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Introduction

I appreciate testifying before this distinguished Commission at a time when, to use Deng Xiaoping's phrase, we should be "seeking truth from facts." Such seeking becomes more difficult, and more important, as the U.S. debate considers both the political and economic realities of the potential accession of the People's Republic of China (PRC) to the World Trade Organization (WTO) during a campaign year.

China is characterized by unprecedented contrasts. It is an old civilization, but a new country, having celebrated only its 50th anniversary October 1, 1999. On a per capita GDP basis, China is a developing country. Yet, key sectors of its export economy are not only globally competitive but also potentially globally dominant. Though its economic reform and opening to the outside since 1978 have been substantial, China's economy remains relatively closed. Beijing seeks to manage its trade and exchange rate as part of a strategy of maximizing Chinese comprehensive national strength.

Despite China's "Middle Kingdom" orientation, the PRC has limited experience operating in a global system. Indeed, for the next 50 years, China sees itself as a developing country, subject to a volatile international system in which it perceives the United States playing a major if not dominant, and not always benign, role. It is no wonder that, in addition to bureaucratized Chinese statistical reporting, authoritative Chinese estimates of how WTO entry may affect China's competitiveness, including its import and export balances, are hard to find. Chinese analysts do not want their economic projections to reveal weakness or to fuel a sense of a China threat.

For many in China, the soul-stopping issue remains: Why does the civilization which invented gunpowder, the compass, moveable type, and paper often frustratingly find itself on the periphery of the modern global system, behind in a world of precision-guided munitions, global-positioning systems, and AOL-Time Warner mega-mergers – all involving free-flowing, real-time, multi-tasked, multimedia information at dot.com valuations?

Let me comment first on context and process, then on structural implications involving China's strategic approach to trade under the WTO.

Context and Process

Debating the relative merits of China's WTO accession in an election year accentuates four U.S. domestic challenges.

First challenge: debating China's WTO entry in a campaign year focuses us on political process, issues such as "wedge votes," "timing," and "the number of calendar days remaining in the congressional schedule." Our public rhetoric tends to highlight either the opportunities or the risks associated with China's WTO application. Polarizing the discussion of China's permanent normal trade relations status into a "straight up or down vote" may fuel disappointment, cynicism, or a future "politically unsustainable" reaction if results (such as projected increases in U.S. agricultural exports to China) subsequently fail to reach optimistic expectations.

Second challenge: focusing on political objectives and political processes holds us hostage to ongoing negotiations affecting China's WTO obligations with us.

For example, Senators from farm states remain concerned that after sweeping discussions of U.S. agricultural export opportunities under liberalizing states trading rights agreements, Premier Zhu Rongji pulled off the table – almost literally as he was walking out the door – the application of states trading rights to U.S. fertilizer exports to China. A seemingly technical issue and perhaps not a deal breaker in itself, U.S. fertilizer export is an example of how the WTO accession package the United States Trade Representative (USTR) first made public in April 1999 continues to be negotiated. But these revisions to China's WTO obligations slide in under

battle-lines already largely drawn. Almost no matter what happens, those likely to be in favor are already in favor and those expected to oppose are already opposed. Ongoing China WTO negotiating changes (e.g., between April 1999 and November 1999) within largely pre-drawn battle-lines put a public burden of proof on opposed to China's WTO entry and a private burden of conscience on those who favor it.

The administration and those who favor China's entering the WTO (which I do under appropriate conditions) must strike a balance between the public desire to see China enter the WTO and the private recognition that China's WTO entry will only begin a new phase in China's trade relations with the United States and the rest of the world. Recall the new bride who said to her mother, "I'm so happy, I feel that I am at the end of my worries" – to which the mother thoughtfully replied, "Yes, dear, but which end?"

The administration has its procedures backwards. In April 1999, the administration published the U.S. and Chinese WTO positions, even as the White House backed away from supporting the agreement. In contrast, the November 1999 Sino-U.S. WTO accession agreement remains confidential, even as the administration promises the political commitment to urge Congress to vote without knowing what final protocols and agreements might obtain.

