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Before the Senate Committee on Small Business & Entrepreneurship
Hearing on Made in China 2025 and the Future of American Industry

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I want to thank Chairman Rubio and Ranking Member Cardin for the invitation to testify today.

I also want to commend the Committee and its staff for their recent report on the challenges to American businesses and workers posed by China's industrial policies, including Made in China 2025.

I share the report's conclusion that a vibrant advanced manufacturing sector is a critical part of a strong American economy, and that the policies that China is pursuing to support the development of the sectors identified as priorities in Made in China 2025 are troubling. They pose a challenge to many American businesses, to U.S. trade policy, and to the rules now governing the global trading system. As the Chamber of Commerce has noted, "[Made in China 2025] is a ten-year comprehensive blueprint aimed at transforming China into an advanced manufacturing leader…in concert with the 13th Five-Year Plan…and other state-led development plants, [Made in China 2025] constitutes a broader strategy to use state resources to alter and create comparative advantage in these sectors."[1]

As China develops, the sources of China's comparative advantage will naturally evolve. It is unrealistic to expect that China—or any other country—would aspire only to conduct assembly work for companies based in other countries. The policies outlined in China 2025 are troubling not because China is looking to support its own development and strengthen its technological base, but because they appear to mobilize the substantial financial capacities of China's state to back the development of sectors where China is now a substantial importer of the rest of the world's goods. These policies are particularly troubling because China's state has a unique capacity to tilt its domestic market toward preferred firms. Through its influence over the purchases of large state-enterprises, China's government can effectively guarantee a large captive domestic market for Chinese producers while informally constraining, if not walling off, foreign firms from full access to China's market. And they are troubling because China's government appears to have sought to accelerate China's technological development by subsidizing the purchase of leading-edge global firms with state funds, and in some cases, supporting efforts to steal technology from foreign firms.[2]

The manufacturing sectors identified for preferential development in China 2025 account for roughly $50 billion of U.S. exports to China—or about a third of all goods exports to China and Hong Kong and about a quarter of total exports of goods and services to China and Hong Kong. Aircraft, integrated circuits, agricultural and construction equipment, and high-end medical equipment are all significant

[1] "Made in China 2025: Global Ambitions Built on Local Protections," U.S. Chamber of Commerce, 2017, https://www.uschamber.com/sites/default/files/final_made_in_china_2025_report_full.pdf.
[2] Chuin-Wei Yap, "Taiwan's Technology Secrets Come Under Assault From China," *Wall Street Journal*, July 1, 2018, https://www.wsj.com/articles/taiwans-technology-secrets-come-under-assault-from-china-1530468440 and Paul Mozur, "Inside a Heist of American Chip Designs, as China Bids for Tech Power," *New York Times*, June 22, 2018, https://www.nytimes.com/2018/06/22/technology/china-micron-chips-theft.html.

components of America's industrial base. As the committee report notes, U.S. exports in these industries are supported by deep domestic supply chains that sustain many small businesses and U.S. jobs.

It is certainly worthwhile to seek to address some of the concerns raised by Chinese industrial policies through the current round of trade negotiations.

But it is still unclear how much progress will be made in the negotiations, as some of the most important distortions are deeply rooted in the nature of China's economic and political system. It will be difficult, in my judgement, to negotiate an agreement that completely addresses the concern that China's state is uniquely able to "rig" China's domestic markets in ways that discriminate against foreign firms so long as China's party-state directly controls much of the commanding heights of China's domestic economy, and so long as there is a sense that China's largest private firms can only remain successful and private with the support of the party and China's government.[3]

As Daniel Rosen of Rhodium Group and Scott Kennedy of CSIS have argued, the United States' "commercial relationship with China must be bounded both by fairness and the expanding needs of national security."[4]

I want to focus on two points in particular: 1) the importance of macroeconomic balance and a fairly valued Chinese currency to a balanced overall commercial relationship and 2) the specific challenges posed by China's import-substituting industrial policies.

