CHINA'S RESPONSE TO THE GLOBAL FINANCIAL CRISIS: IMPLICATIONS FOR U.S.-CHINA ECONOMIC RELATIONS

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ABSTRACT

The response of the People's Republic of China (PRC or China) to the global financial crisis has earned high marks for its effectiveness.[1] Using its huge foreign currency reserves and being relatively unsaddled by debt, China has been able to inject massive amounts of capital into its economy to stimulate growth and productivity.[2] Not only has China responded in a timely and swift manner, but China's response was designed to address some structural imbalances in China's economy, which had been, in the views of some experts, too dependent on exports and the influx of foreign direct investment (FDI).[3] China's three-part stimulus package, further discussed below,[4] was designed to stimulate domestic consumption as a driver of growth and to wean China away from an economic growth model that was primarily dependent on exports and FDI.[5] A more balanced economic model might rely on both trade and domestic consumption, and provide a more stable growth model for the future.[6] As a result, if China can successfully implement its economic reform package, China may emerge from the global financial crisis in a stronger economic position than that which existed prior to the events that precipitated the crisis.

However, China's economic reform package may escalate existing trade tensions with the United States and may even lead to the imposition of trade sanctions by the United States. China's currency policy and stimulus package involve what some

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1 *See China's Role in the Origins of and Response to the Global Recession: Hearing Before the U.S.-China Econ. and Sec. Rev. Comm'n*, 111th Cong. 5 (2009) (statement of Nicholas R. Lardy, Senior Fellow, Peterson Institute for International Economics) ("China is the gold standard in terms of its response to the global economic crisis.") [hereinafter Lardy, *Hearing*].

2 For further discussion on the stimulus package, *see infra* Part II.B.1.

3 For further discussion on China's dependency on exports and foreign direct investment, *see infra* Part II.B. For a detailed discussion of foreign direct investment and its role in international business, *see* DANIEL CHOW & THOMAS SCHOENBAUM, INTERNATIONAL BUSINESS TRANSACTIONS: PROBLEMS, CASES, AND MATERIALS 365–72 (2d ed., 2010) [hereinafter CHOW & SCHOENBAUM, INTERNATIONAL BUSINESS TRANSACTIONS].

4 For further discussion on China's three-part stimulus package, *see infra* Part II.B.1-II.B.3.

5 An economic model dependent on exports and FDI might not be sustainable for the long term and is especially susceptible to the actions and economic fortunes of the foreign nations that trade with China. For this reason, China has adopted policies to wean its economy away from export and FDI dependence. These policies have been in place for some time, preceding the global financial crisis. *See* C. FRED BERGSTEN ET AL., CHINA: THE BALANCE SHEET 26 (Public Affairs 2006).

6 *See Fixing Global Finance: An Interview with Martin Wolf*, YALEGLOBAL, Mar. 5, 2009, http://yaleglobal.yale.edu/content/fixing-global-finance-interview-martin-wolf ("In the long-run, however, it is right for the Chinese to try and absorb more of their production at home and rebalance their economy with more service production which would generate actually many more jobs. They have not done a good job of generating jobs recently, because their development path has been quite capital-intensive, much too much dependent on investment."); *see also* Edward Wong, *China's Export Economy Begins Turning Inward*, N.Y. TIMES, June 25, 2010, at A6, *available at* http://www.nytimes.com/2010/06/25/world/asia/25china.html.

opponents in the United States view as illegal subsidies to domestic PRC industries that produce goods for export to the United States; these critics contend that the United States should impose countervailing duties on these goods to offset the subsidy.[7] In addition, the United States has been consistently calling for China to further allow its currency to float under market conditions rather than to remain pegged to the U.S. dollar within a narrow range.[8] Allowing its currency to appreciate, however, will increase the price of China's exports and may result in a decrease in exports at a time when China seeks to increase exports as part of its recovery from the global financial crisis. These pressures on China to allow its currency to appreciate as it recovers from the global financial crisis will create additional trade tensions between the United States and China. Adding to the tensions is a perception by many in China that the United States triggered the global financial crisis by creating the subprime mortgage problem that led to the financial downfall. From China's perspective, the United States caused the global financial crisis and is now threatening to prevent China from taking the necessary steps to recover from the crisis. This perception could escalate tensions in United States-China economic relations.

The consequences of the global financial crisis for United States-China economic relations are still unfolding, and it is still unclear whether trade tensions will escalate into trade sanctions. What seems clear, however, is that there is a rising tide of protectionism in both countries based upon what hardliners on each side perceive to be unfair practices and policies implemented by the other. Historically, mutual policies of protectionism between trading partners leads to trade sanctions, which would be an unfortunate result for United States-China economic relations. It remains to be seen whether hardliners in both countries will push the two trading partners into an escalating trade war or whether more moderate voices in the two countries can help to address existing trade issues without resorting to a trade war.

This article discusses the potential for an escalation in trade tensions between the two countries as a result of measures taken by China in response to the global financial crisis. This article proceeds in three parts. The first part examines the effects of the global financial crisis on China. The second part examines China's response to the global crisis. The final part of this article examines the position of the United States that China's policies (some of which predated the global financial crisis) and its current economic stimulus package may, in the view of the United States, contain unfair trade practices that justify the imposition of trade sanctions.

I. THE GLOBAL FINANCIAL CRISIS AND ITS EFFECT ON CHINA

To understand the impact of the global financial crisis on China, it is first necessary to understand the general features of China's economy and the current trade and economic issues between the United States and China. The discussion below analyzes key components of China's economy, beginning with the economic

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[7] For discussion on subsidies and countervailing duties, *see infra* Part III.A.2. For a detailed discussion of these terms and the national and international disciplines governing the use of countervailing duties, *see* DANIEL CHOW & THOMAS SCHOENBAUM, INTERNATIONAL TRADE LAW: PROBLEMS, CASES, AND MATERIALS 710–60 (2008) [hereinafter CHOW & SCHOENBAUM, INTERNATIONAL TRADE LAW].

[8] For further discussion on China's currency policies, *see infra* Part I.A.2(b).

reforms that were implemented in 1978 to open China's economy to trade with other nations.[9]

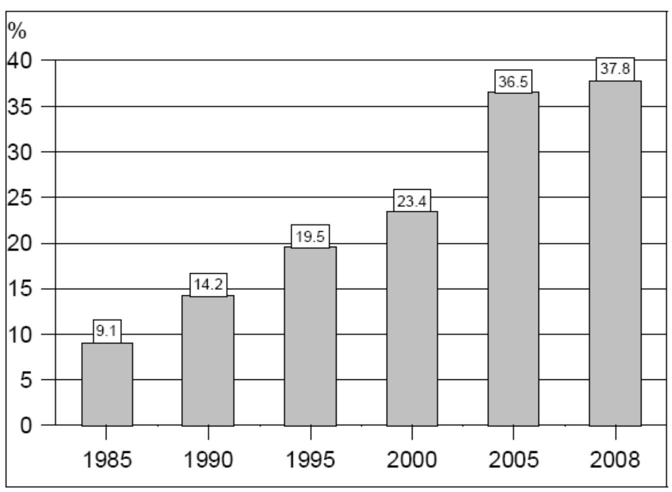
A. China's Export Driven Economy

1. Exports as a Percentage of GDP

China's open door policies came into effect starting in 1985. Since then, there has been acceleration in the following two decades during which China transformed its once static economy into one that is now export driven and dependent on foreign direct investment.[10] In other words, China's unprecedented economic growth has been driven by the sale of exports to foreign countries and by the massive influx of foreign capital by foreign investors (mainly multinational companies) who seek to use China as a platform for the manufacture of goods for sale in China and in foreign markets.

In 2007, China became the world's second largest exporter of merchandise, surpassing the United States and second only to Germany.[11] China's net exports contributed to one third of its GDP growth in 2007.[12] Exports as a share of GDP rose from 9.1 percent in 1985 to 37.8 percent in 2008.

FIGURE 1
CHINA'S EXPORTS OF GOODS AND SERVICES AS A PERCENTAGE OF GROSS DOMESTIC PRODUCT: 1985–2008.



Source: Economist Intelligence Unit.

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[9] For a concise and general overview of key aspects of China's economy and implications for the United States, *see generally* BERGSTEN, *supra* note 5.

[10] *See infra* Part I.A.3 fig.1 at p. 12.

[11] *See* John W. Miller & Marcus Walker, *China Dethrones Germany as Top Goods Exporter*, WALL ST. J., Jan. 6, 2010, at A6, *available at* http://online.wsj.com/article/SB126272143898416853.html.

[12] *See The Spend is Nigh*, THE ECONOMIST, July 30, 2009, *available at* www.economist.com/node/14124376?story_id=14124376.

As the figure above illustrates, in 2008, exports accounted for 37.8 percent of China's GDP. In contrast to China, exports in the United States accounted for 12.7 percent of its GDP in that same year.[13] China's export-driven economy indicates that China is heavily dependent on consumption of its goods by export markets for its economic growth. In addition, China's export industries serve the crucial function of providing employment for China's constantly growing population. Any contractions in China's export sector would result in a slowing down of China's economy and have painful consequences for the country.

2. China's Trade Balance with the United States

China's swift rise as an exporting power has led to an imbalance in the trade of goods with the United States. In recent years, the Unites States has maintained a huge and increasing trade deficit in goods with China.[14] As Table 1 indicates, the United States had a trade surplus with China of $2.7 billion in 1980. In 1985, the trade balance was zero; since then, the United States has run a trade deficit in every year, with the trade deficit reaching a staggering sum of $266 billion in 2008. This is an increase of more than twenty-fold since 1990. The United States has not maintained a trade surplus with China for three decades. From 2006 to 2007, the trade deficit increased by over $40 billion. Given the growth of the trade deficit and current trends, it appears that the United States will continue to maintain a large trade deficit with China for the foreseeable future.

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[13] JOHN TSCHETTER, EXPORTS SUPPORT AMERICAN JOBS, *in* U.S. DEP'T OF COMMERCE, INT'L TRADE ADMIN., at 1 (International Trade Research, Report No. 1, 2009), *available at* http://trade.gov/publications/pdfs/exports-support-american-jobs.pdf.

[14] A trade deficit exists when a nation has a current account deficit, i.e., when a nation imports more goods than it exports. For example, if Country A imports more goods from Country B than Country A exports to Country B, Country A has a trade deficit in goods with Country B while Country B has a trade surplus with Country A. A trade deficit is often viewed negatively by countries because it means that the country with the trade deficit is buying more goods than it is selling to its trading partner. Some countries view this as unfair. Most countries would rather have a trade surplus than a trade deficit. *See* CHOW & SCHOENBAUM, INTERNATIONAL TRADE LAW, *supra* note 7, at 42–43.

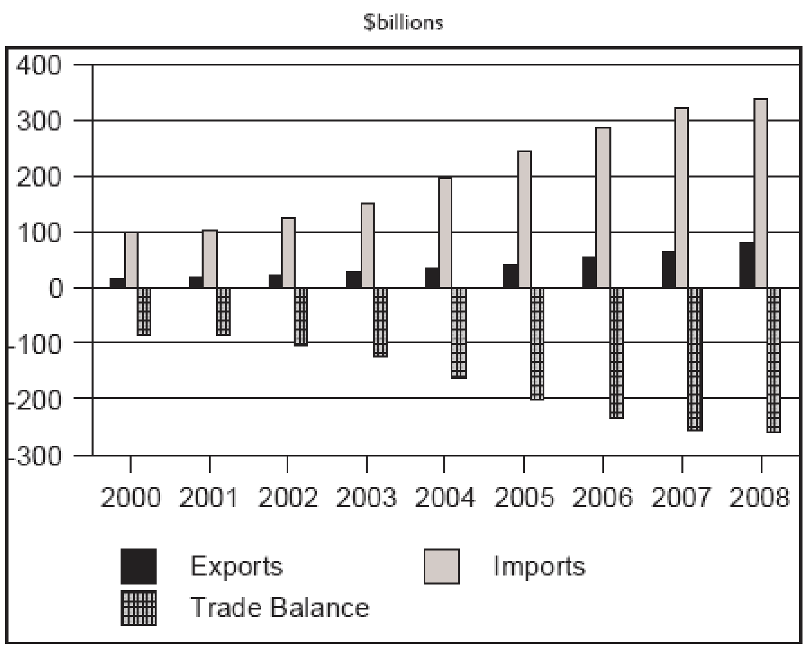
TABLE 1
UNITED STATES MERCHANDISE TRADE WITH CHINA: 1980-2009

($ in billions)

Year	U.S. Exports	U.S. Imports	U.S. Trade Balance
1980	3.8	1.1	2.7
1985	3.9	3.9	0.0
1990	4.8	15.2	-10.4
1995	11.7	45.6	-33.8
2000	16.3	100.1	-83.8
2001	19.2	102.3	-83.1
2002	22.1	125.2	-103.1
2003	28.4	152.4	-124.0
2004	34.7	196.7	-162.0
2005	41.8	243.5	-201.6
2006	55.2	287.8	-232.5
2007	65.2	321.5	-256.3
2008	71.5	337.8	-266.3
2009 projection*	59.2	296.9	-237.7

Source: USITC DataWeb.

