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Testimony of
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Hearing on China's Trade and Investment Policies
Ways and Means Committee
House of Representatives

June 15, 2010

Mr. Chairman, I am honored to appear representing the views of the American Chamber of Commerce in China, comprising over 1,200 member companies doing business in China.

Your hearing today addresses a trade and investment relationship important to both China and the United States. Moreover the relationship will certainly undergo significant changes in the near and medium term, requiring the U.S. to understand clearly the Chinese policy environment and its future direction in order to formulate our own approach.

For over thirty years, China has been on a path of reform and opening characterized by a sustained double digit growth rate, the emergence of China as a major trading power, massive amounts of foreign direct investment, steadily increasing participation of foreign companies in the Chinese economy, large bilateral and global trade surpluses recycled mainly through the purchase of US government debt, a partial shift to a market economy, the creation of one of the world's best highway and high speed rail networks, and the lifting of hundreds of millions of Chinese people out of poverty. On the negative side, this period has also been characterized by increasingly inefficient capital allocation, over investment in manufacturing capacity in many sectors, heavy environment loading leading to serious air and water pollution, high energy and natural resources intensity, and growing income inequality between urban and rural areas and between different regions.

For American companies investing and doing business in China, an initial period of familiarization and limited profitability gave way in 2001 following China's accession to the WTO to much greater market access, profitable operations, and the growth of strategically material businesses. In our most recent Business Climate Survey, 71% of member companies reported being profitable or very profitable in the midst of a global recession, 58% reported increased revenue, 46% reported a higher profit margin from China operations than their global average. 58% are producing goods or services for the Chinese market, as opposed to 12% producing or sourcing goods in China for the U.S. The near and medium term outlook is the most positive of the past three years, and 79% plan to expand in China. Most American companies in China are doing well and some spectacularly well. From the point of view of the broader American business community, China is our third largest export market and by far the fastest growing, as well as a source of inexpensive goods posing a severe competitive challenge in our own market and globally.

As China and the world recover from the global financial crisis, there has been extensive discussion in the G-29, the Strategic and Economic Dialogue and other forums of the need to rebalance unsustainable trade surpluses in China and trade and fiscal deficits in the United States. Both China and the United States have committed to rebalancing. It is important to recognize that the Chinese economy is being driven by internal factors that make structural change and a shift to domestic demand inevitable regardless of policy choices by China or its trading partners.

I would like to draw your attention to three long-term, irreversible trends.

First, due to the success of the one child policy, the Chinese working age population will peak in the near future and then decline. For decades, there has been a large surplus of labor in the countryside, aggravated by dismissing millions of excess workers from bloated state-owned enterprises. Wages in the export-oriented factories in the Pearl River delta were flat for approximately fifteen years until the recent crisis. Recently, however, factory owners report labor shortages, strikes for better pay and working conditions are common, and settlements have doubled wages at some very large facilities such as the Foxconn campus employing 800,000 people. This trend will continue as the working age population begins to shrink. After growing more slowly than productivity for years, wages will begin to grow more rapidly than GDP. This trend will support consumption, and will make Chinese exports less competitive. The large, growing group of retired persons will be supported by a decreasing base of employed workers. China's pension system is not fully funded; therefore there will also be fiscal strains.

Second, urbanization is proceeding at a steady rate of about 1% of the population every year (roughly 13 million people). This will continue in coming decades, and possibly accelerate as the household registration system which restrains the free movement of labor is relaxed. Building urban housing, infrastructure, power supplies, schools and hospitals roughly equivalent to one and half times those of New York City every year will also support consumption.

Third, China's relative lack of arable land, combined with the degradation of water resources, and the shift of land to other uses such as urban housing, will require food and agricultural imports on a massive scale, notwithstanding a strong policy preference for food security based on domestic supplies.

The structure of China's economy and its position in the global economy will be very different over the next twenty years than it has been over the last twenty. From a relatively small base, export growth of 30% or more annually was feasible in the past. Now that China is the world's largest exporter, global demand will not support that and the growth rate will moderate. GDP growth is also expected to decline to a 6-8% range, given the declining working age population. At the same time, as retirees spend their savings and more people move to the cities, there will be strong structural support for consumer markets and domestic demand generally.

