



Washington REPORT

News and analysis from Washington, D.C. about key issues in U.S.-Asia Pacific Relations

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Is A Crisis Brewing In U.S.-China Relations? USAPC Interview with Jim Leach

Congress is poised to pass legislation aimed at rectifying the massive, \$232.5 billion U.S.-China trade deficit primarily by imposing trade sanctions on China over its undervalued currency (see article below). Not a few experts have argued that this approach would have little impact on the bilateral economic imbalance. Even more worrisome, they have warned, is the prospect that such legislation would spark a damaging cycle of sanctions and counter-sanctions—a scenario that ultimately would harm both countries and negatively affect the global economy.

Former Chairman of the House Subcommittee on Asian and Pacific Affairs Jim Leach examines current challenges in U.S.-China relations. He attributes the brewing crisis to difficulties both nations have in understanding the other's political system, changes in U.S. party politics, and public fears about globalization.

USAPC: Some analysts have argued that growing tensions in U.S.-China relations are fueled, in part, by the Chinese government's inadequate understanding of the U.S. governing system. You were in China recently. What was your impression?

Leach: My sense is that there is indeed a crisis brewing in U.S.-China relations. This crisis is based in part on tangible issues and in part on mutual misunderstanding.

It is important to bear in mind that China and the United States view the world in profoundly different ways. China has adopted an "economics first" policy, which it claims is a doctrine of non-interference rooted in the notion of equality of nations. American foreign policy, by contrast, emphasizes political issues and ethical values rooted in the notion of equality of the individual.

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Pressure Builds In Congress To Act On China's Currency Policy

Leading U.S. lawmakers have lost patience with the administration's reliance on consultation to address China's highly regulated currency policy—a policy, they argue, that directly threatens the U.S. economy. In mid-June, the influential chairmen of two powerful Senate committees introduced legislation with strong Republican support.

The bills, which are targeted at China but applicable to all trading nations, generally aim to (1) strengthen the ability of the Treasury Department to determine if a nation's cur-

rency is not properly aligned and (2) impose remedies for inaction by countries that are found to deliberately maintain misaligned currencies.

Baucus/Grassley Bill. Senate Finance Committee Chairman Max Baucus (D., Montana) introduced "The Currency Exchange Rate Oversight Reform Act of 2007" on June 13 with the active support of Ranking Member Charles Grassley (R., Iowa). The bill revises current law so that Treasury would have no choice but to negotiate with countries with "fundamentally misaligned cur-

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Official Washington

In each issue, *Washington Report* will provide the names and contact information for selected executive branch officials with jurisdiction over economic, political, and security issues important to U.S.-Asia Pacific relations. This issue will focus on pertinent personnel from the **Treasury Department**.

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From a Chinese perspective, the American emphasis on the dignity of the individual as contrasted with respect for the state has a weakness. Its value-laden intrusiveness too easily legitimizes self-righteous interventionism, including military action.

From an American perspective, the Chinese “equality-of-nations” approach in some circumstances may be quite reasonable, but in others, appears to disguise a willingness to consort with oppressive governments. When a nation provides foreign assistance to a corrupt regime, some observers may question whether “ethics-blind” giving is respectfully neutral. After all, funds provided to oppressors can be used to further oppress.

And to the extent that aiding corrupt governments provides gratuities to a few in power, the suspicion naturally arises that an implicit *quid pro quo* may develop. For example, in return for state-to-state aid, the assisting government may be given natural resources concessions.

To the Chinese, the world-wide battle for oil and other natural resources concessions may resemble the efforts of 19th century European powers to divide and control China. The model of giving tidbits to insiders to allow social pillaging by outsiders appears to be a replicable approach. The difference in this century is the change in power relationships.

But as Tony Blair revealed in queries about an \$80 billion contract to supply aircraft to Saudi Arabia at the recent G-8 summit, the West comes to the corruption issue with unclean hands in this as well as in prior centuries. The international system has yet to resolve the problem of dealing with conflict-ridden officials in foreign societies.

USAPC: You mentioned mutual misunderstanding also is fueling the crisis in U.S.-China relations.