But it bears repeating that trade with China—measured in the most expansive way—is around 4 percent of U.S. GDP. The overall impact of China on the U.S. economy increases somewhat after taking into account competition between the United States and China in other markets. There should be little doubt that the economic future of the United States will be determined far more by the policy choices we make here in the United States than by our ability to influence the economic and commercial policies adopted in Beijing.[5]

<u>Currency and Macroeconomic Balance</u>

The initial China shock—the loss of jobs in many manufacturing communities associated with the rise in imports from China that followed China's WTO accession—was not the product of the Chinese industrial policies that are the focus of today's hearing.

It stemmed from the end of the uncertainty about U.S. tariffs created by the annual vote on extending China's access to the U.S. market on standard terms, liberalizing reforms undertaken by China that

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[3] Mark Wu, "The 'China, Inc.' Challenge to Global Trade Governance," *Harvard International Law Journal* 57, no. 2 (Spring 2016), http://www.harvardilj.org/wp-content/uploads/HLI210_crop.pdf.

[4] Daniel Rosen and Scott Kennedy, "Building a Better Deal with China," *Center for Strategic and International Studies*, January 28, 2019, https://www.csis.org/analysis/building-better-deal-china.

[5] Total goods and services exports to China and Hong Kong totaled 1.2 percent of U.S. GDP in 2017; total imports of goods and services totaled 2.8 percent of U.S. GDP. 2018 should be broadly similar, though exports are likely to slip as a result of China's soybean tariffs and other retaliatory measures. As a share of GDP, U.S. trade with China has been nearly constant over the last five or six years.

increased its competitiveness, and the distortions created by China's peg to the dollar and its heavy intervention in the foreign exchange market to limit the appreciation of China's currency.[6]

At its peak, China was running a current account surplus of 10 percent of its GDP—and adding over 12 percent of its GDP to its reserves. China's actual intervention was even larger, as China's state banks were also adding to their foreign assets at the time.[7] Such intervention kept the yuan undervalued by as much as 30 percent, and likely added well overall $100 billion dollars to China's overall trade surplus. It was a mistake not to make use of the special safeguards negotiated as part of China's WTO accession—the special 421 safeguard[8]—to mitigate the impact of China's undervalued currency on the U.S. manufacturing sector and the small businesses that the U.S. manufacturing sector supported. Claims that there were no import surges that met the criteria for the 421 safeguard protection are not credible; overall imports from China were at the time growing by around 20 percent a year, and careful analysis indicates—contrary to the assertion of some—that these imports did not primarily displace imports from other Asian economies.

Before the global crisis, there was a credible argument that ending China's currency manipulation on its own would do much to bring better balance into the trading relationship with China. Today, currency intervention is not the primary way Chinese policy distorts global competition—in fact, after the dollar appreciated significantly in 2014, China has more often intervened to keep the yuan from depreciating than to block its appreciation.

The challenges posed by China are consequently in some ways more complicated now, as they stem less from policies that have promoted China's exports and more from policies that have distorted competition inside China. But it is worth remembering that the value of China's currency remains central to the character of the commercial relationship between the United States and China—and has a bigger impact on the conditions facing most American small businesses than most Chinese industrial policies. A stronger yuan encourages firms to produce more in the United States, and to source less from China. A weaker yuan by contrast helps lower the costs of those businesses that have built their operations around low-cost Chinese supplies.

The United States has on net benefitted from the adjustments that China undertook after the global financial crisis that reduced its overall current account surplus and reduced its reliance on exports. U.S. imports from China grew at about one quarter of their pre-crisis pace from 2011 to 2016. But there are real concerns that some of the policies China used to pivot toward domestic demand are themselves unsustainable, as they hinge on heavy investment by now heavily indebted local governments and rapid growth in credit to state firms. Putting the reduction in China's overall external surplus on a more sustainable footing by encouraging policies that reduce China's excessive national savings rate should be a U.S. policy priority. Without such changes, I worry that China will eventually find the temptation to allow its currency to weaken to support a pivot back to an export-based growth model irresistible.

