

# China, 301, and the Search for Reciprocity



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For many years, through bilateral meetings and other means, the United States has attempted to get China to, in fact, stop using forced technology transfer as a condition of market access, to effectively deal with intellectual property theft and cybertheft, and cyberattacks on U.S. companies stealing confidential information, trade secrets and other intellectual property. Others, such as business associations and the U.S.-China Economic and Security Review Commission, have repeatedly outlined the challenges that U.S. and other foreign companies face in China in these areas.<sup>1</sup> *See, e.g.*, 2015 Report to Congress of the U.S.-China Economic and Security Review Commission at 77-139 (includes concerns of various business groups; highlights the interference in the auto sector to force technology transfer) (November 2015); 2016 Report to Congress of the U.S.-China Economic and Security Review Commission at 46-58 (includes update on cyber security issues flowing from China) (November 2016).<sup>2</sup> These efforts were largely unsuccessful.

Last year, the Trump Administration decided to address these issues by starting a formal investigation, under Section 301 of the 1974 Trade Act, of the extent of the problem and what options exist to address it. This decision to open a 301 investigation received bipartisan support

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<sup>1</sup> That this is not a new issue is apparent to anyone who has been involved in China trade issues over the last two decades. My firm did several research projects in 2007 that resulted in publications, including *China's Laws, Regulations and Practices in the Areas of Technology Transfer, Trade-Related Investment Measures, Subsidies and Intellectual Property Protection Which Raise WTO Compliance Concerns* (September 2007) available at <https://www.uscc.gov/sites/default/files/Research/TLAG%20Report%20-%20China's%20Laws,%20Regulations,%20Practices%20in%20Areas%20of%20Technology%20and%20WTO%20Non-Compliance.pdf>.

<sup>2</sup> *See* [https://www.uscc.gov/Annual\\_Reports](https://www.uscc.gov/Annual_Reports).

from Congressional members. It may be that the 301 investigation will turn out to be the most important trade policy action of the Trump Administration because its focus is America's ability to maintain its competitive strengths in innovation and it attempts to address some of the worst forms of distortions created by China's system of active government interference in the operation of the market.

On August 14, 2017, President Trump signed a Presidential Memorandum directing the U.S. Trade Representative ("USTR") to determine "whether to investigate any of China's laws, policies, practices or actions that may be unreasonable or discriminatory and that may be harming American intellectual property rights, innovation, or technology developments." 82 FR 39007 (August 17, 2017). On August 18, 2017, USTR "initiated an investigation pursuant to section 302(b)(1)(A) of the Trade Act of 1974, amended (the Trade Act), to determine whether acts, policies, and practices of the Government of China related to technology transfer, intellectual property, and innovation are actionable under section 301(b)(1) of the Trade Act."<sup>3</sup> USTR requested consultations with the Government of China (which request was reportedly rejected by China), requested public comments, and held a public hearing. USTR received approximately 70 comments from the public.

Following this input, on March 22, 2018, USTR issued a report on its investigation - *Findings of the Investigation into China's Acts, Policies, and Practices Related to Technology Transfer, Intellectual Property, and Innovation Under Section 301 of the Trade Act of 1974* ("301 Report").<sup>4</sup> On the same date, the President issued a Memorandum - *Presidential*

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<sup>3</sup> See [https://ustr.gov/sites/default/files/301/FRN\\_China\\_301.pdf](https://ustr.gov/sites/default/files/301/FRN_China_301.pdf).

<sup>4</sup> 301 Report. <https://ustr.gov/sites/default/files/Section%20301%20FINAL.PDF>.

*Memorandum on the Actions by the United States Related to the Section 301* (“301 Memorandum”).<sup>5</sup> The 301 Memorandum summarized the findings of USTR:

First, China uses foreign ownership restrictions, including joint venture requirements, equity limitations, and other investment restrictions, to require or pressure technology transfer from U.S. companies to Chinese entities. China also uses administrative review and licensing procedures to require or pressure technology transfer, which, *inter alia*, undermines the value of U.S. investments and technology and weakens the global competitiveness of U.S. firms.

Second, China imposes substantial restrictions on, and intervenes in, U.S. firms’ investments and activities, including through restrictions on technology licensing terms. These restrictions deprive U.S. technology owners of the ability to bargain and set market-based terms for technology transfer. As a result, U.S. companies seeking to license technologies must do so on terms that unfairly favor Chinese recipients.

