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Preparing for the U.S.–China Strategic Economic Dialogue

Michael A. Needham, Tim Kane, Ph.D., and John J. Tkacik, Jr.

In mid-December, American representatives led by Secretary of the Treasury Henry Paulson will travel to Beijing to kick off the U.S.–China Strategic Economic Dialogue. These talks will be an ongoing, high-level series of meetings which will take place each year, alternating between the U.S. and China. Within the context of these discussions, Paulson and his Chinese counterpart, Wu Yi, will examine the long-term strategic opportunities and challenges the two countries face in the economic realm.

As Secretary Paulson has correctly pointed out in the past, "The prosperity of the United States and China is tied together in the global economy, and how we work together on a host of bilateral and multilateral issues will have a significant impact on the health of the global economy."[1] In the globalized world of the 21st century, China's continued growth and movement toward a rules-based economic system is clearly in the best interests of China, the United States, and other stakeholders in the international system.

The Pacific Reality

China and the U.S. are the two great powers of the modern era, one ascending and one already a superpower. While China's overall GDP of $7.6 trillion is rapidly approaching America's $11.7 trillion GDP (using comparable data), China's typical citizen is relatively impoverished and far less productive, earning just 15 percent of the income of the typical American.

In the United States, the public's commitment to economic freedom is waning, as evidenced by some of the rhetoric of the 2006 congressional campaign. Both major U.S. political parties have become more populist, and less progressive, in their rhetoric. Free trade is no longer a popular slogan, as Americans now wonder if globalization has made them fools at the hands of foreign mercantilists. Furthermore, many voices across the ideological spectrum question whether China truly intends to be a "responsible stakeholder" in the existing international system. This, coupled with the unfortunate reality of the public's declining support for economic freedom, will increasingly challenge Chinese leaders.

American officials should not approach the Strategic Economic Dialogues as an opportunity to lecture Chinese officials on why alleviating these tensions is in China's interests. The Chinese regime is more than capable, in its own eyes, of deciding what is or is not in its country's interests. Rather, American officials need to make clear that these areas of friction are a natural public reaction to large trade deficits and credible reports of unfair trade practices abroad. The effect of this, especially in an environment with growing skepticism of economic freedom, could very well be the erosion of the U.S.–China economic relationship through measures such as the Schumer–Graham tariff proposal.

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Vital Issues to Discuss

Within the context of the U.S.–China Strategic Economic Dialogue, there are a number of important areas of discussion: trade and investment protectionism; economic espionage; and piracy, counterfeiting, and other violations of property rights. Many Americans see these issues as evidence that China is not a responsible stakeholder in its economic relations with the rest of the world, especially the United States.

The most vital concern is protectionism. Increasingly, Chinese local and central government bureaucracies erect major hurdles to U.S. businesses that have invested in the Chinese markets. This is particularly true in the automobile industry, but also in retailing, banking, financial services, and basic industrial commodities. In October 2006, for example, the Carlyle Group, a private equity fund, agreed to buy only half, rather than the initially-agreed 85 percent, of a state-owned construction firm, the Xugong Group Construction Machinery Co., due to intervention from the Chinese central government. Similarly, Citigroup was forced to scale down its investment in Guangdong Development Bank from 45 percent to 20 percent. Finally, although Beijing has opened up the domestic construction market as agreed on China's accession to the World Trade Organization in 2001, foreign enterprises are required to employ at least 200 staff in China before being allowed to sign any contracts in the country under regulations issued in December 2003. Foreign companies wanting to compete for infrastructure projects must also have at least $35 million in registered capital in China.

The Chinese government blames the United States for this new protectionism. It claims the U.S. Congress blocked the Chinese National Offshore Oil Corporation's (CNOOC) acquisition of Unocal, but China has long denied similar U.S. equity stakes in China's energy production sectors. China also claims that the Committee on Foreign Investment in the United States (CFIUS) blocks Chinese investment in U.S. high tech. These accusations are groundless if the Chinese are unwilling to let U.S. corporations acquire major stakes in Chinese oil producers or Chinese national security industries. Indeed, there is little comparison between the Chinese government's systematic protectionism and the examples the Chinese point to on the American side.

