

STRATEGIC FORECAST: US/CHINA RELATIONS



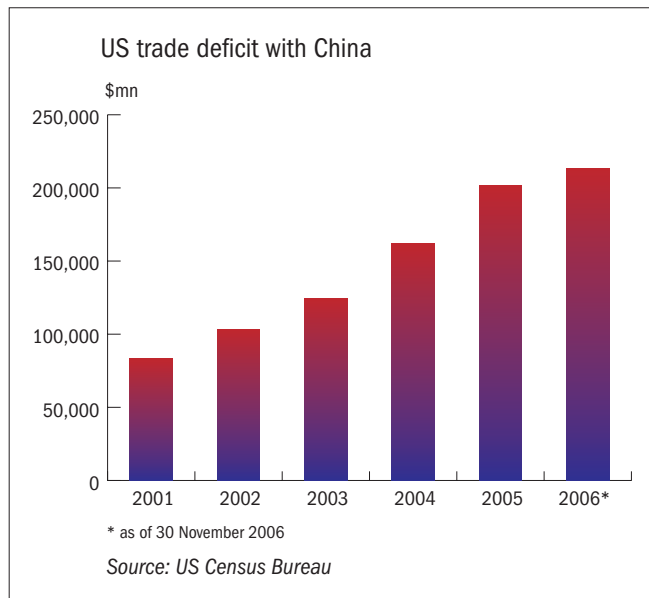
US-CHINA TRADE: FRICTIONS LOOM

Sijin Cheng and Jason Kindopp

Frictions in US-China economic ties could surge under the new Democratic-led US Congress, exacerbated by Beijing's likely resistance to foreign pressure in a period of domestic political sensitivities. Arguing that the current trade relationship rewards China's unfair trade practices, the Democratic majority will likely seek greater oversight on a full range of trade and investment issues, from the operation of the Committee for Foreign Investment in the United States (CFIUS), which reviews foreign direct investment, to the creation of a new Congressional Trade Office. Most directly threatening to China would be the passage of a bill that imposes countervailing duties (CVD) on countries that have "misaligned currencies," something that could apply to China. As congressional frustration with Beijing and the Bush administration builds, tensions could peak around the next round of US-China Strategic Economic Dialogue (SED) in May, especially if China chooses to retaliate by further restricting foreign investment.

The new Democratic leadership in Congress is likely to tap into brewing protectionist sentiments and wield its authority to confront the administration over economic disputes.

Sustained economic growth notwithstanding, the US public is increasingly skeptical of the rewards of free trade. Wages have stagnated even as corporate profitability has risen. As a key beneficiary of free trade, bolstered by a tightly managed exchange rate regime and an economic policy designed to promote exports, China bears the brunt of anti-globalization sentiments that have found new patrons in Congress. Moreover, as China's military



power has grown apace with expanding coffers and industrial prowess, the prospect of China's being able to use its economic gains to fund a potential security challenge to the US further complicates economic relations.

In this shifting congressional climate, the primary risk for US-China economic relations would be a bill that levies CVD or other punitive measures on non-market economies such as China, especially for manipulating the exchange rate. Support could quickly coalesce around a more robust version of a bill first introduced in March 2006 by Senators Charles Grassley

TOP RISKS

- ▼ **Avian Flu**
Virus returns to Europe
- ▼ **Iraq**
Troop surge needs time government does not have
- ↔ **Russia**
Gazprom and Rosneft to gain offshore control
- ▼ **Terrorism**
Algerian terror group's evolution heightens regional risk

HOT SPOTS

- ▲ **Korean Peninsula**
Six-party talks gain new lease on life
- ▼ **Middle East**
Little expected from Saudi-Iranian efforts in Lebanon

GLOBAL ISSUES

- ▲ **Climate Change**
State of the Union continues Bush administration policy shift
- ↔ **Energy**
SPR fill will provide support for oil demand

KEY:

