China’s Role in Global Governance – Foreign Exchange and Intellectual Property: A Comparison

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Abstract

This paper compares Chinese participation in global governance related to intellectual property (IP) and exchange rate policy (ER). Two conclusions hold for both areas. First, China’s behavior within each has demonstrated a recursive dynamic between growing domestic interest articulation, experience/capacity, relative power, and foreign pressure: the first three have caused foreign pressure to be less effective in inducing Chinese policy change. Second, China’s behavior has become more assertive and effective in promoting its preferred regimes within GGOs. Recent successes in ER (an advantageous use of pegging in 2008-10) and in the World Trade Organization (prevailing in key elements of a landmark IP enforcement dispute) are just two examples. We expect China to continue to press for reformist (but not radical) rule adjustments in its favor. But we also find notable differences between the two governance areas. In particular, in IP one would have to applaud the success of the WTO framework in mediating conflict. But when it comes to disputes over what exchange rate mechanism (ERM) China should adopt, the IMF, despite its deep expertise and authority, has played a peripheral role, and other fora (OECD, G20, etc.) are even less important. This may flow from the striking differences in the nature of the two governance regimes.
ON THE EVE of Chinese Vice-President Xi Jinping’s 2012 Valentine’s Day visit to Washington, the U.S. Business and Industry Council took out a full-page ad in The Washington Post. The caption: “From China, With Love.” Above it were pictures of Valentine’s Day candy hearts reading “I.P. Theft” and “Currency Manipulation.” Indeed, two of the most fraught issues in US-China economic relations are intellectual property (IP) protection and exchange rate (ER) policy. This paper describes how China’s pursuit of its preferred IP and ER regimes has become more assertive and more effective over time.¹

We also seek to explain that change. We assume that China’s overarching goals - economic growth and political stability – have been constant. Instead, we hypothesize that changed behavior within these two governance regimes flows potentially from four causal factors: (1) growing governance expertise and capacity, as China has trained lawyers and economists and vastly expanded the range of its participation in global governance organizations (GGOs); (2) growing relative economic power – China’s export market share, at 11%, is now the world’s largest, 25% larger than the United States; (3) changes within China’s domestic political economy, as interest groups emerge and organize; and (4) shifts in China’s growth strategy – low-wage to high-tech, export-led to consumption-demand led, an “industry-first” focus to a consumer/household focus.

Comparing the IP and ER areas, two conclusions hold for both. First, China’s behavior within each has demonstrated a recursive dynamic between growing domestic interest articulation, experience/capacity, relative power, and foreign pressure: the first three have caused foreign pressure to be less effective in inducing Chinese policy change. Second, China’s behavior has become more assertive and effective in promoting its preferred regimes within GGOs. Recent successes in ER (an advantageous use of pegging in 2008-10) and in the World Trade Organization (prevailing in key elements of a landmark IP enforcement dispute) are just two examples. We expect China to continue to press for reformist (but not radical) rule adjustments in its favor.

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Our qualitative analysis is based on archival research, primary documents, secondary literature, and field research. We conducted interviews in Beijing (November 2011), and in Washington (spring 2012), with officials, academics, representatives of American private sector firms doing business in China, and American private sector analysts.

Section One puts the issues in context. Section Two chronicles the central conflicts in IP and ER over three time periods. Section Three traces changes over this period in China’s assertiveness and effectiveness within IP and ER global governance, and relates those changes to our four causal stories. Section Four discusses the implications of our analysis for the future of Chinese involvement in global governance regimes more broadly.
Intellectual property and exchange rate policies

Global governance in IP and ER differs in multiple dimensions: the formality of the international regime, the existence of explicit rules, the strength of the regime, and the extent of membership. In general, the more explicit the rules and the more binding they are, as in IP, the more states are expected to comply with them. When rules are vague and the commitments ambiguous, as in ER, states retain more policy space, and more powerful states have more autonomy.

The term IP covers patents, copyright, trademarks, trade secrets, geographical indications, plant variety protection, and sui generis forms of property protection. IP policy is subject to explicit, formal, extensive, binding and enforceable regulation through the WTO Agreement on Trade-related Aspects of Intellectual Property (TRIPs). TRIPs is the most important multilateral IP agreement because it mandates broad coverage and high standards for IP protection. As of August 2012, 156 member states belonged to WTO. WTO rules exert a strong effect on member states, as violators are vulnerable to economic sanctions. IP rules target firms’ actions, whether private or state-owned, and must be implemented in national laws.

Regulating the exchange rate mechanism (ERM) differs dramatically. IP rules apply across myriad markets; here the sole issue is arrangements for currency exchange. There are no explicit rules or legislation, only Article IV of the International Monetary Fund (IMF) agreement, a scant 800 words, written with a distinctly “gentlemen’s agreement” flavor. Article IV speaks of avoiding “manipulating exchange rates...to gain an unfair competitive advantage,” but also explicitly permits a pegged ERM, such as that used by China after 1997. There is no enforcement. Sovereign states are free to choose among ERMs, subject only to jawboning in annual IMF Article IV “consultations,” or in bilateral or plurilateral venues. Almost all OECD states allow their exchange rate to float on the market. Many small and developing states intervene to peg their rate to the US dollar.