A second area of concern is China's unwillingness to enforce intellectual property rights (IPR) and address other acts of counterfeiting and money laundering. Chinese government officials claim intellectual property rights protection is a challenge of means, rather than will. This claim is dubious, as any salesman who has tried to sell illegally counterfeited Beijing 2008 Olympics merchandise could attest. In fact, 55 percent of companies associated with the American Chamber of Commerce in China reported they were negatively affected by IPR violations and 41 percent said counterfeits of their products had increased since China's accession to the WTO.[2] U.S. businesses lose an estimated $20–25 billion per year in trademark, patent, and copyright losses.[3]

With per capita GDP at 15 percent of the U.S. level, the Chinese economy can afford to eschew IPR in the short term, but it does so at the expense of its long-term credibility. A bad business reputation will chill future investment and even growth prospects. Systematic IPR violations create doubt and hesitancy in companies seeking to do business in China. Chinese leaders need to treat these issues seriously; they also need to treat WTO dispute res-

1. "Remarks by Treasury Secretary Henry M. Paulson on the International Economy," September 13, 2006.
2. The American Chamber of Commerce People's Republic of China, "White Paper 2006: American Business in China," 34.
3. Estimating the amount of revenue lost because of piracy is an inexact science. The $20 billion to $25 billion number is based on industry estimates of the full retail value for all illegal products sold in China each year, and it is useful in pegging the magnitude of the problem. Although not everyone who bought an illegal product would have bought a legal version if given no other choice, lost revenue due to piracy in China is in the billions of dollars, even by the most conservative estimates. Further damage is done both to reputation and to health by Chinese firms that pirate trademarked pharmaceutical packaging and sell placebos or worse as genuine drugs. See Henry A. Levine, Deputy Assistant Secretary of Commerce, "Is China Playing by the Rules? Free Trade, Fair Trade, and WTO Compliance," statement to the Congressional–Executive Commission on China, September 24, 2003, at *www.hongkong.usconsulate.gov/uscn/trade/general/doc/2003/092501.htm.*

olution seriously as a legitimate avenue of action—after all, they voluntarily signed up for the WTO—rather than a "senseless" act which will have "an extremely negative impact" on U.S.–China trade relations, as Chinese Commerce Minister Bo Xilai argued.[4] China's refusal to participate in the international Financial Action Taskforce to combat money laundering by terrorist groups and criminal organizations furthers this impression.

Finally, officials should discuss Chinese government-led espionage. China has conducted espionage operations to obtain military technology and commercial trade secrets through over 3,000 front companies operating in the United States. The Chinese government runs a program linked to its military, called 863, which invests in companies with innovative technologies, and supports research institutions, enterprises or provincial governments with ties to many economic espionage cases. Silicon Valley has been a major target of the Chinese espionage operations, and about a dozen espionage cases with suspected ties to China are currently under FBI investigation in the Silicon Valley area. According to the FBI, the number of cases involving China nationwide is not available, but it has increased more than 50 percent in the past few years. Chinese espionage often involves Chinese students and visiting business executives as well as Chinese nationals and Americans of Chinese descent living in the United States. Economic espionage in general is causing at least $45 billion in annual losses for the largest 1,000 U.S. companies.

Conclusion

The U.S.–China economic relationship is vital to the prosperity of the United States, China, and the entire world. Negotiators on both sides have a prime opportunity to move the relationship forward during the biannual U.S.–China Strategic Economic Dialogue and should seize the opportunity this December. It is important for the American side to discuss their concerns with the Chinese without lecturing Chinese government officials on where their interests lie. The U.S. approach should make clear the fundamental problems in the relationship that feed American concerns about Chinese intentions and pave the way for further problems in the future. American and Chinese interests ultimately lie in economic freedom, and it is vital to move rapidly to address the issues standing in the way.

Michael A. Needham is Director of, and John J. Tkacik, Jr., is Senior Research Fellow in China Policy in, the Asian Studies Center at The Heritage Foundation. Tim Kane, Ph.D., is Director of the Center for International Trade and Economics at The Heritage Foundation.

4. Chris Buckley, "Top U.S. Official Warns China on Piracy Anger," *Reuters*, November 14, 2006.