To these factors propelling change, we can add the lack of natural resources, already driving initiatives to increase energy efficiency and develop clean, renewable energy sources. These will be intensified as the necessity of mitigating climate change becomes compelling.

China is thus at an inflection point, and will change dramatically in future years. The really interesting question is, how? And with what policy mix?

China successfully navigated the global recession by reliance on traditional administrative measures rather than market forces. At the direction of state leaders, a massive increase in lending from state-owned banks flowed primarily to state-owned enterprises and investment companies affiliated with municipalities, for the purpose of investing in infrastructure and other projects approved by central and local planners. It was effective in maintaining growth, though many observers (including myself) think that an increase in bank non-performing assets in future years is likely. But for the moment those who believe the state can effectively direct the development of even an economy as large as China's are full of confidence. They also see no particular reason to think that the American reliance on a regulated but largely free market is a better approach, given recent experience.

There is concern in the American business community that in managing through change, China will resort to top down industrial planning, and to discriminatory measures favoring domestic enterprises over foreign companies and the state-owned sector over the private sector, resulting in narrowing market access and slower movement toward a market economy.

These concerns focus especially on a policy nexus supporting "indigenous innovation"and are felt most strongly by high tech companies and others heavily dependent on intellectual property. Traditional complaints over ineffective, but slowly improving, protection of

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intellectual property rights have evolved into a more fundamental concern over China's industrial policies. Late last year the Ministry of Science and Technology issued Circular 618 on criteria for a national indigenous innovation product catalogue; the criteria directly discriminated against products with foreign intellectual property whether imported or manufactured in China. In response to widespread concern, the Chinese government removed the most objectionable parts in a subsequent draft of the guidelines, and issued assurances that it was always their intention to treat foreign-invested companies in China as local companies.

Despite these actions, broad concern remains that nationality of intellectual property ownership will be a criterion for government procurement, for more favorable tax treatment, for subsidies and other preferential policies.

Beyond indigenous innovation itself, other policies we would cite include:

- Import substitution policies such as the Guiding Catalogues of Major Indigenous Innovation Technologies and Equipment of 2009, which specifies import substitution as a goal.
- The Government Procurement Law directly discourages procurement of imported products. China is not a member of the WTO Government Procurement Agreement and its first offer to join was not commercially meaningful; a second offer is due by July 10.
- Standardization mandates such as the Ministry of Industry and Information Technology requirement that the Chinese WLAN Authentication and Privacy Infrastructure (WAPI) standard be included with any Wi-Fi enabled mobile device.
- The 2008 Patent Law expanded the grounds for compulsory licensing, though China has not yet used them. It also requires foreign companies in China to submit to a review by Chinese authorities of whether a patent originated in China "relates to the security or vital interests of the State", including "economic interests", before it can be filed abroad.
- The Standardization Administration of China is developing standards rules that could lead to compulsory licensing or licensing on non-commercial terms of foreign technologies used in "mandatory national standards", and possible anti-trust consequences for refusal to comply.
- Exclusion of representatives of foreign-invested enterprises from participating in and/or voting in China's standards setting committees.
- Exemptions from infringement in the patent law and drug registration rules for "research" and "non-commercial use" and for research for the purpose of producing

generic pharmaceuticals. These facilitate stockpiling of infringing products, reverse engineering, and generic competition with innovative pharmaceutical companies in advance of patent expiration.

- Technology transfer on terms favorable to the Chinese party required to win large contracts.
- Selective enforcement of the Anti-Monopoly Law.
- Bid specifications that favor local producers, for example in the wind power sector.
- New encryption requirements that infrastructure in key sectors use domestic technology.

These are supported by interest rate controls that distort the cost of capital by making low cost bank loans and export credit facilities available to companies in sectors targeted for development.

Taken together, these measures and supporting planning documents suggest a strategy of supporting Chinese enterprises in specific growth sectors to develop or obtain access to intellectual property, gain scale in protected domestic markets, export overcapacity to global markets, and compete both domestically and globally as national champions. Narrowing market access thus may be seen as part of a broader competitive strategy.

