal prosecutions. While the Chinese government claims that such prosecutions have occurred, the U.S. copyright industry are aware of only a very few that have involved U.S. or other non-Chinese works. One of these cases was the infamous *Guthrie* case (involving a large DVD wholesale piracy ring run by a citizen of the United States). While this case did involve piracy of U.S. product, it is dwarfed by comparison

⁸ A fundamental issue remains that copyright piracy is still viewed by many in China as a problem to be dealt with administratively rather than in the criminal courts. Administrative enforcement of copyright has been under the auspices of the National Copyright Administration of China (NCA), which is neither properly equipped nor staffed with the resources or personnel to address the large-scale piracy problem in China. The failure to have any one agency in charge, which has the wherewithal to do the job of achieving deterrent enforcement, has led to *ad hoc* approaches to enforcement.

with the organized criminal activities conducted by Chinese citizens, who are rarely prosecuted for their crimes.⁹

China's Commitments in the US-China Joint Commission on Commerce and Trade—the "JCCT"

In meetings of the US-China Joint Commission on Commerce and Trade – the JCCT – in April 2004 and July 2005, China made a number of potentially important commitments to improve intellectual property enforcement for our industry, but so far China's implementation of these commitments has been lacking.

Perhaps most importantly, China committed in April 2004 to "significantly reduce IPR infringement levels". Under any measure, this clearly has not happened. The legitimate market, while it has improved somewhat, remains under siege. Piracy of sound recordings remains at an astounding 85%.

In addition, China agreed to

- Increase penalties for IPR violations by taking the following actions by the end of 2004:
 - Subject a greater range of IPR violations to criminal investigation and criminal penalties.
 - Apply criminal sanctions to the import, export, storage and distribution of pirated and counterfeited products.
 - Apply criminal sanctions to on-line piracy.
- Crack down on violators by:
 - Conducting nation-wide enforcement actions against piracy and counterfeiting, stopping the production, sale and trade of infringing products, and punishing violators.
 - Increasing customs enforcement action against the import and export of infringing products and making it easier for rights-holders to secure effective enforcement at the border.
- Improve protection of electronic data by:
 - Ratifying and implementing the World Intellectual Property Organization (WIPO) Internet Treaties as soon as possible.
 - Extending an existing ban on the use of pirated software in central government and provincial agencies to include local governments.

⁹ *In re Randolph Hobson GUTHRIE III, Abram Cody THRUSH, WU Dong and WU Shibiao* (Shanghai No. 2 Intermediate Court, April 19, 2005).

Our Recommendation

China's current reliance on administrative inspections, seizures and modest fines does not work. China's criminal enforcement authorities must become actively involved in the fight against piracy in China. Unless this occurs, we foresee matters either staying the same or become even worse.

The US Government—our Executive Branch and the Congress—has been increasing pressure on China toward this end. We are extremely grateful for the help that the U.S. Government—both the Executive Branch and the Congress—is providing us. This hearing helps in this regard. The U.S. Government and U.S. industry must continue to insist that China fully implement the commitments it made in the WTO and in the JCCT over the past two years—especially to significantly reduce piracy. Our industry is working intensively with the Office of the U.S. Trade Representative to prepare the necessary elements of a possible WTO legal complaint against China, but of course we hope that the Chinese Government will quickly take steps to address the inadequacies of the current flawed system such that litigation will not be necessary.

Russia: the Next China?

As serious as problems are in China, and they are serious indeed, the challenges we face in protecting our intellectual property in Russia are even more daunting. Lawlessness, physical danger, and corruption are part of the daily challenges we face in trying to protect our rights in Russia. These types of problems are even more prevalent in Russia than in China.

Russia is one of the largest producers and exporters of pirated CDs and other copyrighted products in the world. In fact, the statistics demonstrate a dramatic increase in music theft, certainly not a crackdown.