This is why USTR must be particularly vigilant as China works through its accession requirements and final protocol. Congress should review carefully China's final WTO accession package, reflecting any changes from the European Union, India, and the 13 or so other countries still completing their bilaterals, before it votes on U.S. permanent normal trade relations with China. Should Congress vote on China permanent normal trade relations before China's WTO protocol of accession is finalized, Capitol Hill should strictly condition its action on no further revisions of China's WTO obligations disadvantageous to the United States.

A *third* U.S. challenge is short time horizon. The time of challenge for Sino-U.S. trade relations is further down the road. I never use the term "concessions" when describing China's WTO approach. The term "China's one-way concessions" may be tactically useful to make Americans think we got a good WTO deal. However, I believe in market efficiencies and those market reforms will benefit China's consumers and economy, including its export competitiveness.

China, despite historic moves in the direction of reform and openness, remains in some ways a closed economy. While trade as a proportion of Chinese GDP reached 37% in 1998, some at the IMF calculate that China's non-process trade as a proportion of GDP may remain in single digits. In the future, China's fixation on exports will be demonstrated in new areas, such as its already burgeoning exports in non-grain agricultural products such as poultry and fish. These agricultural products use rural land and labor, require limited investment (foreign or domestic), and move China up the value-added ladder. This is particularly the case when specialty items like custom-cut chicken breasts are sold at premium prices to customers in Japan.

As Japan did, China seeks to move up the value-added ladder. Currently, China imports capital- and technology-intensive items from the United States such as airplanes, while exporting consumer items, such as toys, apparel textiles, and electronics. Will China in fact continue moving up the value-added ladder, over time building cars, not only for Wuhan, but also for California and Detroit? Will its technology incubators modeled on Silicon Valley contribute to global hardware and software? Will it become commercially viable in space launch, biotechnology, and other leading-edge technology and manufacturing sectors – and do so in a fair way?

Our WTO protocol efforts have diligently built safeguard provisions, including against potential Chinese dumping (15 years), import surges (12 years), and market-disruption in textiles (until the year 2009). If fully enforced, these safeguards represent significant near-term protection. Yet, while 12 to 15 years is an eternity in Washington political time, it is a little more than a decade in global trade time, just as it is a little more than a decade in the life of an upcoming generation Chinese leader like Hu Jintao who will only be in his 60s, a potential governing prime, in that time period.

All this underscores the need to make Sino-U.S. trade a stable and constructive element in China's relations with us and with the world. Most aspects of trade are, of course, positive sum. Yet, we do not want to strike a WTO deal with China in 2000 only to return a few years later to say our trade deficit with China has become politically unsustainable and we want to change the trade goalposts. Of course, such demands for trade adjustment would be more likely and problematic in an election year during an U.S. economic downturn and sharp rise in domestic protectionist sentiment.

Disparaging talk of congressional MFN-fatigue has come largely from those wishing to end yearly congressional debate on China trade. But congressional prerogative with major U.S. trade partners gives operational definition to the elusive terms "politically unsustainable." This is why some members of Congress are exploring alternative legislative mechanisms to maintain regular review of all aspects of Sino-U.S. trade. It is why I recommend a regularly established, authoritative congressional review to monitor and rectify significant and chronic bilateral trade surpluses run by any major trade partners with the United States.

A *fourth* U.S. challenge derives from our perceived need to portray technical and messy trade and economic issues in terms of larger U.S. values, including political freedom in China.

It is understandable for the administration, as National Security Adviser Sandy Berger recently skillfully did, to portray China's WTO entry as a policy vehicle for peace, stability, reform, and democratic change in China. Economic reform will continue to have wide-ranging impact in China, as it has had from 1978 to the present. And political change in China may indeed continue as the PRC conforms its economy to WTO disciplines.

