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**Linkage Politics in Sino-American Relations**

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# Linkage Politics in Sino-American Relations

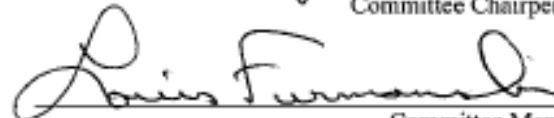
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## **Abstract**

A common phenomenon that exists in any complex relationship between two countries is “linkage” across different policy issues. Linkage means to establish a relationship making progress in one area dependent on, or affecting progress in another area between the two countries. This thesis explores how linkage has evolved in the U.S.-China relationship across three different issue areas: currency, trade, and investment. The thesis argues that, as China’s economy has grown more quickly relative to the United States economy, China has gained advantages in bargaining with the United States. Unlike linkage politics of the 1980s and 1990s, more recently, the United States has been less able to put the same pressure on China that it used to because China has been able to minimize linkages across different areas. In particular, China’s participation in multilateral governance arrangements such as the World Trade Organization (WTO) shields it from direct pressure in the Sino-American bilateral relationship. In contrast, China has been able to make use of American vulnerabilities, particularly those arising from America’s trade and budget deficits, to deflect pressure to make concessions on trade, investment, and currency issues. These three areas not only link with each other but also have linkage with some other non-economic areas in Sino-American relations.

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## I. Introduction

As of 2011, the United States has the world's largest economy and China the second largest. China has the world's largest population and the United States has the third largest. Sino-American relations are increasingly complex nowadays. The United States and China are neither allies nor enemies, but competitors in some areas and partners in others. China and the U.S. are the world's largest mutual trading partners. China is also the largest foreign creditor for the United States. China and the United States are not only major trade partners, but also have common interests in many other fields, such as counterterrorism and nuclear nonproliferation. The Sino-American relationship has become the world's most important bilateral relationship of the 21st century.

A common phenomenon that exists in any complex relationship between two countries is "linkage" across different policy issues. Linkage means to establish a relationship making progress in one area dependent on, or affecting progress in another area between the two countries. For example, one country could use its economic advantage to affect trade relations with the other country, or a country could use its economic advantage to bargain over military issues with the other country. Linkage offers three advantages: First, countries could use the power that may be available in one policy domain to achieve cooperation in other domains from linkage. Second, linkage can be an important source of bilateral cooperation by allowing countries to bridge their differences through negotiation. Finally, by allowing countries to engage in cross-regime bargaining, linkage creates broader patterns of international cooperation (Perez 2006).

In Sino-American relations, both countries seek to establish or minimize linkage across

issues in order to improve their bargaining positions. For example, when the U.S. wants China to adjust its currency, the U.S. will seek to establish linkages between currency and trade policies in order to bargain with China. Thus, the threat of trade protectionism might pressure China to adjust the value of the Renminbi (RMB). In the same way, China could use some other issues, like Iran and North Korea, to minimize the attempt by its partner to assert linkages between currency and trade.

This thesis explores how linkage has evolved in the U.S.-China relationship across three different issue areas: currency, trade, and investment. As China's economy has grown more quickly relative to the United States' economy, China has gained advantages in bargaining with the United States. Unlike linkage politics of the 1980s and 1990s, more recently, the United States has been less able to put the same pressure on China that it used to because China has been able to minimize linkages across different areas. In contrast, China has been able to make use of American vulnerabilities, particularly those arising from America's trade and budget deficits, to deflect pressure to make concessions on trade, investment, and currency issues. These three areas not only link with each other but also have linkage with some other non-economic areas in Sino-American relations.

The first section of this thesis briefly introduces the Sino-American relationship. The second section of the thesis defines the concept of linkage, surveys earlier academic studies of linkage, and shows how it may be used to explain foreign policy choices. Then, the thesis looks at linkage within Sino-American currency relations, in particular, how the U.S. attempts to use linkage to put pressure on China's currency policy and how China attempts to deflect the pressure. The fourth section of the thesis looks at linkages between trade and some other issues in Sino-America relations. Next, the thesis considers the linkages between and across

investment, trade, and currency. Finally, the thesis examines linkages between economic and non-economic issues, such as the status of Taiwan, regional military security, counterterrorism, and human rights.

## **II. Historical Background**

In the period immediately after World War II, the People's Republic of China (PRC) was isolated from the Western trading and financial system, and interacted much more frequently with the Soviet Union. China followed the Soviet model of urban-led industrialization, state ownership of the means of production, and central planning to build a new China. Because of Cold War hostilities, the United States did not recognize the PRC, and maintained diplomatic relations with Taiwan instead. China's relations with U.S. were rendered even worse by the Korean War in 1950, which destroyed nearly all possibility for normal bilateral relations (Carter 2001).

In 1958, China instituted the Great Leap Forward (1958-1960) to accelerate structural economic change and promote greater ideological purity. But the Great Leap Forward resulted in a great loss to China and the economy suffered. Although China's economy began to recover, it suffered another setback during the Culture Revolution (1966-1976). Both the Great Leap Forward and the Cultural Revolution left China technologically backward and politically isolated. As Sino-Soviet relations began to deteriorate, China was diplomatically isolated as well. At this point, China began to repair relations and open its market to the West, especially the United States. At the same time, improving relations with China was also important for the American President, Nixon, in his election campaign. In 1969, the United States relaxed trade

restrictions and other impediments to bilateral contact. In 1971, the young American ping pong player Glenn Cowan missed his US team bus but was waved by a Chinese table tennis player, Zhuang Zedong, onto the bus of the Chinese team and this led to the “Ping Pong Diplomacy” for Sino-American relations. The American athletes became the first Americans to officially visit China since 1949 (Marcus 2007).

In 1972, this episode of Ping-Pong diplomacy led quickly to President Nixon’s famous about-face regarding China. Nixon traveled to Beijing, Hangzhou, and Shanghai. Both U.S. and China issued the Shanghai Communiqué, setting the stage for the full normalization of diplomatic relations. In this Communiqué, the U.S. acknowledged that there is only one China and that Taiwan is part of China. In May 1973, the U.S. and China established the United States Liaison Office (USLO) in Beijing and a counterpart PRC office in Washington, DC. In the Joint Communiqué signed in 1979, the United States transferred diplomatic recognition from Taipei to Beijing and repeated the acknowledgment in the Shanghai Communiqué that there is only one China and that Taiwan is a part of China. On March 1, 1979, the United States and China established embassies in Beijing and Washington, DC.

High-level exchanges have played a significant role in Sino-American relations during the last two decades of the 20<sup>th</sup> century. President Ronald Reagan and Premier Zhao Ziyang exchanged visits in 1984. In July 1985, President Li Xiannian visited the United States, and the first President Bush visited China two times, once in October 1985 and again in February 1989. In 1997, Chinese president Jiang Zemin visited U.S. and President Clinton visited China in 1998. In 2009, President Obama visited China and Chinese President Hu Jintao visited U.S. in 2011. U.S. and China also established the high-level bilateral talks, the China-U.S. Strategic Economic Dialogue, in 2006.



In 1978, Deng Xiaoping implemented a policy of economic reform and opening to the outside world, and established four special economic zones for foreign investors. In particular, China abandoned its Soviet-style emphasis on heavy industry in favor of light industrial production for export. Chinese enterprises began to operate under market conditions. At the same time, China also depended on its diplomatic relations with the United States and other countries for its trade, investment, and economic development. China tried to dismantle many barriers to foreign companies and make a better environment for their business. U.S. and China promoted trade relations when they signed a trade agreement in 1979 that granted China Most-Favored-Nation (MFN) trading status with the United States. This agreement reduced American tariffs on Chinese products and helped China to export more to the United States (Spero and Hart 2010). In 2001, China entered the World Trade Organization (WTO), and Foreign Direct Investment (FDI) inflows increased very quickly as more and more multinational corporations came into China.

Nowadays, China's economy is the second largest in the world, just after the United States. With the success of its economy, China participates in globalization and plays an important role in many global initiatives. China also seeks to modernize its military, and develop advanced weapons (Lawrence and Lum 2011). As China has become a more important partner for America in the 21st century, the U.S. has broadened its cooperation with China over global and regional strategic problems, counterterrorism, and many other issues. China also cooperates with U.S. and learns from the U.S. in many issues, such as high technology and education.

However, there are increasing frictions between the U.S. and China as well. For the United States, the main friction with China includes the RMB's value, the trade deficit, industrial policies, and North Korean problems. For China, the main frictions with the U.S. include arms sales to Taiwan; President Obama's meeting with Dalai Lama; U.S. joint military exercises with

Japan and South Korea in the Yellow Sea; and territorial disputes in the South China Sea. (Lawrence and Lum 2011).

Though China has made great progress implementing reforms and opening to the outside world, China remains a highly centralized, authoritarian system. There is growing economic inequality between urban and rural areas. The main questions in China are whether its rapid growth would continue and whether the political system would be able to survive a future period of low growth. There are also a lot of challenges for U.S. in many areas, such as economic development, job opportunities, and counterterrorism. Sino-American relations offer many opportunities for linkage politics to be practiced. In order to understand how linkage politics evolves, the work of other scholars must be examined in order to gain insight into the patterns of linkage.