Leach: Yes. We have a tendency to overlook the economic challenges China faces and the rapidity of change in Chinese society. The Chinese are trying harder to understand us than we are trying to understand them. But China’s state-centered approach makes it difficult for them to deal with our separation-of-powers system. The U.S. system defies Chinese sensibilities.

The Chinese, like other foreigners, particularly wonder about the relationship between the executive and Congress in foreign policy. This should come as no surprise because our constitutional model is unique and the congressional-executive relationship is in constant flux. It depends on circumstance, party control, the happenstance of personalities in key legislative and executive positions, and input from the public.

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Congressional Watch

In addition to developing legislation aimed at forcing China to revalue its currency, U.S. lawmakers in the second quarter of 2007 pursued two important initiatives that could affect U.S. economic relations with the nations of the Asia Pacific more broadly.

● **Labor and Environmental Standards in FTAs**—On May 10, U.S. Trade Representative (USTR) Susan Schwab concluded an agreement with House Democrats aimed at clearing the way for timely congressional approval of free trade agreements (FTAs) with Colombia, Panama, Peru, and South Korea. The deal also was supposed to open the door for an extension of the president's Trade Promotion Authority (TPA), which expired on July 1.

The bipartisan agreement set forth enforceable provisions pertaining to labor standards, the environment, intellectual property protection for medicines, government procurement, port security, and investment, which the administration must negotiate into all FTAs. In return, the lawmakers agreed to approve legislation implementing the Peru and Panama FTAs—and suggested they would support the others if certain elements were renegotiated to conform to the deal. Ways and Means Committee Chairman Charles Rangel (D., New York) hailed the bipartisan agreement as “an historic breakthrough.”

On July 2, however, Rangel, House Speaker Nancy Pelosi (D., California), and other leading Democrats back-pedaled. They informed USTR that House Demo-

crats would not approve the Colombia or South Korea FTAs, regardless of how the accords had been revised to comply with the agreed upon standards (see article on page seven). For the foreseeable future, these FTAs are dead, Pelosi indicated.

● **TPA Expiration**—In the same stinging press release, Pelosi *et. al.* also informed the administration that the House would not even consider renewing TPA until and unless the United States “expand[s] the benefits of globalization to all Americans.” TPA, also referred to as “fast-track authority,” allows the President to negotiate trade agreements subject to an up or down vote in Congress without amendment.

The absence of TPA places Washington at a disadvantage in negotiating new trade agreements. Potential partners now likely will fear that any trade accord they conclude with the United States will be upended by congressional amendments. As a consequence, some experts worry that U.S. leadership in liberalizing global trade may be compromised by TPA's lapse.

The U.S.-South Korea FTA was signed before TPA expired so fast-track rules will apply when USTR sends the implementing legislation to Capitol Hill. The only question is when. The administration is not legally bound to send the bill to Congress within a certain timeframe. In the meantime, USTR Schwab reportedly has urged House Democrats to show their “good faith and commitment” to U.S. trading partners and approve the four FTAs in the spirit of the May 10 agreement.

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China Currency Bills

rency caused by clear policy actions by the relevant government.” It also would establish a tight, six-month timeframe for the adoption of “appropriate policies to eliminate the misalignment.”

Should a country fail to reform its currency policy after six months, various penalties would be imposed, including making currency undervaluation a factor in antidumping cases. After one year, the U.S. Trade Representative would be required to file a case in the World Trade Organization (WTO) against the government responsible for the currency. In addition, Treasury would be required to consult with the Federal Reserve Board about remedial intervention in currency markets.

Dodd/Shelby Bill. On June 21, Senate Banking Committee Chairman Christopher Dodd (D., Connecticut) and Ranking Member Richard Shelby (R., Alabama) introduced “The Currency Reform and Financial Markets Access Act of 2007.” The Dodd/Shelby bill also aims to

make it easier for Treasury to determine that China deliberately maintains an undervalued currency. It would do this by redefining “currency manipulation” to apply to countries that have (1) a material global currency account surplus (2) significant bilateral trade surpluses with the United States, and (3) prolonged one-way intervention in the currency markets.