However, promoting U.S. trade policy in terms of peacefully transforming China's political system only confirms hostile U.S. political intentions in the minds of some Chinese, thereby justifying their resistance to implementing fully their trade obligations. In my view, systemic political change in China may well be a natural consequence of China's intensified global economic interaction, but we should not characterize the promotion of such change as a direct or indirect U.S. policy objective.

Structural Implications

I do not believe the United States and China are destined to be enemies, trade or otherwise. I do, however, register concern that China's strategic approach inclines it to structure trade and exchange rate policy (under the WTO or otherwise) so as to maximize competitive position with the United States, with neighbors such as Japan, Korea, and the ASEAN countries, and with Taiwan.

- 1. Because trade with the United States and the world under the WTO remains essential to China's economic growth, and thereby to its employment rate, social stability, further economic strengthening, Beijing will continue to manage its trading system as part of its strategic development approach. It does so with a sharpened sense of vulnerability after the Kosovo war, and thereby with an intensified imperative to use all means possible to accelerate comprehensive national strength and international position.**

Trade is a matter of fundamental survival to China, not only as a latecomer developing country intent on preserving a distinct Chinese culture but also as a communist state seeking ideological adjustment in a globalizing world. What are to us matters of "political sustainability" are to China matters of "political survival."

From the U.S. perspective, two-way trade with China (\$84.7 billion in 1998) accounts for less than 1% of U.S. GDP. This is true even given sharp increases in the volume and trajectory of China's trade surplus with us. It will remain true even if China's trade surplus with the United States surpasses that of Japan by year (see attached graph). And, depending on whether one uses Chinese, U.S., or a hybrid set of trade statistics, total trade deficits may be more or less acute.

China's desire to join the WTO represents an element of economic policy continuity in two ways. One is that China's growth strategy still depends on its exports and trading system contributing significantly to overall economic reform. Second is that China continues to see its ongoing reforms attracting necessary foreign technology, capital, management, quality control, and, especially, access to global market and distribution channels. This self-improving cycle seeks to move China's trading system up the competitive and value-added ladders.

I recall a conversation with Deng Xiaoping where a member of our delegation asked, "Mr. Vice Chairman, what can I do as a member of Congress from Texas who would like to sell more cotton to China?" Mr. Deng replied, "If you want to import more into China, help China get GSP (general system of preference) status."

Deng's development strategy included using China's market potential to attract foreign direct investment, which would in turn spur China's economic development. China took the lion's share of developing country FDI in the 1990s, using it to provide technology, management, employment and direct training, and essential marketing and distribution channels to U.S. and global consumer markets based on large economies of scale. Significant export quotas (earlier 100% in some cases for the most preferential treatment) and hard currency quotas helped build China's reserves.

Following the Kosovo war, China is re-assessing its basic modernization model, including its balance between economic and military priorities. Particularly the May 7, 1999, accidental bombing of the PRC embassy in Belgrade challenged two fundamental Chinese strategic premises. First was that the 21st century would be characterized by peace and development, where the United States and China would have differences but the overall U.S. approach would be non-threatening.

Second was that China's overall comprehensive national strength compared to that the U.S. was one of lagging equilibrium. Yet sharply improved U.S. capabilities between Desert Storm and the Kosovo war suggested China's capabilities are not in lagging equilibrium (behind the United States but at a more or less constant distance), but rather in lagging disequilibrium (not only behind, but falling more so).

Accelerating in the Kosovo aftermath, China is adjusting its defense procurement and military R&D, including closer exchanges with Russia. On the one hand, Chinese purchases of SU-27 and SU-30 fighter-jets and Sovremenny-class destroyers with Sunburn missiles may attest to the limits of China's current cost-effective indigenous military industrial capabilities. On the other hand, China's economic modernization under WTO trade conditions will increase Beijing's familiarity with global commercial-off-the-shelf technologies and processes. These will include global, market processes useful in reducing cost and shortening development times for the design, testing, and production of military and military-oriented industrial capabilities.