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[6] C. Fred Bergsten and Joseph E. Gagnon, "Currency Conflict and Trade Policy: A New Strategy for the United States," *Peterson Institute for International Economics*, June 6, 2017, https://piie.com/system/files/pr_currency_conflict_002.pdf.
[7] Brad W. Setser "China's WTO Entry, 15 Years On," January 18, 2017, *Follow the Money*, https://www.cfr.org/blog/chinas-wto-entry-15-years.
[8] Robert E. Lighthizer, "Evaluating China's Role in the World Trade Organization Over the Past Decade," Testimony Before the U.S.-China Economic and Security Review Commission, June 9, 2010, https://www.uscc.gov/sites/default/files/6.9.10Lighthizer.pdf.

Because reducing China's high savings rate is now essential to preserving China's domestic macroeconomic equilibrium, expanding China's system of social insurance may be almost as critical to the long-term health of the Chinese-American commercial relationship as are changes in China's industrial policies. [9] China, with a low level of household consumption relative to the size of its economy and relatively high taxes on formal work, also needs a policy agenda that does more "to meet the needs of working families."

The Challenge Posed by Made in China 2025

China has recognized that the Made in China 2025 industrial plan has created frictions in its relations with a number of countries, not just the United States, and is reportedly in the process of rebranding its industrial policies. But the basic policy thrust behind China 2025 hasn't changed—China still aims to build up its domestic industries in a set of strategic sectors through a combination of state subsidies and domestic preference for "indigenous" production and firms and in some cases selective application of competition law and using the standard setting process to favor national firms.

The sectors identified in Made in China 2025 are at the heart of the United States' advanced manufacturing economy. The civil aircraft industry is, by far, America's leading export sector. It alone easily accounts for over 10 percent of all the goods the U.S. exports to China. The U.S. share of semiconductor manufacturing—actual fabrication—is more modest than it once was. [10] Yet exports of semiconductors "fabbed" in the United States are still an important U.S. export to China and Hong Kong, generating around $10 billion of U.S. exports, and circuit designs from U.S. firms account for about half of the global market. The U.S. position in the manufacture of telecommunications networking equipment also has slipped over time, but the United States continues to be a leader in many of the technologies that are central to the creation of a modern telecommunications network. Medical and agricultural equipment have long been an important part of the U.S. manufacturing base. Robotics and artificial intelligence are likely to be central to industries of the future.

China's plan to reserve a portion of China's domestic market for its own production in these sectors thus represents a clear threat to a substantial portion of current and future U.S. exports to China. It is hard to see how overall trade with China can move closer to balance if China no longer wants to import U.S. aircraft and U.S. designed chips. China buys an awful lot of soybeans, but even if it replaced all of its current imports from Brazil with U.S. production, overall U.S. exports to China would increase by only $20 billion. U.S. imports from China are now around $600 billion.

It is worth noting that the challenge China poses to American manufacturing has evolved over time. China today is increasingly designing and producing the capital goods central to the infrastructure of a technologically advanced economy, not simply assembling consumer goods for American and other multinational firms. China can now produce and export the equipment to generate and distribute electricity, whether from renewable or non-renewable sources; the handsets needed to connect to a phone network; the base stations and switching equipment needed to run an efficient telecommunications network; and the heavy machinery needed to build ports, roads, and other physical

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[9] Longmei Zhang, Ray Brooks, Ding Ding, Haiyan Ding, Hui He, Jing Lu, and Rui Mano, "China's High Savings: Drivers, Prospects, and Policies," *International Monetary Fund*, December 11, 2018, https://www.imf.org/en/Publications/WP/Issues/2018/12/11/Chinas-High-Savings-Drivers-Prospects-and-Policies-46437.

[10] Michaela D. Platzer and John F. Sargent Jr., "U.S. Semiconductor Manufacturing: Industry Trends, Global Competition, Federal Policy," *Congressional Research Service*, June 27, 2016, https://fas.org/sgp/crs/misc/R44544.pdf.

infrastructure. While in some cases China's exports of advanced capital goods still depend on access to imported foreign technology, China's growing exports in sectors central to the basic infrastructure of a modern economy necessarily mean that considerations related to security will play a larger role in our trading relationship over time.