Third, China directs and facilitates the systematic investment in, and acquisition of, U.S. companies and assets by Chinese companies to obtain cutting-edge technologies and intellectual property and to generate large-scale technology transfer in industries deemed important by Chinese government industrial plans.

Fourth, China conducts and supports unauthorized intrusions into, and theft from, the computer networks of U.S. companies. These actions provide the Chinese government with unauthorized access to intellectual property, trade secrets, or confidential business information, including technical data, negotiating positions, and sensitive and proprietary internal business communications, and they also support China’s strategic development goals, including its science and technology advancement, military modernization, and economic development.<sup>6</sup>

Based on these findings, the President directed the following three actions:

- Tariffs -- USTR shall “take all appropriate action under section 301 of the Act (19 U.S.C. 2411) to address the acts, policies, and practices of China that are unreasonable or

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<sup>5</sup> 301 Memorandum. <https://www.whitehouse.gov/presidential-actions/presidential-memorandum-actions-united-states-related-section-301-investigation/>.

<sup>6</sup> 301 Memorandum.

discriminatory and that burden or restrict U.S. commerce,” and shall consider “whether such action should include increased tariffs on goods from China.” USTR “shall publish a proposed list of products and any intended tariff increases within 15 days,” and “after a period of notice and comment ... publish a final list of products and tariff increases, if any, and implement any such tariffs.”

- WTO Dispute Settlement – USTR shall “pursue dispute settlement in the World Trade Organization (WTO) to address China’s discriminatory licensing practices,” and shall, within 60 days, report on its progress.
- Investment Restrictions -- Using any available statutory authority, the Treasury Secretary “shall propose executive branch action ... to address concerns about investment in the United States directed or facilitated by China in industries or technologies deemed important to the United States,” and report his progress within 60 days.<sup>7</sup>

In April 2018, USTR published its proposed tariff list on Chinese products. *See Notice of Determination and Request for Public Comment Concerning Proposed Determination of Action Pursuant to Section 301: China’s Acts, Policies, and Practices Related to Technology Transfer, Intellectual Property, and Innovation*, 83 FR 14906 (April 6, 2018). In the notice, USTR proposed “that appropriate action would include increased tariffs on certain goods of Chinese origin,” that is “an additional duty of 25 percent on a list of products of Chinese origin.” 83 FR at 14907. The proposed list covers approximately 1,300 separate tariff lines, “is based on extensive interagency economic analysis and would target products that benefit from China’s industrial plans while minimizing the impact on the U.S. economy. Sectors subject to the proposed tariffs include industries such as aerospace, information and communication technology, robotics, and machinery.” USTR Press Release, *Under Section 301 Action, USTR Release Proposed Tariff List on Chinese Products* (April 4, 2018). USTR requested public comments by May 11 on the proposed list of products – regarding the products listed, the tariff rate, and the appropriate aggregate level of trade to be covered. *See* 83 FR at 14908. A public hearing is scheduled for May 15, 2018.

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<sup>7</sup> *See* 301 Memorandum.

On March 23, 2018, the U.S. filed a WTO complaint -- DS542: *China — Certain Measures Concerning the Protection of Intellectual Property Rights*. The United States requested consultations with China concerning certain Chinese measures which the U.S. alleges are inconsistent with China's obligations under the TRIPS Agreement. In particular, the U.S. claimed that:

- China denies foreign patent holders the ability to enforce their patent rights against a Chinese joint-venture party after a technology transfer contract ends.
- China also imposes mandatory adverse contract terms that discriminate against and are less favorable for imported foreign technology.
- Therefore, China deprives foreign intellectual property rights holders of the ability to protect their intellectual property rights in China as well as freely negotiate market-based terms in licensing and other technology-related contracts.<sup>8</sup>

In response to the U.S. complaint, on April 4, 2018, China filed a complaint concerning the U.S.'s 301 action – DS543: *United States — Tariff Measures on Certain Goods from China*. China alleged that the 301 tariffs would violate the WTO's most-favored nation principle, would violate Article 23 of the Dispute Settlement Understanding (DSU) because the U.S. chose to act unilaterally rather than go through the WTO's dispute settlement process, and would lead the U.S. to exceed its bound tariff rates.<sup>9</sup> China also said that it would impose an additional 25 percent tariff on a list of 106 U.S. goods (including soybeans, airplanes, automobiles, beef, and chemicals) worth \$50 billion in retaliation for the U.S. 301 tariffs.<sup>10</sup> On April 5, 2018, President Trump reacted to China's retaliation tariffs by threatening an additional \$100 billion in tariffs, stating:

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<sup>8</sup> See *China – Certain Measures Concerning the Protection of Intellectual Property Rights, Request for Consultations by The United States*, WT/DS542/1, IP/D/38 (March 26, 2018).