### **III. Literature Review**

Scholars have studied linkage politics in many different settings. According to Arthur Stein, linkage politics is “a state’s policy of making its course of action concerning a given issue contingent upon another state’s behavior in a different issue area” (Stein 1980, p. 62). This literature review will introduce some ideas and approaches that are useful for understanding linkage politics between the United States and China.

Linkage, in the sense that one issue connects with another issue, is as old as politics itself. Politics in one place always relates to politics somewhere else. In the modern world, the amount of linkage in world politics has become greater. As technology shrinks the world and increases interdependence of nations, linkage phenomena cannot be ignored by scholars. The idea of

linkage is widely used in understanding the relation between national and international politics. Inquiries into the politics of foreign trade and so much research into the functioning of international organizations benefit from awareness of linkage phenomena. Linkage phenomena are important for political science because it has to explain the relations between the units it investigates and their environment (Li and Thomas 1975).

The study of linkage has several goals. One goal is to link the polity to its environment and to mark the boundaries between nations and the international system. Each country has different interests. Each country is strong and weak in different ways. These differences affect how linkage takes place. Another goal of study concerns the aspects of the international system, particularly institutions, with which polities become linked. Finally, the study of linkage reveals the important role that ideas can play as sources of issues within both national and international politics.

By itself, linkage does not explain how political decisions and outcomes occur. As ties between nations multiply, linkages may exist between countries without one country having leverage over another country. Common forms of linkage include economic linkage, geopolitical linkage, social linkage, communication linkage, and transnational civil society linkage. (Levitsky and Way 2006). The fact of linkage produces a politics of linkage only when nations define their interests differently and encounter disagreement. Disagreement does not always mean that nations are competitors or enemies. For example, during the 1950s and 1960s, the United States used linkages between different issues to build cooperation with its allies and strengthen Atlantic relations (Wallace 1976). For many years the United States and China had very hostile relations. The two countries fought directly during the Korean War, and indirectly during the Vietnam War. Linkage between issues involved threats of punishment, not promises of rewards. Still, this is an

example of linkage politics. The fact that the United States and China have two very different political systems shows how important the relationship between domestic and international variables is for understanding linkage politics. Domestic politics in the two countries are so very different, so Americans and Chinese respond differently to the same incentive. The United States is democratic, China not so very much. The United States is rich, and China is still poor but growing quickly. Both Americans and Chinese understand this, and this awareness also becomes a part of linkage politics. Domestic politics in both countries can influence how linkage from national to international politics does, or does not, take place. (Lohmann 1997).

Linkage politics is also influenced by private actors and both the domestic and international level. For example, in the United States international financial questions have been influenced by the role that American banks play in shaping policy. As Benjamin Cohen (1985) shows, big banks in the United States were heavy lenders to sovereign borrowers during the 1980s. Banks participated in the process of making foreign policy, and they affected direct interstate relations and the foreign policy environment, and their effects altered the government's policy options and the issues of salience for policy. Bank decisions changed how foreign policy is implemented, even when banks had different priorities than governments. When sovereign borrowers could not pay back their loans to the banks, the interests of banks and governments split. The banks wanted to be paid, but the United States wanted to help the sovereign borrowers. This put constraints on American policy. The United States also wanted the sovereign borrowers to change their economic policies, and offered to influence the banks. In this way, the banks became an opportunity for American foreign policy.

In U.S.-China relations, there are also many private actors that shape linkage politics. American companies want to export to China, and they lobby to keep trade open between the

two countries. During the 1990s, attempts by the U.S. Congress to link China's MFN status to human rights were opposed by American business interests (Cohen 2010). In the American bureaucracy, the State Department supported human rights but the Commerce Department supported free trade. In 1994 the Commerce Department's view won. Other American companies are hurt by imports from China, and they try to restrict trade. Some actors want the RMB to become weaker, while others want it to be stronger. American companies that have invested in production for export in China oppose protectionist measures against China, like the tire import restrictions of 2009. Chinese companies also seek export markets in the United States, and want to acquire technology from American companies. Other private actors like Non-Governmental Organizations (NGOs) want to influence American and Chinese policies about other issues, like human rights behavior and the status of Taiwan. These private actors are not motivated by economic gains, but they operate across national borders like companies.

For linkage politics, the domestic and international context matters, as well as the type of actors involved. To explain decisionmaking, an important approach in political science is rational choice theory (also called game theory). Rational choice assumes that policymakers weigh the costs and benefits of each decision, and seek to maximize benefits. A country's foreign policy can be explained as a pattern of decisions in response to the rational behavior of decisionmakers in other countries (Stein 1980).

From a rational choice view, linkage politics is a form of strategic interaction. If each actor always preferred to do what the other one wanted, then there is no conflict and each will obtain its best outcome without linkage. Only when an actor does not like an equilibrium outcome will a desire for linkage arise. The problem for the aggrieved actor is that it cannot change its own course of action simply, for an equilibrium outcome is one from which neither

actor can move alone without making itself worse off. So the actor who wants change must get the other actor to change its course of action. Linkage can make this change possible.

According to Arthur Stein (1980), there are three different kinds of linkage: coerced linkage, threat-induced linkage and mutual linkage. Coerced linkage happens when the actor who wants change abandons its favored strategy and thus forces the other actor to change its behavior. For example, in 1956 the United States forced Great Britain to withdraw from the Suez Canal by stopping its support for the British Pound, even though the Americans usually defended the currency of its ally. Coerced linkage is easiest when one actor is much stronger than the other like the U.S. and Great Britain.

Threat-induced linkage occurs when the actor wanting change threatens to abandon its favored strategy in order to force the other actor to change its behavior. To get the other actor to change behavior, the first actor threatens to (but does not actually) do what is against its own interest. Whether this works depends upon how credible the threat is. If the actor wanting change is stronger than the other, then the threat is more credible. But if the actor wanting change values its favored strategy too much, then threatening to change it will not be credible to the other actor. Even a weak actor may win over strong actor by behaving irrationally or pushing a situation out of control. For example, North Korea gains cooperation from the United States by threatening to attack South Korea. Also, if North Korea would collapse the chaos would threaten both South Korea and China. So North Korea wins by being weak.

In the third kind of linkage, mutual linkage, both actors want a different outcome than the current equilibrium. Each actor wants to maximize its interests, but realizes that doing so would provoke the other actor to behave in ways that produce a worse mutual outcome. As a result, each actor avoids its preferred strategy in order to gain an outcome that is still better than no

cooperation at all. The most famous version of mutual linkage is called “Prisoners’ Dilemma”, a strategic problem that is common in human behavior (Axelrod 1984). In Prisoners’ Dilemma, each actor wants to exploit the other (“defect”) while the other cooperates. But both actors know that if both defect, then the outcome is worse than if both had cooperated. Unlike coerced and threat-induced linkage, in this form of mutual linkage, each actor must give up its preferred strategy (defection) in order to gain the second-best benefits of cooperation. Otherwise, mutual defection produces worse results than cooperation or exploitation.

Mutual linkage describes many situations where one actor does not have superior power over another. Prisoners’ Dilemma can emerge in situations where there are more than two actors, and the benefits to cooperation are collective. According to Stein, “scholars have often noted that the basic problems of international economic order are those that result from a deficient equilibrium outcome in the prisoners’ dilemma game” (1980, p. 79). For example, each country wants to trade freely in other countries’ markets, while protecting its own. But free trade generally is preferable to protectionism generally.

The rational choice approach also shows what makes linkage policies effective. To pursue successful linkage policies, an actor seeking change must understand the context of linkage, and what each actor’s preferences are. The actor must be able to communicate its own preferences, and manipulate the preferences of other actors. The basic solution to prisoners’ dilemma situation is to create mutual understandings of linkages across time. Robert Axelrod calls this the “shadow of the future”. In prisoners’ dilemma, actors have an incentive to cooperate over the long term, but to defect if the interaction is brief. For example, the United States and China both gain from free trade over a long time. In the short run, however, free trade hurts companies in each country that lose markets.

Another way of gaining cooperation is to create mutual understandings of linkages across policy issues, or a “quid pro quo arrangement in which each player sacrifices on some issues in order to gain more on others” (McGinnis 1986, p. 142). The key to such linkage is that each actor concedes more on issues that it cares less about in order to gain more on issues that it considers of greater importance. The result may be patterns of cooperation that would not have existed had policy issues been treated separately. The theoretical and practical challenge is to recognize when attempts at issue linkage hurt cooperation rather than help it. For example, multilateral policies of free trade represent one of the most successful examples of linkage since World War II. The general benefits of global free trade have been achieved by countries balancing those general benefits against the particular harm free trade causes to certain domestic industries. Linkage politics within the broad issue of international trade have proven very successful (Davis 2004). Over time, tariff levels fell, and by 1995 the linkage politics of international trade resulted in the creation of the World Trade Organization (WTO). Yet since then further progress in trade negotiations have stalled. The attempt by the Doha Round of trade negotiations to link agricultural, services, and intellectual property issues failed to produce an agreement (Bergsten 2005). This happened partly because developing countries are stronger than they used to be and they resist rich countries’ priorities (Yoo 2009).