- There are now 47 optical disc replication plants in Russia, most of which are involved in piracy. Five plants would be sufficient to meet the needs of the legitimate Russian market. As a result of that excess capacity, Russia has become the world's largest exporter of pirated music.
- At least 9 of these production plants are located on so-called "Russian State Restricted Access Regime Enterprises" in which the Russian Government itself is the owner of the premises. Local law enforcement authorities are not permitted access to these facilities.
- Russia is now home to some of the world's only Internet-based pirate *pay* download services – including a particularly notorious one known as "allofmp3.com."

The case of allofmp3.com helps illustrate the music industry's frustration. Through its online services based in Russia, allofmp3.com sells music to anyone in the world willing to pay ten cents a song. But allofmp3.com has not secured the rights to do so – and doesn't bother to pay the people who wrote and own the songs being sold. There should

be no question about the law – at the very least allofmp3.com is violating the reproduction rights afforded by Russian Copyright Law and Criminal Code, and the laws of the countries where the songs are being downloaded. But our industry’s requests for legal action against allofmp3.com have been routinely denied by Russian prosecutors.

What Should Be Done?

We need to change the political calculus so that failure to control piracy has clear ramifications for the Russian Government – ramifications that outweigh the costs associated with stopping piracy. Specifically:

(1) USTR should reexamine Russia’s eligibility to participate in the Generalized System of Preferences until it has satisfactorily protected intellectual property from theft. It is wrong that U.S. taxpayers should, in effect, be helping to finance Russian exports to the U.S. while the interests of U.S. intellectual property owners are being systematically undermined. The United States needs to point out how failure to address copyright piracy will impede Russia’s goals, whether such goals relate to attracting foreign investment, joining the WTO, or other matters.

(2) We must learn from the China experience. Congress should insist upon demonstrated and sustainable reform before supporting Russia’s accession to the WTO. By every measure, the steps taken before China was admitted to WTO have failed America’s inventors and creators. The U.S. should ensure that relevant legal and enforcement measures are in place and implemented before we accept Russia into the WTO. WTO accession is not a political prize -- it represents a commitment to abide by international rules. The WTO institution and global confidence in world trade rules is quickly undermined when WTO parties openly mock trade discipline.

Let’s face it – today Congress has some bilateral leverage because Russia wants to enter WTO. Once they are in, the leverage diminishes significantly, as we have seen with China. One aspect of Russia’s accession to the WTO, known as granting them “Permanent Normal Trade Relations” or “PNTR” must be approved by Congress. We urge Congress to inform our Executive Branch that it will not approve PNTR unless and until Russia acts to significantly clean up its copyright piracy mess.

Conclusion

Copyright piracy in China—and in Russia—remains rampant. Much more needs to be done by each of these countries. Our industry urges the United States—and the rest of the international trading community—to bring greater pressure on China and Russia to combat much more effectively the rampant piracy in their countries. This must not be allowed to continue. It has already gone on for far too long.

QUESTIONS FOR THE RECORD FROM JOE PAPOVICH

**United States Senate
Committee on Finance**

**Hearing on
“U.S.-China Economic Relations”
March 29, 2006**

QUESTIONS FROM SENATOR BAUCUS**Question 1**

Mr. Papovich, the Chinese government made a number of commitments to reduce piracy and counterfeiting during the last JCCT round in Beijing last summer. The next round of the JCCT is scheduled next month (in April). Has China fulfilled the IPR commitments it made at last year's JCCT? Can you give it a grade on its fulfillment? What possible metrics could industry develop to measure China's IPR success and failures?

Answer

I suggest that one look at the combined set of IPR “outcomes” reflecting Chinese commitments made at the April 2004, July 2005, and now the April 2006 JCCT meetings. In these meetings, China made many potentially important commitments to improve intellectual property enforcement for our industry. However, so far, China's implementation of these commitments has been incomplete.

My testimony identifies most of these commitments relevant to my industry. First and foremost, China committed in April 2004 to “significantly reduce IPR infringement levels”. Under any measure, this has not happened. Any field trip to any major Chinese city would demonstrate that the market remains awash in pirate product.

China JCCT commitments can be characterized as both procedural and substantive in nature. Not surprisingly, China has done a better job at implementing its procedural commitments. For example, in December 2004 issued a new judicial interpretation that lowered the thresholds China uses to determine when to criminally investigate and prosecute copyright infringements. However, the revised interpretation continues to pose problems for rightsholders such that not many criminal investigations have been undertaken against copyright pirates.