However, unlike the Baucus/Grassley bill, the Banking Committee version would require Treasury to seek remedy for currency manipulation primarily through the International Monetary Fund (IMF). In addition, the Dodd/Shelby bill would establish a congressional disapproval process when Treasury fails to cite manipulation.

“**WTO-Legal.**” Supporters of both bills claim they represent important departures from other legislation aimed at penalizing China for currency manipulation because they allegedly are consistent with World Trade Organization (WTO) rules. Earlier proposals, such as a bill that would have imposed a 27.5 percent tariff on all Chinese imports if Beijing did not revalue the RMB, were

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The only constant is that Congress generally responds to constituents more rapidly than the executive. Indeed, one assumption of our founders when they wrote the Constitution that has proven frail was the notion that the executive would have a near monopoly on knowledge in the foreign policy arena. As communications techniques have become more sophisticated and as more issues have become international in an era of globalization, publics have reached out to their elected Members of Congress to express concern.

Former Speaker of the House Tip O'Neill used to comment that all politics are local. This observation may be an enduring truth, but there is increasing relevance to a corollary: in an era of globalization, all local politics are influenced by international events.

Hence, while history is always a helpful guide, there is a general trend toward greater activism in Congress on foreign policy issues. This trend is likely to accelerate rather than reverse.

This particularly will be the case on trade matters. The Constitution established in Article I that commerce is the only foreign policy area in which Congress has primacy. If lawmakers perceive constituent interests are being harmed by foreign commercial practices, it should come as no surprise to trading partners that Congress will attempt to flex its muscles.

But in addition to separating power at the national level, the American system bifurcates authority in a federalist manner. The power separation motif is quadruplicated.

We not only have a legislative-executive-judicial division at the national level, but we have analogues at the state, county, and city levels. These separation and bifurcation approaches create overlaps and tensions between levels as well as branches of government.

While foreign policy is generally considered exclusively a national responsibility with the executive being the principal player, state laws can sometimes apply and state office holders can sometimes exercise authority. California Governor Arnold Schwarzenegger recently has done this in the environmental arena.

USAPC: In recent months, the Bush administration's approval ratings have slid precipitously. To what extent has that emboldened Congress on trade policy, in general, but particularly toward China?

Leach: As a general proposition, the executive accretes power during war-time. However, if policies do not work out, Congress will begin to sharpen its elbows.

Moreover, if the legislature is controlled by a party different from that of the executive—which normally can-

not happen in parliamentary settings—there can be quite vibrant differences of judgment between the president and Congress. We are beginning to see that dynamic play out in various policy areas with significant implications for U.S.-China relations.

USAPC: The Republican and Democratic parties also have changed considerably in the past decade or so. These transformations affect policy. How do you explain the fluid state of U.S. party politics to Chinese officials who never have operated in a truly multiparty system?

Leach: The interplay between the Republican and Democratic parties and within each of these parties adds another layer of complexity to the U.S. system. This may be particularly perplexing to officials of a nation with a one-party monopoly on power.

There are many ways to break down the composition of the parties. One way is to describe the Democratic Party as composed of one group of members that is of an academic, free-trade bent, and another group that is of a more labor-oriented, protectionist dimension. Because labor controls Democratic Party finances and organization, it is the dominant wing today.

Within the Republican Party, there historically has been a division between moderates and conservatives. That division is no longer central. The division that now dominates is between two streams of conservatism: (1) "individual-rights" conservatives symbolized by two former presidential candidates, Robert Taft of Ohio and Barry Goldwater of Arizona, who were free-trade oriented; and (2) social conservatives, who are more driven by concerns for social values than abstract economic principles. The constituency of the latter group is often lower-to-middle-class voters whose job security is increasingly in doubt. Social conservatives who are concerned about

The huge trade imbalance is complicated by a policy framework that may cause Americans to retrench from active internationalism

immigration and jobs issues are the dominant dimension of the Republican Party today.

So we have a Democratic Party with a largely anti-trade perspective controlling Congress with few inhibitions about taking on a weakened president and a Republican Party dominated by members who are not inherently of a free-trade persuasion.