Each governance system will ideally provide a public good. IP protection is supposed to provide incentives for producers to innovate, and for authors to create cultural products. By offering exclusive, limited rights innovators and creators may get rewarded for their contributions. Many argue that without the incentives that property rights provide inventions and culture would be under-produced. Yet such rights also impede diffusion of the innovations, diffusion which benefits consumers and follow-on innovators. Policymakers must strike the right balance between the interests of producers and consumers. Intellectual property rights create scarcity in goods that are not formally scarce, and can increase the costs of goods. These rights can be abused to kill competition, secure monopoly power, and promote rent-seeking behavior. Many analysts argue that the scope and scale of IP protection that works for Organization for Economic Cooperation and Development (OECD) countries is not appropriate for countries at earlier stages of development and net importers of IP-protected goods and services, such as China.

Regulation of ERMs through the IMF is intended to provide stability and predictability about future exchange rates for those engaged in international commerce. These features promote long-range commitments, growth, and price stability. Current economic wisdom holds that a flexible exchange rate, with minimal government intervention, best meets the needs of large countries. But support also exists for a pegged ERM. The Economist observes: “Tellingly, the official international financial architects...have steered clear of the subject.”2
Chinese behavior: intellectual property

The United States and China have long battled over IP protection. Over time China has become more assertive, reflecting a dynamic nested within a broader relative international power shift. China’s intellectual property policies over the past forty years are a product of domestic choices, international pressures, and a dynamic economic development model. This section examines three periods: market opening in 1978 through 1991; the 1992 US-China Memorandum of Understanding (MOU) and China’s route to WTO accession in 2001; and post-WTO accession policies through 2012.

Beginning in the 1970s, US business leaders pressed their government to combat inadequate protection of their IP abroad. Through unilateral pressure, bilateral negotiations, regional and multilateral agreements, the United States prompted much of the rest of the world to adopt its preferred high standards of intellectual property protection. China entered this vortex in 1979 when the United States established diplomatic relations with China. After China joined the WTO, US influence over China’s IP policies weakened. China has implemented some innovative domestic IP policies that preserve policy space for China to pursue its own development path.

Domestic priorities and international pressure: 1978-1992

China’s evolving development model has altered its approach to GGOs. Deng Xiaoping’s 1978 “Reform and Opening” blueprint began China’s engagement in the rapidly globalizing economy. China began to replace structures of a command economy with a regulatory state. One of China’s first economic reforms was its 1979 “Law of Joint Ventures Using Chinese and Foreign Investment.”

Determined to attract foreign investment without destabilizing the overall economy, in 1980 Deng Xiaoping established Special Economic Zones (SEZs) as enclaves for foreign investment. The first SEZ was in Shenzhen. Other early SEZs were located in southern coastal areas Zhuhai and Shantou in Guangdong Province, and Xiamen in Fujian Province. China established SEZs to assemble finished goods for export. Foreigners invested in turnkey factories and set up production facilities for low-value-added assembly work.


Chinese leaders identified science and technology as keys to China’s economic future. Moving to upgrade its technological and scientific capabilities, China realized the importance of protecting IP in a market-based system, but at the same time sought technology transfer and diffusion. Its 1984 patent law was designed to promote local innovation and diffusion by offering invention, industrial design, and utility model patents (so-called “petty patents”). The latter cover incremental improvements and protection is relatively short term. China’s law specified that
invention patents’ specifications would be publicly disclosed after eighteen months. State-owned enterprises could not license their technology without administrative approval, and pharmaceutical products, chemicals and process inventions were excluded from patent protection. These provisions were weaker than OECD patent laws and the discrepancy created friction between OECD trading partners. Most of the patenting activity in this period was domestic, with petty patents being popular and easy to obtain.

While much of this activity responded to foreign pressure, domestic policy priorities drove it as well. The Central Committee of the Chinese Communist Party issued the Decision on the Reform of the Economic System in 1984, followed by the 1985 Central Committee’s and State Council’s Decision on the Reform of the Science and Technology System. China established a National Science Foundation and rolled out three important government R&D programs: 863, Spark, and Torch. These programs offered financial incentives for science and technology personnel to become entrepreneurs; for example in 1984 eleven technicians from the Chinese Academy of Sciences formed the firm Legend (now Lenovo, a major global PC supplier).

During this period the Chinese discovered that they needed to gain greater mastery over IP protection in order to acquire enhanced R&D capabilities. Foreign firms were reluctant to transfer valuable technology without confidence that the Chinese would protect it. While state-owned enterprises mastered production of items such as television sets, they were not acquiring product development capabilities for capturing more value in the production chain.