In some specific instances, the policies that China has adopted are direct violations of the WTO's rules—and in other cases, notably in informal expectations for technology transfer to a joint venture partner in order for a firm to access China's domestic markets, China's practices clearly violate the spirit of its WTO commitments.[11]

But it is also important to note that in some cases Chinese policies aren't direct violations of the current trade rules—in part because the rules weren't really designed with expectation that the state would continue to occupy the commanding heights of one of the world's two largest economies.[12]

Subsidies to domestic industries, for example, are not a violation of China's WTO commitments. Foreign partners have the right to take action to offset the impact of specific subsidies that can be demonstrated to have a caused a material injury to their business, but not to stop the subsidies. But in China's case, proving the existence of a sector-specific subsidy that is actionable under U.S. trade law can be challenging. Any firm that can access the state banking system rather than having to rely on the informal financial system effectively gets a subsidy, particularly as China has been willing to absorb the losses that state banks incur on lending to priority sectors. In many cases, the support has been provided by government backed investment funds and development banks that notionally are state enterprises, rather than through the government budget—complicating the legal case for trade action.[13]

The need to wait for evidence of material injury effectively means that trade action is often only legally permitted after Chinese subsidies have already altered the competitive landscape of the industry. No other country can provide over $50 billion to national funds that support the development of the semiconductor sector—and also provide an additional $100 billion in support from multiple provincial funds.[14] China's state enterprises, backed by these funds, are making large investments in semiconductor manufacturing capacity that could drive down prices—and then the state funds could help China's new national champions acquire their foreign competitors and their technology.

China's large subsidies for strategic sectors gain additional potency because of how they interact with China's capacity to put pressure on its leading firms to substitute domestic production for imports. For example, China is clearly seeking to leverage Huawei's leading position in the telecommunications industry to strengthen its domestic semiconductor manufacturing industry. Germany's Mercator Institute noted "Chinese high-tech industries, in particular the national champions, are expected to

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[11] "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," *Office of the United States Trade Representative*, March 22, 2018, https://ustr.gov/sites/default/files/Section%20301%20FINAL.PDF.
[12] Wu, "The 'China, Inc.' Challenge to Global Trade Governance".
[13] Jennifer Hillman, "The Best Way to Address China's Unfair Policies and Practices is Through a Big, Bold, Multilateral Case at the WTO," Testimony Before the U.S.-China Economic and Security Review Commission, June 8, 2018, https://www.uscc.gov/sites/default/files/Hillman%20Testimony%20US%20China%20Comm%20w%20Appendix%20A.pdf.
[14] Bob Davis and Eva Dou, "China's Next Target: U.S. Microchip Hegemony," *Wall Street Journal*, July 27, 2017, https://www.wsj.com/articles/chinas-next-target-u-s-microchip-hegemony-1501168303.

acquire the capabilities to create independent innovative technological solutions and replace their foreign competitors on the domestic market and increasingly also on global markets.” [15]

The civil aviation industry provides the best example of how China potentially can leverage the states’ broad role in the economy to discriminate against imports. China now account for about 20 percent of total global aircraft demand. All of the major Chinese airlines are effectively state controlled, and can tilt their future purchases toward China’s own nascent civil aviation industry (Hainan airlines is privately-owned, but its leveraged parent—HNA—now relies on state backing.)[16] China is not a signatory to the WTO’s government procurement agreement, and such purchases would not be covered by the procurement agreement in any case (most purchases by state firms are considered commercial not governmental purchases).

The market structure in sectors like railway equipment and telecommunications networking equipment is similar to that of the aircraft industry: China’s central government owns the companies that account for the bulk of Chinese demand. In other sectors, such as medical equipment, selling into the Chinese market requires navigating multiple procurement lists, including provincial procurement lists for devices eligible for reimbursement by public insurance. China’s government has indicated that it wants to raise China’s share of the domestic hospital market to 50 percent by 2020, and 70 percent by 2025.[17]

As Mark Wu of Harvard Law School has argued, China—and the Chinese Communist Party—possesses a set of policy levers that impede the ability of U.S. and other firms to successfully export to China yet are hard to counter through standard trade tools. Chinese imports of manufactures have consistently grown more slowly than China’s own economy; they are now a smaller share of China’s economy than they were prior to China’s WTO accession.[18] Few U.S. firms outside of the commodity sectors believe that they can successfully produce in the United States and sell large quantities to China; Boeing is more the exception than the rule.