This presents China with an awkward challenge. The huge trade imbalance with America is complicated by a policy framework that may cause Americans to retrench from active internationalism. Overlapping these

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phenomena is the irony that the vast majority of countries in the world, including the United States, feel they are being disadvantaged by globalization even though global GDP growth is quite solid.

People everywhere are finding social change to be so rapid that more and more factors of life seem outside the control of average citizens. When fears and frustration dominate life, protectionist sentiment flourishes.

USAPC: Reps. Mark Kirk (R., Illinois) and Rick Larsen (D., Washington) formed the U.S.-China Working Group about two years ago ostensibly to create a more informed debate on China in Congress. Do you think we need more initiatives like that? Will a more educated body politic be less inclined to advocate protectionist solutions?

Leach: Congressional initiatives like the U.S.-China Working Group are thoughtful and helpful. Unfortunately, they are of marginal significance in dealing with pressures building in the body politic.

Those pressures are quite high, despite the fact that U.S. unemployment of 4.5 percent is constrained relative to many societies. Nevertheless, a sense of “job jeopardy” is on the rise in America.

The job mix is changing. We are witnessing a movement of basic manufacturing out of the country, which is difficult for a country which has always been a making and producing society. We also are witnessing greater social division between the “haves” and the “have nots.”

Some elements of the “have” population have developed effective ways to manage and lead globalization, while those in the “have not” category are finding it more and more difficult to get and keep a satisfying job.

Protectionist sentiment is thus mushrooming in the United States and could cause the country that generally has led the world in more liberal trade patterns to reverse gears, particularly if recessionary pressures grow.

USAPC: As we speak, the U.S. Congress indeed is clamoring to impose trade sanctions on China over its undervalued currency, the *remembi* (RMB). Beijing has resisted this pressure, apparently preferring to pursue economic reforms in an incremental manner. Were you able to impress upon the Chinese the need to accelerate the pace of reform?

Leach: Despite the fact that it will affect our trade imbalance only marginally, Congress is pressing forcefully on the currency valuation issue. Americans want equity even if a 40 percent valuation shift produces only modest trade shifts.

From China’s perspective, there is a sense that U.S. industry has decided to move significant production offshore based upon the cost structure in America. The only question is where.

Chinese authorities therefore are more concerned about the relationship of the RMB to other Asian currencies and the Mexican *peso* than they are about the relationship of the RMB to the U.S. dollar. So, in reality, China is pursuing more of a “beggar-their-neighbor” policy than a “beggar-the-U.S.” policy.

The Chinese government clearly prefers to reform its policies in an incremental manner and has allowed the RMB to appreciate only seven percent over the past two years. While I personally believe it is best to have open markets for both currencies and goods, I understand the constraints of Chinese domestic politics. There are more severely underemployed Chinese workers than the entire American workforce, and China has little sympathy for Japanese, Vietnamese, or Indian workers.

But the point I tried to get across in my recent series of talks in China was that there is a significant difference between “marginal incrementalism” and “steadfast gradualism.” The dangers of countervailing acts increase with the level of the Chinese government’s perceived intractability.

USAPC: Nevertheless, it appears that even “steadfast gradualism” likely will not derail protectionist initiatives making their way through Congress.

Leach: I have no doubt the 110th Congress is going to consider legislation that will challenge China significantly and that the trade issue potentially could be strident in the coming presidential campaign. ♦

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China Currency Bills

not WTO-legal and no doubt would have invited retaliation from China, proponents have acknowledged. Nevertheless, given heightened tensions in U.S.-China relations, experts warn that Beijing likely would lash out in much the same way if Congress passed the Baucus and/or Dodd bills—no matter how “legal” they may be under the WTO.