One of the most significant concepts developed by international relations scholars to explain cooperation is the idea of a “regime”. According to Stephen Krasner (1983), a regime consists of “implicit or explicit principles, norms, rules and decision-making procedures around which actors’ expectations converge in a given area of international relations”. The concept is useful in explaining linkage politics because it seems to account for patterns of cooperation that persist even when the original circumstances that gave rise to the cooperation are gone (Keohane



1984). For example, the policy of international free trade arose after World War II when the United States was by far the most powerful nation. Now that the United States is not so influential compared to other countries, free trade still exists. Scholars argue that a “regime” exists in international trade that supports free trade. Countries accept that free trade is a benefit, and are willing to negotiate for free trade using principles and norms like reciprocity and nondiscrimination. The WTO provides rules and procedures that states can use to prevent exploitation by other states. In particular, when a country becomes a member of the WTO it gains Most Favored Nation status with all the other members of the group.

Two features of the “regime” idea promote issue linkage. The first is that regimes bring different issues together so that states can make bargains with each other. For example, a country with low-cost labor like China can reach agreement with a country with high-cost labor like the United States to lower trade barriers if the trade regime also promotes negotiations over other economic topics like investment and intellectual property protection. The second feature of the regime idea is that it promotes certain ways of understanding issues. For example, when governments share understandings that free trade leads to better economies than trade protectionism, agreements to lower trade barriers become easier to make. The result is what Ernst B. Haas calls “cognitive convergence” (Haas 1980). Haas argues that shared understandings produce different kinds of linkage. “Tactical” linkage occurs when issues are brought together that have no coherence, and the linker simply seeks to gain leverage in one issue by bringing in another. American pressure on the British to withdraw from the Suez in 1956 was an example of tactical linkage. “Fragmented” linkage occurs when all actors bargaining agree on an outcome, but not necessarily how to get to it. Agreements that involve such linkage may use side-payments to gain cooperation. The third form of linkage is “substantive”, meaning

that actors share understandings about both outcomes and means. Here, linkage will “proceed on the basis of cognitive developments based on consensual knowledge linked to an agreed social goal” (Haas 1980, p. 372).

When a regime exists in an area of international cooperation, linkage will be less “tactical” and more “fragmented”. The strongest regime will show “substantive” linkage. For example, the regime governing nuclear non-proliferation is not so well established, since countries like India, Pakistan and North Korea violate the regime rules. To stop Iran from getting nuclear weapons, linkage is tactical. Economic sanctions and other pressure are placed on Iran. In the international trade regime, linkage is substantive because WTO members agree that free trade is good, and accept that the WTO provides for punishment if countries break free trade rules. “Cognitive convergence” means that countries share understandings of both proper ends and means to achieve free trade.

Regimes are important for shaping how nations define and pursue their interests. As Haas (1980, p. 397) states, “regimes are norms, procedures, and rules agreed to in order to regulate an issue-area. Norms tell us why states collaborate; rules tell what, substantively speaking, the collaboration is about; procedures answer the question of how the collaboration is to be carried out”. According to Robert Keohane (1984), regimes encourage linkages and side-payments within defined issue-areas. However, the emergence of regimes makes it more difficult to establish linkages between issues defined as governed by a regime with those issues outside the regime. Thus, “successful regimes organize issue-areas so that productive linkages (those that facilitate agreements consistent with the principles of the regime) are facilitated, while destructive linkages and bargains that are inconsistent with regime principles are discouraged” (92). Regimes promote more linkages, but narrower ones.

Scholars' work on linkage provides a framework for understanding how linkage politics between the United States and China has changed over the last three decades. Arthur Stein (1980) describes three kinds of linkage in terms of the power of the actors. Ernst Haas (1980) describes three kinds of linkage in terms of how much shared knowledge exists in an issue area. Combining the two sets of linkage makes a framework that is useful for understanding Sino-American relations:

**TABLE 1**  
**Types of Linkage**

		<b>Linkage Based on Degree of Shared Knowledge Among Actors (Haas 1980)</b>		
		Low ("tactical")	Medium ("fragmented")	High ("substantive")
<b>Linkage Based on Relative Power of the Actors (Stein 1980)</b>	Highly unequal ("coerced")	<b>X</b>		
	Somewhat unequal ("threat-induced")		<b>X</b>	
	Equal ("mutual")			<b>X</b>

This framework combines a realist focus on the power of actors with an interpretivist concern with how cognitive factors shape the possibilities of linkage. Boxes with "X" mark those combinations that are most congruent. For example, when power differences are great, linkages with low cognitive coherence (across unrelated issue areas) are likely. When relative power is not so unequal, linkages are more likely to involve compromises and side-payments. Finally, when relative power is equal, linkages are more likely to reflect "cognitive convergence" among actors.

Linkages outside of these boxes are possible, but logically unlikely. When shared

knowledge is high, coerced linkage is unnecessary. If, for example, a weak and a strong nation share understandings about an issue area (free trade), then linkage is governed by the rules of the regime which apply to both nations, and not by coercion. If nations of equal power practice “tactical” linkage (without cognitive coherence) across unrelated issues, then linkage becomes very difficult to sustain. “Mutual” linkage among equal powers creates prisoners’ dilemma problems that require “cognitive convergence” to solve.

Since re-establishing relations in the 1970s, linkage politics between the United States and China have evolved because of changes in the relative power of both countries (realist factors) and their understandings of issues (interpretivist factors). As China has become more powerful compared to the U.S., the U.S. cannot play the same linkage politics, especially about human rights. Linkage politics takes place within issue-areas, not across issue-areas. Also, as the Chinese economy becomes larger and more liberal, China accepts norms like free trade and intellectual property protection (Yee 2010). Globalization makes China a more responsible actor because it now has more to lose if globalization doesn’t work (Zhu 2006). For example, after the financial crisis of 2008 China spent almost \$600 billion, 15% of GDP, to stimulate the economy. This caused the Chinese economy to grow and helped the entire world economy (Cheok 2009). The U.S. and China had a shared understanding that fiscal stimulus would help the world economy and that free trade must continue.

Using this framework, the thesis now turns to look at Sino-American linkage politics in the areas of currency, trade, and investment.

#### **IV. The Sino-American Currency Issue**

China has held its currency fixed against the U.S. dollar for many years. From October 1997 to July 2005, the official exchange rate was 8.28 RMB to the dollar. The currency appreciated to 6.83 RMB to the dollar between the summer of 2005 and late 2008, an appreciation of roughly 20 percent. Since then, the RMB has held steady against the dollar (Levy 2010).

More countries complain about the value of the RMB as China has played a more important role in the global economy. There is more and more trade between China and other countries, and currency affects the price of Chinese products for the other countries. Since the undervaluation of the RMB makes Chinese products much cheaper, China is able to export more. To keep the value of the RMB from rising, the Chinese government accumulates excess currency in the form of foreign exchange reserves. China invests its reserves, mostly U.S. Dollars, in U.S. Treasury debt (Levy 2010).

In order to protect economic stability and investor confidence, China adopted its currency peg to the dollar, a policy that is practiced by a variety of other developing countries. Control over its currency value is an important element of China's economic strategy. As an "Asian Developmental State", China seeks to exploit both its vast supply of cheap labor and its large domestic market for economic development (Gilpin 2001). Dropping the current currency policy could stimulate an economic crisis in China and damage its export industries. It would also increase inequalities between the urban areas and rural areas, with social instability as a result. From China's perspective, undervaluation of the RMB is a good policy. The Chinese believe that a fixed exchange rate is better than a flexible exchange rate for China because an appreciation of RMB would damage Chinese exports and industries (Lairson and Skidmore 2003).

One major uncertainty in this policy debate is that there is no agreement on how to measure the over- or undervaluation of a currency. There are two basic ways to estimate the RMB's undervaluation. One is based on Fundamental Equilibrium Exchange Rates, and the other is based on Purchasing Power Parity (Morrison and Labonte 2011). The fundamental equilibrium exchange rate is based on the belief that current account balances at the present are temporarily out of line with their real value. Estimating what the fundamental current account balance should be, one can calculate how much the exchange rate must change in value in order to achieve the adjustment. Purchasing power parity is the idea that the same basket of products should have the same price in two different countries. If they did not, then arbitragers could buy it in the cheaper country and sell it in the expensive country until the price disparity disappeared. For example, many business men buy products from China and sell them in the U.S., profiting from the price disparities between the two countries. If purchasing power parity is used to estimate whether the RMB is undervalued, then one needs to look at whether the same products in the two countries have the same price, taking into account the different standards of living (Morrison and Labonte 2011).

When the RMB is undervalued, Chinese exports to the United States are cheaper than they would be if the currency were freely traded. An undervalued currency also attracts foreign companies' attention to China as a destination for foreign investment in export-oriented production facilities, some of which comes from U.S. firms. But the RMB's undervaluation can't be sustained indefinitely because it makes the economy much more dependent on fixed investment and net exports for economic growth. It also makes imports more expensive and hurts Chinese consumers and some Chinese firms that import products from American companies. (Morrison and Labonte 2011). If the RMB is stronger, Chinese consumers would benefit because

imported products will be cheaper for them.