- ▲ Positive Development
- ▼ Negative Development
- ↔ Neutral Development

and Max Baucus, the latter now the chairman of the Senate Finance Committee. The Grassley-Baucus bill proposed to change the US Treasury's mandate from naming "currency manipulators" to identifying "fundamentally misaligned currencies," and to create a comprehensive monitoring system for international trade and foreign exchange practices. The change significantly lowers the bar for labeling and punishing countries for their exchange rate regime, since Treasury would no longer need to demonstrate intent. Rather, it could simply determine that a country's existing exchange rate has departed from the rate that would be consistent with "fundamental macroeconomic conditions based on a generally accepted economic rationale." Senators Lindsey Graham and Chuck Schumer,

who co-sponsored but later dropped a harsher bill calling for a 27.5% import tariff on Chinese goods, are now working with Grassley and Baucus on a new version in what is a sign of gathering support for anti-Chinese legislation. With Nancy Pelosi, a long-time critic of China, now speaker of the House, grievances about China will likely loom large in upcoming legislation.

In addition, House Democrats introduced legislation on 18 January to expand congressional oversight on trade negotiations, proposing a Congressional Trade Office (CTO) that would work alongside the US Trade Representative (USTR) to formulate trade agreements, prosecute trade disputes and monitor trade policy more broadly. The CTO would monitor WTO compliance records by all foreign countries, but China is singled out. Lawmakers claim that given China's significant impact on world trade, Congress must play a key role in ensuring "full and continuous monitoring" of China's compliance record.

The focus on China extends beyond trade. Lawmakers have attempted to reform CFIUS to solidify recent trends toward tightening approval criteria, which will effectively prevent any Chinese firms with ties to the government from investing directly in the US. A bill introduced by Representative Carolyn Maloney (D-NY) with bipartisan support hopes to expand and extend the mandate of CFIUS, allowing the committee to impose any condition on investors considered necessary to mitigate security risks. It would also allow CFIUS to revisit completed mergers, and even force divestiture if the buyer is deemed noncompliant at any time. Attempts in 2006 to codify CFIUS reforms failed when the Senate and House could not reconcile their bills. Even if agreement between the two chambers remains elusive, however, CFIUS will continue to adhere to more stringent standards in the current legislative environment. The preeminence of state-owned enterprises in China's "go out" strategy – part of a conscientious government campaign to groom national champions – will expose Chinese firms to rigorous scrutiny, dampening the prospect of the US as a destination for China's growing overseas investment.

Lastly, pressure will mount on the USTR to file more complaints against China at the WTO. Not only did the Grassley-Baucus bill plan to elevate the USTR General Counsel to a Senate-confirmed position with statutory authority to investigate and resolve trade enforcement cases, but the administration shows increasing preference for multilateral mechanisms for trade disputes. In addition to a

KEY CONGRESSIONAL PLAYERS



SENATE

Committees to watch

Senate Finance Committee: Max Baucus (D-MT) – Chairman

Senate Foreign Relations Committee: Joe Biden (D-DE) – Chairman

Senators to watch

Senator Chuck Schumer (D-NY): Ranking member of the Economic Policy subcommittee of the Banking Committee

Senator Lindsey Graham (R-SC)

➔ These two senators co-sponsored a bill proposing a 27.5% tariff on imports from China.

Senator Max Baucus (D-MT): Chairman of the Finance Committee

Senator Chuck Grassley (R-IA): Ranking Republican on the Finance Committee

➔ These two senators co-sponsored a bill authorizing Treasury to identify misaligned currencies



HOUSE OF REPRESENTATIVES

Committees to watch

Ways and Means Committee: Charles Rangel (D-NY) – Chairman

International Relations Committee: Tom Lantos (D-CA) – Chairman

House Committee on Financial Services: Barney Frank (D-MA) – Chairman

Representatives to watch

Randy Forbes (R-VA): Co-chairman of the Congressional China Caucus

Nancy Pelosi (D-CA): Speaker of the House and an outspoken critic of China's human rights and trade practices

Tom Lantos (D-CA): Chairman of the House International Relations Committee and a critic of political oppression in China

Sander Levin (D-MI): One of the most senior members of the House Committee on Ways and Means and a supporter of more rigorous labor standards in trade agreements

pending WTO complaint against China's auto parts tariffs co-filed with the EU and Canada, the US has threatened to take individual intellectual property rights disputes to the WTO and start a comprehensive review of China's export subsidies.