Administration Impetus. Senators Baucus and Dodd unveiled their proposals in the wake of a series of actions

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China Currency Bills

by the Bush Administration which, in the view of many U.S. lawmakers, fell far short of calling China to task for its policy of actively intervening in currency markets to prevent the RMB from appreciating too rapidly:

SED. The second meeting of the cabinet-level U.S.-China Strategic Economic Dialogue (SED), held May 22–23 in Washington, produced agreements to promote bilateral aviation services, expand access to China's financial services market, promote energy security and environmental protection, and strengthen the enforcement of intellectual property rights laws in China. However, Chinese officials would not agree to accelerate currency reform beyond the current incremental pace. Nor were they swayed by a toughly worded letter to Vice Premier Wu Yi from members of the House Ways and Means Committee, saying they had "serious concerns about China's massive and constant intervention in the currency markets."

Treasury Report. On June 13, the Treasury Department issued its semi-annual, congressionally mandated "Report to Congress on International Economic and Exchange Rate Policies." The report analyzes the relationship between the U.S. dollar and the currencies of major trading partners. If Treasury determines that a trading partner is manipulating its exchange rate "for purposes of preventing effective balance of payments adjustments or gaining unfair competitive advantage in international trade," the department must enter into negotiations with that country to ensure "regular and prompt" adjustment of its exchange rate relative to the dollar.

The so-called Treasury Exchange Rate Report has raised concerns about undervaluation of the RMB since at least October 2003, but has yet to formally designate China as a "currency manipulator. The June 13 report did not break this pattern. It acknowledged that the RMB is undervalued, but stated that "China did not meet the technical requirements for designation under the terms of the [law] during the period under consideration."

House Trade Subcommittee Chairman Sander Levin (D., Michigan) blasted the report, referring to it as the "kind of dodge that gives the Administration no credibility with American businesses and workers disadvantaged by China's persistent currency manipulation." As described above, Baucus and Dodd responded with legislation giving Treasury a much stronger mandate to negotiate with China and other nations that maintain misaligned currencies.

Section 301 Petition. The proverbial last straw for Baucus, Dodd, and other lawmakers frustrated by the U.S.-China trade deficit may well have been the administration's decision on June 13 to decline a request from 42 Members of Congress to initiate WTO dispute settlement

procedures against China. The request, which was made under Section 301 of the Trade Act of 1974, alleged that China's exchange rate policies are inconsistent with IMF rules. The Section 301 process would have set the stage for punitive action in the event that the WTO ruled in Washington's favor and Beijing did not alter its policy.

In declining the petition, U.S. Trade Representative Susan Schwab said the administration continues to believe that "firm engagement with China, in concert with international institutions and other countries, offers the best change of success."

Outlook. Baucus has indicated that he would like to mark up and report his bill from the Finance Committee before the August recess and bring it before the full Senate for a vote in September. The July 10 report that China's trade surplus with the United States had surged to a record \$26.9 billion in June likely will create additional momentum and support for the measure.

But regardless of the Senate's action, the Constitution stipulates that revenue-raising bills must originate in the House. At press time, it was unclear whether House Ways and Means Chairman Charles Rangel (D., New York) would craft a companion to the Baucus bill or promote another measure that would make exchange rate misalignment a countervailable export subsidy.

Insiders agree, though, that a China-targeted currency bill likely will pass both houses of Congress before the year's end. It remains to be seen whether U.S. lawmakers can override an anticipated veto by President Bush. ♦

DoD Faults China For Inadequate Military Transparency

The lack of transparency in China's military affairs will continue to fuel international concerns about its global aspirations and compel the United States and other nations to "hedge against the unknown," the Defense Department said in a report issued on May 25. The congressionally mandated annual report, *Military Power of the People's Republic of China 2007*, noted that Washington welcomes the rise of a peaceful and prosperous China that can participate as a responsible stakeholder in the global system. But Chinese leaders apparently do not understand that being a "responsible stakeholder" also means talking more openly about what is driving the pace and scope of China's military transformation, the report suggested.

In particular, the Defense Department questions the official Chinese military budget because this figure does not include large categories of expenditure, such as those for strategic forces, foreign acquisitions, military-related

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Asia Pacific Dialogue

Asia Pacific Economic Cooperation (APEC):

The Eighth Meeting of APEC Energy Ministers, May 27–June 3, Darwin, Australia—The APEC Energy Ministers issued the “Darwin Declaration,” which recognizes the need to deploy cleaner, more efficient and sustainable energy technologies. Specifically, the declaration established a voluntary Energy Peer Review Mechanism, which will focus on assisting APEC economies to increase their energy efficiency and reduce their dependence on oil.