This first era began with bold domestic economic change and a commitment to engaging in global markets. Now open to foreign investment, foreign pressure certainly played a role in China’s post-Opening and Reform IP policies. However, China also adopted important domestic policy changes to spur further development and to encourage local incremental innovation through its utility model and design patents.

**1992-2001: Shifting gears in response to foreign pressure and domestic change**

Relations over IP remained tense throughout the late 1980s and 1990s. The United States decried China’s failure to protect US-held IP. A series of threats of trade-wars, counter-threats, and official reports of egregious violations of US-held IP rights ensued. In January 1992 the US and China concluded a Memorandum of Understanding on IP.

The 1992 Chinese Patent Law amended China’s law to conform to OECD standards. It extended the invention patent term from 15 to twenty years, and the utility model and design protection from five to ten years. It allowed for patenting of chemicals, pharmaceutical products, food and beverages, and products of chemical processes.

The proximate cause of the 1992 amendment was US pressure, but a deeper domestic shift helps to account for China’s willingness to submit to US demands. After the Tiananmen crisis in 1989, the Party put economic reforms on hold as it struggled over its post-Tiananmen direction. In 1992 Deng Xiaoping succeeded in pushing the country forward with economic liberalization and announced this commitment during his famous Southern Tour (nanxun). Domestically, China doubled down on its efforts to improve its scientific and technological capacity. It sought to deepen market reforms and to promote commercialization of its scientific achievements. China established incentives to promote domestic progress. New laws in 1993 offered royalty-sharing
opportunities for domestic inventors and designers, qualified ownership possibilities, and increased autonomy for state-owned enterprises. In 1995 the State Council and the Central Committee committed to provide further investment in and incentives for basic research, high technology, and commercializing technology.\textsuperscript{11} These changes led to both a surge in domestic patenting and a large spike in foreigners filing invention patents in China.

Despite the 1992 reforms, USTR constantly pressured China. Tempers flared again in 1995. China rebuffed US efforts to get China to shut down twenty-nine factories that allegedly produced millions of copies of American software and movies.\textsuperscript{12} The United States threatened to block Chinese accession to WTO and to levy US$2.8 million worth of trade sanctions over this conflict. China claimed that it would hold up applications of American companies seeking to establish businesses in China and suspend talks on joint ventures with American automobile manufacturers.\textsuperscript{13} In 1995 and 1996, in the shadow of US pressure and China’s efforts to join the WTO, China and the United States reached Agreement(s) Regarding Intellectual Property Rights.\textsuperscript{14}

China’s quest to join the WTO gave its trading partners leverage in the accession process. The United States and the European Community (EC) opposed its accession for many years. It took China fifteen years to attain WTO membership and China had to make major concessions that the United States and the EC demanded,\textsuperscript{15} such as waiving the developing countries’ grace period for implementing TRIPs; China would enjoy no transition period.

This second era began with foreign-induced policy change in which China aligned its patent laws with stricter OECD standards. Its desire to join the WTO kept foreign pressure on pre-accession policy change steady and effective. China adopted domestic policies to further invigorate and incentivize domestic technology production and innovative activity.

\textit{2001-2012: Post-accession and the push for indigenous innovation}

Since China joined the WTO in 2001, US influence over China’s IP policy has weakened. China has implemented some innovative domestic IP policies and strategies for developing technological capabilities. Three important trends in this period have been capacity building initiatives, a sharp rise in Chinese patenting and IP litigation, and China’s commitment to indigenous innovation.

Despite extensive FDI and robust exporting, China captures very little of the value of the goods it assembles and sends abroad. Concerned about technology leakage, foreign firms tend to keep their core technologies to themselves. For each Chinese-made Apple iPad that sells for US$499, China retains only about US$25, mainly labor costs.\textsuperscript{16} Chinese leaders are eager to spur indigenous innovation to capture more value in licensing fees and royalties.

China has introduced new incentives. In 2003 the government began to use invention patent filings as criteria for promotion and tenure in universities, and provided patent subsidies to encourage domestic filing. China designated funds to attract accomplished Chinese scientists and scholars, “sea turtles,” who studied or worked abroad to return to China.\textsuperscript{17} (In Chinese, “sea turtle” is a homophone for “return from overseas.”) In 2005 about 35,000 sea turtles returned.\textsuperscript{18} Gross domestic spending on R&D surged from US$89.6 billion in 2000 to US$300.3 billion in 2006.\textsuperscript{19}

China has invested in improving its IP management and capacity. China increased the number of IP courts, trained judges in IP, and introduced a university IP curriculum. To manage the huge increase in patenting activity it has expanded its State Intellectual Property Office (SIPO) from 2,700 patent examiners in 2007 to roughly 6,000 in 2011, with plans to increase it to 10,000 by 2015. SIPO is poised to become the largest patent office in the world.