These policies are layered on top of an intellectual property enforcement regime that 74% of our members believe is ineffective according to our 2010 Business Climate Survey. We are especially disappointed that central government state-owned enterprises are not yet fully compliant with China's legal requirement that they use only licensed software. These favored enterprises may once have been bloated; they are now profitable and well-resourced.

Those of us who believe in the greater efficiency and adaptability of free markets don't think such an approach will work well to meet China's needs. But in the short term, it would constitute a competitive challenge we must take seriously. Accompanying the challenge is an even larger opportunity, for given its circumstances China cannot withdraw into autarkic isolation.

In our engagement with China, our priorities should therefore be market access, protection of intellectual property, and furthering China's transition to a market economy. We recommend the following:

- Central government SOE's should be required to certify annually to the State-Owned Assets Supervision and Administration Commission that all software on their computers, including operating systems and applications software, is properly licensed, and that this certification be subject to government audit and verification by relevant software providers.
- We recommend the suspension of indigenous innovation product catalogues pending negotiation of policies that do not discriminate against imports or the products of foreign-invested enterprises.
- We support prioritizing negotiation of China's accession to the Government Procurement Agreement of the WTO, with sub-central as well as central government commitments. This would provide welcome assurance of future market access.
- The American Chamber of Commerce in China participates in two private sector/public sector partnerships in aviation and energy that bring together US and Chinese government agencies with American and Chinese enterprises in capacity-building programs funded by the Trade Development Administration. The Aviation Cooperation Program and the Energy Cooperation Program have successfully generated business opportunities and built institutional and personal relationships that will be of lasting benefit to both countries. Such partnerships should be extended to other sectors and enlarged.
- China's currency is widely expected to resume appreciation in the near future as the need to control inflation becomes more pressing. While welcoming this as a contribution to global rebalancing, the United States should also provide technical assistance and policy support for a more fundamental reform, deregulation of interest rates. With interest rates deregulated, China will be able to develop its domestic bond market, a market-based cost of capital, liberalization of capital controls on cross border portfolio investment and ultimately a more flexible exchange rate regime.
- A medium term goal should be negotiation of a bilateral investment treaty that will support Chinese foreign direct investment in the United States and American investment in China, recognizing the large role of the state-owned sector in China.

We must also recognize that our trade and investment relationship with China does not occur in a bilateral world. It is important for the U.S. to exercise forward-looking leadership in Asia and globally by supporting and shaping regional integration through the APEC and Trans Pacific Partnerships platforms, engaging actively with ASEAN, ratifying the Korea-US Free Trade Agreement, and leading the creation of a new system of financial system regulation.

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Finally, we must look to our own competitiveness by reviewing R&D tax credits, maintaining immigration rules that attract talented engineers and scientists, improving our educational system, strengthening export promotion, completing reform of our export control regulations and similar measures.

The National Export Initiative set a goal of doubling U.S. exports within five years. Our members strongly support it, and believe that our success in doing business in China will be highly correlated with success of the NEI.

In 2009 we celebrated the first thirty years of formal diplomatic relations between China and the United States, a period which saw rapid development of trade and investment between the two countries. On that occasion, the American Chamber of Commerce in China outlined a vision for the next thirty years ending in 2039. We believe it is realistic to think in terms of three trillion dollar goals:

1) Increasing US exports to China from $80 billion dollars to one trillion dollars annually;

2) Increasing the revenues of US firms producing goods and services in China for the Chinese market from approximately $100 billion dollars to one trillion dollars annually; and

3) Welcoming cumulative foreign direct investment from China in the United States of one trillion dollars. Just as Japanese capital has contributed to job creation and economic development in the U.S., so too can Chinese direct investment, giving the investors a deeper interest in our mutual prosperity.

Coming out of a painful recession and facing structural change in both countries, increased trade tensions and the recurrent temptations of protectionism may be inevitable. The competitive challenge from China will undoubtedly intensify. It is highly unlikely that our economic systems will smoothly converge over time. Our relationship with China therefore demands sustained attention and strategic thinking from the government as well as the private sector. Our members believe that the scale and attractiveness of the opportunity fully justify the effort.

Thank you very much.