China committed to and established an interagency body to coordinate IPR enforcement led by Vice Premier Wu Yi, and a US-China IPR working group was established. China established an “ombudsman” in its Washington embassy. China issued a notice clarifying that sound recordings were covered by the December 2004 revised criminal thresholds. Regulations and guidelines that China committed to issue have been issued, even though in some instances the substance of these issues leaves something to be

desired. China began the process of preparing to ratify the WIPO internet treaties, including issuance of regulations governing administrative enforcement on the Internet. However, these regulations are troubling and, if implemented as currently written, would actually make online copyright enforcement more difficult in China than before these regulations were issued.

China fulfilled its commitments to issue guidelines on the “timely referral” of cases from administrative to criminal authorities. Chinese Customs has issued guidelines on transferring certain customs cases to the criminal authorities. These guidelines could be helpful—it’s too soon to tell as we have not seen them.

However, China has done less with respect to its substantive JCCT commitments. As stated, infringements have NOT been substantially reduced. Large numbers of pirated product continue to be seized by the Chinese authorities. However, little follow-up enforcement has occurred; shops shut down re-open shortly thereafter. We have still not seen evidence that China has applied in a meaningful manner criminal sanctions against on-line piracy and/or imports, exports, distribution, storage and sale of pirated product. China’s markets are still awash in pirated product. A positive step was the recent Chinese announcement that it has closed six and suspended operations at eight optical disc factories, as described in my testimony.

There are a variety of metrics for achieving progress in China. Perhaps the most effective would be to attack the source of CD piracy at the production level. Each optical disc has a forensic “finger-print” that identifies the machine on which it was produced. My industry has a forensic capability for identifying such matches. The Chinese police also now have an optical disc forensic facility in Shenzhen that can ostensibly do so. We have proposed a collaborative relationship between our industry’s forensic lab and China’s. If China were to agree to this, we believe that effective action could be taken against the source of optical disc piracy in China. However, to date, China has not responded substantively to our proposal.

A second metric would be for China to undertake and well-publicize criminal prosecutions of those who distribute and sell pirated product, with deterrent remedies imposed and announced. At this time, China’s copyright pirates have little fear of China’s enforcement system. The non-transparent nature of China’s justice system continues to be a MAJOR problem. To date, the only well-publicized prosecution has been against an American citizen apprehended by the Chinese authorities.

Question 2

I have repeatedly warned this administration from closing WTO accession negotiations with Russia before it cleans up its act on IPR. What lessons does China hold for Russia on IPR, particularly on its WTO accession? What are the pitfalls we must avoid? What successes can we hope to replicate?

Answer

Frankly, Russia is making less of an effort to enforce against copyright piracy than China did prior to its accession to the WTO in 2001. During the mid-1990s, the US twice came very close to unilaterally imposing Section 301 trade sanctions against China. These actions led China to take some meaningful steps against copyright piracy, especially against pirate CD producers. Many Chinese pirate producers were closed and pirate exports virtually ceased. China maintained such enforcement until after it had been admitted to the WTO. As a result, my industry supported China's WTO accession and the PNTR vote in the U.S. Congress.

In contrast, the efforts of the Russian government in the advent of its WTO accession have not been effective at stemming pirate optical disc production or export. Our industry has recommended that the US government take action under US trade law against Russia, as it did in the mid-1990s against China. For example, in 2000 our U.S. copyright alliance, the International Intellectual Property Alliance, petitioned USTR to suspend Russia's GSP benefits. Our petition has remained "under review" for six years. Moreover, we proposed in each of the past two years that Russia be designated a Priority Foreign Country under the Special 301 provisions of the Trade Act of 1974, as amended.

To its credit, USTR has been insisting that Russia take meaningful IPR enforcement actions as a condition for concluding the bilateral WTO accession negotiation. It is critical that Russia take such actions as a condition for its entry into the WTO.