Most benchmarks of success for China’s various IP initiatives are quantitative. While quantity does not necessarily indicate quality, quantitative progress has been remarkable. Between 2005 and 2010 patent applications to SIPO jumped from 476,264 to 1,222,286; of these, Chinese filed 1,109,228 applications whereas foreigners filed 112,858. During 2002 and 2003 China filed more trademark applications than any other country. China’s copyright applications for computer software went from 21,500 in 2006 to 82,000 in 2010. In 2008 China became the eighth largest user of the Patent Cooperation Treaty (PCT). WIPO administers the PCT, collecting fees from firms that seek patent protection in multiple countries with a single international application. By 2010 China had jumped to fourth, behind the United States, Japan, and Germany; between 2009 and 2010 alone Chinese PCT applications surged by 55.6%. The Chinese telecom firm Huawei became the fourth largest PCT applicant, accounting for 25% of all Chinese applications.

China has learned lessons the hard way, but has been a quick study. Getting burned by foreigners’ strategic patenting and being sued taught China important lessons. While the patent system can be a tool to spur innovation, firms can also deploy it as a market weapon. Strategic patenting is not about stimulating innovation, but rather extracting maximum value from global value chains of production. Foreigners often have charged very high licensing fees for mature, trivial and even off-patent technology. The Chinese have learned that foreign firms used patenting strategies including “litigation threatening, alliance, and overcharging synchronously, to earn excess benefits.” Until 2007 China had no anti-monopoly legislation to protect itself against these abuses.

Litigation has educated Chinese firms. In 2004 the Chinese firm Zhejiang Dongzheng Electrical Co. prevailed against a North American electronics firm, Leviton Manufacturing Co. Inc., in a patent infringement case. The Chinese firm’s president promoted its victory as a model and urged other Chinese firms to fight back. A French electronics firm, Schneider Electronics, had competed with the Chinese firm, Chint, for European markets since the mid-1990s. Schneider sued Chint for IP infringement in 19 cases in Europe and 6 in China, winning injunctions against Chint. In 2006 Chint used its utility model portfolio to counterattack, suing Schneider for infringement. SIPO determined that Chint’s patent was valid and enforceable. In 2009 Schneider paid Chint $23 million to settle the lawsuit. Chinese firms routinely sue foreigners for Chinese-held utility model infringement. Foreign firms claim that these utility model
infringement cases are difficult to fight and refer to them as “junk patents.” Chinese firms’ strategic patenting suggests that they are learning to game the system to extract rents just as OECD-based firms have been doing for decades.

China has emerged as the world’s most litigious country over IP. Domestic litigation has surged, with most cases involving Chinese litigants suing other Chinese firms. Between 2003 and 2010, IP lawsuits in China rose from 9,000 to 42,902. Chinese firms Huawei and ZTE, competitors inside China, now sue each other for infringement in European markets.

This complex of policies and practices represents a more comprehensive strategy to promote indigenous innovation, strategic sectors and technology transfer. Promoting national champions in strategic sectors, offering incentives for patenting, government procurement policies, standard setting, investing in R&D, investing in research and IP management are all elements of indigenous innovation that the 2006 National Science and Technology plan articulated. US firms doing business in China have claimed that indigenous innovation is “a blueprint for technology theft on a scale the world has never seen before.”

US pressure on China to enforce IP protection remains strong. The US International Trade Commission reported that IP infringement in China and China’s indigenous innovation policies cost US firms US$48 billion in 2009. In the wind energy sector, foreign firms’ market share has gone from 75% in 2004 to 14% in 2009, a result that the US Chamber of Commerce attributes to technology transfer requirements for joint venture partners, local content requirements and preferential treatment for Chinese wind energy firms.

China still depends on foreign technologies. Even its leading firm Huawei admitted in an internal document that “all of its core technologies were obtained through mergers and acquisitions or patent licensing.” Some analysts expect China to make little progress in crossing over to a truly innovation-based economy. Yet with China’s increasingly educated population, its phenomenal economic growth, its engagement with international institutions such as the WTO that expand its market access, and its shift to promote economic growth through domestic consumption by the rising middle class, the combination of supply and demand factors will most likely drive future innovation.

**Chinese behavior: exchange rate policy**

1978-1992: Absorbing and accepting international norms

From 1949 to the late 1970s, China maintained a pegged, overvalued exchange rate. The government retained all foreign exchange, and monopolized all trade through a dozen foreign trade corporations (FTCs). The share of trade in GDP was low and declining.