Certainly, a rapidly evolving congressional agenda and bureaucratic resistance may still deflate tensions. Developments in the war in Iraq, as well as domestic initiatives such as healthcare reform, could well steal the limelight from trade issues.

Domestic politics in China will discourage major concessions

With only a slim majority in the Senate, Democrats may not be able to translate their party's leadership into veto-proof legislation that contains significant penalties for China (or other nations). Democratic presidential hopefuls will have to decide whether to advocate a moderate position or pander to the far left, and that will keep the political situation fluid. Moreover, proposed legislation could face tacit or open resistance from government bureaucracies and businesses, which could undercut increased congressional authority. For example, the Grassley-Baucus bill calls on the Treasury Secretary to identify misaligned currencies, authority that Secretary Henry Paulson would be loathe to exercise after investing significant political capital in the SED. Likewise, despite loud complaints about intellectual property violations, businesses are reluctant to share information with the USTR to pursue WTO cases for fear of losing access to the Chinese market.

Yet protectionist sentiments in Congress could spike if unpredictable events, much like CNOOC's bid for Unocal in 2005, coincide with upcoming

flashpoints that put the spotlight on trade with China. The Senate Banking, Housing, and Urban Affairs Committee plans to hold a hearing on 31 January on Treasury's report on international exchange rate policies and the SED, during which tempers will likely flare. Over 30 lawmakers have already petitioned the Commerce Secretary on 19 January to apply CVD to non-market economies, and the Department of Commerce is reviewing a similar petition by the paper industry. Hearings on China's exchange rate by the Senate Finance Committee, now scheduled for March, will not only set the stage for Treasury's report to Congress in April, but will also keep tensions high, especially since Treasury is unlikely to name China as a currency manipulator. Therefore, the next SED in May could see lawmakers' frustration come to a head. The Democratic leadership may demand the administration obtain policy concessions from Beijing on exchange rate liberalization, or face the possibility of punitive legislation.

Domestic political sensitivities, however, will likely discourage Chinese leaders from making what could be construed as excessive concessions to the US. Elites will be consumed by intense jockeying ahead of the critical 2007 Party Congress, at which President Hu Jintao is expected to shake up the all-powerful Politburo and pave the way for his succession. Bureaucracies vying for control may even begin to endorse targeted retaliation against US businesses. Faced with, at best, policy incrementalism from Beijing, and further protectionism in a worse-case scenario, US lawmakers could decide to take matters into their own hands. A veto-proof bill that imposes CVD on China for misaligned exchange rates and illegal subsidies could hurt US-China economic relations and trigger a cycle of retaliation and protectionism.

AVIAN FLU ▼

Virus returns to Europe

The reemergence of H5N1 avian influenza in Hungary and Russia suggests the virus will likely spread in birds throughout Europe and Eurasia in the coming months. The timing of these outbreaks is similar to last year when H5N1 spread through domestic flocks and migratory birds in much of this area, causing significant economic damage and fears of a human influenza pandemic. If H5N1 does spread, import bans on poultry from infected countries will be instituted and there will likely be sporadic human cases in coming months. Winter bird migration patterns and cooler weather appear to be a factor in the spread among birds but the virus does not appear to have changed in ways that make it easily transmissible among humans. If and when this occurs (possibly triggering a human pandemic) remains uncertain. This unfolding situation is a cause for concern but poultry industry practices, strong surveillance and good communication capabilities in this region lessen the likelihood of the virus becoming endemic among birds as it is in Southeast Asia. This situation will be exacerbated, however, if countries fail to report suspected cases in a timely manner.