<sup>9</sup> See *United States – Tariff Measures on Certain Goods from China, Request for Consultations by China*, WT/DS543/1, G/L/1219 (April 5, 2018).

<sup>10</sup> See, e.g., *China prepares trade tariff retaliation*. NHK World – Japan (April 4, 2018). [https://www3.nhk.or.jp/nhkworld/en/news/20180404\\_40/](https://www3.nhk.or.jp/nhkworld/en/news/20180404_40/)



Rather than remedy its misconduct, China has chosen to harm our farmers and manufacturers. In light of China's unfair retaliation, I have instructed the USTR to consider whether \$100 billion of additional tariffs would be appropriate under section 301 and, if so, to identify the products upon which to impose such tariffs.<sup>11</sup>

It is the Administration's position that, except for the issues raised in the WTO dispute settlement complaint, Section 301 action would provide some counterbalance where the issues addressed are not covered by the WTO agreements and are not amenable to the WTO dispute settlement process. One issue however that, it could be argued, is addressed in China's WTO commitments is that of forced technology transfer. Under its WTO Accession Protocol,

China shall eliminate and cease to enforce ... local content and export or performance requirements made effective through laws, regulations or other measures. ... China shall ensure that the distribution of import licences, quotas, tariff-rate quotas, or any other means of approval for importation, the right of importation or investment by national and sub-national authorities, is not conditioned on: ... performance requirements of any kind, such as local content, offsets, the transfer of technology, export performance or the conduct of research and development in China.<sup>12</sup>

China has undoubtedly revised or eliminated some measures to nominally meet these commitments, but China has continued to implement its policy of technology transfer under the surface. USTR's 301 Report acknowledges China's Protocol commitments but also explains that China has not met its obligation to eliminate forced technology transfer, instead using implicit pressure on foreign investors.

The evidence collected in this investigation from hearing witnesses, written submissions, public reports, journal articles, and other reliable sources indicates there are two key aspects of

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<sup>11</sup> Statement from President Donald J. Trump on Additional Proposed Section 301 Remedies (April 5, 2018). <https://www.whitehouse.gov/briefings-statements/statement-president-donald-j-trump-additional-proposed-section-301-remedies/>

<sup>12</sup> *Protocol on the Accession of the People's Republic of China*, Decision of November 10, 2001, WT/L/432, at Article 7.3 (emphasis added).

China's technology transfer regime for inbound foreign investment.

First, the Chinese government uses foreign ownership restrictions, such as formal and informal JV requirements, and other foreign investment restrictions to require or pressure technology transfer from U.S. companies to Chinese entities. These requirements prohibit foreign investors from operating in certain industries unless they partner with a Chinese company, and in some cases, unless the Chinese partner is the controlling shareholder. Second, the Chinese government uses its administrative licensing and approvals processes to force technology transfer in exchange for the numerous administrative approvals needed to establish and operate a business in China.

These two aspects of China's technology transfer regime are furthered by the non-transparent and discretionary nature of China's foreign investment approvals system. Prior to 2001, China often explicitly mandated technology transfer, requiring the transfer of technology as a *quid pro quo* for market access. In 2001, China joined the WTO and committed not to condition the approval of investment or importation on technology transfer. Since then, according to numerous sources, China's technology transfer policies and practices have become more implicit, often carried out through oral instructions and "behind closed doors."<sup>13</sup>

The continued requirement of forced technology transfer, whether explicit or implicit, to condition foreign investment approvals on technology transfer requirements would appear to violate one of China's Protocol commitments. That the U.S. (or any other Member) has not brought a WTO challenge on this issue may be due to the difficulty in obtaining evidence to establish such a claim or the reluctance of companies to cooperate with the U.S. government in such a challenge due to the fear of retaliation by China. But, it is clear that forced technology transfer is a serious problem for U.S. companies in China, as the 301 Report noted.