Then came rapid change. By the mid-1980s, firms could sell foreign exchange on swap markets in dozens of cities. By 1988, China had a dual track exchange rate mechanism (ERM): the swap market and a higher, overvalued official rate. Over the next six years, the official rate moved ever-closer to the swap rate. By 1994, 80% of all foreign exchange transactions occurred on the swap market. Then a further reform unified the two rates at 8.28 RMB/dollar, which was close to an equilibrium rate. The yuan was freely tradable for foreign trade (current account) transactions.
In spring 1992, Deng Xiaoping had thrown his political weight behind rapid integration with the world economy. By 1994, China’s target ERM matched Western economists’ conventional wisdom at that time: free private-sector purchase and sale of the yuan for both trade transactions and financial transactions (capital account), coupled with a managed float.\textsuperscript{45}

Why did China choose full convertibility and a managed float? We see no sign of domestic pressures from differentially affected interest groups. China simply adopted the institutions of the industrialized world it proposed to join. This is a case of what Steinfeld [17-18] calls “institutional outsourcing”: China, he argues,

rescued itself [after 1978] from an existential crisis by linking itself to a particular kind of global economic order...by internalizing the rules of the advanced industrial West...by playing our game.\textsuperscript{46}

1992-2005: China backs into a peg; then, under fire, abandons it

From 1997 to 2005, China’s exchange rate was pegged at 8.28 RMB to the U.S. dollar, requiring strict capital controls. Why did China choose to peg, given the 1994 commitment to a managed float and full convertibility? At the end of the period, China de-pegged, in the face of intense foreign pressure. What explains this second decision, and its timing? Unlike 1980-1994, politics - both external and domestic - is central.

The East Asian Financial Crisis (EAFC) precipitated China’s decision to peg. Between mid-May and mid-August 1997, the local currencies of Indonesia, Malaysia, Thailand and the Philippines came under attack by international speculators who anticipated a future devaluation. The attacks enforced the prophecy; the currencies devalued chaotically by between 40 and 80%. GDP fell by up to 13 percent. Political unrest followed. The consensus of economists, which a year earlier endorsed a managed float ERM, now belatedly recognized that this middle path between a free float and a hard peg was not viable in a world of currency speculators and hot money flows.

In the second half of 1997, then, China faced a stark choice. Should it continue integrating with the world financial system, further relax capital controls, and risk a willy-nilly devaluation? Or should it maintain and tighten capital controls, and peg its exchange rate, warding off speculative attacks on the yuan? By October 1997, China’s decision was clear. Exchange rate movement ceased. The ERM hardened into a dollar peg, and capital controls tightened.

Pegging brought an external payoff. A devalued yuan would have hurt China’s struggling East Asian trade partners. By pegging, China emerged as a reliable regional leader, elbowing Japan aside. In February 1998 Japan had devalued by 20%. By June, US Treasury Secretary Rubin labeled China “an island of stability in Asia.” while Rubin’s aides derided the Japanese Finance Minister as “Minister for the Destruction of the World Economy.”

Domestic interests pushed the other way. State enterprises were being shut down, increasing unemployment. In December 1997, an “articulate group of manufacturers and academics” inside China argued forcefully for devaluation.\textsuperscript{47} But in March 1998, resisting pressure to devalue, the government instead launched a large public works project that successfully offset the shock of falling exports. The fiscal deficit rose from 0.7 percent of GDP in 1997 to at least 2.7% by 2002.
Interviews with Chinese who were involved at that time reveal that the foreign policy payoff from a steadfast exchange rate was a welcome side effect, but that the main motivation was domestic stability. An intensely conservative central government bureaucracy was alarmed by the sudden exchange rate shifts in China’s neighbors and the social unrest that followed. This event also taught policymakers that IMF orthodoxy could change overnight.

From 1997 to 2000, the pegged rate happened to keep the real exchange rate close to equilibrium. But then the current account surplus grew steadily, crossing the red line of 3% of GDP in 2003-2004. Although appreciation was needed, by 2003 policymakers had grown comfortable with the predictability of a pegged rate, and domestic interests had emerged to defend it. Meanwhile, recession had U.S. politicians searching for scapegoats abroad and demonizing China. In July 2005, under fire, China shifted to a more flexible ERM, allowing slow yuan appreciation.

Note the distinction between the policy shift the IMF and Treasury were pushing on China, and the demands of Congress and the Chamber of Commerce. The former wanted China to allow its exchange rate to float. The latter wanted the yuan to appreciate. China grudgingly acceded to the appreciation, but not the float. Of course, had they released the yuan to a market float, it would have appreciated even faster than it did, as China’s 2006-2010 current account imbalances demonstrated.

But China’s ERM was not the initial cause of these imbalances. They were “made in America.” A high-tech asset bubble in the late 1990s, followed by a housing asset bubble, pushed up US consumer spending, as households overestimated their wealth and borrowed against home equity. In October 1997, the American household saving rate fell below 1%, the lowest rate ever recorded. By 2002, the U.S. government was borrowing heavily to finance two wars, after sharply cutting taxes in 2001. The resulting U.S. savings imbalance inevitably generated a U.S. trade imbalance.

Even though China’s peg had not caused the imbalance, it arguably disadvantaged some third-country trade partners. For example, the euro was appreciating against the dollar and hence also against the yuan. Not surprisingly, by August 2002 the finance ministers of Canada, Britain and several European countries had joined the “currency manipulation” chorus. Through 2003, the US Congress turned up the heat.