– Scott Rosenstein

RUSSIA ↔

Gazprom and Rosneft to gain offshore control

A reported plan giving Gazprom and Rosneft control of all Russia's off-shore oil and gas fields would indicate deepening resource nationalism, and mark continuing rapprochement between the two national champions. The new move would complement an existing bill to restrict foreign investment in large Russian hydrocarbon fields. With Russian offshore production expected to outpace onshore in several decades, the measure would elevate Gazprom and Rosneft above privately held Russian majors, reflecting the national champions' success in using political connections for economic advantage. The plan also indicates warming of relations between the two companies, which have been bitter rivals economically and politically. This enhances political stability ahead of the 2008 presidential elections, and suggests a more predictable energy sector thereafter. But Russia's insufficient offshore technology and expertise risks poor extraction of these resources, and foreign investors could be lured into minority positions with stumbling partners. Moreover, Gazprom and Rosneft ascendancy depends on the stability of the current political system. That should last while Putin remains close to political power under his successor. But after 2012, the Russian system will become less predictable, and the national champions' current advantages could vanish along with their benefactors.

– Cliff Kupchan & Alexander Kliment

IRAQ ▼

Troop surge needs time government does not have

Increased domestic pressure to withdraw troops from Iraq only gives the administration a short period to demonstrate results from its new strategy before the drumbeat for withdrawal both from Democrats and critical Republicans overwhelms the White House. The increase in troop numbers is aimed at containing if not pacifying ongoing sectarian clashes wracking the capital. But for the plan to work US and Iraqi forces must hold cleared areas. That likely requires much more time than the four to six months the administration like has before domestic pressure reaches a threshold at which it cannot be ignored. US strategic flexibility in Iraq is now constrained by Bush's poor approval ratings, the Democratic-controlled congress and the increasing number of Republican critics who have rejected Bush's strategy. Knowing this, Sunni insurgents are likely to keep up the pressure, continuing their attacks on Shia civilians and exposed US forces. However, the radical Shia leader, Moqtada al Sadr, recognizes that he cannot survive a direct confrontation with US forces. As a result, he may keep his Mahdi Army in check and feign cooperation while he waits out the four-to-six-month period during which extra US forces will likely be in Baghdad.

– Peter Khalil

TERRORISM ▼

Algerian terror group's evolution heightens regional risk

While Algerian security services interpret the Salafist Group for Preaching and Combat's (GSPC) 27 January announcement that it is now the Al Qaeda Organization in the Islamic Maghreb as a positive sign that the group is fracturing, the announcement signals the likely future emergence of Islamist violence elsewhere in North Africa. From the state security apparatus' perspective the announcement reveals a schism in the GSPC with some members wanting to remain focused on realizing an Islamic state in Algeria and others wanting to broaden the movement's activities to other North African states. The split suggests a weakening of the group's coherence and therefore its capabilities in Algeria proper. However, the split could lead to expansion of activities elsewhere in North Africa and there is already evidence of this. Successful domestic Algerian security measures during the last several years pushed GSPC forces south into Mali, Niger, and Chad. Tunisian security forces killed gunmen in December 2006 and January 2007 they claimed were affiliated with the GSPC. To the west, Morocco is quietly consulting with Algerian security officials to develop its counterterrorism strategy and tactics in the run-up to Morocco's legislative elections scheduled for September.