As did the Rumsfeld Commission to Assess the Ballistic Missile Threat to the United States, we must remain alert as to how market-enhanced military capabilities in countries including China may increase the threats to

the United States, or to U.S. allies or friends, from potential direct or indirect confrontation, proliferation, and espionage.

China's heightened imperative to hasten strategic strengthening also underscores the concern that Beijing may focus on increasing global competitiveness without equally opening to itself or to the outside. For example, China may seek to develop domestic pillar industries into large, vertically integrated, globally competitive Chinese conglomerates. Yet these conglomerates could separate domestic and international responsibilities, such as the China National Petroleum Company (CNPC) is seeking to do by participating through a PetroChina subsidiary in international capital markets.

After the Asian crisis, China seeks a development model less dependent on exports. However, its immediate incentives to heed domestic mercantilist pressures while seeking global WTO trade benefits remain strong. Understandably, depending on interim developments, China could find itself having to delay change that make it unacceptably vulnerable to the global pressures associated with open liberalization. For example, current Sino-U.S. WTO financial services agreements call for implementation of foreign bank operations in local currency within five years. The concomitant pressure toward full *renminbi* convertibility in that period may be more than China will feel it can accommodate to within that time frame.

More certain is that China will seize immediate opportunities to use external WTO standards to attract FDI, secure long-term markets, reduce its own domestic deficit-widening subsidies (e.g., in agriculture), and thereby help restore reasonable growth momentum by reducing dependence on domestic fiscal stimulus while moving toward more efficient patterns of growth and asset management.

- 2. China will resist changing mercantilist approaches to trade, including with the United States. Not as a consequence of WTO conditions but against U.S. expectations and projections, the U.S. bilateral trade deficit with China may continue to increase over time, possibly dramatically.**

Many interlinked imponderables remain regarding whether the WTO will facilitate China's resumption of a reasonable growth approach less

dependent on domestic fiscal expenditure. Over time, China may shift toward an economic growth model based on greater domestic consumption. Factors beyond quality and price will also shape Chinese consumption patterns. For example, the current Chinese appetite for foreign products may someday be tempered by nationalistic or patriotic taste – a manifestation of rising nationalism in Chinese self-identity.

Many China developments will remain double-edged. For example, Chinese use of domestic Internet and accompanying e-commerce capabilities will expand as China continues to attract FDI related to computer peripherals and to net-based systems. However, even if information free-flow affects political change, Chinese public opinion may still reflect strong nationalism or xenophobia, including strong anti-U.S. sentiments. It was, after all, directly via the Internet that Chinese students first learned that a PRC embassy in Belgrade had been bombed – with no context and without interpretation, this news sparked widespread emotional protests.

Old issues like pirating and counterfeiting remain unresolved. Procter and Gamble loses 15% of \$1 billion a year in sales in China to counterfeit product. Microsoft says 95% of Microsoft products in China are pirated or counterfeited. And China's recent demand that Internet service providers register with the security bureau, that Internet content providers take responsibility for what goes on net, and that foreign companies divulge their encryption keys bespeak China's continuing search for domestic control and economic competitive advantage.

In WTO terms, the United States spent considerable effort to develop China protocol requirements that eliminate technology transfer requirements. Such provisions are, however, extremely difficult to enforce. Companies pressed to trade advanced technologies for a share in China's market often see little alternative to accepting if they want to operate in China.

One U.S. company said it initially enjoyed Chinese market access after sharing advanced technology. Later, domestic Chinese competition stiffened. Chinese parallel product development of its premium semiconductor chip both copied and built on its technology, based on knowledge learned or passed on by its joint venture partner. Opaque and sometimes discriminatory Chinese regulations favored its domestic

competitors. Those domestic Chinese competitors seized the real prizes – the lucrative market opportunities in China’s interior and in developing countries such as India and Vietnam.

Balancing realism and fatalism suggests that U.S. WTO protocol agreements regarding technology transfer should be seen as important and worthy of efforts at enforcement, without being oversold to labor or others as a solution to the transfer of U.S. technology or U.S. employment to China.