Due to the fact that much of China's technology transfer regime occurs "behind closed doors," confidential surveys provide an important source of information on how the regime works in practice. These surveys make clear that China's technology

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<sup>13</sup> 301 Report at 19 (footnotes omitted).



transfer regime is a persistent problem for U.S. companies in China, particularly in high-tech sectors targeted by the Chinese government.

According to the US-China Business Council's (USCBC) most recent member survey, 19 percent of responding companies stated that in the last year they had been directly asked to transfer technology to China. Of these, 33 percent said that the request came from a central government entity and 25 percent that it came from the local government.

Annual surveys conducted by the American Chamber of Commerce in China (AmCham China) reflect a similar problem. For example, in a 2013 survey of 325 U.S. companies in various sectors, more than one-third of respondents (35 percent) reported that they were concerned about "de facto technology transfer requirements as a condition for market access." In a 2017 survey, 36 percent of respondents cited "reducing the need for us to engage in technology transfer" as one factor that would cause them to increase their investment levels in China.

Other evidence indicates that this problem may be even more widespread than these surveys suggest. For example, one participant testified in the hearing for this investigation that while he was aware of these survey results, his own research indicated through "many, many private interviews with companies...*we did not find a single instance in which companies had not felt pressure and in many cases caved into the pressure to share technology.*"<sup>14</sup>

The economic disconnect between the U.S. and China is exemplified by the long-standing problems with China concerning forced technology transfer through investment restrictions and acquisition of U.S. companies, intellectual property rights violations, and cyber theft that are outlined in USTR's 301 Report. The consequences of this disconnect are starkly evident – a lopsided trade relationship and distortion of normal trade flows caused by China's economic system. The 301 measures present a forceful call to reexamine the U.S.-China bilateral trade relationship, especially because WTO agreements do not concern, and therefore cannot address many of the problems identified. Some may view the 301 measures as a blunt

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<sup>14</sup> 301 Report at 22 (footnotes omitted; italics in original).

instrument, but they have gotten the attention of the world. Indeed, USTR succinctly stated the goal of the 301 measures is to rebalance the lopsided bilateral relationship:

Under President Trump's leadership, the United States is committed to rebalancing the U.S.-China trade relationship to achieve more fair and reciprocal trade. After years of U.S.-China dialogues that produced minimal results and commitments that China did not honor, the United States is taking action to confront China over its state-led, market-distorting forced technology transfers, intellectual property practices, and cyber intrusions of U.S. commercial networks.

The goal is to address unfair Chinese economic practices and create a level playing field that will give all Americans a better chance to succeed.<sup>15</sup>

The U.S. has repeatedly raised the issues of forced technology transfer and the enforcement of intellectual property rights on a bilateral basis with China, and has gained bilateral commitments from China in such forums as the U.S.-China Strategic and Economic Dialogue (S&ED) and the U.S.-China Joint Commission on Commerce and Trade (JCCT), and in visits by Chinese President Xi Jinping. But, as the 301 Report shows, China's commitments have been largely not implemented.

In the bilateral relationship, China repeatedly has committed to eliminate aspects of its technology transfer regime. On at least eight occasions since 2010, the Chinese government has committed not to use technology transfer as a condition for market access and to permit technology transfer decisions to be negotiated independently by businesses. China has further committed not to pressure the disclosure of trade secrets in regulatory or administrative proceedings. The evidence adduced in this investigation establishes that China's technology transfer regime continues, notwithstanding repeated bilateral commitments and government statements ....<sup>16</sup>

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<sup>15</sup> USTR, Section 301 Fact Sheet. <https://ustr.gov/about-us/policy-offices/press-office/fact-sheets/2018/march/section-301-fact-sheet>.

<sup>16</sup> 301 Report at 6-7. See also Table I.1 on page 8 (listing China's bilateral commitments relating to technology transfer, 2010-16).

Thus, as the “longstanding and serious U.S. concerns regarding technology transfer remained unaddressed, despite repeated, high-level bilateral commitments by China to remove or no longer pursue problematic policies and practices,”<sup>17</sup> the U.S. determined that there was a colorable basis for the U.S. to take forceful action through initiation of a Section 301 investigation to address China’s unfair trade practices and to readjust the status quo of the unbalanced U.S.-China trade relationship.