FIGURE 2
UNITED STATES TRADE BALANCES WITH CHINA: 2000-2008



Source: USITC DataWeb.

Not only does the United States maintain a growing trade deficit with China but, as Table 2 illustrates, China has the largest trade imbalance with the United States among its major trading partners. This figure is greater than the U.S. trade deficit with the European Union, which has the world's largest economy and consists of 27 countries. China now accounts for over one-third of the United States' trade deficit on a global basis.

TABLE 2
UNITED STATES MERCHANDISE TRADE BALANCES WITH MAJOR TRADING PARTNERS: 2008

($ in billions)

Country or Trading Group	U.S. Trade Balance
World	-800.0
China	**-266.3**
Organization of Petroleum Exporting Countries (OPEC)	-175.6
European Union (EU27)	-93.4
Canada	-74.6
Japan	-72.7
Mexico	-64.4
Association of Southeast Asian Nations (ASEAN)	-50.6

Source: USITC DataWeb.

The United States' growing and seemingly permanent massive trade deficit with China has raised concerns that China may not be playing by the rules of international trade by engaging in unfair trade practices that contribute to the growing size of the deficit.[15] Critics of China do not argue that China should export fewer goods to the United States; rather, they argue that China should reciprocate by purchasing more imports from the United States in order to correct the trade imbalance.[16] Critics often

15 Many experts dispute the argument that China's growing trade surplus is primarily due to unfair trade practices. Many argue that the growing U.S. trade deficit with China is largely the result of the movement of production facilities from other Asian countries to China. Products such as computers and electronic goods, once made in Japan, Taiwan, Hong Kong, and South Korea, are now made in China and then exported to the United States. Statistics support the view that manufacturing is shifting from other Asian countries to China—while imports of certain products such as computer equipment from China have increased, imports of those same products from other Asian countries have decreased. *See* WAYNE MORRISON & MARC LABONTE, CHINA'S CURRENCY: A SUMMARY OF THE ECONOMIC ISSUES 8, CONG. RESEARCH SERV. REPORT RS21625 (2009) [hereinafter MORRISON & LABONTE]. China has become a platform for the assembly and finishing of products that originate in other Asian countries. This view paints a far less threatening view of China, but it is one that is not popular with the press or the United States government.

16 Of course, another method that will reduce the U.S. trade deficit with China is for U.S. consumers to purchase fewer Chinese imports and to save and invest more of their funds. If U.S. consumers spent less and saved more, the U.S. trade deficit with China and the rest of the world would decrease. Spending less and saving more will have many beneficial effects for

point to several major Chinese policies that contribute to the U.S. trade deficit with China.

a. Lack of Reciprocal Spending By China

In international trade, the basic concept is that in order for all nations to benefit, spending must be circular.[17] Nations that export goods and maintain a trade surplus earn revenue and should use their earnings to purchase goods from their trading partners. This type of reciprocal spending would tend to reduce the trade imbalance over time. China exports textiles (clothing), shoes, toys, and furniture[18] to the United States and should, thus, use its earnings to purchase imports from the United States, consisting of airplanes, power generators, and pharmaceuticals. Each nation should sell goods in its area of comparative advantage[19] so that all nations would benefit by achieving greater levels of consumption and enjoy a higher standard of living that would not be possible without international trade.[20] If China purchased more goods and services from the United States, the United States' trade deficit with China would tend to decrease over time. However, critics argue that China is not reciprocating in its trading relationship with the United States; China is not spending its earnings from the sales of exports to the United States to purchase U.S. goods and

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the U.S. economy beyond reducing the trade deficit with China. Since the savings rate in the United States is zero or negative, the United States is living beyond its means and continuing to incur an ever-increasing trade deficit. The United States is funding its spending by borrowing from China and other countries. Foreign countries purchase debt instruments (government bonds) but also purchase equity investments so that more and more of the U.S. economy is now owned by foreign investors. It is unclear how the United States can continue to live beyond its means indefinitely, but it appears that most politicians are not willing to deliver the message to U.S. consumers that it is necessary to save more and spend less. Most politicians and government officials find it more expedient to criticize trading partners than to deliver the unpleasant and unwelcome message to the U.S. consumer that it is necessary to consume less and save more.

[17] *See* CHOW & SCHOENBAUM, INTERNATIONAL TRADE LAW, *supra* note 7, at 44.

[18] In recent years, China has shifted its composition of exports away from labor intensive, low technology goods to high technology goods. In 2009, the largest categories of exports from China to the United States were computer equipment, manufactured commodities, and telecommunications equipment; apparel was sixth. *See* U.S. Int'l Trade Comm'n, *U.S. Imports for Consumption at Customs Value from China: Fiscal Year 2009* (Aug. 31, 2010), http://dataweb.usitc.gov/scripts/cy_m3_run.asp?Fl=m&Phase=HTS2&cc=5700&cn=China; *see also* MORRISON & LABONTE, *supra* note 15, at 6.

[19] The concept of comparative advantage is that due to certain factor endowments (such as arable land and water and mineral resources), differences in climate, education and culture, certain countries may have inherent efficiencies in some industries over others. For example, Country A may be much more efficient in producing automobiles than shoes while Country B might be more efficient in producing shoes than automobiles. Rather than both countries producing automobiles and shoes, each country should concentrate on the area of its greatest strength and efficiency, and then trade with the other country for goods that it does not produce. By trading, both counties will be able to enjoy increased consumption of automobiles and shoes and obtain a higher standard of living than what would be possible without international trade. *See* CHOW & SCHOENBAUM, INTERNATIONAL TRADE LAW, *supra* note 7, at 32–33.

[20] *See* CHOW & SCHOENBAUM, INTERNATIONAL TRADE LAW, *supra* note 7, at 33–36.

services in return.[21] According to its critics, China is "hoarding" its earnings.[22] As a result, imports from the United States to China have grown at a much slower pace than exports from China to the United States.[23]

If China is not spending but "hoarding" its earnings, what is China doing with its earnings? China is saving its earnings by purchasing U.S. Treasury securities (bonds issued by the U.S. government) with its earnings and has now become the largest holder of U.S. bonds.

TABLE 3
CHINA'S HOLDINGS OF U.S. SECURITIES: JUNE 2002-JUNE 2008
($BILLIONS AND PERCENTAGE CHANGE)

2002	2003	2004	2005	2006	2007	2008	2002-2008 % change
188	255	341	527	699	922	1,205	566%

Source: U.S. Department of Treasury.

Notes: U.S. securities include short term and long-term debt, including Treasury securities, U.S. government agency securities, corporate securities, and equities.

TABLE 4
CHINA'S HOLDINGS OF U.S. TREASURY SECURITIES: 2002-APRIL 2009
($BILLIONS AND PERCENTAGE AS A TOTAL OF FOREIGN HOLDINGS)

	2002	2003	2004	2005	2006	2007	2008	April 2009
China's Holdings ($billions)	118.4	159.0	222.9	310.0	396.9	477.6	727.4	763.5
Holdings As a Percent of Total Foreign Holdings	9.6%	10.4%	12.1%	15.2%	18.9%	20.3%	23.6%	23.4

Source: U.S. Treasury Department.

Notes: Data based on periodical surveys by the Treasury Department, which often revises estimates for the previous year but not for all years and thus should be interpreted with caution.

As Table 3 indicates, China's holdings of U.S. securities increased by nearly $1.1 trillion dollars (or by 566%) from 2002 to 2008, the largest increase of holdings by

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21 *See* Martin Crutsinger, *Trade Gap Widens as Imports and Exports Both Rise*, ABC NEWS (July 13, 2010), http://abcnews.go.com/Business/wireStory?id=11150658; Charles A. Kupchan, Op-Ed., *Soothing China-U.S. Tensions*, N.Y. TIMES, Mar. 30, 2010, *available at* http://www.nytimes.com/2010/03/31/opinion/31iht-edkupchan.html.

22 *See* Joseph E. Stiglitz, *How to Fix the Global Economy*, N.Y. TIMES, Oct. 3, 2006, *available at* http://www.nytimes.com/2006/10/03/opinion/03stiglitz.html?ref=joseph_e_stiglitz. Of course, China has no legal obligation to spend its earnings by purchasing more U.S. goods, and China is not violating any laws when it saves and invests its earnings. However, critics feels that such a practice, although legal, is not fair because China benefits from U.S. purchases of China's goods, but the United States does not receive an equivalent benefit from China; China does not buy sufficient quantities of U.S. goods in return and, instead, saves rather than spends its earnings.

23 *See supra* Part I.A.2 tbl.1 at p. 5.

far of U.S. securities by any foreign country. These increases are attributable to some of China's currency policies.[24] China's holdings of U.S. Treasury securities rose from $118.4 billion in 2002 to $727.4 billion in 2008, an increase of over 600 percent. China's holdings of U.S. bonds now comprise 23.6 percent of all of its foreign holdings.

China's massive holdings of U.S. securities have several important consequences for U.S.-China economic relations. When China purchases U.S. government securities, China is lending money to the United States and helping the United States fund the U.S. federal deficit. Without the infusion of funds from China, the U.S. government would need to find other ways to raise revenue or otherwise engage in painful budget cuts. The purchase of U.S. Treasury securities by China has allowed the U.S. government to forego raising taxes. By not raising taxes, the U.S. government is allowing U.S. consumers to have more funds at their disposal. Many consumers use these funds to purchase even more cheap Chinese imports, thereby adding to the growing trade deficit. The cycle appears to be one that never ends, resulting in a continuing U.S. trade deficit that grows with no end in sight.[25] A second consequence is that many U.S. observers believe that China's massive holdings of U.S. securities might give the country increased leverage over the United States on political and economic issues: China could threaten to sell massive amounts of U.S. securities, thereby triggering a devaluation of the dollar and economic instability in the United States, and then use that as leverage on important political issues. Finally, China's large holdings create a relationship of dependence by China on a healthy U.S. economy. China has an incentive to keep buying U.S. securities in order to protect its significant investments in the United States.

b. Currency Policies

A second concern raised by critics of China's trade policies concerns China's currency policies. Under classic international trade theory, trade imbalances tend to naturally correct over time.[26] When the United States purchases goods from China, the United States will exchange U.S. currency for the Chinese yuan or Renminbi (RMB or "people's currency") in order to pay for the goods. In a free market under which the exchange rate is allowed to float—that is, fluctuate in accordance with supply and demand—the increasing demand for imports from China will raise the demand for RMB so that the RMB will appreciate against the dollar.[27] In other words, as demand for Chinese imports continues to increase in the United States, the demand for RMB should also continue to increase with the result that more U.S. dollars will be necessary to purchase the same number of RMB.[28] The appreciation of the RMB will mean that Chinese goods will become more expensive to the U.S. consumer and, conversely, U.S. goods will become cheaper to the Chinese consumer.[29] U.S. consumers will need to pay more dollars in order to acquire the

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[24] For further discussion on China's currency policies, *see infra* Part I.A.2(b).

[25] *See* CHOW & SCHOENBAUM, INTERNATIONAL TRADE LAW, *supra* note 7, at 47.

[26] *See id*. at 45.

[27] *See id*.

[28] *See id*.

