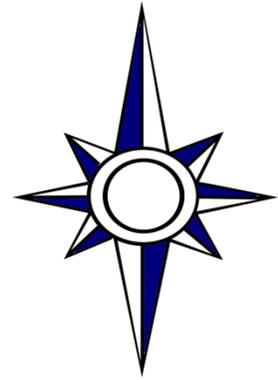


# Comparative Connections

A Quarterly E-Journal on East Asian Bilateral Relations



## US-China Relations: Cooperation Faces Challenges

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Presidents Barack Obama and Hu Jintao met twice this quarter, first on the sidelines of the Nuclear Security Summit in Washington in April and again on the margins of the G20 Summit in Toronto in June. Nevertheless, tensions lingered over US arms sale to Taiwan and the military relationship remained suspended. The Chinese rejected a request from Secretary of Defense Robert Gates to visit China. The second round of the Strategic and Economic Dialogue was held in Beijing in late May, yielding agreements on energy, trade environment, and healthcare. Many hours were spent during the quarter in discussions between the two countries on an appropriate response to the sinking of the South Korean warship, but the gap was not narrowed. In June, China finally announced the long-awaited decision to allow its currency to be more flexible, though it remains unclear how fast and to what extent it will permit the *yuan* to appreciate.

### Strategic and Economic Dialogue, round two

After months of tension between the United States and the People's Republic of China, the two powers convened in Beijing for the second round of the Strategic and Economic Dialogue (S&ED), May 24-25. The two days of in-depth discussions provided an opportunity for senior officials from both countries with responsibility for diplomatic and economic issues to exchange views on an ever-expanding agenda of bilateral, regional, and global problems. The talks yielded no surprises: in areas that the US and China have overlapping interests, they agreed to enhance cooperation and where interests diverge, they tried to better understand each other's positions and pledged to keep talking.

The US delegation to the S&ED numbered more than 200 people, including 15 Cabinet secretaries and agency chiefs. As the host country, the size of the Chinese delegation was even larger. Located inside the Great Hall of the People adjacent to Tiananmen Square, the talks opened with positive rhetoric on both sides. In his opening address, Chinese President Hu Jintao expressed his hope that "through candid and in-depth discussions on overarching, strategic and long-term issues of mutual interest, the two sides will enhance trust and dispel misgivings, and further push forward China-US cooperation." In addition, Hu called for maintaining close interactions, developing a pattern of mutually beneficial and win-win cooperation, strengthening coordination on regional hot-spot and global issues, and deepening mutual understanding and friendship between the Chinese and American people. Hu also reiterated language from the joint statement issued during President Obama's visit to China last November, saying, "we should respect each other's core interests and major concerns."

In her remarks, US Secretary of State Hillary Rodham Clinton lauded China's extraordinary economic growth and reiterated the importance of cooperation over competition. She

enumerated several key areas of common concern on which “there is much work to be done” – including North Korea, Iran, Afghanistan and Pakistan, counter-piracy, military-to-military cooperation, climate and energy, education, health, development, and economic recovery and growth – but expressed confidence that the second round of talks would make progress on these issues and provide a framework for “delivering real results to our people.”

In contrast with the first round of the S&ED, Clinton’s tone and message was less effusive, perhaps signaling that the high expectations the Obama administration held regarding the US-China relationship in its early months in power had given way to a more realistic stance. At the inaugural session last summer, Secretary Clinton repeatedly stated that the US and China were “in the same boat” and should row in the same direction in order to overcome the economic crisis and address a host of global challenges. This year, Clinton emphasized that the two countries have different histories and are at different stages of development. Senior Chinese officials struck a similar tone, suggesting that Beijing too had lowered its expectations of what the bilateral relationship could deliver. Vice Premier Wang Qishan noted that the US and China have differences “in history, culture, national conditions, development stage, economic structure, and market sophistication,” but now are able to manage these differences in a “more rational and mature manner.” Clinton’s counterpart, State Councilor Dai Bingguo, stated that the two countries would inevitably have disagreements and differences and echoed Hu Jintao’s call for both sides to “respect each other’s core interests and major concerns.”

Nevertheless, both sides continued to espouse the view that US-Chinese cooperation is essential. Clinton re-stated the assessment put forward by President Obama at the first round that “few global problems can be solved by the United States or China acting alone. And few can be solved without the United States and China working together.” Dai Bingguo echoed this view, noting that the chances for peace in the 21<sup>st</sup> century will be seriously undermined if the US and China are unable to establish a new type of partnership.