– Geoff D. Porter

KOREAN PENINSULA ▲

Six-party talks gain new lease on life

A successful three-day December meeting in Berlin between the chief US and North Korean negotiators – Christopher Hill and Kim Gye-gwan – has helped advance stalled six-party talks. The format of the Berlin meeting – a purely bilateral dialogue outside the immediate context of the six-party negotiations – represented a major concession by the US, while favorable language from Pyongyang suggests that North Korea found something of interest in the US position. Press reports suggest some progress on two major issues: unfreezing some North Korean assets on the grounds that they are the result of legitimate transactions, and possible North Korean suspension of operations at the Yongbyon reactor in exchange for further US concessions. This suggests six-party talks may advance when they reconvene in Beijing on 8 February. While a positive development there are some caveats. The process can still founder over the timing and extent of each side's concessions. Nor is it clear whether North Korea will agree to the complete and verifiable dismantling of its nuclear program, as the US and Japan continue to demand. If the talks bog down over such issues, the situation could deteriorate, since Japan has threatened further sanctions and North Korea has said it would conduct a second nuclear test.

– Harry Harding

MIDDLE EAST ▼

Little expected from Saudi-Iranian efforts in Lebanon

Despite a reported agreement between Saudi Arabia and Iran to try and stem Sunni-Shia tension in Lebanon, a durable solution to the current crisis will remain unlikely without Syria's consent. Iran's National Security Advisor Ali Larijani and his Saudi counterpart Prince Bandar bin Sultan have agreed to pressure their respective Lebanese allies – Hizbullah and the Future Movement of Saad Hariri – to sign on to an Arab League initiative that would allow for a new national unity government and a joint committee to study a draft law to set up the Hariri tribunal. Yet Syria – through its local allies – will likely object to such a compromise fearing that Iranian and Saudi influence in Lebanon will be earned at its expense and that the formation of the tribunal may lead to the prosecution of its security officials. Meanwhile several alarming trends are emerging, including the emergence of sectarian militias claiming to defend certain neighborhoods within the capital. Although recent communal clashes will probably be contained, the army – given its sectarian composition and limited capacity – may be unable to maintain security should a compromise fail to materialize.

– Firas Maksad

CLIMATE CHANGE ▲

State of the Union continues Bush administration policy shift

George Bush's renewable energy proposals and use of the phrase "climate change" in his State of the Union address will not satisfy environmentalists but displays the administration's slowly increasing support for action. Increased domestic and international attention has compelled the Bush administration to address the issue. The proposals, presented as important for energy security and environmental protection, provide private sector incentives and federal support for investment in biofuels, clean coal, and nuclear energy, and set modest targets for reduced gasoline and increased renewable energy consumption. Automakers will bear much of the burden with the energy sector facing few new responsibilities. But critics argue against including greenhouse gas (GHG) emitting coal as an alternative fuel, that proposals fall short of the Kyoto targets, and that there are no mandatory caps for carbon dioxide emissions. Many state GHG initiatives as well as legislation making its way through congress are pushing for more stringent GHG limits and Bush will probably be soon presented with a GHG bill for his approval. If Bush's political capital continues to decline, and if bipartisan and private sector support continues to coalesce, congress may attempt to impose mandatory carbon caps before Bush leaves office.

– Scott Rosenstein

ENERGY ↔

SPR fill will provide support for oil demand

President George W. Bush's announcement in the annual State of the Union address that he intends to expand the US Strategic Petroleum Reserve (SPR), while providing support for oil demand, also has implications for the US policy regarding Iran. In the short term the government must first fill existing capacity; the US government's purchase of 36 million barrels over the coming year will help support demand. The longer-term expansion, for which funds would need to be appropriated by Congress, would double the size of the reserve to 1.5 billion barrels by 2027, and also support demand. The Bush administration believes increasing the SPR is necessary given the potential for instability in oil producing regions and the growth in consumption since it was first established in the 1970s, but this has implications for US foreign policy. Filling the SPR to capacity, while adding some cushion in the event of a disruption in the Persian Gulf, also adds to the credibility of discussions about the Bush administration's military options regarding Iran's nuclear ambitions.

– Greg Priddy