[29] *See id*.

same amount of goods from China, whereas Chinese consumers will have to pay fewer RMB in order to acquire the same amount of goods from the United States.[30] If China begins to export fewer goods to the United States and import more goods from the United States,[31] the appreciation of the RMB against the U.S. dollar should result in a decrease of the trade imbalance in favor of China and a decrease in the U.S. trade deficit with China.[32]

The discussion so far assumes that the RMB is a freely traded currency and that its exchange rate is allowed to float. Historically, however, China has maintained a fixed exchange pegged to the U.S. dollar with very narrow ranges.[33] As a result, although the high demand for the Chinese currency should result in an appreciation of the RMB versus the dollar and a correction in the trade imbalance between the two countries, the increased demand has not, until recently, resulted in an appreciation of the RMB due to China's own fiscal policies.[34] Critics charge that the RMB is undervalued and that the purpose of undervaluing the RMB is to support China's export industries.[35] China's response is that its currency policy is not meant to favor exports over imports; rather, it is designed to maintain economic stability through currency stability.[36] Under current economic conditions, an appreciation of the RMB would harm export industries by making exports more expensive, which might lead to employment disruptions, worker unrest, and social chaos.[37] China also believes that its own banking system is too underdeveloped to deal with the speculative pressures that would come with a freely convertible currency.[38]

Under lobbying and pressure from other countries, China modified its currency policy in 2005.[39] China announced a new policy that the RMB exchange would be a managed float, i.e., allowing the RMB to appreciate within very narrow ranges against a basket of currencies that include the U.S. dollar, the Japanese yen, the Euro, and a few other currencies.[40] Unlike a true floating currency, the RMB would be allowed to fluctuate up to .03% (later changed to .05%) on a daily basis.[41] Although the RMB has appreciated from 8.11 to the dollar on July 21, 2005,[42] to

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30 *See id*.

31 *See* CHOW & THOMAS SCHOENBAUM, INTERNATIONAL TRADE LAW, *supra* note 7, at 45.

32 *See id*.

33 *See id.* at 45–46.

34 *See id.* at 46.

35 MORRISON & LABONTE, *supra* note 15, at Summary ¶ 1.

36 *See id.* at 2.

37 *See id.*

38 *See id.*

39 *See id.* at 1.

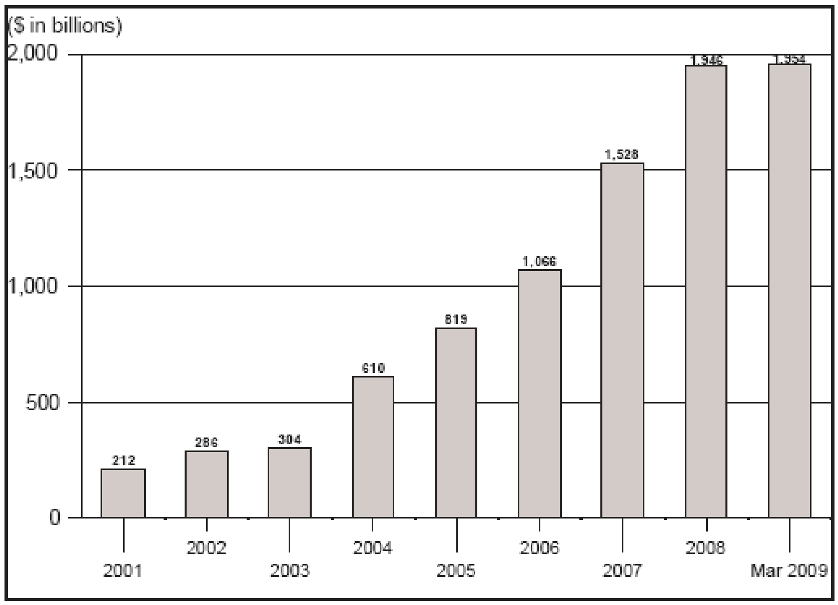
40 *See id.*

41 *See* MORRISON & LABONTE, *supra* note 15, at 1.

42 *See id. See also* Luo Yuanjun, *China's Foreign Trade Under a Stronger Yuan*, CHINA TODAY, Oct. 20, 2005, *available at* http://www.chinatoday.com.cn/English/e2005/e200510/p26.htm.

6.78 as of this writing,[43] many critics point to the sharp increase in China's foreign currency reserves (which grew from $400 billion in 2003 to $1.95 trillion in 2008) and China's large and growing trade surplus with the United States ($266 billion in 2008) as evidence that the RMB is still undervalued by as much as 40%.[44] The

FIGURE 3
CHINA'S ACCUMULATION OF FOREIGN CURRENCY RESERVES: 2001-09 ($BILLIONS)



Source: Chinese State Administration of Foreign Exchange.

United States is continuing to put pressure on China to allow the RMB to appreciate further, resulting in intense trade tensions between the two countries. China claims that it wishes to adopt a more flexible currency policy, but at a gradual pace.[45]

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[43] *See* XE.com, Universal Currency Converter Results, http://www.xe.com/ucc/convert.cgi (last visited Nov. 10, 2010), for the current exchange rates. As of this writing, RMB appreciated 6.78 to the U.S. dollar.

[44] Ernest H. Preeg, *Exchange Rate Manipulation to Gain an Unfair Competitive Advantage: The Case Against Japan and China*, *in* DOLLAR OVERVALUATION AND THE WORLD ECONOMY 267-84 (C. Fred Bergsten & John Williamson eds., 2003); *see also* Roya Wolverson, *Confronting the China-U.S. Economic Imbalance*, COUNCIL ON FOREIGN RELATIONS, Feb. 17, 2010, *available at* http://www.cfr.org/publication/20758/confronting_the_chinaus_economic_imbalance.html ("U.S. policymakers, businesses, and labor groups have argued that the Chinese currency is undervalued by as much as 40 percent against the dollar, making Chinese exports--such as steel pipes and tires--to the United States cheaper and putting massive dollar flows in the hands of the Chinese.").

[45] *See* MORRISON & LABONTE, *supra* note 15, at 2.

As Figure 3 illustrates, China's foreign currency reserves grew from $212 billion in 2001 to $1.95 trillion in 2009, an increase of over 900%. China now has the largest foreign currency reserves in the world,[46] allowing the country to make global investments and loans to further its interests in building ties in Africa and the Middle East, and to meet its energy needs. Critics point to China's massive foreign currency reserves, accumulated in just eight years, as another indication of China's unfair trade practices based on currency manipulation.

c. Export Subsidies

A third cause often cited by critics of China's trade policies is that China's exports benefit from subsidies provided by the PRC government.[47] A subsidy can be in the form of a direct financial payment or in the form of an abatement of charges (such as taxes) that would be otherwise due from the business entity.[48] A subsidy can also take the form of favorable business arrangements such as reduced rent for facilities and reduced prices for utilities and other inputs.[49] Many critics charge that China provides subsidies to many of its own state-owned enterprises that are then allowed to charge lower prices for its exports to the United States and, thereby, obtain a competitive advantage over other goods that do not benefit from the subsidy.[50] Under a recent United States Department of Commerce ruling, non-market economies, like China, are subject to countervailing duties, i.e., a duty or tax imposed by the United States Customs and Border Patrol, upon an import at the border to offset the trade-distorting effect of the government-provided subsidy.[51]

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[46] *See* Li Yanping & Zhang Dingmin, *China's Foreign Reserves Rise at Slowest Pace Since 1999 in Second Quarter*, BLOOMBERG, July 11, 2010, *available at* http://www.bloomberg.com/news/2010-07-11/china-june-money-supply-lending-growth-slow-on-government-curbs-on-credit.html.

[47] In international trade, a subsidy is defined as a financial contribution by a government to a business or firm. *See* Agreement on Subsidies and Countervailing Measures Agreement art. 1, Apr. 15,1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1A, 1869 U.N.T.S. 229, *available at* http://www.wto.org/english/docs_e/legal_e/24-scm.pdf. *See also* U.S. Tariff Act of 1930, 19 U.S.C. § 1677(5)(A) (2009) (defining countervailable subsidy). *See also* CHOW & SCHOENBAUM, INTERNATIONAL TRADE LAW, *supra* note 7, at 712.

[48] *See* CHOW & SCHOENBAUM, INTERNATIONAL TRADE LAW, *supra* note 7, at 717.

[49] *See id.*

[50] *See An Assessment of China's Subsidies to Strategic and Heavyweight Industries*, U.S.-CHINA ECON. AND SEC. REV. COMM'N (Cap. Trade Inc., Washington, D.C.), at 131.

[51] The imposition of countervailing duties on imports from China marks a departure from a long held position established by Georgetown Steel Corp. v. United States, 801 F.2d 1308 (Fed. Cir. 1986), which held that countervailing duties could not be imposed on products from non-market economies that are not governed by the rules of supply and demand in a free market. In determining whether a subsidy exists, the basic comparison is between the actions of the government against a market-based benchmark. Is the government providing the firm with a benefit that is above and beyond what is available in the market? However, if there is no meaningful market-place benchmark in the foreign country (as in the case of non-market economies), it becomes impossible to make this comparison. For this reason, the United States refused to apply countervailing duties to non-market economies, such as China. However, on March 30, 2007, the U.S. Department of Commerce reversed this longstanding policy by

3. Foreign Direct Investment

Foreign direct investment (FDI) refers to the injection of capital into China by foreign investors (mainly multinational corporations).[52] An example of FDI occurs when a U.S. company establishes a subsidiary in China for the purpose of conducting business in China.[53] FDI is important to China's economy for several reasons. First, many foreign invested enterprises (FIEs)[54] are engaged in exports of goods from China, helping China fuel its growing trade surplus with the United States.

Second, FDI plays a crucial growth in China's economic development by providing a massive influx of capital. In order to establish these business entities, the U.S. company will be required by the PRC government to inject capital into China to meet the business entities' physical needs, such as building a factory or office

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imposing preliminary countervailing duties on imports of high gloss paper from China. *See* Tim Truman, *Commerce Department Targets Chinese Subsidies on Coated Free-Sheet Paper*, INTERNATIONAL TRADE UPDATE (Int'l Trade Ass'n, Washington, D.C.), Apr. 2007, at 1. The United States cited reforms in China's economy as evidence that a meaningful market-place benchmark is now available for the purpose of determining whether the government is providing countervailable subsidies. China has challenged this ruling both in U.S. courts and before the WTO. *See* Steven R. Weisman, *China Wins Trade Ruling About Paper*, N.Y. TIMES, Nov. 21, 2007, *available at* http://www.nytimes.com/2007/11/21/business/world business/21trade.html; Jeanette Clinkunbroomer, *Tariffs on Imported Paper May Be Back*, PRINTING NEWS, Nov. 17, 2009, *available at* http://www.printingnews.com/print/Printing-News/Tariffs-on-Imported-Paper-May-Be-Back/3$11457; Jeanette Clinkunbroomer, *Paper Outlook 2010: Running in Place*, PRINTING NEWS, Apr. 21, 2010, *available at* http://www.printingnews.com/publication/article.jsp?pubId=3&id=12268&pageNum=3.
Some observers consider this policy change to be an example of the rising tide of protectionist sentiment against China in the United States. Proposed legislation in Congress (i.e., H.R. 496) would ensure that the U.S. Commerce Department continues to apply countervailing duties to goods from non-market countries, such as China. *See* WAYNE MORRISON, CONG. RESEARCH SERV., RL 33536, CHINA-U.S. TRADE ISSUES 24 (2009) [hereinafter MORRISON, TRADE ISSUES]; *see also U.S. Paper Companies Commend Tariff Decision*, BUS. J. MILWAUKEE, Apr. 30, 2010, *available at* http://milwaukee.bizjournals.com/milwaukee/stories/2010/04/26/daily.html.

[52] A more formal definition of FDI is as follows: foreign direct investment (FDI) refers to the influx of capital supplied by foreign investors for the purpose of acquiring a lasting ownership interest in a business entity located in a foreign country. A good example would be when a U.S. parent company establishes a wholly or partially subsidiary in a foreign country. The subsidiary is a creature of the domestic law of the foreign nation host but the owner of the subsidiary is a U.S. company. *See* CHOW & SCHOENBAUM, INTERNATIONAL BUSINESS TRANSACTIONS, *supra* note 3, at 366.

[53] The business entity could take the form of a joint venture with a local partner or a wholly foreign owned enterprise in which the foreign investor is the sole owner. Both cases involve FDI because the foreign investor injects capital into the business entity and obtains a lasting or permanent interest in the business entity, which itself is a creature of Chinese law.

[54] A foreign invested enterprise is the technical name under PRC law of the business entity established by China by the multinational company. The business entity is a creation of PRC law, but it is owned in part or in its entirety by a foreign investor.

buildings and purchasing equipment and supplies.[55] Further, the newly established business entity will need to hire local workers, providing employment opportunities for new graduates of China's universities.