But despite the drumbeat of foreign criticism, and high-level exchanges between China and the United States, it was not until late 2004 that the first inter-ministerial debates over exchange rate policy occurred. De-pegging was probably approved at the December Economic Work Conference. In May and June 2005, the Central Economic and Financial Leading Group hammered out a draft decision, which was taken through the State Council and then to the Politburo and announced on July 21, 2005.

The nominal ER, unchanged for eight years, appreciated by 2.1% on the spot, but then appreciation slowed to a crawl. By June 2008 the yuan had risen only 18% in nominal terms, and only 9% in real terms. The exchange rate remained closely controlled – a “moving peg” ERM rather than a managed or free float. The PBOC was still burdened with an exchange rate target: the ER’s rate of change. Speculators still enjoyed a one-way bet: the yuan would only move up.
Hence, capital controls had to remain in place, and monetary policy could not be devoted to macroeconomic stabilization.

It would have been in China’s interest, and the world’s, had the adjustment come two years earlier. Six factors contributed to the long delay in de-pegging, and the cautious choice of a moving peg:

1) Unlike 1997, the external shock was inflationary – higher export demand from the U.S. The appropriate exchange rate response was appreciation, rather than devaluation. Exporters naturally lined up against releasing the nominal peg. Said one informant:

   China bore a lot of costs from not devaluing (in 1997). After the crisis, what was originally a temporary solution became comfortable, and the lobbying force of the exporters was strong. In 2003, they said, “Even a 1 or 2% rise in the exchange rate will create real problems for us.” I argued before the Premier (for ER movement), but failed.51

2) Domestic politics worked against an early resolution. The shock emerged during the 2003 political transition, when risk-averse Chinese central government politicians tend to freeze up. “In Chinese politics,” we were told, “the middle is always right.” Also, Chinese politics is increasingly consensual. Just as Zhu was less powerful than Deng, so Zhu’s successors were less able than Zhu to enact change.52

3) It’s intrinsically difficult to compensate the potential losers from a currency appreciation, because it involves a single price that impacts across the whole breadth of the economy. China made enormous concessions to win WTO accession. But the pain was sector-specific, allowing sector-specific political inducements sweetened the pill. “Exchange rate pain is harder to offset, and much more uncertain.”53

4) Overt foreign pressure stoked nationalism. A senior Ministry of Finance official commented angrily, “This is a sovereignty issue. No other country has a say in this.”1 Wright54 argues that the issue rose to the Politburo only because of punitive threats from Sen. Schumer and Lindsay, and that the decision was delayed by perhaps two months until they agreed to withdraw their amendment.55 Interviewees uniformly agreed that the shift should and would have come at least a year earlier, had it not been necessary to visibly resist foreign demands.56

5) Bureaucratic lobbying delayed and then minimized the 2005 shift. The central government bureaucracy had only one natural champion of a managed float, the PBOC, which has nothing like the clout of the US Fed. Arrayed against it were the MOC, the MOF and perhaps the NDRC, all ranking much higher than PBOC.

6) Perhaps because the issue became so politicized in the United States, the IMF was less effective. Its superb technical staff engaged China each year in Article IV consultations. That quiet advice might have been heeded earlier, had it not been drowned out by U.S. politicians.

To summarize: In the 1997-2005 period, China’s ERM shifted twice. In 1997, the East Asian crisis derailed evolution toward a managed float, and a temporary dollar peg then evolved into a

fixed policy. Between 2000 and 2005, global trade imbalances, originating in the US, led to pressure on China to de-peg. Although this pressure caused China to dig in its heels, in the end the ERM shifted to a moving peg. Factors contributing to this outcome were foreign pressure, lobbying interests within China, and an increasingly consensual and conservative Chinese leadership.

3. After the 2005 de-peg: China charts her own course

Table 2 shows a steady nominal appreciation since July 2005. Fig.2 confirms that the real exchange rate is also flexible and appreciating over time.

### Table 2: Appreciation of the Nominal RMB Exchange Rate After 2005

<table>
<thead>
<tr>
<th>Year</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
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<tr>
<td>Nominal Exchange Rate</td>
<td>8.19</td>
<td>7.97</td>
<td>7.60</td>
<td>6.94</td>
<td>6.83</td>
<td>6.77</td>
<td>6.45</td>
<td>6.35</td>
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<tr>
<td>Annual % change</td>
<td>1.1</td>
<td>2.7</td>
<td>4.9</td>
<td>9.5</td>
<td>1.6</td>
<td>0.9</td>
<td>5.0</td>
<td>0.9</td>
</tr>
</tbody>
</table>

Source: IMF. Annual averages. 2012: January-July

Figure 2. Real Effective Exchange Rates 2004-2010: RMB, US$, Euro, Yen

The annual data conceal a seeming reprise of the 1997-2005 events. In July 2008, China again froze the Renminbi’s nominal value against the dollar, at 6.83. This rate persisted through 2009 and the first half of 2010, provoking renewed strident calls from the US Congress for appreciation. In other words, despite the 2005 “reform”, after precisely 36 months of modest flexibility and gradual appreciation, China re-pegged its exchange rate, for precisely 24 months, and then de-pegged again.