I should note that it is particularly important for small business that the United States prioritize opening Chinese markets to U.S. exports, not just making China safe for investment by U.S.-based multinational companies. Small businesses are more likely to be able to export to China than to be able to navigate the hurdles associated with establishing a Chinese subsidiary and producing inside China. Concerns about the impact of “buy China” policies on U.S. exports would not go away even if China ended all of the informal technology transfer requirements imposed on U.S. firms seeking to invest in China. China could still give preference to foreign firms that have set up inside China over foreign firms looking to export into China.

U.S. Policy Response

[15] Jost Wübbeke, Mirjam Meissner, Max J. Zenglein, Jaqueline Ives, and Björn Conrad, “Made in China 2025
The making of a high-tech superpower and consequences for industrial countries,” *Mercator Institute for China Studies*, August 2016, https://www.merics.org/en/papers-on-china/made-china-2025.

[16] Lucy Hornby and Sherry Fei Ju, “Beijing leans on lenders to back debt-hit HNA’s bond sale,” *Financial Times*, June 15, 2018, https://www.ft.com/content/613379f6-70af-11e8-92d3-6c13e5c92914.

[17] Tom Hancock, “Multinationals lose ground in China’s medical devices,” *Financial Times*, May 27, 2018, https://www.ft.com/content/ea032bba-5f33-11e8-9334-2218e7146b04.

[18] Brad W. Setser, “China Should Import More,” *Follow the Money*, November 7, 2018, https://www.cfr.org/blog/china-should-import-more.

The committee's report identified a number of potential policy responses to the Chinese industrial policies embedded in Made in China 2025 and its likely successors.

I support stronger screening of inward Chinese investment—and even outright limits on Chinese investment in certain sectors as a means of putting pressure on China to drop its most egregious industrial policies. Such restrictions on investment are generally compatible with the United States' WTO commitments. I also believe that the United States should be proactively preparing CVD and anti-dumping cases against imports in those sectors that China has targeted in China 2025, and should be ready to self-initiate such cases—and also to file more legally challenging "adverse" effects WTO cases to counter the loss U.S. firms could face on their sales in China and third-party markets. The United States should also be ready to match Chinese export financing to balance the competitive landscape in third party markets and to encourage China to sign up to international disciplines on its own export financing.

I am more leery of prohibitions on U.S. exports of critical components as a means of trying to impede Chinese industrial development. Such restrictions have a role in protecting U.S. national security and as a punishment for violations of sanctions and the outright theft of U.S. intellectual property. But if applied broadly as part of a "counter-industrial policy" strategy, they would likely reinforce China's efforts to build up its own domestic capacity across a broad range of sectors.

Many traditional U.S. allies share the United States' concerns with the trade-distorting impact of China's import and technology-substituting policies, so there also may be scope for joint action. Several U.S. allies, for example, are currently considering tightening their own restrictions on Chinese investment.

Conclusion

The United States ultimately cannot determine how China manages its own domestic economy. The policy variables under our control are our openness to investment from China—and our willingness to continue to trade with China on standard WTO terms while China acts to limit its imports from us.

China equally cannot set the conditions for competition and innovation here in the United States. The United States should not ignore Chinese policies that are adverse to U.S. economic interests, but our top priority should always be to reinforce the United States' own sources of competitive advantage. China doesn't determine how much we invest in our own infrastructure, how much support we provide for research and development, how much we invest in our own workforce, how we use the tax system to incentivize and reward low-wage work, or how we tax the international activities of U.S. multinational companies. While it is no doubt controversial, I attach particular importance to ending the provisions of the new tax code that appear to continue to reward the offshoring of intellectual property and certain factories and jobs. Rather than courting Chinese state investment, the United States should be encouraging American firms to invest more here at home. Provisions that artificially lower the tax of large multinational companies only shift the tax burden onto American small business. The committee report helpfully noted a set of policy areas where agreement might be possible even with different parties in control of the House and Senate. Policy decisions made in these areas, far more than any policy decision made in China, will determine our economic future.