Third, FDI also provides the crucial component of technology transfer. In most cases, the foreign investor will need to transfer or license its technology to the business entity in China in order for the business to operate successfully.[56] For example, in the case of a U.S. pharmaceutical company with a joint venture in China, the U.S. company will need to license its patents to the joint venture so that the joint venture can manufacture the patented drugs.[57] Without access to the patents, the Chinese joint venture will be unable to manufacture the products. In most cases, the technology component is the most valuable business asset of the U.S. company. Where the U.S. company is providing technology, the technology can be valued and treated as part of the capital contribution of the U.S. company in China. The role of FDI is crucial to China because FDI provides capital, thereby resulting in new construction projects and, more importantly, providing China with the access to advanced technology that is crucial to competitiveness in the modern world.

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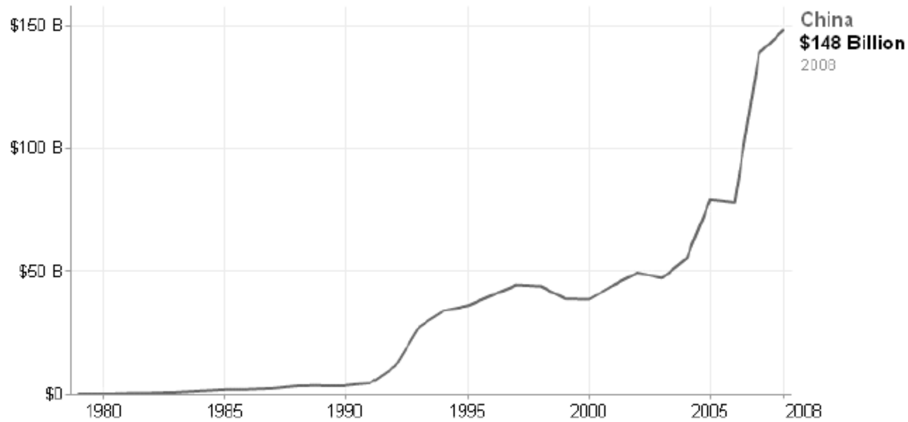
[55] All foreign invested enterprises must be approved by the appropriate approval authorities. Depending on the size of the investment, the approval authority will be the Ministry of Commerce at the central level and its provincial and local branches. As part of the approval process, the approval authority will carefully scrutinize the financial needs of the proposed foreign invested enterprise and will require that enough capital be injected by the foreign investor to establish a sustainable and operational business. The approval authorities will often scrutinize the documents submitted by the foreign investor carefully, line-by-line, and require detailed, minute changes. *See* CHOW & SCHOENBAUM, INTERNATIONAL BUSINESS TRANSACTIONS, *supra* note 3, at 492. For various historical and political reasons, FDI is not subject to the discipline of the World Trade Organization. *See* CHOW & SCHOENBAUM, INTERNATIONAL TRADE LAW, *supra* note 7, at 323–24.

[56] In this context, technology refers to knowledge or information that is often protected by intellectual property rights. *See* CHOW & SCHOENBAUM, INTERNATIONAL BUSINESS TRANSACTIONS, *supra* note 3, at 324.

[57] The U.S. company will first register the patents in China under its own name. This is a crucial step because it establishes that the U.S. company is the owner of the intellectual property. The U.S. company will then license the patents to the joint venture or the wholly foreign owned enterprise. The joint venture or wholly owned enterprise becomes the licensee of the technology whereas the U.S. company is the owner/licensor. This is typically what is referred to as technology transfer—that is, the owner of technology gives access to the technology to a third party.

TABLE 5
FOREIGN DIRECT INVESTMENT IN CHINA, INFLOWS
($BILLIONS)



Source: World Bank Indicators

In 2008, FDI inflows to China totaled $148 billion, making China the largest FDI recipient among developing countries and the third largest recipient of FDI overall in the world.[58] FDI has been a major factor in China's productivity gains and economic growth. Most of the world's largest multinational corporations, such as General Motors, Procter & Gamble, and Coca-Cola, have substantial investments in China.[59] The PRC government estimates that, as of 2007, there were 286,200 approved FIEs in China and that these FIEs employed more than 42 million people and accounted for 31.5% of gross industrial output.[60] Annual FDI in China grew from $2 billion in 1985 to $148 billion in 2008. The total cumulative level of FDI in China at the end of 2008 is estimated to be about $880 billion.[61] Thus, FDI has played a crucial role in China's modernization and industrialization.

4. Summary

As the preceding discussion indicates, China's economic growth has been heavily dependent on exports and FDI. Unlike the United States, domestic

[58] China's FDI only trails behind the EU, the largest overall recipient, followed by the United States in second place. *See* WAYNE MORRISON, CHINA AND THE GLOBAL FINANCIAL CRISIS: IMPLICATIONS FOR THE UNITED STATES, CONG. RES. SERV. REP. RS22984, at 1 (2009) [hereinafter MORRISON, GLOBAL FINANCIAL CRISIS].

[59] *See* DANIEL CHOW, THE LEGAL SYSTEM OF THE PEOPLE'S REPUBLIC OF CHINA IN A NUTSHELL 35 (2d ed. 2009) [hereinafter CHOW, NUTSHELL].

[60] *See* WAYNE MORRISON, CHINA'S ECONOMIC CONDITIONS, CONG. RES. SERV. REP. RL33534, at 9 (2009) [hereinafter MORRISON, ECONOMIC CONDITIONS].

[61] *See* Penelope B. Prime, *China and India Enter Global Markets: A Review of Comparative Economic Development and Future Prospects*, 50 EURASIAN GEOGRAPHY & ECON. 621, 630 (2009).

consumption in China is not a major driver of economic growth. An economic model like China's is heavily dependent on its trading relationships with foreign countries for its continued growth. As the next section indicates, such trading relationships have come under severe pressure as a result of the global financial crisis.

5. Impact of Financial Crisis

China's exposure to the global financial crisis is moderated by its lack of direct exposure to the subprime mortgage problem. China places numerous restrictions on capital flows, particularly outflows of capital to foreign destinations.[62] These policies limit the ability of Chinese citizens to invest abroad, thereby compelling many Chinese citizens and private firms to invest their savings domestically in PRC banks, the stock market, business ventures, and the real estate market. Many Chinese citizens, however, are able to illegally circumvent these restrictions and invest abroad. Some of these investments may have been in subprime mortgages, but the extent of this investment is unclear and is likely to be relatively small.[63]

The PRC government accounts for the bulk of foreign investment overseas, much of it derived from China's massive foreign currency reserves. But the PRC government invests mainly in safe low-yielding instruments, such as U.S. Treasury securities. As of June 2008, the U.S. Treasury Department estimated that China's holdings of U.S. securities totaled $1.2 trillion, up from $922 billion in June 2007. This makes China the second largest holder of U.S. securities in the world, behind Japan.[64] Of this total, $527 billion were in long-term U.S. government agency securities, $522 billion in U.S. Treasury securities, and the remainder in corporate securities and debt.[65] PRC authorities do not release detailed information about its financial holdings, so it is not possible to determine with certainty how much of this investment was in subprime mortgages and mortgage-backed securities. However, PRC officials are cautious and conservative by nature in their investment strategies; it would have been unlikely for the officials to invest heavily in securities that might have been viewed as speculative, even if such investments were extremely popular with investors in the United States. In addition, PRC officials are not likely to invest in mortgage-backed securities and other innovative financial instruments that few people, including investment experts in China or the United States, seem to fully understand. While it is likely that China did have some investments in subprime mortgages, this exposure was most likely small and was not, by itself, the cause of significant financial losses to China.[66]

While China's direct exposure to subprime mortgages may have been limited, the effect of the subprime mortgage problem did affect China because the problem had a significant and harmful impact on the economies of China's two largest trading partners: the United States and the EU. The result of the economic downturn in the

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[62] *See* MORRISON, GLOBAL FINANCIAL CRISIS, *supra* note 58, at 2.

[63] The PRC government will tolerate some circumvention of laws against foreign investment so long as the infractions are minor. The lack of a crackdown on private individuals and private firms investing overseas in subprime mortgages suggests that the amount of this illegal activity was insignificant.

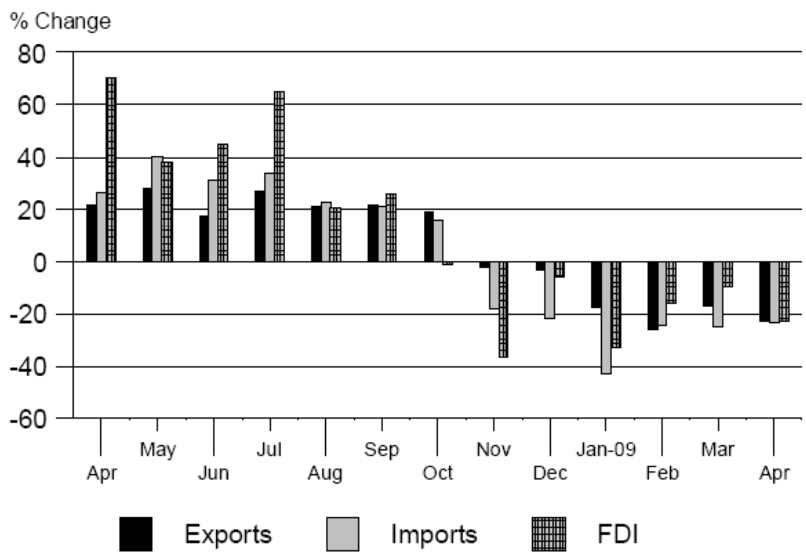
[64] *See* MORRISON, GLOBAL FINANCIAL CRISIS, *supra* note 58, at 2–3.

[65] *See id.* at 3.

[66] *See* Lardy, *Hearing*, *supra* note 1, at 6–7.

United States, the EU, and other countries around the world contributed to a significant slowing down of China's economy. As a result of the global financial crisis, China's largest target export markets have considerably slowed their purchases of Chinese exports: consumers in the United States and EU are not spending as a result of the financial crisis, and China's exports have declined significantly.[67] FDI inflows to China have also decreased sharply as cost cutting measures by multi-national companies (MNCs) have resulted in low availability of capital for foreign investment. In April 2009, FDI inflows to China were down by 22.5%, as compared to April 2008 when FDI surged by over 70%.[68]

FIGURE 4
CHANGES IN CHINA'S MONTHLY TRADE AND FDI INFLOWS: APRIL 2008-APRIL 2009



Source: Global Insight and China's Customs Administration.

The declines in merchandise trade, the influx of FDI, and exports have led to sharp retractions of China's economy. For the first four months of 2009, industrial output rose by 5.5%, well below the 12.9% growth rate in 2008.[69] China's real GDP growth was expected to slow to 6.6% in 2009.[70] This might seem like a steady rate of growth, but this is an economy that grew at an annual rate of nearly 10% from 1979 to 2008,[71] a three decade period that began with economic reforms and ended up at

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[67] China's exports and imports were down in February 2009 by 25.7 percent and 24.1 percent respectively. *See* MORRISON, GLOBAL FINANCIAL CRISIS, *supra* note 58, at 4.

[68] *See id.*

[69] *Id.*

[70] *Id.*

[71] MORRISON, ECONOMIC CONDITIONS, *supra* note 60, at 4.

its present rate. Some believe that China's economy needs to grow at a rate of at least 8% per year because China's expanding population requires the creation of 20 million new jobs per year.[72] In January 2009, the PRC government estimated that the slow down in China's economy due to the global economic crisis led to the loss of 20 million jobs in 2008.[73]

Another effect of the global financial crisis in China is the slowing down of China's real estate market. In fact, in several of China's cities, there are signs of a bubble that is bursting, including a slowing down in construction and falling prices, and increases in uncompleted and unoccupied buildings.[74]

An additional indication of the impact of the global financial crisis on the overall health of the economy is the sharp decline in the Shanghai Stock Exchange Composite Index, China's main stock market, which lost two-thirds of its value from December 31, 2007 to December 31, 2008.[75]

Taken together, these effects, especially loss of the ability to create new jobs through the growth of the economy and the loss of current jobs due to the global economic crisis, could create a serious social problem for China. The popular support for the Communist Party of China (CPC) is based on its ability to deliver increased economic growth and prosperity for China's population, the vast majority of who are still quite poor by international standards.[76] The failure of the CPC's delivery of this part in the implied compact will lead to social unrest and challenges to its authority. Already, China has seen, in recent years, a sharp increase in incidents of violent protests by disgruntled groups who believe that they are not receiving their share of the fruits of China's economic rise.[77] Some of these protests

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[72] MORRISON, GLOBAL FINANCIAL CRISIS, *supra* note 58, at 4; *see generally* MORRISON, ECONOMIC CONDITIONS, *supra* note 60, at 22–23.

[73] MORRISON, GLOBAL FINANCIAL CRISIS, *supra* note 58, at 4.