A second lesson is that the US should ensure that Russia agree in its WTO accession working party report to unambiguous and meaningful interpretations of the TRIPS Agreement's enforcement provisions that will enable other WTO Members to effectively utilize WTO dispute settlement if Russia does not adequately enforce against copyright pirates after it joins the WTO. Large-scale copyright piracy re-emerged in China after its accession. In order to obligate Russia to effectively control copyright piracy after its WTO accession, it is critical that Russia agree in the Working Party Report to such commitments and interpretations of the TRIPS Agreement's enforcement provisions.



**Statement for the Record
U.S. Senator Rick Santorum
Committee on Finance
U.S.-China Economic Relations Revisited
March 29, 2006**

Chairman Grassley, I appreciate your willingness to schedule this hearing on U.S.-China economic relations. Together with Senator Baucus, you have been a strong leader on highlighting areas of our bilateral relationship that require attention or redress. Most importantly, you have supported efforts to bring about constructive change where needed.

Securing a strong and equitable trading relationship with China ought to be one of the highest priorities for the Bush Administration. Ambassador Portman recently noted that U.S. goods exported to China alone exceeded \$34 billion in 2004, an increase of 81% since China entered the WTO in 2001. However, while China is a key export market for U.S. exporters, the current U.S.-China trade deficit of over \$200 billion is cause for concern. China's willingness to adhere to commitments regarding the protection of intellectual property rights of American innovators is also a major concern to me. If the creativity, genius and intellectual capital of Americans cannot be protected, America stands to lose its greatest edge over our global competitors.

The hearing could not have been more timely given the upcoming U.S.-China Joint Commission on Commerce and Trade (JCCT) meeting and the mid-April U.S. visit of Chinese President Hu. In all, you have picked an appropriate time to hear from the Administration, business and financial leaders, and various outside stakeholders.

This is the first hearing held by the Committee on Finance since the Administration released its "Top-to-Bottom Review" of U.S.-China trade relations. I cannot help but note the optimistic tone of the title, "Entering a New Phase of Greater Accountability and Enforcement." I look forward to Ambassador Bhatia's testimony on the Administration's recent review and details on ways to achieve the goals articulated by the review. I applaud the Administration for taking a hard look at U.S.-China trade relations, and I am pleased to see that specific action items were identified to achieve U.S. priority goals.

I appreciate the identification of six priority objectives the Administration intends to pursue with respect to China. A goal such as expanding USTR's trade enforcement capacity to better ensure China's compliance with trade obligations is something that this Committee needs to support. So too the goal of expanding USTR's capability to obtain and apply comprehensive, forward-looking information regarding China's trade regime and practices to U.S. trade policy formulation and implementation.

I also wanted to comment on remarks Ambassador Portman delivered last November in Beijing. The affect of these comments was that China needed to step up and take a greater role in ongoing WTO Doha Round negotiations. The Top-to-Bottom Review built on these remarks by noting "China's ascendancy as a major international trading partner brings with it certain responsibilities for maintenance of the multilateral, global trading system." This statement is long overdue.

Yesterday, Chairman Grassley and Ranking Member Baucus introduced legislation that enhances the ability of the United States to address currencies whose imbalance harms the U.S. economy. I was pleased to be an original cosponsor of this bill. Through actions such as opposing multilateral bank financing, disapproving loans from the Overseas Private Investment Corporation, and refusing to increase an offending country's voting share in the IMF, this bill sends a strong message to countries like China that the U.S. expects more in the way of action on addressing imbalances in currency exchange rates.

Lastly, I look forward to working with USTR and Commerce on ways to ensure China's compliance with commitments on intellectual property rights protections. I commend Ambassador Portman for his remarks last November when he stated "China should roll up the illegal distribution networks that are known to bring millions of fake DVDs and CDs to market...Likewise, government offices and government-controlled firms should not use fake software." It is essential that there be pressure by the Administration to see that China brings its government purchasing regime in line with international standards. With that observation in mind, I commend you Mr. Chairman for including a provision in your recent bill that creates a Senate-confirmed official at USTR to enforce trade commitments.

Again, thank you for scheduling this hearing and thank you for assembling a broad range of expert witnesses. I look forward to hearing their testimony this morning.