The lower prices from the RMB's undervaluation improve the purchasing power of American consumers. The lower prices for U.S. firms of the imported inputs in their production also make such firms more competitive. On the other hand, lower priced goods from China may hurt U.S. industries that compete with those products from China, reducing the output of their production and affecting their employment. And the RMB's undervaluation makes U.S. exports to China more expensive, thus reducing U.S. exports to China and work opportunities for U.S. workers (Morrison and Labonte 2011).

Since 1988, the U.S. Congress has required the Treasury to report twice a year on countries that might "manipulate" their currencies to gain unfair trade advantages. Manipulation is not defined by Congress, so the Treasury has discretion in deciding what it means. The Articles of Agreement of the International Monetary Fund (IMF) recommend that member nations avoid manipulating their exchange rates, but the IMF cannot force nations not to do so. If the U.S. Treasury calls China a currency manipulator, it means that Congress might authorize trade sanctions against China. It is unclear whether the rules of the WTO recognize currency "manipulation" as something for which WTO provides a remedy. China intervenes not to make the RMB cheaper, but to keep it from rising in value more quickly than it might. China also argues that it intervenes not to make the RMB cheaper, but to assure economic stability in China. Some Western economists also argue that the American trade deficit would exist even if China allowed the RMB to become more expensive.

The U.S. has claimed in different international settings that China manipulates its currency, and that it should allow its currency to float freely in international markets. However, China argues that it must control its currency because it's important for the stability of the

Chinese market and trade. Whether or not the United States declares China is a currency manipulator, the U.S. demands that China stop its massive intervention. If China refuses, the United States threatens to impose a countervailing duty on Chinese exports. The U.S. Congress failed in 2010 to pass legislation requiring this punishment. The Treasury Department, and the Executive Branch, do not want to punish China. Instead, they want to negotiate bilaterally with China, or deal with the problem of currency values in a multilateral setting (Levy 2010).

International institutions are not an important source of linkage in Sino-America currency relations. Because the WTO does not recognize currency values as a trade factor, the United States can't use the WTO's Dispute Settlement Body to punish the Chinese for currency manipulation. WTO is not an important institution to adjust the currency conflict between U.S. and China. The IMF has great expertise and its Articles of Agreement assign it a role in engaging with member countries to follow its rules on currency issues. However, the IMF's power to compel action on the part of a member is generally limited to loan conditionality. The IMF would be the appropriate institution under which to establish new norms for international financial behavior, if agreement on those norms could be reached. Since the end of Bretton Woods, the role the IMF plays in currency relations has changed. There is no longer an international monetary regime that organizes international monetary relations. Attempts to influence currency values are undertaken instead by major countries cooperating in settings like the Group of Seven during the 1980s (Levy 2010). While the IMF does recognize that the Chinese government intervenes in exchange markets to limit the appreciation of the Chinese currency, that international institution provides the United States with no way to pressure China. If China benefitted from IMF loans, then this would offer a pressure point for the U.S. to exploit. However China has no need of such loans.



Globalization also shapes the Sino-American currency issue. As China opens itself to the global market, the RMB begins to play a role in global exchanges that the Chinese cannot control. As China integrates into the world economy, China must allow the RMB to trade freely, and must open its capital markets to investors. This will also reduce the conflict between internal trade and external trade, encourage consumption, stimulate domestic demand, and reduce inflation. If the RMB could be traded freely, it may become important as an international reserve currency. The U.S. Dollar is still the world's major reserve currency, but this could change as China's role in the world economy becomes more important. Because the United States gains many benefits from the Dollar's reserve status, it knows that pushing the Chinese to revalue the RMB might make it a more truly international currency, thus reducing the Dollar's role.

The currency issue in Sino-America relations directly affects the purchasing power for people in these two countries. A weak RMB increases Americans' ability to purchase imported Chinese goods and hurts China's ability to purchase products from the United States. A stronger RMB has the reverse effect. Employment is also linked with the currency in both U.S. and China. The value of the Chinese currency affects employment levels in both U.S. and China. When the RMB devalues, Chinese products will be cheaper and more Americans are willing to buy Chinese products, thus creating more jobs for Chinese people. When the RMB appreciates, Chinese products will be more expensive relative to American goods, encouraging American consumers to buy goods produced in their own country. This promotes employment in the American economy. But most of these American people who lost jobs are in the manufacturing sector, however, where the size of manufacturing employment is dependent on productivity growth, not imports from China, and there is a long-run trend that is moving U.S. production away from manufacturing and toward the service sector (Elwell 2004). U.S. employment in

manufacturing has fallen from 31.8% in 1960 to 22.4% in 1980, to 10.7% in 2005, to 10.5% in 2006 (Lazear, Baicker and Slaughter 2007). This trend is not solely related to the Chinese currency issue. Rather, it is caused by changing technology and comparative advantage.

Inflation and deflation also have a linkage with currency. The exchange rate could affect inflation in both U.S. and China, and inflation rates in turn could also affect the stability of currency. When the RMB appreciates, the price of Chinese goods will be more expensive in China, and American goods will be cheaper, thus reducing inflationary pressure in Chinese for American goods. But in the U.S., Chinese products will be more expensive, but they are still cheaper than American products, so it will also reduce consumer welfare because Chinese goods are more expensive than before but they are still cheaper than American goods, so American consumers will still choose to buy Chinese goods but they have to spend more to buy them.

The U.S. and China use bilateral diplomacy through the Economic and Security Dialogue to address the currency controversy. The U.S. has tried to persuade China to reform its currency policy through such negotiation and other high level talks. In recent years, the United States Secretary of the Treasury, Timothy Geithner, and the United States Secretary of Defense, Robert Gates came to China to talk about RMB appreciation, and the minister of China, Wen Jiabao, also went to U.S. to reach a consensus with U.S. on the RMB issue.

Americans point out that the RMB contributes to a big trade deficit for America. It's true that the level of the RMB contributes to the American trade deficit in the short- run. However, the trade deficit is related not so much to currency rates, but economic globalization. With globalization, the U.S. buys more and more products around the world. Yet many of the imported products from China are actually produced by American multinational companies in China, so American companies earn profits from these products. Half of China's exports come from

enterprises created by foreign direct investment (Cheok 2009). In addition, U.S. trade with China also benefits the American service sector, as and more and more American service companies (like UPS) benefit from access to the Chinese market.

Ultimately, the trade imbalance between U.S. and China is not solely dependent on the Chinese currency, but on features of America's economic structure such as its large financial deficits and low saving rate. Moreover, the U.S. not only has a trade imbalance with China, but also with many other countries in the world. With increasing American FDI in China, those investors have an interest in maintaining the RMB's undervaluation. When the RMB is undervalued, the American investors will spend less than they expected which reduces their costs and attracts more American investment in China. From the perspective of international trade, U.S. and China have different areas of comparative advantage. Only when China imports more American advanced products will the trade deficit and imbalance be reduced.

China has committed to making the currency more flexible in the near term and to eventually adopt a floating currency in the long run, but the reforms should be gradual in order to avoid disruptions to the economy. China also worries that if the RMB played a bigger role in global finance, then China might lose control over credit conditions and capital flows in and out of the country. Ultimately, China's currency policy serves as part of the country's economic development strategy. A low RMB subsidizes export industries at the expense of other sectors of the Chinese economy (Morrison and Labonte 2011).

Because there is no international currency regime that creates shared understandings of what proper currency values should be, Sino-American currency relations cannot be dealt with in a multilateral context. The Chinese do intervene to keep the RMB lower than it otherwise would be, but there is no way of agreeing on where it should be. Exchange rates impact trade and

investment relations, but the WTO provides no forum for dealing with currency values, and the U.S. actually benefits in the investment area. A cheap RMB makes American investment in China easier. China's foreign reserves are also invested in U.S. government debt, so the cheap RMB that creates trade surpluses also helps fund the fiscal practices of the U.S. government.

For these reasons it is difficult for the United States to practice linkage politics over currency values because the U.S. is vulnerable both in the short and the long term. In the short term the Americans need the Chinese to use their export earnings to purchase American debt. This allows the United States to finance its budget deficits. China owns about 25% of all American debt held outside of the United States. This gives China leverage. For example, in 2009 when Treasury Secretary Geithner suggested that China was a currency "manipulator", the Chinese retaliated by reducing their purchases of U.S. Government debt. In the long run, the United States needs China's support for the Dollar's status as an international reserve currency. However, a fall in the value of the Dollar hurts China's vast holdings of debt valued in Dollars. This encourages China to propose the expanded use of new forms of international money like the IMF's Special Drawing Rights (Zhiyue 2010). In the long run, if the U.S. Dollar loses its reserve status, America will be less able to borrow so much from the rest of the world.

## **V. The Sino-American Trade Issue**

U.S.-China trade has experienced dramatic growth since the reestablishment of diplomatic relations and the signing of a bilateral trade agreement which provided mutual Most-Favored-Nation (MFN) treatment. According to the statistics of the Chinese Customs, the value of Sino-US trade increased from US \$ 12.88 million in 1972 to US \$ 2.45 billion in 1979.

Between 1979, when the two countries established normal diplomatic relations, and 1989, China's imports from and exports to the US annually grew by 15 per cent and 22 per cent respectively (Raman 2001). Trade between the two economies has continued to increase at a great rate and the U.S. remains one of China's major export markets. Chinese exports to the U.S. rose from \$100 billion in 2000 to \$338 billion in 2008, while imports rose from \$16 billion to \$71 billion.