Section 301 of the Trade Act of 1974 (19 U.S.C. § 2411 et seq.) provides broad statutory authority to address three categories of acts, policies, or practices: (1) perceived violations of trade agreements, (2) “an act, policy, or practice of a foreign country” that is “unjustifiable” and burdens or restricts U.S. commerce, and (3) in the discretion of USTR, “an act, policy or practice of a foreign country” that “is unreasonable or discriminatory” and burdens or restricts U.S. commerce.<sup>18</sup> If USTR determines that an act, policy, or practice violates a trade agreement, is unjustifiable and burdens/restricts U.S. commerce, or is unreasonable and burdens/restricts U.S. commerce, then the statute directs USTR to take certain authorized actions, “subject to the specific direction, if any, of the President” and to take “all other appropriate and feasible action within the power of the President.”<sup>19</sup> The actions authorized by the statute include suspension, withdrawal, or nullification of the benefits of trade agreements; import duties or import restrictions; or the negotiations of binding agreements with a foreign country that commits the foreign country to (i) eliminate or phase out the act, policy, or practice that is at issue, (ii) eliminate any burden or restriction on U.S. commerce resulting from such act, policy, or practice,

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<sup>17</sup> 2017 USTR Report to Congress on China’s WTO Compliance (Jan. 2018) at 9.  
<https://ustr.gov/sites/default/files/files/Press/Reports/China%202017%20WTO%20Report.pdf>.

<sup>18</sup> 19 U.S.C. § 2411(a)(1), (b)(1).

<sup>19</sup> 19 U.S.C. § 2411(a)(1), (b)(2).

or (iii) provide the U.S. with compensatory trade benefits.<sup>20</sup> USTR is not required to take a 301 action if the act, policy, or practice at issue involves a trade agreement that has dispute settlement procedures available or where such dispute settlement finds no violation in fact.<sup>21</sup>

In 1998, the European Union (EU) challenged the WTO consistency of the Section 301 statute. Although not based on a particular case, the EU's complaint claimed that Section 301 violated the Dispute Settlement Understanding (DSU) because it imposed specific, strict time limits within which unilateral determinations by USTR must be made and trade sanctions must be taken, even before WTO panel proceedings were finished.<sup>22</sup> On December 22, 1999, the panel found that Section 301 was not inconsistent with U.S. WTO obligations because the statute provided USTR with adequate discretion to comply with the DSU in all cases, and that USTR had in fact exercised that discretion in conformity with U.S. WTO obligations in every Section 301 determination involving an alleged violation of U.S. WTO rights.<sup>23</sup> The EU did not appeal, and the panel report was adopted by the WTO Dispute Settlement Body on January 27, 2000.

The Statement of Administrative Action to the Uruguay Round Agreements Act addressed the relation of the DSU and Section 301 and found them consistent.

Article 23 provides that WTO members must use DSU procedures when they seek to remedy a violation of a Uruguay Round Agreement. Furthermore, no member may issue a "determination" that another government has violated a Uruguay Round Agreement unless a panel or Appellate Body has first reached that conclusion.

Article 23 is consistent with law and practice under section 301 of the Trade Act of 1974. When the Trade Representative initiates a section 301 investigation in a case that involves a trade agreement, the Trade Representative is required by section 303(a)(2) to initiate

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<sup>20</sup> 19 U.S.C. § 2411(c)(1).

<sup>21</sup> 19 U.S.C. § 2411(a)(2).

<sup>22</sup> See *United States - Sections 301 - 310 of the Trade Act of 1974*, Request for Consultations by the European Communities, WT/DS152/1 (Nov. 30, 1998).

<sup>23</sup> See Report of the Panel, *United States - Sections 301-310 of the Trade Act of 1974*, WT/DS152/R (Dec. 22, 1999).

the formal dispute settlement procedures provided under that trade agreement. Moreover, under section 301, the Trade Representative makes a determination whether U.S. rights have been violated under a trade agreement only following U.S. participation in those proceedings. Finally, neither Article 23 nor section 301 requires the United States to use DSU procedures when the Trade Representative considers that an investigation does not involve a Uruguay Round Agreement.<sup>24</sup>

The SAA further noted that:

Neither section 301 nor the DSU will require the Trade Representative to invoke DSU dispute settlement procedures if the Trade Representative does not consider that a matter involves a Uruguay Round agreement. Section 301 will remain fully available to address unfair practices that do not violate U.S. rights or deny U.S. benefits under the Uruguay Round agreements and, as in the past, such investigations will not involve recourse to multilateral dispute settlement procedures.