Round two of the S&ED brought few tangible accomplishments in areas of US priority (such as gaining Chinese support for condemning North Korea’s torpedo attack on the *Cheonan* warship, discussed below), but did reaffirm the importance of mutual cooperation, arguably Beijing’s primary objective. The meeting yielded 26 results, including agreement to strengthen exchanges and cooperation in such areas as energy, the environment, science and technology, culture, education, health, customs, nuclear security, counterterrorism, and law enforcement. The two sides signed seven documents on cooperation in nuclear safety for the AP1000 nuclear reactor, shale gas development, eco-partnerships, supply chain security, and infectious diseases, while reiterating their commitments to actively implement the US-China Memorandum of Understanding to Enhance Cooperation on Climate Change, Energy and Environment and the Ten-Year Framework on Energy and Environment Cooperation.

On issues where differences prevailed, there was a candid exchange of views and both sides agreed to continue close consultations. For example, the plenary session that was chaired by Secretary Clinton, State Councilor Dai Bingguo, Secretary of the Treasury Timothy Geithner, and Vice Premier Wang Qishan focused on development issues, but the wide gap between the two countries’ approaches to development assistance was not narrowed. On human rights, there was agreement to continue discussions on the basis of equality and mutual respect, and

specifically to continue the bilateral Human Rights Dialogue held in Washington May 13-14 with another round of talks next year in China.

In the economic track, the US lobbied with some success against Beijing's indigenous innovation policy, which gives preference to products with intellectual property developed in China over foreign competitors in the domestic market. The Chinese agreed to delay implementation of the policy to "assess public comments" and to engage in a series of dialogues with various relevant Chinese and US agencies. According to a US fact sheet released at the conclusion of the S&ED, both countries also committed to innovation policies "consistent with strong principles, including nondiscrimination, intellectual property rights protection, market competition, and no government interference in technology transfer." China also agreed to resubmit an offer to join the World Trade Organization's (WTO) Agreement on Government Procurement in July 2010, which will allow for more equitable consideration of US goods and services in China.

Beijing urged the US to loosen its controls on exports of high-technology equipment to China and asked the US to grant China market economy status. Without market economy status, Chinese firms are often at a disadvantage when facing anti-dumping probes by the US or Europe, as the production cost information they provide is regarded with skepticism. After the close of the meeting, the Chinese media reported that the US had committed to recognizing China's market economy status, but US officials claimed that no such promise had been made. Under agreements signed in 2001 when China entered the WTO, the country will automatically attain market economy status in 2016. Among WTO members, 97 have agreed to grant China market economy status, but two of China's top trading partners, the US and the European Union, have refrained from doing so.

Discussions also focused on joint efforts to promote a strong economic recovery and more balanced growth. The US Treasury Department Fact Sheet enumerated many measures taken by China to increase the contribution of consumption to its growth, which increased from 4.1 percentage points of China's real GDP growth in 2008 to 4.6 in 2009. Also highlighted was the strong growth in US exports to China, up 20 percent in the past two years. At the same time, China's current account surplus in 2009 fell by one-half from its peak, as a share of GDP, and declined further in the first quarter of 2010. The US pledged to achieve fiscal sustainability in the medium- and long-term, including reducing its deficit to about 3 percent of GDP by 2015, and to sustain post-financial crisis gains in household savings rates. The two countries agreed over the medium-term to rationalize and phase out inefficient fossil fuel subsidies that encourage wasteful consumption, reduce energy security, impede investment in clean energy sources, and undermine efforts to cope with the threat of climate change. In addition, they agreed to respectively reform their financial sectors and strengthen regulation, and enhance the legitimacy of multilateral financial institutions.

Many of the accomplishments of the second round of the S&ED were on easily agreed upon issues – trade, environment, energy, and healthcare – where US and Chinese interests converge. On security problems addressed in the strategic track – Iran and North Korea – there was greater divergence. The two sides did agree, however, to convene bilateral dialogues in the coming year on security, arms control, and nonproliferation; regional matters and policy planning; and UN peacekeeping operations.

After 100 hours of dialogue, one important consensus reached was that the S&ED is a valuable mechanism to promote the shared vision of Presidents Hu and Obama for a positive, cooperative, and comprehensive bilateral relationship. Both sides recognize there is a deficit of strategic trust, which inhibits greater cooperation, and they hold out hope that the S&ED will facilitate better understanding and enable a broadening of common interests that can underpin a genuine partnership in the future.

### **The *Cheonan* sinking: differing perspectives and interests**

A South Korean corvette, the *Cheonan*, suffered an external explosion, broke in two and sank within hours on March 26, killing 46 South Korean sailors. A five-nation investigation team concluded after two months of meticulous research that North Korea was responsible for the attack. The appropriate response to that finding was the focus of much discussion between Secretary Clinton and State Councilor Dai Bingguo at the S&ED in Beijing. In her opening speech, Clinton called North Korea a “matter of urgent concern.” She noted that the US and China had worked together to pass and enforce a strong UN Security Council resolution in the wake of North Korea’s nuclear test and called on China to once again work with the US to address the challenge posed by the sinking of the ship and to advance shared objectives for peace and stability on the Korean Peninsula.