As living standards increase and a middle class emerges in China, economic growth has promoted the purchasing power of the Chinese people. China's growing economy, its large foreign exchange reserves, and its large population make it an enormous export and investment market for the United States. China needs export growth in order to maintain jobs for people and preserve social stability. As China continues to run current account surpluses by exporting to the U.S. and other advanced country markets, it has little alternative to buying U.S. treasuries with the reserves it accumulates while managing its exchange rate. If China does not buy treasuries from U.S., it will experience pressure from U.S. government. The U.S. needs willing buyers for the treasuries issued to finance its budget deficit, which has expanded greatly due to bailout and fiscal stimulus operations (Prasad 2009).

In recent years, China has been one of the fastest-growing U.S. export markets. U.S. exports to China have increased two to three times as fast as U.S. exports to other major U.S. export markets. China is an important market for a broad range of American products, from agriculture, to manufacturing, to services. U.S. exports to China include both raw materials and high-tech products. For example, China is the largest market for American soybeans, which results in great profits for American farmers. In the manufacturing sector, China also buys a lot of more technologically advanced products from the U.S. such as commercial aircraft and automobiles. It remains the American government's policy to seek more export opportunities in

the Chinese market (Geithner 2010).

Most products the U.S. imports from China are computers and parts, miscellaneous manufactured articles, communications equipment, apparel, and audio and video equipment. In recent years, U.S. also increased imports of more advanced technology products from China. But most of these products are the result of American multinational corporations in China or Sino-American joint ventures.

Trade with China benefits many American economic interests, such as consumers and those business interests engaged in import and export activities. However, some other U.S. groups, especially the domestic firms and workers that compete with low-cost imported Chinese products, experience losses, mainly because of cheaper Chinese products. This gives rise to trade conflicts between U.S. and China.

U.S.-China trade relations have become strained for reasons beyond the size of the trade deficit. The U.S. contends that China has not fully met its WTO commitments, and provides inadequate protection for intellectual property. The United States has brought trade dispute cases against China in the WTO to try to resolve disagreements that could not be dealt with through negotiations, and China has also brought cases against the United States. For example, in 2009, the United States filed a case against China's export restrictions on raw materials. The United States charged that Chinese policies are intended to lower prices for Chinese firms and help them obtain an unfair competitive advantage. In the same year, China brought a WTO case against the United States because of its imposed additional duties on Chinese tires. (Zhiyue 2010).

There has also been a chronic disagreement between the U.S. and China over the accuracy of each other's trade statistics. For example, according to Chinese Customs some years ago, the total value of bilateral trade was \$ 74.47 billion with a trade surplus of \$ 30 billion in

favor of China. But according to the U.S. State Department, the total value of the bilateral trade was \$ 109 billion, with U.S. imports from China amounting to \$ 94 billion and exports to China amounting to \$ 15 billion, thus leaving a Chinese trade surplus of \$79 billion. Chinese Customs figures reflect the value of only those goods exported from mainland China directly to the U.S., excluding those products sent to Hong Kong for re-export to the U.S, which are treated instead as exports to Hong Kong. The American figures, on the other hand, include the value of both mainland Chinese and Hong Kong goods. However, U.S. export figures include only goods directly sent to China and not those sent to Hong Kong (Raman 2001).

As noted in the previous section, many U.S. policymakers, labor organizations, and businesses charge that the Chinese government continues to manipulate its currency against the dollar in order to make Chinese products competitively cheaper. Because the WTO offers no forum for regulating currency values, WTO members like China and the United States cannot solve their disagreements this way. The exchange rate is only one factor affecting trade balances, and changes in it seldom have immediate effects. Even if China increased imports, US exports would not benefit immediately (Suominen 2010).

Disputes over intellectual property rights also impact U.S.-China trade relations. Many American business companies contend that weak intellectual property rights protection in China damages their interests, and the United States has pressed China to improve its intellectual property rights protection regime. China has agreed to bring its intellectual property rights laws into compliance with the WTO's Trade-Related Aspects of Intellectual Property Rights agreement, which commits members to protecting intellectual property. But the intellectual property rights problem still exists in the trade between U.S. and China. The protection of intellectual property rights was a difficult issue during the first trade negotiations in 1979, as the

Chinese negotiators were unfamiliar with the concept. Traditional communist attitudes towards intellectual work made it difficult for the Chinese to recognize its results as a form of property. Negotiations on the first Sino-American trade agreement stalled over the issue until China conceded some protection for patents and other intellectual properties. China began bringing its protections up to international standards by joining the Berne Convention and adopting the Uniform Commercial code in 1992. It also applied to join the Geneva Phonograms Convention (Tan 1990; Wang 1993).

Bilateral and multilateral contacts are important for Sino-America trade relations. For example, in order to enhance the economic relations between the two countries, U.S. and China engage in high-level talks through the Strategic and Economic Dialogue. This dialogue covers a range of economic and non-economic issues. The Strategic and Economic Dialogue is crucial to improve the economic relationship between U.S. and China. Maintaining high-level dialogues can help in building trust and a deeper awareness of how each side thinks. In particular, bilateral talks help each country understand the internal political dynamics of the other. (Prasad 2009).

In addition to currency relations, U.S.-China trade issues also have an effect on investment. Financial flows between the two economies have increased but also become more lopsided over time, with bilateral foreign direct investment flows from the U.S. to China declining from \$5.4 billion in 2002 to \$2.7 billion in 2007 (Prasad 2009). Growing trade promotes financial ties because when people in the two countries do business with each other, they need financing from banks.

The WTO is a crucial multilateral forum by which U.S. and China seek to manage their trade relations. From the perspective of linkage politics, the WTO is distinctive because it limits the ability of member nations to gain leverage on trade issues by linkage with non-trade issues,



and vice versa. An important point in Sino-American relations was reached in 1980, when the U.S. granted China Most Favored Nation (MFN) status. Because China is a nonmarket economy, this status had to be renewed every year by American administrations because of the Jackson-Vanik Amendment to the Trade Act of 1974. If Congress does not like renewal, it can pass legislation against it.

Before 2001, China was not a member of the WTO and dealt with U.S. trade relations bilaterally. Between 1980 and 2000, when the U.S. granted China permanent status, the U.S. often linked trade with China to other issues. In exchange for renewing each year its MFN status, China had to bargain over other issues like human rights, Tibet, Taiwan, and nuclear nonproliferation. Domestic politics in the United States shaped these linkages. Democrats wanted to protect American jobs and promote human rights. Republicans wanted to protect Taiwan. The Reagan, Bush, and Clinton administrations always supported MFN renewal, but Congress was the place where opponents of China sought to link MFN status to other issues. Each year China faced pressure to make concessions to the Americans. Chinese found this humiliating and said it interfered with their independence and internal affairs. Trade became linked with non-economic issues. For example, in 1987 the U.S. restricted high technology exports to China in order to stop it from selling Silkworm missiles to Iran. After Tiananmen Square, the U.S. imposed trade sanctions and opposed World Bank loans to China. China supported Operation Desert Storm in 1990 to help keep its MFN status. China also cooperated with the U.S. over Cambodia and North Korea. Each year until 1994, China faced opposition in Congress that linked trade to other policy disputes. In his campaign in 1992, President-elect Clinton claimed that Bush was too nice to China. However, as trade with China became more important for the U.S., American business began to lobby for MFN status. After 1994 the Clinton

Administration did not emphasize human rights linkage. Instead, Clinton argued that free trade with China would encourage democratic reforms within China. Still, disputes over Taiwan in the late 1990s continued to link trade with foreign policy in U.S.-China relations (Cohen 2010).

When China joined the WTO in 2001, U.S.-China trade relations changed. Because of the rules of the WTO, the United States could no longer link trade with China to other issues that were not related to trade. As Robert Keohane wrote about regimes, they encourage some linkages related to the regime but discourage linkages that aren't related. To join the WTO, China had to make many economic reforms. It had to lower trade barriers. China made concessions to the United States to gain approval of its WTO membership. But once China became a WTO member, trade disagreements are handled by the WTO dispute resolution process (Grimmett 2010). The core ideas of the free trade regime are reciprocity and nondiscrimination. For example, China must treat all WTO members the same. Also, China cannot treat foreign companies differently than domestic companies. Under the trade regime that the WTO promotes, disputes are handled in a multilateral setting. This means that bilateral issue linkages that the U.S. Congress promoted in the 1990s are not possible anymore. Also, China's membership in the WTO has increased its economic power. Trade and investment expanded greatly. Until the 1990s, China valued access to the U.S. market more than the U.S. valued access to the Chinese market. During the Clinton era this changed, so American thinking changed. The United States values access to China's market too much to sacrifice it. Also, Chinese investment of its trade surplus in U.S. government debt gives the United States another reason to support free trade.