[74] *Id.*

[75] *Id.*

[76] In 2009, China's gross national income per capita was estimated at $3,590. WORLD BANK, GROSS NATIONAL INCOME PER CAPITA 2009, ATLAS METHOD AND PPP (2010), http://siteresources.worldbank.org/DATASTATISTICS/Resources/GNIPC.pdf. In that same year, the annual per capita disposable income of urban households was 17,175 yuan, or about $2,583, whereas the annual per capita net income of rural households was 5,153 yuan, or about $775. NATIONAL BUREAU OF STATISTICS OF CHINA, STATISTICAL COMMUNIQUÉ OF THE PEOPLE'S REPUBLIC OF CHINA ON THE 2009 NATIONAL ECONOMIC AND SOCIAL DEVELOPMENT, Population, Living Conditions and Social Security, Figs. 14–15 (Feb. 25, 2010), *available at* http://www.stats.gov.cn/english/newsandcomingevents/t20100226_402623115.htm. *See also* Trade Policy Review Body, *Trade Policy Review: Report by China*, WT/TPR/G/230 (Apr. 26, 2010), *available at* http://www.wto.org/english/tratop_e/tpr_e/g230_e.doc ("China's per-capita GDP still ranks behind more than 100 countries. Calculated by the World Bank's poverty standard of 1.25 USD per person per day, China still had some 150 million people living in poverty by the end of 2008."); Olivia Chung, *Wen Plugs Concerns over Stimulus Exit*, ASIA TIMES, Mar. 6, 2010, *available at* http://www.atimes.com/atimes/China_Business/LC06Cb01.html ("The urban-rural income gap is now at its widest since the country launched its reform and opening-up policy in 1978.").

[77] *See* Chris O'Brien, *Economy Protests Worry Beijing*, WASH. TIMES, Nov. 28, 2008, *available at* http://www.washingtontimes.com/news/2008/nov/28/economy-protests-worry-beijing/; Wu Zhong, *Beijing Hears Dissenting Voice on Unrest*, ASIA TIMES, Apr. 28, 2010,

predated the current global economic crisis and were directed at the perceived inequities generated by China's unprecedented period of economic expansion, such as huge disparities in wealth acquisition. A loss of jobs and the overall decline of the economy due to the global financial crisis pose a major threat because it might lead to increased social instability that could threaten the ability of the CPC to remain in power.

II. CHINA'S RESPONSE TO FINANCIAL CRISIS

Among many groups in China, there is a lot of anger and resentment directed at the United States for precipitating the global financial crisis through the subprime mortgage problem.[78] Many in China find it difficult to believe that U.S. banks and the financial industry could create financial products that no one seemed to really understand and that these exotic subprime mortgages were packaged as securities and other financial products;[79] these, in turn, were sold in huge quantities in the United States and abroad. As previously discussed, China's leaders are quite conservative in their fiscal policies and, thus, avoided these financial products.[80] But many people in China, including China's leaders, are truly puzzled by what they see as irresponsible financial behavior. There is also anger because China's economy is heavily dependent on the United States, which is one of the largest target markets for China's exports and one of the largest foreign investors in China.[81] Many people in China believe that China was lulled into creating close economic ties with the United States based on a false belief that the United States economy was stable and

available at http://www.atimes.com/atimes/China/LD28Ad01.html; *China Fears Job Riots*, CNN WORLD NEWS, Nov. 20, 2008, *available at* http://www.cnn.com/2008/WORLD/asiapcf/11/20/china.jobs/.

[78] This observation is based upon the author's own experience.

[79] Liu Mingkang, Chairman, China Banking Regulatory Comm'n, Address at the British Museum (May 6, 2008) (transcript available at Embassy of the People's Republic of China in the United Kingdom of Great Britain and Northern Ireland) ("[I]f we look into how the sub-prime loans are made by American mortgage lenders, how such mortgage loans are then packaged and securitized by the investment intermediaries, and how the whole process has given rise to huge conflicts of interest[,] I am [not] surprise[d] if we look into how the regulators view and respond to such so-called innovations. It is indeed a big mishap for human beings to face at the outset of the new millennium."). *See also* Edward Wong, *Booming, China Faults U.S. Policy on the Economy*, N.Y. TIMES, June 17, 2008, *available at* http://www.nytimes.com/2008/06/17/world/asia/17china.html?pagewanted=1.

[80] China purchased very few of these financial products; *see* Lardy, *Hearing*, *supra* note 1, at 6-7.

[81] *See, e.g.*, Thomas Omestad, *Chinese Blame U.S. Policies for Financial Crisis During Economic Talks*, U.S. NEWS AND WORLD REPORT, Dec. 4, 2008, *available at* http://politics.usnews.com/news/articles/2008/12/04/chinese-blame-us-policies-for-financial-crisis-during-economic-talks.html; Jiang Yuxia, *U.S. Subprime Crisis to Affect China's Exports*, CHINA VIEW, Mar. 8, 2008, *available at* http://news.xinhuanet.com/english/2008-03/08/content_7746470.htm. *See also Global Financial Crisis Spills over to China's Labor Market*, CHINA DAILY, Nov. 2, 2008, *available at* http://www.chinadaily.com.cn/bizchina/2008-11/02/content_7166354.htm; *Vice Premier: Tap Consumption Potential to Sustain Growth*, CHINA DAILY, Dec. 3, 2008, *available at* http://www.chinadaily.com.cn/bizchina/2008-12/03/content_7266480.htm.

prosperous with a world class financial industry, a prudent and conscientious government, financial regulators, and sophisticated consumers.[82] There was a common perception in China that with regard to most financial and business matters, the United States was far ahead of China and that China had much to learn from the United States. As a result, China felt secure in building strong ties with the United States economy by investing heavily in manufacturing exports to the United States, purchasing U.S. government securities, and welcoming foreign direct investment from U.S. companies.[83]

When the subprime mortgage problem triggered the global financial crisis, many in China believed that it was naïve and foolish to trust the United States; in retrospect, sectors of the financial industry in the United States seemed to be reckless, driven by greed and their own personal interests, and oblivious to the effect of their machinations on other countries and the global economy.[84] China's leaders were also shocked and surprised that the United States government seemed to have completely overlooked the problem and may have even contributed to it. The failure of the United States government to anticipate the subprime mortgage problem has also damaged the perception in China that the United States has highly skilled government and banking regulators.[85] China has long viewed the United States with envy and admiration because the United States seemed to be an economic juggernaut that achieved vast amounts of wealth and was a leader as a modern and industrialized country.[86] In contrast, China was a country in dire poverty only a few decades ago, and the United States was viewed from afar as a model to which China could aspire to within the limits of China's vastly different political system and values. The subprime mortgage problem and the subsequent global financial crisis that it triggered has drastically altered this perception. There is now a sentiment in China that the United States is reckless, fallible, and driven by greed, and countries

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[82] *See* Andrew Peaple, *A Mixed Ending for Paulson in China*, WALL ST. J., Dec. 5, 2008, *available at* http://online.wsj.com/article/SB122846766539882535.html; *China's Wen Guardedly Hopeful—But Premier Has Tough Words for U.S. Role in Financial Crisis*, WASH. POST, Jan. 29, 2009, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2009/01/28/AR2009012803902.html (Wen offered lightly veiled criticism of the United States and Western financial institutions when he listed the causes of the financial crisis as "a 'blind pursuit of profit' and 'a lack of self-discipline' among financial institutions, [as well as] a failure of regulators to keep up with new financial instruments.").

[83] *See* MORRISON, TRADE ISSUES, *supra* note 51, at 8–10. *See also* Ian Bremmer, *Gathering Storm: America and China in 2020*, WORLD AFFAIRS, July/Aug. 2010, *available at* http://www.worldaffairsjournal.org/articles/2010-JulyAugust/full-Bremmer-JA-2010.html; Fang Cai, *The Roles of Chinese Cconomists in Economic Reform* 8 (The Australian Nat'l U. Asia Pac. Sch. Econ. & Mgmt., China Economy Papers 1998/2, 1998), *available at* http://dspace.anu.edu.au/bitstream/1885/40391/1/cep98-2.pdf.

[84] *See, e.g.*, MARK GILBERT, COMPLICIT: HOW GREED AND COLLUSION MADE THE CREDIT CRISIS UNSTOPPABLE 3, 41, 66–67 (2010).

[85] *See generally* Bonnie S. Glaser & Lyle Morris, *Chinese Perceptions of U.S. Decline and Power*, 9 JAMESTOWN FOUND. 4 (2009); *see also* Fu Mengzi, Op-Ed., *Old Order Should Yield Place to New*, CHINA DAILY, May 18, 2009, *available at* http://www.chinadaily.com.cn/opinion/2009-05/18/content_7785807.htm.

[86] David M. Finkelstein, *China Reconsiders Its National Security: "The Great Peace and Development Debate of 1999,"* PROJECT ASIA (CNA Corp., Alexandria, Va.,) Dec. 2000, at ii.

like China that create close economic ties with the United States put themselves at risk of suffering the consequences of the irresponsible behavior.[87] China has long believed that the United States is far superior to China in business and financial matters; however, this belief has now been shaken in China, and many believe that China is now paying the price for having overestimated the business and financial prowess of the United States.[88]

The consequences of the global financial crisis for China and its relationship with the United States are several. In China there is both a political and economic response. These responses, described below, trigger legal consequences.

A. Political Response

One political response in China has been a call by hardliners for a rejection of economic reform and a return to China's pre-reform centrally-controlled economy implemented by Mao after the establishment of the PRC in 1949.[89] This position is extreme, and there is no realistic possibility that it will be implemented. However, some moderates have called for a slowing down of China's market reforms and a more cautious and measured attitude; this is in contrast to the enthusiastic dedication to accelerate and deepen reforms of China's economy to achieve a market-oriented economy, which appeared to be the position of the PRC government until the global financial crisis struck.[90] An approach calling for slowdowns might have some political traction, but might also have a negative effect on China's trading partners. China may restrict or limit access to its markets and various sectors of the economy to foreign direct investment and participation. This would have a negative impact on trade with the United States and other trading partners.

Another, perhaps less obvious political response, might be a stronger nationalist/protectionist attitude on China's part. A protectionist attitude seems to be already clearly manifested in China's new indigenous innovation policy of its government procurement program,[91] which calls for the government purchase[92] of

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[87] Jason Dean et al., *Chinese Premier Blames Recession on U.S. Actions: Beijing Rethinks Some of Its American Investments*, WALL ST. J., Jan. 29, 2009, at A1, *available at* http://online.wsj.com/article/SB123318934318826787.html.

[88] Zhu Qiwen, Op-Ed., *Many Lessons to Draw from Financial Crisis*, CHINA DAILY, Sept. 24, 2008, *available at* http://www.chinadaily.com.cn/opinion/2008-09/24/content_7054016.htm. *See also* Niall Ferguson & Joanne J. Myers, *The Ascent of Money: A Financial History of the World*, PUB. AFF. PROGRAM (Carnegie Council for Ethics in Int'l Aff., New York, N.Y.), Nov. 20, 2008.

[89] *See generally* CHOW, NUTSHELL, *supra* note 59, at 21–27 (providing an overview of China's economy prior to economic reforms).

[90] *See* Yan Liang, *China and the Global Financial Crisis: Assessing the Impacts and Policy Responses*, 18 CHINA & WORLD ECON. 56 (2010); *see also* Eswar S. Prasad, *Effects of the Financial Crisis on the U.S.-China Economic Relationship*, 29 CATO J. 223 (2009).

[91] *See* Christopher Rugaber, *U.S. Companies Slam China's Innovation Policies*, ABC NEWS, June 15, 2010, *available at* http://abcnews.go.com/Business/wireStory?id=10923064; *see also* Stanley Lubman, Op-Ed., *China's 'Indigenous Innovation' Policy Creates Obstacles for Foreign Business*, WALL ST. J., Apr. 7, 2010, *available at* http://blogs.wsj.com/chinarealtime/2010/04/07/stanley-lubman-chinas-indigenous-innovation-policy-creates-obstacles-for-foreign-business/; s*ee also* Doug Palmer, *China Innovation Policies 'A Deep*

technology that has been developed exclusively in China. Under this new policy, the PRC government will purchase technology (products or services that embody intellectual property) for its many public works projects only if the technology was developed exclusively in China. For example, if an MNC developed a patented product, such as a power generator, in the United States, the PRC would refuse to purchase the product. If some component of the product had been developed abroad but the product was the result of research and development in China, the PRC government would refuse to purchase the product under this new policy. Since government procurement in China (and in the United States) involves hundreds of billions of dollars in purchases every year, this new policy threatens to effectively foreclose the United States from a highly lucrative government procurement market since just about every product today involves technology. China's economic stimulus package of $586 billion calls for the government purchase of products for China's numerous public works projects, but the indigenous innovation policy might block the United States from any opportunities to sell its products to China. Since government procurement is not covered by the World Trade Organization, the United States would have no legal basis to contest China's decision to block the purchase of foreign technology for its government projects.[93] As a result, many U.S. companies are calling this policy unfair and harmful, although it is not illegal.[94] The

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Concern' - USTR, REUTERS, Feb. 25, 2010, *available at* http://in.reuters.com/article/idINIndia-46479520100225.