3. **As core elements in China’s strategic approach to comprehensive national strength, Beijing will increasingly see trade and exchange rate management as a means and measure, and thereby as an instrument, of national influence.**

Some 15 years ago, a senior Chinese policy official familiar with his central bank’s holdings of significant dollar-denominated reserves first introduced me to the concept that a country might use dollars holdings as an instrument to influence the United States.

As explained to me, Chairman Alan Greenspan’s January 1999 China trip discussions touched on the U.S. interest that any shift in PRC reserves among *Euros* and dollars occur gradually and that any PRC draw-down of dollar reserves during potentially volatile times include sensitivity to U.S. markets. And, when Beijing signaled its intent to move forward seriously with its WTO accession negotiations, it sent that message through Chairman Alan Greenspan and then-Secretary Robert Rubin. Beijing understands well trade and financial leverage as part of strategic national strength.

Current Chinese discussions of cyber-war, financial war, and economic war are evidence of concepts in search of operational principles. No wonder Taipei worries about the growing PRC holding of Taiwan NT dollars, about PRC-held shares in Taiwan companies, about possible PRC ability to influence Taiwan’s stock market through the Hong Kong media, and about those who sell Taiwan stock futures in Hong Kong or Singapore.

One can imagine speculative attacks against the Taiwan currency and Taiwan stock market aimed at destabilizing Taiwan’s political economy. Over time, it may be difficult for Washington to distinguish an attack on

Taiwan using non-traditional means, none of which might trigger traditional indications and warnings, from a more conventional one that would establish U.S. obligations under the three communiqués and Taiwan Relations Act.

This kind of thinking on the part of China and others should be one of several reasons for the US. Treasury and other responsible departments to do two things:

- a) Create greater monitoring capability regarding those who hold significant dollar reserves, especially in relatively liquid forms such as U.S. treasuries, and
- b) Assess through interactive scenarios how much pressure countries holding large dollar-denominated holdings might bring to bear against the U.S. or against key U.S. friends and allies.

Regarding greater transparency of international reserves, as a result of the 1994 Mexican crisis, IMF members now regularly publish international holdings; publishing the currency composition of those reserves could extend useful transparency. Regarding interactive scenarios, such could consider different combinations of China, Japan, and other countries acting in parallel or in concert, as well as the leverage China or other countries might bring to bear on the United States and, equally importantly, on economies smaller than the U.S., including Korea, Taiwan, and the ASEAN countries. To be useful, such scenarios will not derive from mechanical efforts to manipulate exchange rates but rather will build on sets of potentially interlocking economic, financial, and political contingencies in which new combinations of leverage and derivative leverage might be manifest.

To neglect or dismiss such possibilities could leave us open to unpleasant surprises, as confronted countries in Southeast Asia during the Asian financial crisis that had paid insufficient attention to matters such as public and private debt and encumbrances on international reserves.

4. **The most significant structural implications of China's WTO-enhanced trade and financial competitiveness may not be those affecting bilateral Sino-U.S. relations, but those improving China's competitive position in Asia and the world.**

As in the military arena, it is a red herring to compare U.S. and Chinese economic and financial strength, certainly in head-to-head per capita comparisons, but even in aggregate, either in purchasing power or exchange rate terms. China's target is not economic and financial parity with the United States. Rather, China's immediate objectives include increasing its regional economic and financial standing and influence.

In Asia, China's prestige increased during the financial crisis while Japan's decreased. China gained stature by supporting Thailand financially. Beijing still claims credit for maintaining *yuan* stability. Yet, China's adamant nonsupport for the yen as a regional currency or for a major Japanese role in an Asian Monetary Fund bespeaks Sino-Japanese competition to determine Asia's financial structure.