The WTO does not cover all trade issues. For example, agriculture is excluded. So are services. Intellectual property protections are not strong. The Doha round of trade negotiations sought to include these issues under the WTO. Still, when the U.S. and China have trade

disagreements, they must work through the WTO. One effect of the WTO as a trade forum is that it shifts trade dispute resolution away from bargaining, where linkage strategies might be useful, and towards litigation according to WTO procedures. In 2007, the United States filed three cases in the WTO against China. The first case concerned export subsidies (USTR 2007). The U.S. contended that China was violating the Subsidies Agreement and National Treatment Principles by providing various tax rebates to Chinese firms. The second case involved intellectual property protection. The U.S. argued that China's threshold for establishing trademark counterfeiting and copyright piracy was too high. The U.S. also argued that Chinese law lacked procedures and penalties. In a third case, the U.S. argued that China restricted film imports and limited foreign companies from distributing films and DVDs. The U.S. also complained that Chinese distributed simply copied the films of produced by American companies like Disney (Malawer 2007).

As the U.S. sees it, China has not fully met its obligations as a member of the WTO. The USTR's ninth annual China WTO compliance report to Congress identified several problem areas. According to the report, China provided inadequate intellectual property protection. It pursued industrial policies and national standards that unfairly favored Chinese firms, and placed restrictions on trading and distribution by foreign companies. Finally, China's trade laws and regulations were characterized by a general lack of transparency. (USTR 2010). For example, in March 2006 the USTR filed a WTO complaint against China for its use of discriminatory regulations on imported auto parts, stating that the purpose of these rules was to discourage the use of imported parts and to encourage foreign production to relocate to China. In February 2008, a WTO panel ruled that China's discriminatory tariff policy violates WTO rules on national treatment (Morrison 2011).

The WTO has helped both U.S. and China solve many problems and conflicts in their

mutual trade relations. Within the WTO framework, U.S. and China have lowered trade barriers between the two countries. When China entered the WTO in 2001, China allowed the United States to treat it as a non-market economy for 12 years for U.S. safeguards. This has enabled the United States to impose restrictions on Chinese products in order to protect American domestic producers. For example, in April 2009 the United States International Trade Commission contended that tire imports from China hurt U.S. domestic producers. It recommended additional tariffs on Chinese tire imports and increased adjustment assistance to those producers and workers affected (Morrison 2011). The United Steelworkers argued that the tires from China had hurt the tire producers in the United States and contributed to the loss of tire-related jobs. In September 2009, President Obama announced that he would impose additional tariffs on certain Chinese tires for three years and these levels on tariffs were less than the USITC's recommendations (Morrison 2011).

In Sino-America trade relations, there will always be some obstacles, but both countries have compelling reasons for continuing the relationship. There are some ways that both the U.S. and China can improve trade relations. In the past, the U.S. typically used unilateral sanctions to deal with trade conflicts with China, which placed stress upon the relations between the two countries. Both U.S. and China have used the WTO to deal with the conflict in trade, which reduces the likelihood of broken relations. China is more likely to respect a ruling from a multilateral institution than to bow to bilateral pressure from the U.S. For its part, the U.S. can rely upon the multilateral pressure via the WTO to encourage China to open its markets further, since other WTO members have a stake in ensuring China's compliance with its WTO commitments.

## **VI. The Sino-American Investment Issue**

Since establishing normal diplomatic relationships in 1979, U.S.-China investment ties have become a significant part of their economic relationship. In 1980, just after U.S. and China established diplomatic relations, U.S. began its investment in China. Due to their lack of knowledge and experience, U.S. companies invested only tentatively at first. After 1990, as China pursued more investment friendly policies, more and more American enterprises entered the Chinese market and the American investment in China increased nearly 22 percent each year in the last decade of the 20<sup>th</sup> century. After China joined the WTO, foreign direct investment (FDI) inflows rose steadily each year (Davies 2010). By 2000, more than 300 enterprises that belonged to the Fortune Global 500 were invested in China. After 2005, the rate of American investment in China decreased, but American enterprises did not want to lose the Chinese market as more and more European companies came to China. American firms have adjusted their strategy to compete with other countries to maintain market share in China.

China's investment in U.S. experienced three steps. The first step was to sell products made in China to the U.S. directly. The second step was to be listed on the American stock market to collect capital. The third step was direct investment in U.S. Some Chinese companies built factories or set up joint ventures with some other American companies. While there are many Chinese products sold in the U.S., few Chinese companies produce directly there. As a result, Chinese brands are not well known.

China doesn't have any globally recognized brands and most Chinese companies just produce low-price products for the world. Chinese companies do not compete directly, and on the basis of quality, with the big foreign enterprises. Nonetheless, due to the vast buildup of China's foreign exchange balances, and international pressure to change its currency policies,

investing outside, especially in U.S. and buying some American companies is the best way for Chinese companies to succeed and achieve their aims.

There are two kinds of investment from China to the U.S. The first is direct investment, when private Chinese companies invest in small U.S. companies. The second investment is from Chinese government or State-Owned Enterprises (SOEs) to invest in or buy American companies (Owyang and Leong 2009).

Chinese companies with low brand profiles invest in American companies to promote their brand recognition and establish a presence in the global market. In recent years, Chinese enterprises have entered the U.S. market faster and faster. As Chinese companies seek to expand and diversify investment in the U.S., the barriers from U.S. government to Chinese investment have become an issue in the bilateral relationship. One successful example of Chinese investment in the U.S. is the consumer products company Haier. The Chinese home appliance producer Haier Group built a factory in South Carolina in 1999 and entered into the US market (Tan 2010). Then, Haier established the Haier Holding Company, Haier Real Estate Ltd., Haier America Trading Company based in New York, as well as design, research and development centers elsewhere. Nearly all its employees are Americans. Another example of Chinese investment is from a mid-sized Chinese solar panel manufacturing company, DaSol Solar, which opened a small office in Washington, D.C., to look for business opportunities in the United States.

In addition to private companies, Chinese SOEs want to invest in the U.S., and the Chinese government continues to adopt economic policies that encourage Chinese investment abroad. Most Chinese investment in the U.S. is from SOEs, while the government itself engages in portfolio investment. To balance the trade surplus with the U.S., Chinese government has to

buy the debt from American government. If China always holds its dollar reserves and does not use them, any fall in the value of the dollar will inflict losses on China's dollar holdings. Outward investment is a way to avoid these foreign exchange losses. Another reason why the Chinese government encourages outflows of money from China is to reduce pressure on the RMB and minimize inflation in China. Chinese SOEs encounter difficulties in pursuing foreign investments because the American government or some merchants will be anxious that their technology would be stolen by Chinese companies and Chinese investment will limit American autonomy, injure domestic industry, or even harm national security. So the American government often restricts these Chinese SOEs. For example, the state-owned China National Offshore Oil Corporation (CNOOC) attempted to buy American oil company Unocal Corporation in 2005, but failed due to opposition from the American Congress, which doubted the motives of the Chinese company and argued that it did not represent a free-market transaction.

Likewise, in 2007, Haier wanted to buy Maytag but failed because of American government opposition. Huawei is another case. Huawei tried to cooperate with the U.S. firm Bain Capital Partners to buy 3Com Corp, an American company that makes systems to protect against computer hackers. But U.S. refused Huawei's investment because of the company's alleged ties with the Chinese military (Davies 2010). There are also some cases of Chinese companies successfully acquiring American companies, like Lenovo. In 2005, Lenovo acquired the personal computer division of IBM with the consent of the American government. IBM is famous in the world, so the purchase helped Lenovo to enter the international market.

WTO promotes investment between U.S. and China. Before China joined the WTO, there were many restrictions and problems in the U.S.-China relations, such as intellectual property

protection. Since China joined the World Trade Organization in December 2001, China has worked hard to strengthen its Intellectual Property Rights (IPR) regime, including the revision of major laws on patents, copyrights and trademarks in line with the requirements of the Trade-Related Aspects of Intellectual Property Rights agreements of the WTO. WTO helps China to increase the share of the service sector, especially the financial industry. After joining the WTO, China has allowed foreign banks expand their investments and operations, including foreign currency services (Davies 2010). American banks, long limited to doing business in local currency with foreign companies, were allowed to conduct business in the local currency with Chinese enterprises beginning in December 2003. They gained access to RMB business with local individuals in December 2006 (Cohen 2010).

U.S. foreign investment into China is only a small part of U.S. foreign investment worldwide. Before the 1990s, China did not permit foreign mergers and acquisitions, but after China joined the WTO, the U.S. increased its investment in China very quickly. American investment has been welcomed by the Chinese government because it brings new products and technologies. American companies will continue to invest in China to gain broader access to the Chinese consumer, and these American companies try to match China's needs and goals. For example, some years ago, China did not have a large market for nutrition products, so Amway came into China and expanded the market. When Amway just came to China, their way of selling met opposition from Chinese government. But after some negotiation, Amway agreed to support some Chinese initiatives like the 2008 Olympics, which helped Amway to open the Chinese door and built their large market in China. In addition, Amway tries to align its business culture with the Chinese market, with the aim of making the mainland its top market (Einhorn 2010). Another example is investments by American cosmetic companies. Maybelline built its



factory and made products in China to lower its expenses and increase profit. Johnson & Johnson is another example. Johnson & Johnson acquired Beijing Dabao Cosmetics Co Ltd in 2008, giving Johnson & Johnson access to the broader market in China (Davies 2010). Some American delivery service companies have also come to China, like UPS. UPS has built its office in many cities in China, so it has a large business in China. Because of China's large labor supply, more favorable tax policies, and the potential market, American companies pay more and more attention to the Chinese market.