The Fifth Secure Trade in the APEC Region (“STAR V”) Conference, June 27–28, Canberra, Australia—The STAR V conference, “Mitigating Risks; Containing Costs,” explored cost-effective solutions to enhance the safe and secure movement of people and trade in the region. Mike Smith, Australia’s Ambassador for Counterterrorism, chaired the conference.

Meeting of Ministers Responsible for Trade, July

5–6, Queensland, Australia—The APEC Trade Ministers agreed that APEC should support “more intensive activity across APEC’s Agenda in support of regional economic integration.” U.S. Trade Representative Susan C. Schwab represented the United States.

Key Official Meetings, July–August 2007:

● **Assistant Secretary of State for East Asian and Pacific Affairs Christopher Hill** will attend the so-called Six-Party Talks on North Korea’s nuclear program, set to resume July 18, Beijing, China.

● **U.S. Treasury Secretary Henry Paulson** likely will attend the 14th APEC Finance Ministers Meeting, August 2–3, Coolumb, Australia.

● At press time, **U.S. Secretary of State Condoleezza Rice** had yet to confirm whether she will attend the 14th meeting of the Association of Southeast Asian Nations (ASEAN) Regional Forum, August 2, Manila, Philippines.

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China’s Military

research and development, and China’s paramilitary forces. Beijing maintains its budget for 2007 is about \$45 billion, but the Pentagon estimates that it could be as much as \$85 billion to \$125 billion.

The Defense Department also is concerned about the implications of China’s improved nuclear capabilities. China currently is capable of targeting its nuclear forces throughout the region and most of the world, including the continental United States, according to the report. The Pentagon further asserts that Beijing’s efforts to modernize its longer-range ballistic missile force by adding more survivable systems call into question its policy of “no first use of nuclear weapons” at any time and under any circumstances.

The introduction of more capable and survivable nuclear systems in greater numbers—such as the DF-31 intercontinental-range ballistic missile (ICBM), a longer range DF-31A ICBM, and a new submarine-launched ballistic missile, the JL-2, for deployment on the new JIN-class nuclear-powered submarine also in development—suggest Beijing “may be exploring the implications of China’s evolving force structure, and the new options that force structure may provide,” the report maintains.

With respect to security in the Taiwan Strait, the Pentagon warns that China, indeed, would use force against Taiwan to prevent its independence. Toward that end, Beijing has defined ambiguously circumstances that would precipitate its military response. The report is

available at <http://www.defenselink.mil/pubs/pdfs/070523-China-Military-Power-final.pdf>. ♦

Congress Unlikely To Approve Korea FTA Soon

The United States and South Korea formally signed a free trade agreement (FTA) June 30 aimed at increasing trade and investment flows between the two nations. Washington and Seoul announced completion of the FTA on April 2. However, officials had to revisit the agreement to bring certain provisions into compliance with labor and environmental standards agreed to May 10 by the administration and Congress. House Democrats tied their support for several pending FTAs to the inclusion of tougher standards in these areas (see item on page three).

Nevertheless, House Speaker Nancy Pelosi (D., California), Ways and Means Committee Chairman Charles Rangel (D., New York) and others indicated July 2 that they would not support the U.S.-Korea FTA. They said that the accord does not address effectively the “persistent problem of non-tariff barriers” blocking U.S. manufactured imports, particularly in the automotive sector.

Because the deal was signed before the president’s trade promotion authority expired July 1, Congress will have no choice but to approve or reject the FTA without amendment. The White House obviously does not want a flat-out rejection. Insiders suggest that USTR may try to address Democratic concerns via side letters before sending the implementing legislation to Capitol Hill. ♦



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The United States Asia Pacific Council (USAPC) was founded in April 2003 by the East-West Center (EWC). It is a non-partisan organization composed of prominent American experts and opinion leaders, whose aim is to promote and facilitate greater U.S. engagement with the Asia Pacific region through human networks and institutional partnerships.

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