Some explain this as political: China asserting itself against the West. One government official saw things this way: “We’re saying: we will make these changes whenever we want to, on our timetable, not yours.” In July 2008, China was preparing for the fall party meetings where the Hu-Wen administration expected to win a second five-year term – an opportune time to flex muscles. But one could also argue that China again acceded to U.S. pressure: Congressional threats, Treasury Secretary statements, and so forth. At the time of the Chinese decision to once again de-peg (June 21, 2010), Congressional action was looming, and a G20 meeting was just a week away.

A more likely explanation can be found in the path of the dollar/euro exchange rate. When the dollar is depreciating against the euro, yuan-dollar appreciation is tolerable. Beginning in January 2006, the dollar depreciated steadily against the euro, and by July 2008 had lost more than 20% of its value. The yuan, floating slowly upward, appreciated against the dollar, but by less than 20%. The net result: Chinese exports to the U.S. were disadvantaged, but exports to Europe received a net boost.

But the dollar-euro exchange rate turned around in mid-2008 – just when China re-pegged. By mid-2010 the dollar had regained all the lost ground. In this period, if the yuan had continued to appreciate against the dollar, it would have appreciated twice over for eurozone trade (doubly hurting Chinese exports there). It’s easy to imagine Chinese ministries, local governments and exporters crying for a peg, and getting it.

In this third period, Chinese currency management has become far more confident and sophisticated. A senior, knowledgeable informant summarized the difference:

> In 1997, and even in 2003, we barely understood the difference between real and nominal exchange rates. Any volatility in the yuan was viewed as threatening. Now, at a technical level, we’re much more sophisticated. We’ve also created swap mechanisms that enable our producers to hedge against currency and interest rate movements, which reduces their concerns somewhat.

### China’s assertiveness and effectiveness

Is China a status quo power with respect to global governance? As Kennedy suggests, framing this question this way makes the answer obvious. To the extent that China has been effective in achieving its own goals by working within the global governance system, it will presumably favor the status quo. China’s core goal is rapid economic growth via industrialization, and its industrialization strategy is rapid integration into the world economy. Over the last twenty years, both strategy and goal have succeeded beyond anyone’s wildest imaginings.
As the current rules have benefited China, we expect China to favor reformist, not radical, change. Not every rule works to China’s advantage. China will push to reform the rules, in part by asserting its own power as a rule-maker. Looking at IP and ER, China has been effective pursuing its growth goal. Has China successfully asserted itself by remaking rules?61

**Intellectual property**

China has gained impressive competence in IP policy and GGOs in a short time and is a skilled participant in the WTO. Highlights of China’s participation include its effective performance in a landmark WTO copyright case, and its more assertive participation in the TRIPs Council and WIPO.

Since joining the WTO China has been an observer in every Dispute Settlement case to learn first-hand how the system works. China has been a quick study and defended itself ably in a WTO Copyright enforcement case. It has affirmed a considerable amount of policy discretion under TRIPs.

Frustrated by what they perceived to be China’s flagrant lack of copyright enforcement, US-based trade groups pressed the Bush administration to seek remedies through the WTO dispute settlement process. In April 2007 the United States brought its first IP enforcement case against China to the WTO.

The case included three claims: first, that China violated TRIPs by denying copyright protection for censored works; second, that China violated TRIPs by disposing of goods seized in counterfeit raids by donating and/or auctioning them off; and third, that China lacked criminal sanctions for counterfeiting and piracy below certain thresholds.

The WTO Panel’s report upheld most of China’s practices.62 The WTO ruled that China’s denial of copyright protection for censored works violated Article 5(1) of the Berne Convention for the Protection of Literary and Artistic Works (which is incorporated into TRIPs). Subsequently, in 2010 China amended its copyright law in response to the panel’s rulings.63

China prevailed on the second claim concerning the disposal of pirated and counterfeit goods seized in raids. Copyright and trademark rights holders seek to keep these goods off the market. China has an agreement with the Red Cross to donate these goods, and sometimes China auctions goods off after removing the infringing trademarks.64 The panel ruled that China’s practices did not violate TRIPs but ruled that simply removing the infringing trademark before auction was insufficient.65

The United States argued that China violated Article 61 covering criminal penalties for infringements. This third claim raised the issue of “commercial scale” of infringement – how much infringement constitutes “commercial scale?” TRIPs negotiators never agreed. US negotiators sought and failed to obtain low thresholds and a broad definition for commercial scale in TRIPs. China has used a far “narrower and more common usage understanding of ‘commercial scale’ …to mean ‘a significant magnitude of infringement activity.'”66 China argued that the term “‘commercial scale’ was intentionally vague … because a large bloc of Members would never have accepted a more specific and intrusive obligation.”67 China further argued that in its bilateral agreements the United States defines “commercial scale” to cover any
activity for financial gain, underscoring that “the United States failed to secure in the TRIPS … negotiations the obligation that it nonetheless seeks to impose here.” The United States submitted industry-generated reports of losses to infringement in China, press articles, and anecdotal evidence for its case. Both China and the WTO panel criticized the evidence for being “insufficient” and “uncorroborated” and maintained that the accuser “failed to satisfy its burden of proof.”