However, many American do not trust the willingness of the Chinese government to fully implement its WTO commitments. As they see it, the corruption and local protectionism are still prevalent in China, and gaining the cooperation of local officials and government is a continuing problem (Morrison 2011). For example, the American investment firm, Goldman Sachs acquired Henan Luohe Shuanghui Industry successfully in 2007, but then failed to acquire Huiyuan Drink Industry because of interference from the Chinese government. At the same time, when some Chinese companies want to do business in U.S. directly, they will also encounter interference from the U.S. government. But over time, the government of the two countries will get together to reduce these obstacles for mutual benefit.

Most investment is governed by bilateral agreements and treaties rather than multilateral agreements. China has pursued an active investment diplomacy since the last two decades of the 20<sup>th</sup> century, having signed 127 Bilateral Investment Treaties (BITs) by 2010 and 112 double taxation agreements by 2009 (UNCTAD). The U.S. and China are attempting to negotiate a BIT to improve the investment climate and create more benefit for both countries. China seeks new investment outlets for its trade surpluses. For its part, the U.S. seeks ways of opening the big Chinese market of 1.3 billion consumers (Snarr 2010). A Sino-American agreement would

address investment protection, increase transparency, reinforce predictability in bilateral investment, and address concerns over potential investment barriers.

U.S-China investment also impacts national security policy. National security is paramount for a country, and countries use national security as a reason for refusing investments from other countries. The failed attempt by CNOOC to purchase Unocal has already been noted. The Chinese enterprise Huawei Technologies Co. wanted to invest in the United States and purchased the American company 3Leaf, but the U.S. used a security review to refuse Chinese investment because they thought there might be some connection between Huawei and Chinese military (Davies 2010). China has realized the linkage of national security these years and also began to play this card with the U.S. in some fields of investment, like the internet. In 2010, Google suspended its investment in China for some time because of its opposition to Chinese censorship policies.

Investment between U.S. and China always links to the market. The Chinese company Haier invested successfully in U.S., and the most important reason for its success is that Haier does much work on American market and it knows what kind of products have a large market and more consumers. Also, many American enterprises operate successfully in the Chinese market. General Motors (GM) is one example of this. GM knows that there is a big market for cars, so they invested in China and cooperated with some Chinese companies to build cars especially for the Chinese market. They not only opened the Chinese market but also made their brand widely recognized in China. Wal-Mart is another good case. Wal-Mart knows that China has a large population, and everyone needs to go to the supermarkets for shopping. So they invested and opened many shops in China, and in a short time, they built a big market and enlarged their business in China. Compared with some other supermarkets, Wal-Mart has a

bigger market and larger scale of consumers because it has many stores in different provinces in China. Moreover, Wal-Mart also has made e-commerce investments in China, like its investment in 360 buy.com and Yihaodian (Wee 2011).

Sino-America investment is closely related to the labor market. When a country invests in another country, it will create many jobs for the local people. For example, when the Chinese enterprise Haier invested in South Carolina, most of its employees came from the local community. Similarly, when American enterprises invest in China, they will also create a lot of jobs and bring more opportunities for the local people. Chinese cheap labor is a factor that attracts American companies to invest in China. From a relatively small number of manufacturing affiliates in 1989, the U.S. multinational presence in China has grown to become a broader business community that now includes financial services and, more recently, industries that use high-skilled and high-wage workers (Burke 2000).

Investment also influences the two nations' broader development policies. Each government will pursue policies that promote economic development, and some policies will affect investment a lot, like currency and tax policies. For example, if China keeps its currency low, it will reduce the cost of investment for foreign companies and attract more American investment to China, but this will increase the costs of Chinese investments in the U.S., and more Chinese investors will think about whether it's worthwhile investing in the U.S. So currency policies link with investment policies. Foreign tax policy is also crucial for investment. If the two countries reduce their taxes for foreign products, investment will be easier, and more companies will be willing to invest in both countries. After China's open policy, the Chinese government reduced taxes for foreign investors, and this policy attracted many American companies and some other companies to invest in China. In the delta area in China, most foreign investors even

do not need to pay tax in some fields. The U.S. government has also relaxed its taxes on some Chinese companies, helping to reduce the costs of their investment. As a result, more and more Chinese companies invest in U.S. in recent years.

Protectionism is another linkage in Sino-American trade. When China wants to buy some products from U.S. or sell some product to U.S., they often encounter the problem of protectionism. Also, when some American companies come to China, some Chinese people think they will bring a lot of competition to Chinese companies and gain too much from China, and some critics think they may also destroy some Chinese industries. For example, when some American food companies come to China, they take over many Chinese companies. Many Chinese people support protectionist policies for the same reason that Americans do.

Investment flows between U.S. and China could strengthen many companies in both countries in globalization. When American companies invest in China, it means that they are not only gaining access to the Chinese market but also able to make their products much more cheaply and help them to sell more in many other countries. But if they did not invest in China, their products will not be cheap enough for the customers in other countries to buy. When Chinese companies invest in the U.S., it also means that these companies come into global market and this will help them to strengthen their brands and to be more active in globalization. Chinese investments in the US are not always profitable. The Sovereign Wealth Fund lost over 50% of its \$8 billion dollar investment in less than a year in the finance groups, Blackstone Group and Morgan Stanley (Petras 2011).

## **VII. Non-Economic Issues in the Sino-American Relationship**

In U.S.-China relations, the greatest challenge is the issue of Taiwan. Taiwan is the only issue over which disagreement or misunderstanding might lead to an outright military confrontation between the United States and China (Anderson 1999). Thus, how China and the U.S. manage the issue of Taiwan has become central to the bilateral relations.

After establishing the formal China-U.S. diplomatic relations in 1979, the U.S. has basically acted within the framework of the principles of the three China-U.S. joint communiqués. In these documents, the U.S. acknowledged that there was only one China, and that Taiwan belonged to it. At the same time, the U.S. affirmed its commitment to a peaceful resolution of the Taiwan question, and to continued military support for Taiwan. In effect, the U.S. has deliberately assumed an ambiguous position in order to postpone any coercive resolution of the dispute.

Relations between Taiwan and China are very complex, and have an obvious impact on the U.S.-China connection. The United States seeks to balance its obligations to the security of Taiwan under the Taiwan Relations Act with its commitments to China under the three communiqués. The U.S. wants to minimize Taiwan as a point of friction with China. However, the U.S. remains committed to a security relationship with Taiwan, which includes increased sales of arms despite objections from China. These arms sales are also likely to continue to include potential components of any eventual missile defense system (Anderson 1999).

China's goal regarding Taiwan is reunification, while America's goal is to promote democracy abroad, so it makes uncertainty for both U.S and China on how to solve the Taiwan issue. This is perceived in China as directly threatening to the Chinese regime (Anderson 1999). As the Sino-American relationship becomes more important for the U.S., its old commitment to

Taiwan appears increasingly as an obstacle. China will more clearly express its will with respect to this question and pressure the American side to adhere to its previous agreements and give assurances that the U.S. will not allow an independence movement in Taiwan to damage U.S.-China interests. Because U.S. needs the help and support of China in UN in some international issues, like North Korea and Iran, the U.S. is sensitive to Chinese concerns.

In order to get economic and trade compromises from China and keep good relations with China, U.S. is willing to make some adjustment on arms sales to Taiwan. The U.S. needs the support from China in many important international organizations and meetings, like WTO and Nuclear Safety Summit. For example, the White House announced that it would not sell F-16s to Taiwan so as to make sure that China would participate in the Nuclear Safety Summit in April, 2010, and support American government.

To get the support from U.S. on Taiwan issue, China also compromises on some other important issues with America, like human rights, currency, trade and nuclear proliferation. For example, in May, 2008, Chinese representatives agreed to increase market access, open financial sector to American investment, promote energy security, and strengthen the rule of law to America (Cohen 2010). All of these actions by China were contingent upon support from America on its Taiwan policy.

Although official military-to-military relations between the United States and China did not begin until 1980, security cooperation between the United States and China started in 1971, with intelligence-sharing about Soviet military capabilities. Since then, the relationship has developed unevenly, with each side finding shifting rationales for cooperation. In 2001, the American Defense Department reassessed its military relations with China, which led to a decline in contacts. But the completion of the policy review and the holding of Defense

Consultative Talks in December 2002 has enabled these contacts to (Pollpeter 2004). Both the U.S. and China now recognize that the overcoming obstacles to better military relations require addressing not just specific problems, but the more general place of China in a global security context. Above all, the possibility of armed conflict between the United States and China forces both countries to cultivate a military relationship that will at least reduce misunderstandings. (Pollpeter 2004; Campbell and Weitz 2006).

The Joint Statement published during Chinese President Hu Jintao's January 2011 visit to the United States affirmed that "a healthy, stable, and reliable military-to-military relationship is an essential part of President Obama's and President Hu's shared vision for a positive, cooperative, and comprehensive U.S.-China relationship." Moreover, both sides agreed on "the need for enhanced and substantive dialogue and communication at all levels: to reduce misunderstanding, misperception, and miscalculation; to foster greater understanding and expand mutual interest; and to promote the healthy, stable, and reliable development of the military-to-military relationship" (Glaser 2011).