Some U.S. projections suggest China's export competitiveness under WTO may increase significantly vis-a-vis the ASEAN countries (especially Thailand, Indonesia, Malaysia, and the Philippines). Other studies indicate increased Chinese exports may not take U.S. market share, but they could reduce Korea's or Thailand's share. Over time, Chinese export competitiveness vis-a-vis its regional neighbors may reduce the link between countries of strategic importance to the United States while making those countries more susceptible to Chinese influence.

The timing of Beijing's and Taiwan's WTO entry may prove politically mutually enforcing in terms of U.S. domestic politics. But the structural implications for mutual WTO obligations by mainland China and Taiwan remain unclear. Initial estimations suggest that WTO agreements will deepen U.S.-Taiwan commercial interaction, even as they require Taiwan to liberalize cross-strait economic and commercial interchange. As noted above, in the future we may have to differentiate carefully how structures of PRC-Taiwan trade under the WTO relate not only to U.S. trade and commercial interests, but also to regional security interests.

Over time, it may become impossible for US. policy to distinguish between actions Beijing or others take for economic or commercial reasons and actions Beijing or others take specifically to influence strategic alignment. And Beijing may be able to exert significant economic or financial pressure on Tokyo, or on Seoul, Jakarta, Thailand, or Taipei, before it can do so on the United States.

Summation

Regarding process and context, I argued:

- In a campaign year, the current U.S. debate on China's WTO entry focuses us on near-term political process like "timing" and "wedge votes." Serious effort, such as this Commission represents, is required to distill real longer-term trade implications of China's potential WTO entry from current, politically required public rhetoric.
- "Straight up or down votes" hold us hostage to our own rhetoric even as ongoing revisions in China's overall WTO accession rights and obligations continue. The Congress should be careful about voting on permanent normal trading relations for China without knowing the full details of what China's final WTO accession protocols include.
- The challenge for Sino-U.S. trade relations lies in the future, when safeguard provisions expire, complicating efforts to make Sino-U.S. trade a stable and constructive element in our overall relationship.
- While we understandably portray technical and messy China trade and economic issues in terms of larger U.S. values, we should characterize systemic political change in China as a possible consequence of globalization, not an U.S. policy objective.

Regarding structural implications, I asserted:

- Beijing will continue to manage its trading system as part of its strategic development approach, with a sharpened sense of vulnerability after the Kosovo war and therefore with an intensified strategic imperative to use all means possible to accelerate its comprehensive national strength and international position.

Especially as global, market transfers of technology and process accelerate economic and military synergies in countries including China, the United States will want to monitor carefully continuing trade-related concerns regarding direct and indirect confrontation,

proliferation, and espionage, including as they may affect U.S. friends and allies.

- Not as a consequence of WTO but against U.S. expectations and projections, China's managed approach to trade and exchange rate (as Sino-U.S. trade balance trends suggest) argues the U.S. bilateral trade deficit with China may continue to increase over time.

Not only regarding China, the United States should establish an authoritative congressional mechanism to monitor and rectify significant and chronic trade deficits with major U.S. trade partners.

- As core elements in China's strategy of comprehensive national strength, Beijing sees trade and exchange rate management as a means and measure, and thereby as an instrument of, national influence.

Current global realities should be sufficient cause for the United States to 1) create greater monitoring and alert capability regarding those who hold significant dollar reserves or other potential means to influence the United States economically or financially; and 2) assess through non-mechanical, interactive scenarios how, where, when, and to what extent other countries, individually or together, might seek economic or financial influence over the United States or over key U.S. allies and friends.

- The most significant structural implications of China's WTO-enhanced trade and financial competitiveness may not be those affecting bilateral Sino-U.S. relations, but those improving China's competitive position in Asia and the world.

Short-term, bilateral analysis of the impact of China's WTO entry is insufficient to reveal potential longer-term, regional and global consequences for China's neighbors as Beijing increases its ability to exert economic or financial pressure on Tokyo or, more immediately, Seoul, Jakarta, Thailand, or Taipei – thereby possibly loosening strategic ties important to the United States.

(as of February 24, 2000)