[92] Government procurement refers to the purchase by government entities of goods and services. Governments play a major role in the purchase of goods and services in many countries. Although there is pressure to buy local goods, some countries have joined the World Trade Organization Agreement on Government Procurement, which requires that its members give equal access to foreign goods and services. Government procurement involves hundreds of billions of dollars of purchases, so this is a lucrative market for business entities and the competition to sell to governments around the world is fierce. *See* Agreement on Government Procurement, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 4, Legal Instruments—Results of the Uruguay Round, 33 I.L.M. 1125 (1994).

[93] National treatment is a basic principle contained in Article III of the General Agreement on Tariffs and Trade 1994 (GATT), one of the basic disciplines administered by the World Trade Organization. *See* General Agreement on Tariffs and Trade 1994, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1A, Legal Instruments—Results of the Uruguay Round, 33 I.L.M. 1125 (1994). Under GATT Article III, member states are prohibited from discriminating against imports in favor of domestically produced goods. If, for example, a member state placed more onerous conditions on the sale of imports than on domestic products, the conditions might be a violation of the National Treatment Principle. However, GATT Article III:8(a) exempts government procurement from the National Treatment Principle. *Id.* As a result, member states are free to discriminate against foreign imports in government procurement. The WTO Agreement on Government Procurement applies the National Treatment Principle to government procurement but this is a plurilateral agreement—that is, it is a voluntary agreement to which member states can agree to join. The U.S. is a member of the WTO Agreement on Government Procurement, but China is not. This means that in government procurement, China is free to discriminate against foreign goods in favor of domestically produced goods.

[94] The Indigenous Innovation policy might be a backlash against the United States for the harsh criticism by the United States of China's poor record on the protection of intellectual

indigenous innovation policy is just one example, but there are many other government policies that are also viewed as favoring domestic Chinese industries over foreign competition. Of course, China can also use many subtle and ingenuous methods to discriminate against U.S. products and companies that are difficult to detect.

A third political response may be a general hardening of attitudes towards the United States in trade and politics. Although China has long viewed the United States with admiration, it is an admiration that is mixed with fear and resentment. The United States has long attempted to take positions on China's unresolved political issues that have irked PRC leaders. The most prominent example is the United States' position on Taiwan, which China regards as a renegade province. At one time, the United States and Taiwan had a mutual defense treaty—that is, each party promised to come to the defense of the party if attacked.[95] Of course, while this treaty was "mutual," it was really a promise by the United States to protect Taiwan against a military strike by China. It should not be surprising that China viewed the mutual defense treaty, since abrogated,[96] with a great deal of anger and resentment, as it was considered to be an intrusion into China's own internal affairs and a direct and blatant threat to China's sovereignty and national security. China continues to harbor a deep resentment against the United States on the Taiwan issue.[97] For example, the United States continues to provide advanced weapons (such as world class fighter jets) to Taiwan over China's vehement objections.[98] In recent years, China has been further irked by the sympathetic position that many in the United States have taken towards Tibet, which China views as part of the motherland. It is difficult to underestimate the effect of these deep and bitter resentments on attitudes in China towards the United States because they are never too far from the surface.

Many in China also believe that the United States uses its military and economic power to pressure and bully China on economic and political issues. In recent years, for example, the United States has taken to lecturing China on the need to protect U.S. intellectual property rights. Although Chinese officials sit morosely through these meetings and lectures, the perception is that the United States is arrogant and

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property rights. Not surprisingly, China does not like being lectured to and berated by the United States on the need to protect U.S. technology and intellectual property in China.

95 *See* Nancy J. Murray, *Treaty Termination by the President Without Senate or Congressional Approval: The Case of the Taiwan Treaty*, 33 SW. L.J. 729 (1979); *see also* Ronald P. Cima, *Unilateral Termination of the 1954 Mutual Defense Treaty Between the United States and the Republic of China Pursuant to the President's Foreign Relations Power*, 12 VAND. J. TRANSNAT'L L. 133 (1979).

96 *See* Daniel P. McCurdy & Richard J. Richardson, *Recognition, Diplomacy, and International Law: The Curious Case of the United States and China*, 9 INT'L INTERACTIONS 103 (1982).

97 *See* CHOW, NUTSHELL, *supra* note 59, at 14; *see also* Press Release, Embassy of the People's Republic of China in the United States of America, China Opposes U.S. Congress' Resolution on Taiwan (July 19, 2004), *available at* http://www.china-embassy.org/eng/xw/t143465.htm.

98 Michael Wines, *U. S. Alarmed by Harsh Tone of China's Military*, N.Y. TIMES, Oct. 12, 2010, at A1, *available at* http://www.nytimes.com/2010/10/12/world/asia/12beijing.html?pagewanted=1 ("Why do you sell arms to Taiwan? We don't sell arms to Hawaii.").

condescending.[99] Finally, many in China believe that the United States is intentionally and secretly attempting to frustrate and block China's rise in the world because the United States does not wish to see another strong and prosperous country projecting its power and influence around the world as a challenger to the first class world power of the United States.[100] While this sentiment may seem far fetched to some in the United States, China was subject to domination by foreign nations in the nineteenth and early twentieth century and suffered a brutal all-out invasion by Japan that was intended to completely subjugate and destroy the country.[101] While no one in China believes that the United States has any military ambitions against China itself, the habit of mistrust of strong foreign powers is deeply ingrained in China. These simmering resentments, the eruption of the global financial crisis, and China's increasing self-confidence coinciding with its own rise in the world as an economic power, create pressures on China's leaders to stand up to the United States and to resist or reject U.S. pressure tactics. Hardliners in China might even call for retaliatory trade sanctions against the United States. If China takes this position on its currency and resists U.S. calls for devaluing its currency, trade tensions could escalate.[102]

B. Economic Response

China's elites believe that China might have been too dependent on an export-driven economy and an economy dependent on FDI for growth. The downturn in exports and the influx of FDI have caused severe repercussions in China, thereby contributing to a significant rise in the shutting down of businesses and a spike in unemployment. China has adopted three steps designed to create economic growth through increases in domestic consumption that is intended, perhaps permanently or as part of an overall policy, to replace the loss of growth due to the decline in exports and FDI.

1. Fiscal Policy

In November 2008, China tapped into its huge foreign currency reserves and introduced a $586 billion package. The package was designed to provide capital for domestic spending and to stimulate the economy by providing job creations and

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[99] *See generally* Daniel Chow, *Anti-Counterfeiting Strategies of Multinational Companies in China*, 41 GEO. J. INT'L L. (forthcoming 2010).

[100] *See, e.g.*, Michael Swaine, *Perceptions of an Assertive China*, 32 CHINA LEADERSHIP MONITOR (Carnegie Endowment for Int'l Peace, Washington, D.C.), Spring 2010, at 2–4; *A World Remade: The United States and Rising Powers in the 21st Century*, LEVERAGING US STRENGTH IN AN UNCERTAIN WORLD (Stanley Found. Conf. on Nat'l and Global Sec., Washington, D.C.), Dec. 7, 2006, *available at* http://secure.stanleyfoundation.org/registration/securityconference/panels/rising_powers.php#transcript. *See also Why China Opposes US-South Korean Military Exercises in the Yellow Sea*, PEOPLE'S DAILY ONLINE, July 16, 2010, *available at* http://english.peopledaily.com.cn/90001/90780/91342/7069743.html; Barbara Demick & John M. Glionna, *U.S.-South Korea War Games Raise China's Hackles*, L.A. TIMES, July 28, 2010, *available at* http://articles.latimes.com/2010/jul/28/world/la-fg-china-korea-exercises-20100729.

[101] *See id.* at 4–9.

[102] Part III of this article further explores this issue; *see infra* p. 24.

public works with the goal of increasing GDP by 2 to 3 points.[103] The following table presents a breakdown of the allocations under the stimulus package.

TABLE 6
CHINA'S DOMESTIC STIMULUS PACKAGE

	In Chinese Yuan (billions)	In U.S. Dollars (billions)	As a Percent of Total Stimulus Package	As a Percent of China's 2008 GDP
Transport infrastructure investment	1,500	220	37.5	5.0
Post-earthquake reconstruction	1,000	146	25.0	3.3
Public housing	400	59	10.0	1.3
Rural infrastructure	370	54	9.3	1.2
Research and development and structural change	370	54	9.3	1.2
Environmental development	210	31	5.3	0.7
Healthcare and education	150	22	3.8	0.5
Totals	4,000	586	100.0	13.3

Source: Global Insight

The economic stimulus package includes steps to assist China's top pillar industries (those industries deemed essential to China's national security, economic growth, and long-term competitiveness), such as automobiles, steel, shipbuilding, textiles, machinery, electronics and information technology, light industry (consumer products), petrochemicals, metals, and logistics.[104] Among other steps, China is expected to provide subsidies to business entities in the form of tax cuts, tax rebates, and tax credits for exports, direct government grants, and capital funds for investment overseas.[105] Many of these measures may be considered illegal subsidies by the United States and may create trade issues.[106]

2. Monetary Policy

China's stimulus package includes policies to loosen control on banks so they can lend more money. The PRC government will eliminate lending quotas and reduce interest rates so that banks are able to lend to companies and households.[107]

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[103] *See* Andrew Batson, *China Sets Big Stimulus Plan in Bid to Jump-Start Growth*, WALL ST. J., Nov. 10, 2008, *available at* http://online.wsj.com/article/SB122623724868611327.html; *see also* William Patalon III, *Massive China Stimulus is Viewed as an Attempt to Help the West*, MONEY MORNING, Nov. 11, 2008, *available at* http://moneymorning.com/2008/11/11/china-stimulus-package-2/.

[104] *See* MORRISON, GLOBAL FINANCIAL CRISIS, *supra* note 58, at 6.

[105] *See id.* at 7.

[106] For further discussion on illegal subsidies, *see infra* Part III.A.

[107] *See* Lardy, *Hearing*, *supra* note 1, at 5.

Some of the loans will be at favorable rates to state-owned enterprises that export goods and services. Unlike the United States where banks are still unwilling to lend, China's banks have responded almost immediately by lending to business enterprises and households.[108]

3. Social Programs

China has substantially stepped up its social programs in health care, insurance, and pensions in its stimulus package. For example, on April 7, 2009, the PRC government announced plans to spend $124 billion over the next three years to create a universal health care system for all of its citizens.[109] By 2011, the health care system should be in place and cover most of the population. The PRC government is also attempting to raise rural incomes and to narrow the gap between the incomes in rural and urban areas.[110] For example, since February 2009, the PRC government has offered rebates of 13 percent to rural residents for the purchase of household appliances.[111] Public housing projects, infrastructure projects, and plans to build schools and train teachers are all targeted in rural areas.[112] The government has also promised to increase subsidies to farmers.[113]

These social programs are designed to promote consumer spending to fuel the growth of the economy. To understand the importance of these reforms, it is necessary to note that the amount of precautionary savings in China is extremely high in comparison to other countries—about 30 percent to 40 percent in recent years.[114] Precautionary savings occur when people believe that they need to provide for their own health care and retirement savings. If the PRC government is now providing these services, this will free up these savings for consumption that will help drive growth and productivity of the economy.

III. POTENTIAL TRADE U.S.-CHINA TRADE ISSUES AS A RESULT OF CHINA'S RESPONSE TO THE GLOBAL FINANCIAL CRISIS

By all accounts, China's response to the global financial crisis has been effective, and China's economy seems to be recovering on track.[115] However, several aspects of China's economic recovery plan may be viewed by some hardline constituencies

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108 *See id.*

109 *See* MORRISON, GLOBAL FINANCIAL CRISIS, *supra* note 58, at 7.

110 *See Government to Address Urban-Rural Income Gap*, PEOPLE'S DAILY ONLINE, Sept. 11, 2010, *available at* http://english.peopledaily.com.cn/90001/90776/90882/7137089.html.