Chinese officials reportedly were skeptical of the outcome of the investigation. One official bluntly asked Secretary Clinton why China should believe US intelligence based on its poor track record in Iraq, where the U.S. had insisted there was a nuclear weapons program, and in Belgrade, where it had accidentally bombed the Chinese Embassy. The US urged Beijing to follow Russia’s example and dispatch a team of experts to South Korea to review the evidence that has been collected, a request that China said it would consider but has yet to act on.

US officials painstakingly explained that China’s ties with South Korea had been damaged by Beijing’s selfish response to the *Cheonan* sinking. Five weeks passed after the incident before the Chinese sent official condolences to South Korea, and even then noted only that it was a tragic “accident.” When South Korean President Lee Myung-bak visited Shanghai, the Chinese leadership failed to inform him that North Korea’s leader Kim Jong-il was scheduled to arrive in China three days after his departure. The Chinese offered no explanation and showed little appreciation for the restraint exercised by Lee and his domestic political need for a prompt and harsh international response to the unprovoked attack. To US officials, it seemed that the Chinese just wanted the whole issue to go away so they could continue to play the role of good neighbor and pursue their policy of cultivating good ties with both North and South Korea.

Following the talks, Clinton told the press that the discussions with the Chinese about North Korea were “very productive and detailed” adding that “The Chinese understand the gravity of the situation.” She acknowledged, however, that China and the US often viewed things from a different perspective, and the *Cheonan* sinking seemed to be one of those cases. The only positive signal came from Premier Wen Jiabao, who privately told US officials that Beijing would not shield the perpetrator of the attack, a position that he personally conveyed to South

Korea's President Lee during a visit to Seoul a few days later. Although the Chinese promised to review the evidence, it seemed unlikely that they would point the finger at North Korea.

To date, China, along with Russia, has resisted Seoul's efforts to obtain a tough response to the *Cheonan* sinking either in the form of a UN Security Council resolution or president's statement. Throughout the quarter, Chinese officials called on all parties to "keep calm, exercise restraint and appropriately handle the *Cheonan* incident." In a bilateral conversation with South Korea's Foreign Minister Yu Myung-hwan ahead of the trilateral foreign ministers meeting among China, Japan, and South Korea in mid-May, Chinese Foreign Minister Yang Jiechi urged all parties to approach the matter based on long-term interest and the need to preserve stability and peace on the Korean Peninsula. According to a Chinese military source, Beijing worries that direct criticism of North Korea could lead to a new military provocation. US frustration with China's handling of the issue was exemplified by Chairman of the Joint Chiefs of Staff Adm. Michael Mullen in his June 9 speech to the Asia Society. Mullen expressed "dismay" that China had only given a "fairly tepid response" to the attack and called on Beijing and the international community to strongly condemn North Korea's act of aggression.

At the meeting between the US and Chinese presidents on the margins of the G20 Summit in Toronto, President Obama asked for China's support over the sinking of the South Korean warship. The following day, Obama told a press conference that he was "very blunt" on the matter with Hu Jintao and used harsh language to criticize China's policy. Noting that the US was "sympathetic" to the fact that China shares a border with North Korea and understood Beijing's call for restraint, Obama nevertheless insisted that "there's a difference between restraint and willful blindness to consistent problems." He added that "It is a bad habit that we need to break to try and shy away from ugly facts with respect to North Korea's behavior . . . under the illusion that will somehow help to maintain the peace." Obama expressed his hope that Hu would recognize that the unprovoked attack on the *Cheonan* "is an example of Pyongyang going over the line in ways that just have to be spoken about seriously." He called for a "crystal clear" acknowledgement from the Security Council "that North Korea engaged in belligerent behavior that is unacceptable to the international community."

Two days later, China's Foreign Ministry spokesman directly responded to President Obama's charges, denying that his country was hiding from the risks posed by North Korea. Qin Gang insisted that Beijing had to be more cautious in handling its neighbor and that China did not want to "pour oil on the flames." He also maintained that China does not "play favorites with any side," and that "China's position and efforts are beyond reproach."

US and Chinese tensions over the issue escalated further as the quarter ended. In response to reports of a planned joint naval exercise between US and South Korea in the Yellow Sea that could include a nuclear-powered aircraft carrier, China's Foreign Ministry spokesman expressed concern and noted that Beijing was following developments closely. He called for "relevant parties" to "remain calm, exercise restraint and refrain from doing things that could aggravate tension and harm the interest of nations in the region." A few days later, the People's Liberation Army's East Sea Fleet unusually issued a public notice saying that one of its units would engage in live-ammunition firing training in the waters of the East China Sea from June 30 to July 5.

The Chinese denied that the exercise was a response to the US-ROK exercise or was in any way related to the situation on the Korean Peninsula.