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Moreover, the mere fact that the Uruguay Round agreements treat a particular subject matter - such as intellectual property rights - does not mean that the Trade Representative must initiate DSU proceedings in every section 301 investigation involving that subject matter. In the event that the actions of the foreign government in question fall outside the disciplines of those agreements, the section 301 investigation would proceed without recourse to DSU procedures.

Some foreign government practices may involve a number of actions, some of which are covered under the rules imposed by the Uruguay Round agreements and some of which are not. In section 301 investigations involving mixed actions of this kind, the Administration intends to continue the current practice of initiating dispute settlement proceedings against actions falling under a trade agreement and addressing other actions through bilateral negotiations.<sup>25</sup>

The objective of Section 301 is to obtain fair treatment for U.S. goods and services and investment. Hence, elimination of the act, policy, or practice of the foreign country or moves

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<sup>24</sup> Uruguay Round Agreements Act Statement of Administrative Action ("SAA"), H.R. Doc. No. 103-316, vol. 1 (1994) at 1018.

<sup>25</sup> Uruguay Round Agreements Act Statement of Administrative Action ("SAA"), H.R. Doc. No. 103-316, vol. 1 (1994) at 1035.

towards that end is the goal versus retaliation against a trading partner. Retaliation is the stick that is available if necessary.

Recent news reports indicate that trade negotiations with China may occur in the wake of the Section 301 actions. For example, it had been reported that the Treasury Secretary might travel to China to discuss trade matters.<sup>26</sup> Then, on April 24, 2018, President Trump said that Treasury Secretary Steven Mnuchin and U.S. Trade Representative Robert Lighthizer will travel to China “in a few days” to talk trade,” and that he thinks there is a “very good chance of making a deal” of sorts with Beijing.<sup>27</sup> President Trump added: “I think China is very serious; we’re very serious. And we have no choice but to be very serious.”<sup>28</sup> China responded favorably on April 24, 2018. At a press conference, Chinese Foreign Ministry Spokesperson Lu Kang said China “has received the information about the U.S. side hoping to come to Beijing for consultations on economic and trade issues and we welcome it.”<sup>29</sup> He further said that it is “not surprising for China and the U.S., the two large economies, to have some problems in the economic field,” that such “problems can be solved through bilateral consultations or within a commonly recognized multilateral framework,” but that “they can never be solved through unilateral means.”<sup>30</sup>

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<sup>26</sup> See *China welcomes US’ visit to discuss trade, amid talk of trip by US Treasury Secretary Mnuchin*, TheStraitsTimes (April 22, 2018). <http://www.straitstimes.com/world/united-states/us-treasury-secretary-steven-mnuchin-considering-trip-to-china-for-trade-talks>

<sup>27</sup> See *Trump: Mnuchin, Lighthizer to travel to China to ‘negotiate on trade’ in coming days*, Inside U.S. Trade (April 24, 2018); <https://insidetrade.com/daily-news/trump-mnuchin-lighthizer-travel-china-negotiate-trade-coming-days> (subscription required).

<sup>28</sup> See *id.*

<sup>29</sup> See *id.*

<sup>30</sup> See *id.*

Such negotiations may result in a reduction in bilateral tensions short-term, due to some small steps taken by China to rebalance the trading relationship with the U.S. Meaningful reform addressing the systemic problems identified in the 301 investigation remains unlikely.

The 301 concerns are a part of the broader issue of whether to rebalance the seriously unbalanced trade relationship between China and the U.S. and, if so, how. For the Trump Administration, the size and direction of the bilateral trade deficit with China are unsustainable.

Throughout the many years of high-level U.S.-China engagement since China joined the WTO, the U.S.-China trade imbalance has grown exponentially. While various factors can contribute to a trade imbalance, the size and direction of the U.S.-China trade imbalance evidences a trade relationship that is neither natural nor sustainable.