111 *See* MORRISON, GLOBAL FINANCIAL CRISIS, *supra* note 58, at 7.

112 *See id.*

113 *See Chinese Govt Promises to Close Income Gap*, CHINA DAILY, Feb. 26, 2010, *available at* http://www.chinadaily.com.cn/china/2010-02/26/content_9512195.htm; Jonathan Watts, *China Vows to Create a 'New Socialist Countryside' for Millions of Farmers*, THE GUARDIAN (U.K.), Feb. 22, 2006, *available at* http://www.guardian.co.uk/world/2006/feb/22/china.jonathanwatts.

114 The rate of savings in the United States is about zero or below; *see* Louis Kuijs, *Investment and Saving in China* 4–8 (World Bank Pol'y Res., Working Paper No. 3633, 2005).

115 *See* Lardy, *Hearing*, *supra* note 1, at 5.

in the United States as further examples of unfair trade practices that require a retaliatory response. No doubt any action taken by the United States in response to China's economic recovery program will be viewed with hostility, thereby prompting a harsh response in kind by China. In times of economic turmoil, nations tend to adopt policies and attitudes that are more nationalistic and protectionist than in times of economic prosperity. National governments are under pressure to protect domestic industries that may be suffering losses due to the economic turn. If the economic downturn is due to international trade, nations tend to blame each other for the causes of economic turmoil and are more likely to portray themselves as the aggrieved recipient of another nation's imprudent fiscal and economic policies. A global economic downturn tends to create an atmosphere of mistrust and recrimination that may fuel an escalation in trade tensions between the United States and China which might otherwise not exist in a more stable economic environment. Such a tense atmosphere may even lead to the imposition of reciprocal trade sanctions between the two countries and a trade war that could damage the global economy.

A. Three Areas of Potential Concern

The discussion below identifies several areas of concern that might lead to actions on the part of the United States, resulting in an escalation of trade tensions.

1. China's Currency Policy

One major point of contention between the two countries is China's currency policy. Although China has allowed the RMB to appreciate, the exchange rate has mostly held steady for the past two years.[116] Although China has allowed its currency to appreciate in the past five years, many critics argue that the pace of change is too slow and that more drastic measures may be in order. Many critics argue that China must allow its currency to appreciate at a much quicker pace by allowing the RMB to freely float and to have its exchange rate determined by market forces.[117] This is a proposal that is unacceptable to China under present circumstances. The currency

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[116] *See, e.g.*, Mark Drajem & James Rowley, *Pelosi Urges Action on China Currency as Panel Considers Measure*, BLOOMBERG, Sept. 22, 2010, *available at* http://www.bloomberg.com/news/2010-09-22/house-may-vote-next-week-on-china-sanctions-over-yuan-weakness-aide-says.html; Yukon Huang, *Let the Renminbi Depreciate Rather than Appreciate*, FIN. TIMES (U.K.), June 11, 2010, *available at* http://www.ft.com/cms/s/0/ecc8df6 a-74f5-11df-aed7-00144feabdc0.html; Howard Schneider, *House Slaps China on Currency Policy, Deepening Trade Dispute*, WASH. POST, Sept. 29, 2010, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2010/09/29/AR2010092904734.html; Bettina Wassener, *China Lets Its Currency Hit a New High Against the Dollar Just Ahead of a G-20 Meeting*, N.Y. TIMES, June 26, 2010, at B3, *available at* http://www.nytimes.com/2010/06/26/business/global/26 currency.html. *See also* Timothy F. Geithner, *Testimony of Treasury Secretary Timothy F. Geithner, China's Currency Policies and the U.S.-China Economic Relationship Before the Senate Banking, Housing, and Urban Affairs and House Ways and Means Committees* (Sept. 16, 2010), *available at* http://www.ustreas.gov/press/releases/tg858.htm.

[117] *See generally* MORRISON & LABONTE, *supra* note 15. *See* James A. Dorn, *Free China, Float the Yuan*, CATO INST. (Sept. 3, 2003), *available at* http://www.cato.org/pub_display.php?pub_id=4105; *China Shouldn't Fear Floating Exchange Rate, Official Says*, WALL ST. J., Sept. 21, 2010, *available at* http://online.wsj.com/article/SB10001424052748704129204575505432251274448.html.

issue could escalate into a trade war if the United States chooses to implement several options currently available under U.S. federal law to pressure China to change its currency policy more swiftly.

Under Section 3004 of the 1988 Omnibus Trade and Competitiveness Act,[118] the Secretary of the Treasury is required to issue a report every six months on international economic policy and to identify any countries that are manipulating their currencies in order to obtain an unfair trade advantage. After China reformed its currency policy in 2005 to allow a managed float, then-President George Bush declined to cite China for currency manipulation.[119] In 2009, the Secretary of the Treasury issued a report that indicated that China's currency remained undervalued but declined to cite China as a currency manipulator.[120] If the trade deficit continues to grow and China does not make major changes in its current policy, pressure from Congress may amount to a point where the current President would have to declare China as a currency manipulator and impose trade sanctions as outlined in the 1988 Omnibus Trade and Competitiveness Act.[121]

Some bills have been proposed by Congress (i.e., H.R. 2378 and S. 1027) that would make currency manipulation by some countries actionable under U.S. countervailing duty laws. The basic rationale of these bills is as follows: by artificially keeping the value of the RMB low and by preventing the RMB from appreciating against the dollar, China is able to sell its goods at artificially low prices in the United States. An undervalued currency creates the equivalent of an export subsidy for China's goods because these goods are being sold at prices that are less than the prices determined solely by market forces. These export subsidies should be offset by the imposition of a countervailing duty that, in turn, offsets the benefit of the subsidy.[122] For example, if China's currency is undervalued by 40% as some claim, then the price of an export to the United States is 40% less than what it should be under a system allowing for a free and fair exchange rate. Thus, the remedy

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[118] Omnibus Trade and Competitiveness Act of 1988, Pub. L. No. 100-418, § 3004, 102 Stat. 1107.

[119] *See, e.g.*, *U.S. Declines to Cite China on Yuan*, L.A. TIMES, Dec. 20, 2006, *available at* http://articles.latimes.com/2006/dec/20/business/fi-currency20.

[120] *See* REPORT TO CONGRESS ON INTERNATIONAL ECONOMIC AND EXCHANGE RATE POLICIES, U.S. DEP'T OF THE TREASURY OFF. OF INT'L AFF. (Apr. 2009), at 3, 19, *available at* http://www.treas.gov/press/releases/reports/fxreportfinalfor%20webapril152009.pdf. *See also* Doug Palmer & Glenn Somerville, *Update 3-US Gives China Pass on Currency, Congress Unhappy*, REUTERS, July 8, 2010, *available at* http://www.reuters.com/article/idUSN082293 0320100708; Edmund L. Andrews, *U.S. Won't Cite China over Its Currency*, N.Y. TIMES, Apr. 16, 2009, at B1, *available at* http://www.nytimes.com/2009/04/16/business/global/16 currency.html.

[121] Omnibus Trade and Competitiveness Act of 1988, Pub. L. No. 100-418, § 3004, 102 Stat. 1107 (outlining further actions regarding currency manipulation). *See also Lawmakers' Letter on China Currency*, FIN. TIMES (U.K.), Mar. 15, 2010, *available at* http://www.ft.com/ cms/s/0/ed6a4098-304f-11df-bc4a-00144feabdc0.html.

[122] *See* WAYNE MORRISON & MARC LABONTE, CHINA'S CURRENCY: ECONOMIC ISSUES AND OPTIONS FOR U.S. TRADE POL'Y 43, 49–50, CONG. RESEARCH SERV. REP. RL32165 (2008).

would be to impose a tariff of 40% on imports from China to offset or countervail the effects of China's currency manipulation.[123]

2. Countervailing Duties on Subsidized Exports

As described in Part II.B(1), a major component of China's economic stimulus package is to provide financial assistance to key industries that are necessary for China's economic development and recovery. Some of these financial payments are export subsidies, i.e., payments provided to industries (such as steel and textiles, two important exports to the United States) that export their products to the United States at prices lower than would otherwise be available without the benefit of the subsidy.[124] Some in Congress have called for the imposition of countervailing duties to offset the effect of these export subsidies.[125] Legislation has been introduced (i.e., H.R. 496 and H.R. 499) to ensure that countervailing duty laws continue to be applied to imports of goods from China that benefit from export subsidies.[126] It is also possible that the United States will also impose anti-dumping duties on the same subsidized products imported from China.[127] Anti-dumping duties are imposed when

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[123] U.S. laws imposing countervailing duties must be consistent with the World Trade Organization Agreement on Subsidies and Countervailing Measures (1994), *see* Agreement on Subsidies and Countervailing Measures, Apr. 15, 1994, 1867 U.N.T.S. 14; Final Act Embodying the Results of the Uruguay Round of Multicultural Trade Negotiations, Apr. 15, 1994, 33 I.L.M. 1125; Marrakesh Agreement Establishing the World Trade Organization, Annex 1A, Apr. 15, 1994, 33 I.L.M. 1154. China can challenge an attempt by the United States to impose countervailing duties on subsidies created by currency manipulation within the WTO through the WTO's dispute settlement procedure. However, such a challenge could take months, if not years, after the damage to China's export industries and China's economic recovery has already occurred. *See* CHOW & SCHOENBAUM, INTERNATIONAL TRADE LAW, *supra* note 7, at 737.

[124] *See Challenges and Choices to Apply Countervailing Duties to China: Hearing Before the U.S.-China Econ. and Sec. Rev. Comm'n*, 108th Cong. 1 (2006) (statement of Loren Yager, Director, International Affairs and Trade).

[125] Countervailing duties are governed by Section 701 of the Tariff Act of 1930, *see* Tariff Act of 1930, 19 U.S.C. §§ 1671–1671(h) (2009). These provisions implement and are subject to the disciplines of the WTO Agreement on Subsidies and Countervailing Measures Agreement, *see* Agreement on Subsidies and Countervailing Measures, Apr. 15, 1994, 1867 U.N.T.S. 14; Final Act Embodying the Results of the Uruguay Round of Multicultural Trade Negotiations, Apr. 15, 1994, 33 I.L.M. 1125; Marrakesh Agreement Establishing the World Trade Organization, Annex 1A, Apr. 15, 1994, 33 I.L.M. 1154 [hereinafter Marrakesh Agreement].

[126] Trade Enforcement Act of 2009, H.R. 496, 111th Cong. § 201 (2009); Nonmarket Economy Trade Remedy Act of 2009, H.R. 499, 111th Cong. § 2(f) (2009). The text and current status of both bills can be viewed on the Library of Congress webpages which are available at http://thomas.loc.gov/cgi-bin/query/z?c111:H.R.496.IH: and http://thomas.loc.gov/cgi-bin/query/z?c111:H.R.499.IH:. *See also* Scott D. McBride, *Something Wicked This Way Comes: The United States Government's Response to Unsafe Imported Chinese Toys and Subsidized Chinese Exports*, 45 TEX. INT'L L. J. 233, 275–93 (2009).

[127] Anti-dumping duties are governed by Section 731 et seq. of the Tariff Act of 1930, *see* Tariff Act of 1930, 19 U.S.C. §§ 1673–1673(i) (2009). These provisions implement and are subject to the disciplines of the WTO Agreement on the Implementation of Article VI of the General Agreement on Tariffs and Trade 1994 (the Anti-Dumping Agreement), *see* Anti-dumping (Article VI of GATT 1994), Apr. 15, 1994, Marrakesh Agreement Establishing the

an import is traded at an unfairly low price, which is defined as a lower price than the home market of the exporter. The remedy is to impose an additional tariff that offsets the margin of dumping. In some cases, a product can be subject to both countervailing duties and anti-dumping duties at the same time.[128]

3. Safeguards

Under its Protocol of Accession to the World Trade Organization,[129] China agreed to allow the United States to impose safeguards on products from China for a period of 12 years starting from the date of China's accession to the WTO in 2001. Safeguards are considered to be emergency measures that can be imposed by the United States (in the form of quotas and increased tariffs) on imports from other countries to alleviate the harm that can be caused by a sudden surge of imports that cause or threaten to cause material injury to U.S. industries.[130] China was not very skillful in drafting its Protocol of Accession since it allows the United States to target only products from China for safeguard remedies. Under the WTO, safeguards must be imposed on all products causing harm, without discrimination, as to their country of origin; under WTO law, it would not be possible to single out one country for the imposition of safeguards while ignoring similar imports from other countries.[131] However, the China safeguard provision allows the United States to

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World Trade Organization, Annex 1A, Legal Instruments—Results of the Uruguay Round, 33 I.L.M. 1125 (1994), available at http://www.wto.org/english/docs_e/legal_e/19-adp_01_e.htm; *see also* Marrakesh Agreement *supra* note 125.