### **Bilateral meetings at the Nuclear Security Summit and the G20**

Presidents Obama and Hu held a 90-minute meeting on the margins of the Nuclear Security Summit in Washington in mid-April. The meeting produced an agreement that Iran must meet its international nuclear nonproliferation obligations. White House national security aide Jeff Bader told the press that President Hu shared US concerns about Iran's nuclear program and the overall goal of preserving the nonproliferation regime, adding that the two presidents agreed to instruct their UN delegations to work with the P5 + 1 on a new Security Council sanctions resolution, which was subsequently passed.

Meeting on the sidelines of the G20 summit – their sixth tête-à-tête in the almost 18 months since Obama assumed the presidency – in addition to their in-depth discussion about North Korea, Hu and Obama reviewed the overall bilateral relationship and exchanged views on economic matters. Hu told Obama at the outset of the meeting that China wants to “work with the US side to maintain the high-level exchanges and interactions at various other levels and deepen our practical cooperation across the board,” according to the White House. “We also want to strengthen the community in coordination with the US side on major regional and international issues to continue to move forward the positive, cooperative and comprehensive China-US relationship,” the Chinese leader said.

President Obama thanked President Hu for what he called a “very positive letter” that he had recently sent that described the “tremendous progress” that the US and China have made in improving the bilateral relationship. Both sides have worked hard to build a relationship of trust and mutual confidence, Obama noted, adding that “we have accomplished many things as a consequence of that hard work.” On the economic front, Obama welcomed China's recent decision to allow the *yuan* to move more freely against the dollar, but also encouraged Hu to implement currency reform. During the meeting, Obama reiterated his invitation to Hu to make a state visit to the US at a mutually convenient time, which Hu accepted.

### **China and UN sanctions against Iran**

An important success story in US-China cooperation this quarter was the agreement reached in the UN Security Council on a new sanctions resolution on Iran. UNSCR 1929 was passed on June 9 by a 12-to-2 vote, with Brazil and Turkey casting “no” votes. The sanctions target activity by the Revolutionary Guard, which many experts view as increasingly involved in Iran's nuclear program. The resolution also bars countries from allowing Iran to invest in their nuclear enrichment plants, uranium mines, and other nuclear-related technology. In addition, it obligates countries to inspect ships or planes headed to or from Iran if they suspect illicit cargo is aboard.

China's support for the resolution was secured after substantial diplomatic effort and a few key concessions. For months, Beijing had opposed talking about sanctions, contending that doing so would hamper finding a diplomatic solution. But Teheran's unwillingness to cooperate with the international community eventually convinced the Chinese that absent greater pressure,

diplomacy would not succeed. In early April, China agreed to begin discussions on Iran sanctions at the UN after the US restated its “one-China” policy to assuage Chinese anger over a large weapons sale to Taiwan in January. Once negotiations got underway in earnest, there was hard bargaining over the measures to be imposed. Beijing and Moscow strongly opposed sanctions against Iran’s banks, insurance industry and other trade that would hurt average Iranian citizens or normal trade. Russia and China also both resisted sanctions on Iran’s oil and gas industry. To alleviate Chinese concerns about energy security, the US and other members of the Security Council coordinated to ensure that China’s energy needs would be met in the event that Iran reduced oil supplies to China in retaliation for its support for sanctions. Chinese analysts also claim that their government won promises from Washington to exempt Chinese companies from any US unilateral sanctions that punish third-country business partners with Iran.

### **Military ties remain frozen**

Although the US and China appeared to have resolved their differences over last quarter’s US arms sale to Taiwan and President Obama’s meeting with the Dalai Lama, enabling Hu Jintao to attend the Nuclear Security Summit in April, tensions in the bilateral relationship nevertheless lingered. The most serious issue of contention was the continued suspension of the military-to-military relationship due to persisting anger in China over US dismissal of Chinese concerns about continuing arms sales to Taiwan. Prior to the S&ED in Beijing, Secretary of Defense Robert Gates requested a visit to China in June as part of a tour of several countries in Asia and Europe. His aim was to put the relationship between the two militaries back on track, but his offer was rebuffed; the Chinese simply told the Pentagon that it was “not a convenient time.”

Relations between the US and Chinese militaries remained sour and the few interactions during the quarter were disagreeable and unconstructive. In contrast to the reportedly amicable conversations at the S&ED even on issues where there was disagreement, discussions between military representatives on the margins of the formal meetings were tense. Speaking to 65 US officials at the Diaoyutai state guesthouse in Beijing, including Commander of US Pacific Command Adm. Robert Willard, Rear Adm. Guan Youfei, a vice minister at the Foreign Affairs Office of the PLA, lectured about US mishandling of the Sino-US relationship, pinning blame on the US for all the bilateral problems. Guan accused the US of being a “hegemon,” scheming to encircle China with strategic alliances, and treating China as an enemy. Although US officials attached little significance to Guan’s outburst, claiming that it was out of step with the rest of the S&ED interactions, the *Washington Post* quoted a senior Chinese official as saying that Guan’s views represented “what all of us think about the United States in our hearts.” The official also noted that the message was not “an accident,” suggesting that it had the approval of the senior Chinese leadership.