In 2001, at the time of China's WTO accession, the United States had a goods trade deficit with China of \$83 billion. In 2003, when the JCCT was elevated, the bilateral trade deficit had increased to \$124 billion. By 2006, when the SED was established, the bilateral trade deficit had reached \$234 billion. When the SED was replaced by the S&ED in 2009, the bilateral trade deficit had dropped slightly to \$227 billion, largely because of the 2008 global financial crisis. In subsequent years, however, the bilateral trade deficit resumed its steep climb, reaching \$350 billion in 2016, the year before the establishment of the CED. Finally, in 2017, when the United States sought to work with China in the newly formed CED, nothing changed. The United States' trade deficit with China stood at \$274 billion in the first nine months of the year and was projected to reach \$365 billion by the end of the year.<sup>31</sup>

Business concerns about the impact that the proposed 301 tariffs, and any Chinese retaliation tariffs, would have on U.S. importers, exporters, and consumers are real and hence many groups will favor a different approach to China or welcome even a temporary respite from potential trade frictions.

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<sup>31</sup> 2017 USTR Report to Congress on China's WTO Compliance (Jan. 2018) at 4.



However, the question for the country and for the Trump Administration is whether the U.S. is actually going to take action to better balance the economic relationship with China? Clearly the efforts of prior administrations to address the growing problems with China, largely through bilateral mechanisms focused on discussions, have not corrected the core challenges of the bilateral relationship. Indeed, the structural differences in economic systems between the United States and most WTO members on the one hand and the state-led economy of China and some of its imitators on the other render the currently structured WTO unusable for resolving many core differences. The WTO is premised on members operating on a largely market-economy driven basis. No one believes that China so operates today. As a result the WTO rules simply don't cover a vast array of distortions created by "state capitalism" or state-led economic systems like China's. If the U.S. is to achieve a rebalanced relationship with China, in the absence of meaningful actions by China to bring its system into conformity with WTO norms, the current section 301 case on forced technology transfer, IP theft and cyber attacks will likely be but the first challenge between economically incompatible systems or the U.S. and China will alter the underlying basis for our trading relationship. Neither course is likely to have a lot of supporters.

A reciprocally beneficial trade arrangement between the U.S. and China should be the goal of both countries, but such an arrangement is not likely without a fundamental restructuring of the ways the U.S. and China relate. China's current economic model simply cannot or will not provide for an outcome that its trading partners expect or that is sustainable. USTR has cogently outlined the dilemma presented by China's failure to operate on market economy principles within the context of WTO membership.

China has shown a willingness to take modest steps to address isolated issues, and it will sometimes make broader commitments

when pressed at very high levels, but it is not prepared to follow through on significant commitments or to make fundamental changes to its trade and investment regime. China is determined to maintain the state's leading role in the economy and to continue to pursue industrial policies that promote, guide and support domestic industries while simultaneously and actively seeking to impede, disadvantage and harm their foreign counterparts, even though this approach is incompatible with the market-based approach expressly envisioned by WTO members and contrary to the fundamental principles running throughout the many WTO agreements.

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It is unfortunate that the United States and other WTO members have had to resort to so many enforcement actions, enforcement-related initiatives and high-level dialogues over the years in an attempt to rein in China's state-led trade regime and to encourage China to act as a more responsible WTO member. It was never envisioned that enforcement would play such a large role for any WTO member, and it is especially unfortunate in the case of China, given that China is the largest trader among WTO members. Indeed, it is simply unrealistic to believe that WTO enforcement actions alone can ever have a significant impact on an economy as large as China's economy, unless the Chinese government is truly committed to market-based competition. The notion that our problems with China can be solved by bringing more cases at the WTO alone is naïve at best, and at worst it distracts policymakers from facing the gravity of the challenge presented by China's non-market policies.

It is important to recall that WTO members are supposed to be moving toward market-based outcomes voluntarily. The expectations of WTO membership were clearly set forth in the Marrakesh Declaration on April 15, 1994, at the conclusion of the Uruguay Round negotiations. There, WTO members expressly affirmed their view that the establishment of the WTO ushers in a "new era of global economic cooperation" that "reflect[s] the widespread desire to operate in a fairer and more open multilateral trading system." WTO members further made clear their determination that their economies would participate in the international trading system based on both "open, market-oriented policies and the commitments set out in the Uruguay Round Agreements and Decisions." (Emphasis added.) It clearly was not contemplated that any member would adopt state-led economic and trade policies instead of market-oriented policies, nor was it contemplated that any member would pursue mercantilist trade

policies instead of policies promoting a fairer and more open multilateral trading system.