[128] Suppose, for example, that Country A provides export subsidies to a company that manufactures the products both for export as well as for domestic consumption in Country A. Suppose that that the company sells the product in Country A at a price that is lower by more than a *de minimis* amount than the company charges in its export market, the United States. Under U.S. law, it would be possible to impose a countervailing duty to offset the effect of the subsidy and an anti-dumping duty equal to the margin of dumping, i.e. the difference between the home market price and the export price (i.e., the U.S. price). Although it is possible to initiate parallel anti-dumping and subsidies investigations against the same imports, such parallel investigations are rare. The burden of defending an anti-dumping or subsidies investigation alone is usually so onerous on the exporter that initiating one type of investigation often accomplishes the goal of the petitioning U.S. industry of pressuring the exporter into a settlement. *See* CHOW & SCHOENBAUM, INTERNATIONAL TRADE LAW, *supra* note 7, at 640.

[129] China's Protocol sets forth the terms and conditions of China's entry into the WTO, *see* Protocol on the Accession of the People's Republic of China Part I.16, Charter of the U.N. Art, 102 (Nov. 10, 2001), *available at* http://www.wto.org/english/thewto_e/acc_e/completeacc_e.htm.

[130] Safeguards are governed by Sections 201 of the Trade Act of 1974, *see* Trade Act of 1974, 19 U.S.C. § 2251 (2009). These provisions implement Article IX of the GATT, the escape clause, and the WTO Safeguards Agreement into federal law. Unlike anti-dumping duties and countervailing duties, which are remedies for unfair trade practices, safeguards may be imposed, even without the involvement of unfair trade, to avoid harm to domestic industries caused by a sudden and unexpected surge in imports. For a detailed discussion of safeguards under WTO and U.S. law, *see* CHOW & SCHOENBAUM, INTERNATIONAL TRADE LAW, *supra* note 7, at 539–47.

[131] *See* Agreement on Safeguards, Apr. 15, 1994, Annex IA, Arts. 2.1, 2.2; *see also* CHOW & SCHOENBAUM, INTERNATIONAL TRADE LAW, *supra* note 7, at 571–81.

discriminate against imports solely from China. Some industry groups in the United States must pressure Congress to invoke safeguards against China. In particular, the textile and apparel industries in the United States are concerned about imports of textiles from China. In 2008, China was the largest supplier of textiles to the United States at $32.7 billion, or 35.1%.[132] From 2002 to 2008, China's exports of textiles to the United States rose by 274%.[133] The textile industry, and many other industries affected by imports from China, may put additional pressure on the U.S. government for trade sanctions against China under the special safeguards provision in China's Protocol of Accession.[134]

B. China's Perspective on Prospective Measures Taken by the United States

No nation wishes to be the recipient of economic sanctions imposed by the United States, but there are several elements in the current United States-China economic relationship that are likely to exacerbate the intensity of the negative reaction from China. As noted earlier, China feels that, to some extent, it has been naïve and foolish in establishing such a strong dependence on the U.S. economy. China now believes that this dependence has been costly because the economic downturn in the United States has created serious repercussions in China. In addition, China places much of the blame for precipitating the global financial crisis on the United States because the U.S. financial industry created the subprime mortgage problem. In other words, China believes that it (and the rest of the world) has been harmed by a financial crisis that is largely the doing of the United States.

China is in a better position than many other countries to withstand the global financial crisis: its conservative and prudent fiscal policies placed an emphasis on saving and investing its earnings, rather than on consumption. This has allowed China to have the resources at hand to finance and implement a $586 billion economic stimulus package. However, China now finds that its economic stimulus package, designed to alleviate the effects of the global financial crisis, might come under challenge by the United States and might be the subject of trade sanctions imposed by the United States. In order words, the United States might seek to undermine and punish China for an economic recovery package that is designed to address the very economic problems caused by the United States in triggering the global financial crisis. Moreover, China's economic recovery package is designed to address a fundamental imbalance in China's economy: an overdependence of exports and FDI. The package is designed as part of a shift to a model of economic growth that creates an important role for domestic consumption as a driver of growth and will further create a sustainable economic model for the foreseeable future. A set of U.S.-imposed trade sanctions might be viewed by China as an effort to derail this fundamental realignment of China's economy.

At this point, if the United States places additional pressure on China to allow its currency to float, China's export industries may be further harmed. As these

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132 *See* MORRISON, TRADE ISSUES, *supra* note 51, at 24.

133 *Id.*

134 Letter from Tracy Mullin, President & CEO, National Retail Federation, to President Barack Obama, Trade Policy, The White House (Mar. 26, 2009) (on file with National Retail Federation), *available at* http://www.nrf.com/modules.php?name=Documents&op=viewlive&sp_id=2777.

industries are now beginning to recover, a significant appreciation in China's currency will result in another slowing down of exports and may result in further layoffs and closings. In addition, China's economic stimulus package is designed to bolster key industries essential to China's long term economic development. These industries have received large government grants or subsidies. Some of these industries will export their products to the United States. If the United States imposes (as threatened) increased tariffs in the form of countervailing duties to offset the subsidies, the effect of China's economic stimulus package will be neutralized by the trade sanctions imposed by the United States. Of course, China's economic stimulus package is comprehensive and the support of export industries is just one element of the package, but it is an important element and attempts by the United States to punish China by imposing countervailing duties for its domestic subsidies or for an undervalued currency is sure to provoke a hostile reaction from China.

The hardliners among China's elites may put pressure on China to stand up to the United States. A common view in China is that the United States caused the global financial crisis and now has the temerity to punish China for attempting to redress the very problem that it caused. Some hardliners in China might even see an intentional attempt on the part of the United States to frustrate China's economic development and to prevent China from developing into a first tier economic power. Under these current political conditions, it is possible that any trade sanctions imposed by the United States might trigger equivalent reciprocal sanctions from China—that is, China might increase tariffs on imports from the United States in an escalating tit-for-tat. Such tactics would have a negative and adverse affect on trade between the two countries, with repercussions for the global economy as a whole.

China may also react to increased trade pressures from the United States by taking other actions that might damage U.S. interests. Some reports indicate that PRC authorities have already agreed to ease enforcement against counterfeiters and other pirates of intellectual property rights on the grounds that commercial piracy, while illegal, provides employment opportunities and economic benefits for local economies.[135] China may also permit the exponential growth in the export of counterfeit and pirated goods to continue unabatedly because these exports, while illegal, nevertheless help China's trade balance and also provide jobs for its millions of otherwise unemployed workers.[136] Some in China might view a policy of tolerating counterfeiting and other forms of commercial piracy as a justified response to bullying by the United States.

On a broader policy front, China may believe that it has become overly dependent on the United States and that it needs to find alternative markets and trading partners. China has for some time begun to strengthen its trading relationships with other countries in Asia through the development of free trade

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[135] *See generally* Daniel Chow, *Counterfeiting in the People's Republic of China*, 78 WASH. U. L.Q. 1 (2000).

[136] *See* CHINA'S FOREIGN TRADE POLICY: THE NEW CONSTITUENCIES 67 (Ka Zeng, ed. 2009); Daniel Chow, *Organized Crime, Local Protectionism, and the Trade in Counterfeit Goods in China*, 14 CHINA ECON. REV. 473, 481 (2003). *See also Intellectual Property Rights Issues and Imported Counterfeit Goods: Hearing Before the U.S.-China Econ. And Security Review Comm.*, 109th Cong. (June 7–8, 2006) (prepared statement of Daniel Chow, Professor of Law, The Ohio State University Moritz College of Law), at p. 214–15.

agreements (FTAs), which eliminate most or all tariffs between trading partners.[137] FTAs create trade among its members but also divert trade from non-members. These FTAs may have a negative impact on U.S.-China trade. If, for example, goods from Japan can enter China subject to zero tariffs, then U.S. imports, which are subject to normal tariffs, may be displaced by Japanese goods. China is leading efforts to create free trade areas in Asia and may even eventually help to create a Pan-Asia free trade area.[138] China may also seek to establish an Asian Monetary Fund, one that can compete with the International Monetary Fund[139] in providing loans to developing countries. A leading role in the Asian Monetary Fund could bolster China's influence with developing countries and allow China to compete with the Untied States for the allegiance of these countries by making "no strings attached" loans.[140]

Finally, China may use the global financial crisis to strengthen its economic relationships with certain countries—i.e., Sudan, Nigeria, and Iran—regarded as rogue states in order to meet China's seemingly insatiable energy needs.[141] Of course, China has already established relationships with such states, but additional unwanted pressure from the United States to reform its currency policy and to remove subsidies from important state-owned enterprises might push China into further expanding and deepening these relationships, both to serve its own needs but also to send a signal to the United States that its pressure tactics may have long-term negative repercussions for United States' foreign policy and global interests.

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[137] *See* CHOW & SCHOENBAUM, INTERNATIONAL TRADE LAW, *supra* note 7, at 90–94.

[138] Liz Gooch, *Asia Free-Trade Zone Raises Hopes, and Some Fears About China*, N.Y. TIMES, Jan. 1, 2010, at B3, *available at* http://www.nytimes.com/2010/01/01/business/global/01trade.html; Fred Thurlow, *All Trade Roads Lead to China*, ASIA TIMES, Nov. 8, 2001, *available at* http://atimes.com/china/CK08Ad01.html.

[139] The International Monetary Fund was established after the end of the Second World War to help avoid the disastrous protectionist monetary policies that contributed to the war. The IMF was designed to help stabilize exchange rates to avoid the unilateral devaluation of currencies by nations and to lend money to nations to help with their balance of payment obligations (i.e., the obligation to pay monetary obligations, such as loans in foreign currency). If Country A took a loan from Country B or Country A purchased goods from Country B, then Country A would need to pay Country B in foreign currency. Country A may not have enough foreign currency on hand due to financial mismanagement or an unexpected downturn in its economy. The IMF can provide a loan to Country A to allow it to meet its repayment obligations.

[140] The IMF, located in Washington, D.C., is often viewed as under the heavy influence of the United States: the United States is the largest contributor of funds to the IMF and the president of the IMF has traditionally always been American. The IMF often places conditions on its loans. Countries usually have to agree to a certain set of fiscal policies and the IMF imposes measures designed to prevent government corruption. China has begun to compete with the IMF in making loans to developing countries, but China's loans come with no conditions, which make them very popular with the recipient countries. *See* Jane Perlez, *China Competes with West in Aid to its Neighbors*, N.Y. TIMES, Sept. 18, 2006, *available at* http://www.nytimes.com/2006/09/18/world/asia/18iht-web.0918aid.2845121.html.

[141] *See* Paul J. Smith, *China's Economic and Political Rise: Implications for Global Terrorism and U.S.–China Cooperation*, 32 STUDIES IN CONFLICT & TERRORISM 627, 632–33 (2009).

IV. Conclusion

With its lack of exposure to subprime mortgage assets and its substantial foreign currency reserves, China has been able to withstand the impact of the global financial crisis better than many countries. The impact of the global financial crisis on China has been the decline in demand for its exports from other countries affected by the crisis and a decrease in the influx of foreign capital. China's reform package is designed to deal with these problems by bolstering exports in the short-term to stem losses in employment and the closing of factories, and by rebalancing its economy in the long-term so that it is not overly dependent on exports and FDI for growth. Pressure tactics by the United States that call for immediate changes in China's internal policies might be viewed with hostility in China and might even be viewed as an intentional attempt to undermine China's economic recovery. While China will never find the threat of trade sanctions from the United States to be a pleasant prospect, the unstable and still precarious economic conditions in China suggest that the reaction from China could be especially severe and hostile. Despite this prospect, hardliners in the United States are calling for harsh measures, such as treating China's currency as a subsidy subject to countervailing duties. If the hardliners from both countries have their way, trade sanctions imposed by the United States might draw retaliatory trade sanctions from China, creating an unfortunate tit-for-tat that might escalate into a trade war. A moderate position on both sides would be based on dialogue without mutual threats and recriminations. Such a moderate position would further seek gradual changes in China's current economic policies (already resulting in progress in recent years). Moderate calls for further gradual reform might resolve some of these trade issues without escalating trade tensions between the two countries.