In a separate meeting on the margins of the S&ED, which *China Daily* pointedly noted took place at the request of the US, Deputy Chief of the PLA General Staff Ma Xiaotian told Adm. Willard and Assistant Secretary of Defense for Asian and Pacific Security Affairs Wallace Gregson that US arms sales to Taiwan, frequent reconnaissance operations by US naval ships and aircraft in the waters and airspace of China’s exclusive economic zones, and US laws that place restrictions on the development of bilateral military exchanges are obstacles to the stable development of China-US military ties. Ma said that US was “fully responsible” for preventing

the growth of US-China military relations and stated that the resumption of sound and steadily developing military relations would hinge on whether the US respected China's core interests and major concerns.

In June, on his way to the region, Secretary Gates complained to the press that "The PLA is significantly less interested in this relationship than the political leadership of China." Two days later, in a speech at the Shangri-La Dialogue in Singapore, Gates recalled that Presidents Obama and Hu had made a commitment to advance sustained and reliable military-to-military relations between their two countries, but that the effort to achieve that goal had been derailed by China's decision to suspend military exchanges in response to US arms sales to Taiwan. Gates insisted that US arms sales to Taiwan are "nothing new" and are an "important component of maintaining peace and stability in cross-Strait relations and throughout the region as well as a response specifically to "China's accelerating military buildup" that "is largely focused on Taiwan." He reiterated that the US does not support independence for Taiwan. Gates emphasized that there is a cost to the absence of military-to-military relations, arguing that they are essential to developing a broad, resilient US-China relationship that "is positive in tone, cooperative in nature, and comprehensive in scope."

Gen. Ma Xiaotian, responding to questions after his presentation on a panel that followed Gates' speech, insisted that China remains committed to establishing a partnership of comprehensive mutual cooperation for the 21<sup>st</sup> century and lamented that the military relationship lags behind other fields of cooperation between the two countries. Repeating the three obstacles to the smooth development of military ties that he had outlined a month earlier in Beijing, he insisted that the Chinese side was blameless. "If anyone has been setting up barriers to cooperation, it is certainly not us," he declared. Moreover, Ma asserted that the sale of arms to Taiwan is not a "normal event." Somewhat surprisingly, Ma denied that the US-China military-to-military relationship had been completely suspended, but instead described some exchanges "such as high-level dialogue" as "temporarily held up." Certain low-level mutual visits, face-to-face exchanges of views, and meetings to discuss maritime security continue, he maintained, although in reality the discussions on the margins of the S&ED are the only meetings that have taken place between the two militaries since the US arms sale to Taiwan in January.

In an apparent response to China's refusal to receive him in Beijing, Secretary Gates did not ask for a meeting with Gen. Ma on the sidelines of the Shangri-La Dialogue. US officials said that no meeting was arranged because the Chinese delegation was not at a high enough level, but that explanation was unconvincing since Gates had met with Ma at the Shangri-La Dialogue in 2008 and 2009. Gates did hold separate bilateral meetings in Singapore with military and political leaders from South Korea, Vietnam, Japan, Indonesia, India, Singapore, and New Zealand.

Several days later in a speech at the Asia Society in Washington, Chairman of the Joint Chiefs of Staff Adm. Mullen reinforced Gates' message that the US-China military relationship should be resumed. Mullen said that he had grown "genuinely concerned" about China's motives for building up its armed forces, including its "heavy investments" in sea and air capabilities and its rejection of military contacts with the US. Then he chided Beijing for its changeable attitude toward efforts to "work together, lead together, to promote regional stability."

Also in June, Sen. Dianne Feinstein, chair of the Senate Intelligence Committee, visited mainland China and Taiwan, where she discussed US arms sales to Taiwan. After her return, she raised the issue with Secretary Gates at a congressional hearing. Feinstein called the sales a “substantial irritant” in US-China relations and pressed Gates on what steps Beijing could take that would allow Washington to reconsider future arms sales to Taiwan. Gates avoided a direct response, noting only that any determination on Taiwan arms sales are “fundamentally a political decision” that is up to Congress and the White House. He added that he was “very concerned” about China’s growing anti-ship cruise missile and ballistic missile capabilities.

As the quarter drew to a close, Beijing signaled that it might be preparing to resume military-to-military ties. Several days after President Obama’s meeting with Hu Jintao in Toronto on the margins of the G8 Summit in which he urged the Chinese president to welcome a visit to China by Secretary Gates, Gen. Staff Ma stated publicly that China welcomes Gates “to visit China at a time that is convenient for both sides.” He added, however, that whether the US-China military relationship can overcome difficulties and return to a normal, stable development path will depend on whether the US is willing to respect China’s core interests and major concerns. Probably not coincidentally, the statement came just as the suspension of bilateral military exchanges passed the six-month mark after the Jan. 29 announcement by the Obama administration of a \$6.4 billion package of weapons to Taiwan.