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... China has fallen far short when it comes to embracing the “new era” contemplated by WTO members, where “global economic cooperation” reflects the widespread desire to operate in a fairer and more open multilateral trading system and where all WTO members pursue open, market-oriented policies. Unfortunately, the “new era” contemplated by China is one that is based on “socialism with Chinese characteristics,” as recently enshrined in the Constitution of the Chinese Communist Party.

It is difficult to envision this troubling situation changing significantly as long as China continues to remain committed to an economy dominated by the state and built on mercantilist industrial policies designed to promote, guide and support domestic industries while simultaneously and actively seeking to impede, disadvantage and harm their foreign counterparts. If China does not truly embrace a market-oriented approach, rooted in the fundamental WTO principles of non-discrimination, market access, reciprocity, fairness and transparency, the very serious and harmful problems generated by China’s trade regime likely will persist.<sup>32</sup>

So the question becomes what to do? Here are some options; none are necessarily attractive:

(1) Pursue resolution through the 301 process.

The Section 301 investigation gives the U.S. a statutory basis for seeking negotiations with China and, failing a resolution, for taking action it believes appropriate to safeguard U.S. interests. Obviously, the timeline included in the USTR 301 report and Presidential action envisions the opportunity to find a meaningful solution to underlying problems without the resort to actually implementing the announced tariffs. It is unclear that China is willing to seriously engage and the risk of retaliation and counter retaliation is obviously present in light of the announcements both from China and from the United States. The best outcome would be a

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<sup>32</sup> 2017 USTR Report to Congress on China’s WTO Compliance (Jan. 2018) at 4-6.

negotiated solution that actually addresses the core U.S. concerns from the 301 case and is enforceable with agreed consequences. One cannot say there would be a significant likelihood of such a result.

(2) Use of the WTO to resolve parts of the controversy.

The U.S. and China have each filed their requests for consultations at the WTO. The U.S. request addressed only those issues the U.S. views as susceptible to WTO review. China challenged the ability of the U.S. to use section 301 even where WTO rules don't apply and challenged the right of the U.S. to impose tariffs if uncovered areas of Chinese activity harm America. As the WTO dispute settlement system will likely take a number of years to reach resolution of either or both cases, it is difficult to envision this being the only route pursued by the U.S. and certainly seems unlikely to deter China from retaliating if the situation gets to the point where duties are imposed by the United States.

(3) Managed trade with China.

Either as part of 301 negotiations with China or separately in an effort to find a path to a more "harmonious" trading relationship, the U.S. must explore options of tying trade flows to agreed targets until such time as China's reforms progress to the point where market forces are actually controlling economic outcomes in China and the state has withdrawn from its central role. Various options could exist if this type of approach were adopted. For example, U.S. and China could quarterly review the relationship and establish targets for imports into China to address the U.S. trade deficit; the U.S. and China could agree that Chinese exports would be limited based on quarterly review; etc. Whatever the practical appeal of this approach (including its not forcing a change in the economic system chosen by China), there is no known interest in such an approach within the Administration, Congress, or the business community.

(4) Revisions to the WTO or creation of a bilateral agreement controlling U.S.-China trade.

Theoretically, one could address the differences in economic systems between the U.S. and many other countries and China through modifications to WTO agreements. Such an approach takes years (likely more than a decade) and so would leave an unacceptable situation in place to continue to worsen. In addition, since any such modifications would depend on Chinese acceptance of the same, the likelihood of this approach working has to be viewed as negligible.

A number of business groups have suggested a bilateral agreement, typically an FTA between the U.S. and China. Theoretically, such an agreement would permit the U.S. to potentially address the ongoing distortions and has the advantage of an approach that could address a wide range of issues and permit periodic updating. However, it is hard to imagine an agreement that would actually address China's distortions that the current Administration would view as enforceable or that China would accept. Moreover, there would likely be significant pressure from business groups to accept an agreement that facially wouldn't work in the name of avoiding disruption in current market conditions.

So there are a number of options that could be pursued to resolve the underlying concerns. None seem likely to get the U.S. to a more balanced relationship with China without change by China, change by the U.S. (*e.g.*, acceptance of managed trade with China as a least bad option), or short to medium term pain to the multilateral system and to U.S. manufacturers and agricultural producers.



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