Security tensions have at times also affected trade relations between the two countries. When China has military cooperation or arms sales with other countries, it will attract U.S. attention. Chinese arms sales to Middle East countries, like the sales of anti-ship Silkworm missiles to Iran, and the missile and nuclear technology to Pakistan ran counter to American interests in the Middle East in the last two decades of the 20<sup>th</sup> century, so the U.S. announced restrictions on high technology exports to China. But China wanted American technology, like the satellites produced by the Hughes Electronics Corporation, so China had to reduce its arms sales to the Middle East in order to buy high technology from America. For its part, when the U.S. engages in military maneuvers with other countries, it can offend Chinese sensibilities, and

thus affect trade relations with China. For example, the U.S. cooperated with Japan and South Korea to practice military exercises in 2010, which angered the Chinese. So the Chinese government bought more weapons from France instead of the U.S. (Cohen 2010).

But on the other side, the U.S. needs help from China to deal with a variety of international problems. China has cooperated with UN efforts to bring peace to Cambodia and has demonstrated increased willingness to share information about what was going on in North Korea. When Iraq invaded Kuwait in 1990, China supported U.S. efforts to mobilize an international coalition to counter the invasion. The U.S. government wanted the UN to impose sanctions on Iraq, requiring the support of the permanent members of the Security Council of the United Nations. The Chinese voted in favor of economic and political sanctions against Iraq. The Chinese could have easily obstructed America's response to the crisis in the Persian Gulf. China agreed to vote for UN sanctions including the use of force in exchange for the Chinese foreign minister being invited to the White House to meet with President Bush. Bush also obtained Qian's agreement to high-level discussion in Beijing on issue of human rights, trade, and the proliferation of weapons of mass destruction (Cohen 2010).

Some nongovernmental organizations in the United States, such as Human Rights Watch, document China's human rights abuses. American official and private business interests have long argued that involvement in international trade leads over the long run to political liberalization in China. In this way, the U.S. has thought to deflect criticism of China's human rights record. While China may lack safeguards now, over time American economic interests would promote democracy in China and improve the human rights situation (Cohen 2010).

Human rights, specifically the rights of workers, and the currency policies are not unrelated. The labor force in China has no rights to organize independent labor unions, and



workers have no way to bargain with employers, which keeps Chinese wages low. In America, labor costs occupy nearly 50 percent in the total cost of production, but in China, the same figure is only 8 percent. Cheap labor reduces the cost of Chinese products and this contributes to the trade deficit between U.S. and China. The RMB's low level also gives Chinese exporters advantages in their business with the U.S., but Chinese workers have not shared in the benefits. In response to a surge in labor disputes and unrest, in 2010 the Chinese government approved substantial wage raises in many enterprises and cities. Some Chinese labor experts and official sources have expressed support for higher wages, a greater advocacy role for China's official union, the All China Federation of Trade Unions, and the process of collective bargaining (Pu 2010).

## **VIII. Conclusion**

Across the three policy areas of currency, trade, and investment, the question of the RMB's valuation is the key dispute that links the three areas together. Trade and investment are linked with each other. Investment could promote both import and export because it provides more products and job opportunities for trade, and trade also improves the opportunities and environment for investment. Foreign direct investment from U.S. to China increases imports from America and exports from China.

Currency plays a key role in trade as well. A low exchange rate makes products cheaper and increases exports. When the RMB is undervalued, it makes Chinese products cheaper to Americans and increases exports for China, but decreases the exports from America. So currency is crucial in Sino-American trade, and American government tries to put pressure on China in

both bilateral and multilateral settings to change its currency policies.

Currency links with investment in Sino-American relations. A depreciation of the RMB reduces the cost of Chinese labor, so it increases labor demand and employment, and attracts more investment from American enterprises. An appreciation the RMB could decrease the cost for Chinese investors who invest in America and encourage more Chinese investors to invest in U.S., but it increases the cost for American investors in China.

China has accumulated vast amounts of dollars, thanks to its economic development strategy that engages with the global market, but uses the Chinese state to tip these terms of engagement in China's favor. In the thirty years since Sino-American relations have become normalized, two things have happened. First, China's economic growth has made it more able to resist American pressures, since the United States values the economic relationship as much as the Chinese do. Second, China has become a responsible member of the international community. It is represented on the U.N. Security Council. It is a member of the WTO since 2001, unlike Russia. Over time, China has been successful in gaining membership in international institutions, even if there is dispute over how well China plays by the rules of those institutions.

At the basis of the Sino-American relationship is mutual interest. After the Cold War, both U.S. and China began negotiating in hopes of a rapprochement. For China, a closer relationship with the U.S. provided China with a good counterbalance to the Soviets. The United States also wanted to increase its alignments against the Soviet Union. The rapprochement was symbolized by the historic visit of Nixon to China (Porter 2011).

At first, the economic balance between the two countries was uneven. During 1980s to 1990s, the United States pursued linkage policies with China that sought to change China's

behavior. The United States targeted China's human rights practices, its arms sales, and its policy towards Taiwan. The United States used economic leverage to pressure the Chinese. In particular, Sino-American relations were disrupted by the Tian'anmen event in 1989. The U.S. expressed its condemnation of human rights practices in China and suspended high-level official exchanges, and stopped weapons exports to China. The US also imposed a lot of economic sanctions to China.

As China established the Special Economic Zones (SEZs) to attract more foreign capital, its economy grew rapidly. The economic balance shifted more towards China. Nowadays, U.S. is still the world's largest economy in the world, but China is growing even more quickly. As U.S. sees, China has used its growing economic to gain advantage in a number of areas, and China has also used its economic leverage to build partnerships with a number of advanced economies for its own success (Prasad 2011). In 2001, China became a member of WTO and agreed to open its markets to foreigners and attracted more investors. The U.S. and China also work on regional issues, like North Korea issue and proliferation of nuclear weapons. The U.S.-China Strategic and Economic Dialogue is another form to promote the bilateral relations on economic and some other issues.

Linkage means to establish a relationship making progress in one area dependent on, or affecting progress in another area between the two countries. In the course of Sino-American relations over thirty years, the nature of linkage has changed. During the period between 1980 and 2000, the U.S. often used economic linkage to achieve non-economic policy goals because China was weak and had to adapt its policies to American preferences. But in the 21th century, this linkage is decreasingly effective. China is stronger and plays an important role in the international stage, and U.S. also needs the help and cooperation with China.

The United States promoted China's membership in the WTO as a way of making China a responsible member of the international community. American policy rests on the idea, since 1994, that as China integrates into the world economy it will become more democratic so that human rights pressure will not be necessary. Now that China is a member of the WTO, linkage between trade issues and other issues becomes more difficult for the United States to practice. The multilateral nature of the international trade regime insulates China from policy leverage. If the U.S. disagrees with China's economic policies, it must complain through the WTO. But the WTO is limited because currency disputes and investment disputes cannot be solved through the WTO. Unlike international trade, there is no international regime that regulates currency and investment disputes (Spero and Hart 2010).

The Sino-American relationship has become more evenly balanced, but their dependencies are deeper and more mutual than ever before. China needs the American market. The United States needs to export to China. China has huge supplies of U.S. dollars as a result of its export-driven growth. China has no choice but to invest its dollars in U.S. government debt. Thus China finances the American budget deficits, and has a stake in the fiscal stability of the United States. China cannot threaten to sell its portfolio of U.S. government debt without hurting itself.

Adapting the earlier Stein-Haas linkage framework, the following table describes the evolution of Sino-American policy linkages over time:

## **TABLE 2**

## Sino-American Currency, Trade, and Investments Linkages, 1980-2010

		<b>Linkage Based on Degree of Shared Knowledge Among Actors (Haas 1980)</b>		
		Low ("tactical")	Medium ("fragmented")	High ("substantive")
<b>Linkage Based on Relative Power of the Actors (Stein 1980)</b>	Highly unequal ("coerced")			
	Somewhat unequal ("threat-induced")	<b>Taiwan</b> (pre 1979) <b>Human rights</b> (pre 1994) <b>Trade</b> (pre 1994)	<b>Taiwan</b> (post 1979) <b>Human rights</b> (post 9/11) <b>Investment</b> (pre 2001) <b>Trade</b> (post 1994)	
	Equal ("mutual")		<b>Investment</b> (post 2001) <b>Currency*</b> ("managed float" post 2005)	<b>Trade</b> (post 2001)

\*Prior to 2005, the RMB/Dollar rate was pegged. Prior to 1994, the RMB was inconvertible.

This table summarizes the evolution of linkage politics within the areas of trade, currency, and investment, with some reference to non-economic issues. Over time, as China has become more powerful and its position in global governance more secure, linkage politics, above all in the trade issue, have evolved to China's advantage. The leverage that the United States can exercise over China has declined as the scope for linkage has narrowed.

While the U.S. and China will be both cooperators and competitors in the future, the influence of linkage upon China will decrease because China has joined most international organizations, like the WTO and G20, and now plays a more important role in the world than before. But linkage will still exist in Sino-American relations and will continue to affect the mutual policies in bilateral relations.

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