### **China resumes RMB exchange rate flexibility**

This quarter China finally announced the long-awaited decision to allow its currency to be more flexible, though it remains unclear how fast and to what extent it will permit the *yuan* to appreciate. The announcement, however, carries the potential to defuse one of the most troublesome issues in the relationship. Many Americans complain that China gains an unfair export advantage over the US by deliberately keeping its currency undervalued. Currency manipulation was the main issue behind the creation of the Strategic Economic Dialogue in August 2006. Then Secretary of the Treasury Hank Paulson proposed the SED as a dialogue mechanism to forestall Congressional action on trade policy. From July 2005 to July 2008, China allowed its currency to appreciate approximately 21 percent. When the financial crisis hit, however, Beijing reinstated the peg of the RMB to the US dollar. Since then, and especially this year, pressure has grown from Washington for China to allow its currency to strengthen.

Recognizing that public hectoring would likely be counterproductive, the US deliberately did not push China publicly to revalue its currency at the S&ED in May. Instead, it decided to heed the warning issued by China’s Foreign Ministry spokesman Ma Zhaoxu months earlier that “wrongful accusations and pressure will not help solve this issue.” Washington hoped that Beijing would see its interests as best served by making a decision to re-introduce flexibility in the exchange rate prior to the G20 meeting in Toronto, which is precisely what happened. At the S&ED, to the surprise of many observers, President Hu specifically mentioned the exchange rate in his opening address. Hu stated, “China will continue to steadily advance the reform of the formation mechanism of the RMB exchange rate under the principle of independent decision-making, controllability and gradual progress.” Following Hu’s remarks, Treasury Secretary Geithner welcomed the Chinese leadership’s recognition that exchange rate reform is necessary for sustaining economic growth with low inflation and reinforcing incentives for China’s private

sector to shift resources to more productive higher value-added activities that will be essential to future growth.

While Secretary Geithner and President Obama seemed willing to be patient with the Chinese on the currency issue, US congressional leaders did not share the restraint. A bipartisan group of senators and congressional representatives led by New York Democratic Sen. Chuck Schumer proposed legislation on June 9 that would eliminate the advantages that China receives from its undervalued currency. Under Schumer's legislation, companies would be allowed to seek import duties to redress the undervalued Chinese currency, which would be considered a subsidy; tariffs would be imposed to counter the effect of the Chinese "subsidy."

The long-anticipated announcement came on Saturday, June 19. China's Central Bank declared that China will "proceed further with reform of the RMB exchange rate regime and increase the RMB exchange rate flexibility." President Obama welcomed the pronouncement: "China's decision to increase the flexibility of its exchange rate is a constructive step that can help safeguard the recovery and contribute to a more balanced global economy." He added that he looked forward to discussing these and other issues at the G20 summit in Toronto. Secretary Geithner's endorsement was somewhat more qualified: "This is an important step but the test is how far and how fast they let the currency appreciate."

The reaction from US business circles and experts was mixed. Some US companies like SGI, a California-based server and data storage equipment company, and Caterpillar, which sells bulldozers, large mining trucks, and gas turbines to China, were pleased because their exports would become more affordable in the Chinese market. Fred Hochberg, chairman of the Export-Import Bank of the United States, contended, however, that there was no certainty that the RMB's appreciation would significantly increase US exports. He told the *New York Times* that the key variable would be the rate at which China allows the RMB to appreciate and the extent to which it is "really market-driven." Perennial critics from Capitol Hill such as Democratic Rep. Sander Levin, chairman of the House Ways and Means Committee, saw China's announcement as nothing new: "We have seen actions like this before and it is clear that China did not allow enough appreciation the last time it adopted a policy like this one, from 2005 to 2008." Other experts such as Derek Scissors, of the Heritage Foundation, argued that the US should focus on other issues such as Chinese subsidies and the US deficit instead of the currency issue, which, he contended, has little impact on US jobs and economic growth.

Just prior to departing for Toronto, President Obama held a joint press conference with Russian President Dmitry Medvedev. When asked about China's currency, he responded with praise for China's initial step, but expressed uncertainty about whether China's actions signify the "rebalancing that we think is appropriate." Obama added that he did not expect "a complete 20 percent appreciation overnight" given the disruption that would cause in world currency markets and China's economy. He allowed that Beijing would make its decisions "based on its sovereignty and its economic platform," a message that was undoubtedly appreciated by Beijing.

In Toronto the majority of the members of the G20 welcomed the plans of the Chinese government to introduce a more flexible exchange rate, but according to a Russian Finance Ministry official, a phrase applauding Beijing's move was dropped from an early draft

communiqué at the request of the Chinese. Apparently, Beijing insisted that discussion of its currency had no place in an international forum and did not want to be singled out. As a result, the G20 members included a more general statement about the need for flexible exchange rate currencies in the final communiqué. Hu Jintao made no mention of China's currency policy in his speech to the G20 gathering, but he warned of serious global economic risks from the drastic fluctuation of the exchange rates of major currencies and the continued volatility from international financial markets.

President Obama did not shy away from seizing his long-awaited multilateral opportunity at the post-summit press conference to express US sentiments on China's exchange rate policy, however. He reiterated that an undervalued RMB has given China a "significant trading advantage" that is not "acceptable or consistent with the principles of balanced and sustainable growth" that all G20 countries have signed on to. Obama again welcomed Beijing's decision to move back toward a path of flexible exchange rates, but added that "the proof of the pudding is going to be in the eating. . . We do expect that as more and more market forces come to bear, that given the enormous surpluses that China has accumulated, that the RMB is going to go up and it's going to go up significantly. And so we are going to be paying attention over the next several months to make that determination." The US president also signaled his intention to work with US manufacturers and US congressional critics to assure an "even playing field."

### **Looking ahead**

An opportunity to further bilateral cooperation will occur in early August, when Larry Summers, director of the National Economic Council, and Tom Donilon, deputy national security adviser, travel to China at the request of President Obama to talk to China's top economic and foreign policy advisors. Hopefully, in the interest of promoting the positive, cooperative, and comprehensive relationship for the 21<sup>st</sup> century that Presidents Hu and Obama have agreed upon, Beijing will soon agree to resume military-to-military ties. Obama signaled that this is a priority for the US when he told President Hu in Toronto that the US is "looking forward to an invitation for a visit by Defense Secretary Gates in the coming months." The two countries will begin planning Hu Jintao's state visit to the US, but the trip is not likely to take place until after the US general elections, perhaps in December or even January 2011.

## **Chronology of US-China Relations\***

**April – June 2010**

**April 3, 2010:** Treasury Secretary Timothy Geithner delays an April 15 report that was expected to declare China a "currency manipulator," saying that Chinese exchange rate policies will be discussed at the May Strategic and Economic Dialogue (S&ED) and at upcoming G20 meetings.

**April 6, 2010:** Foreign Ministry spokeswoman Jiang Yu says China does not manipulate its currency and that the "exchange rate is not the main reason behind the US-China trade deficit."

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\* Chronology and research assistance by CSIS intern Robert Lyons

**April 6, 2010:** US releases its *Nuclear Posture Review*, noting the “lack of transparency” surrounding China’s nuclear program “raises questions about China's future strategic intentions.”

**April 6, 2010:** While traveling in India, Secretary Geithner tells an Indian media outlet that it is “China’s choice” whether to revalue its currency.

**April 6, 2010:** Secretary of State Hillary Clinton holds a phone conversation with Chinese Foreign Minister Yang Jiechi to discuss bilateral ties.

**April 8, 2010:** Secretary Geithner makes a previously unscheduled trip to China, where he meets Vice Premier Wang Qishan in Beijing and discusses Chinese exchange rate policies.

**April 8, 2010:** The United Nations Security Council begins negotiations on sanctions against Iran for its nuclear program.

**April 9, 2010:** Undersecretary of State Robert Hormats speaks at Beijing’s China Institutes of Contemporary International Relations on ways to handle disputes in the bilateral relationship.

**April 12, 2010:** Presidents Barack Obama and Hu Jintao meet on the sidelines of the Nuclear Security Summit in Washington, discussing currency issues and Iran sanctions.

**April 13, 2010:** Deputy US Trade Representative Demetrios Marantis visits Beijing to discuss Chinese intellectual property rights and currency valuation issues.

**April 19, 2010:** House Ways and Means Committee Chairman Sander Levin says that “the US will act” if China does not take steps to appreciate its currency by the June meeting of the G20.

**April 22, 2010:** The US Commerce Department announces that it has set preliminary antidumping duties on imports of certain seamless pipe from China.

**April 29, 2010:** Secretary Clinton has a phone conversation with State Councilor Dai Bingguo to discuss the nuclear programs in Iran and North Korea.

**May 3, 2010:** In Beijing, Assistant Secretary of State for South and Central Asian Affairs Robert Blake and Vice Foreign Minister Wang Guangya hold a “sub-dialogue” on South Asia in which Chinese officials request US support for Chinese civilian nuclear development in Pakistan.

**May 5, 2010:** The five permanent UN Security Council members, including the US and China, support making the Middle East a nuclear weapon free zone.

**May 11, 2010:** Assistant Secretary of State for East Asian and Pacific Affairs Kurt Campbell meets senior Chinese officials in Beijing.

**May 12, 2010:** A US jury convicts a Chinese national named Chi Tong Kuok of illegally smuggling sensitive communications equipment to China.

**May 13, 2010:** Secretary Clinton and State Councilor Dai Bingguo hold a phone conversation to discuss Kim Jong-il's trip to China and the investigation into the sinking of the South Korean naval vessel, the *Cheonan*.

**May 13-14, 2010:** The US and China hold a human rights dialogue in Washington. The US delegation is led by Assistant Secretary of State for Democracy, Human Rights and Labor Mike Posner and the Chinese delegation headed by Ministry of Foreign Affairs Director General for International Organizations Chen Xu.

**May 16, 2010:** US Commerce Secretary Gary Locke arrives in Hong Kong to start a 10-day trade mission to China focused on clean energy cooperation.

**May 24-25, 2010:** The US and China hold second annual Strategic and Economic Dialogue (S&ED) in Beijing.

**May 25, 2010:** Ma Xiaotian, deputy chief of the General Staff of the Chinese People's Liberation Army, meets Commander of US Pacific Command Adm. Robert Willard on the margins of the S&ED in Beijing.

**May 31, 2010:** Wu Bangguo, chairman of the Standing Committee of the National People's Congress (NPC), meet a visiting delegation of US senators led by Dianne Feinstein, chairperson of the Senate Intelligence Committee.

**June 1, 2010:** The US Commerce Department places antidumping duties and countervailing duties on Chinese steel gratings. Chinese Minister of Commerce Chen Deming urges foreign countries to stand against protectionism for the purpose of global economic recovery.

**June 5, 2010:** Secretary of Defense Robert Gates and Deputy Chief of the PLA General Staff Ma Xiaotian attend the Shangri-La Dialogue in Singapore, but unlike prior years, they do not hold a bilateral meeting.

**June 8, 2010:** The US Commerce Department sets preliminary countervailing duties of 15.72 percent on imports of drill pipe from China. In 2009, imports of drill pipe from China were valued at an estimated \$119.2 million.

**June 9, 2010:** Sen. Chuck Schumer (D-NY) announces a Senate vote is planned in two weeks that will place pressure on China to appreciate its currency.

**June 9, 2010:** Twelve of the 15 members of the UN Security Council, including China and the US, vote to apply sanctions against Iran.

**June 9, 2010:** Adm. Michael Mullen, chairman of the Joint Chiefs of Staff, says he is "genuinely concerned" about the motives behind China's military modernization, citing "heavy investments" in sea and air capabilities and its rejection of military contacts with the US.

**June 10, 2010:** Secretary Geithner testifies on China before the Senate Finance Committee.

**June 14, 2010:** The US Department of Agriculture bans the Organic Crop Improvement Association, a leading inspector of organic products, from operating in China because of a conflict of interest that compromises the certainty of the organic quality.

**June 16, 2010:** During a hearing on trade and industrial issues, Representative Sander Levin (D-MI) urges China to raise the value of its currency before the US pursues action against it.

**June 16, 2010:** Senate Intelligence Committee Chair Dianne Feinstein (D-CA) tells Secretary of Defense Gates at a hearing that US arms sales to Taiwan are a “substantial irritant” in relations between the US and the PRC.

**June 16, 2010:** President Obama writes a letter to G20 partners calling for measures to address financial reform, including market determined exchange rates.

**June 19, 2010:** The People’s Bank of China states that it will proceed further with reform of the RMB exchange rate and increase its flexibility.

**June 22, 2010:** China’s Foreign Ministry Spokesperson Qin Gang expresses serious concern over reports that a US aircraft carrier may participate in exercises with South Korea.

**June 23, 2010:** The Senate Foreign Relations Committee holds a hearing titled, “Finding Common Ground with a Rising China” addressing a variety of US-China issues.

**June 23, 2010:** Sen. Charles Schumer (D-NY), says that despite China’s announcement that it will allow greater flexibility in the exchange rate, “not enough is being done. So we are going to move our bill.”

**June 26, 2010:** The G20 Summit drops a commitment to complete the Doha Rounds of talks this year but renews a pledge to come to agreement. China’s Ambassador to the WTO Sun Zhenyu accuses the US of stalling progress on this matter.

**June 26, 2010:** Presidents Obama and Hu meet on the sidelines in Toronto to discuss bilateral ties and other major issues of mutual concern.

**June 27, 2010:** Secretary Geithner and his Chinese counterpart Vice Premier Wang Qishan meet in Toronto to discuss strengthening the economic links in place between the two countries.

**June 29, 2010:** China’s Foreign Ministry spokesman denies that a planned PLA live ammunition exercise in the East China Sea scheduled to begin on June 30 is a response to a joint exercise between the US and South Korean navies in the Yellow Sea.

**July 1, 2010:** Deputy Chief of Staff of the PLA Ma says that China welcomes Defense Secretary Gates to visit China “at a time that is convenient for both sides.”