China prevailed on important claims. The ruling underscored ample discretion in implementing TRIPs, and did little to assuage US rights holders’ concerns about inadequate enforcement. Realizing the weakness of WTO mechanisms to achieve their desired enforcement outcomes, US rights-holders persuaded the USTR to pursue a plurilateral agreement to secure more effective IP enforcement. The United States negotiated the Anti-Counterfeiting Trade Agreement (ACTA) with select trading partners (mainly OECD countries and countries already bound by TRIPs-Plus agreements with the United States). The ACTA is TRIPs-Plus, incorporating features and provisions that the United States could not secure at the multilateral level. China raised its concerns about ACTA in the WTO TRIPs Council. At the June 2010 TRIPs Council meeting China, along with India, Argentina, Venezuela, and Mauritius expressed concern over TRIPS-plus enforcement trends and ACTA. At the October 2010 TRIPs Council meeting, China suggested that ACTA might be incompatible with TRIPs.

China also has concluded bilateral and regional trade agreements with developing country partners seeking to use its soft power to underscore differences between it and the United States and Europe. China does not use trade agreements to transplant Chinese laws in less developed countries. A Chinese diplomat said, “Non-intervention is our brand, like intervention is the Americans’ brand.” China seeks to use its bilateral and regional trade agreements to strengthen its position in the WTO so that it will be better able to fight anti-dumping actions there.

China has supported a “development agenda” in WIPO that would incorporate developing countries’ concerns about intellectual property. For example, China supports protections for traditional knowledge, farmers’ rights, prior informed consent, and access and benefit sharing reforms – none of which are incorporated into TRIPs. The development agenda drove the United States to the plurilateral level (e.g., ACTA) for IP rulemaking as countries like China assert their interests against the United States’ in WTO and WIPO.

**Exchange rate mechanism**

China’s IP policy has many disparate goals. ER policy, by contrast, is part of broad macroeconomic policy with one overriding goal: rapid economic growth through sustained industrialization.

During 1980-94, China passively accepted the misguided global norm of a flexible ERM that left it vulnerable to speculative attack and financial disruption. An opportunity for regional leadership amid the 1997 crisis, and concern over stability, produced a dollar peg. Domestic interest groups solidified that peg; the 2005 break was tardy and fraught. After 2008, China pegged, then broke the peg, based on perceived national interest, and challenged US positions in other areas of international financial governance.
We see here an increasingly assertive China, with growing financial expertise, the world’s largest export market share, and GDP approaching the US. China has in principle accepted the global norm of flexible exchange rates. But it continues to peg when pegging suits, even when the trade surplus exceeds 5% of GDP. Clearly, a “China exception” now exists within that global norm.

Thus within international finance, similarly to the IP regime, China seeks flexibility within the existing system, not an overthrow of the system as a whole. We conclude that China is a status-quo power that, like other powerful countries, will regularly exploit opportunities to remake the rules to its own advantage.

**Implications and conclusions**

We began this chapter proposing to link the Chinese policy choices over time to four causal stories: growing capacity/expertise, growing economic power, domestic politics, and an evolving growth strategy. The first two of these clearly shaped both the IP and ER experience. Compared with the situation twenty years ago, China can now confidently chart its own course in these waters, and carry other countries in its wake. Domestic interest groups’ roles are harder to define, measure, and analyze, and yet they did shape its ER policy choices. Now in both ER and IP, we have no doubt that central government policy choice must heed many voices – local governments, firms, bureaucratic forces at every level – to an extent that would have been unthinkable in the early 1990s. And (in the IP arena, but not ER), firms themselves are increasingly actors.

Our conclusions about China’s evolving development strategy are more complex, because the concept itself is more complex. China is moving from low-wage assembly processes to higher-skill, higher-technology processes, due to rising educational levels and heavy R&D investment. OECD countries may come to regret the aggressive approach they deployed to get China to embrace the IP regime. If China successfully crosses the bridge from imitation to innovation, then hefty royalty and licensing fees will be flowing from West to East.

The remaining components of a development strategy story are more ambiguous. Primary reliance upon export-led growth must end. China’s share of world exports might rise from 11% to 15%, or even 20% - but in the long run, China’s exports can grow only as fast as world trade grows. At that point, where will households get the income needed to substitute for exports as China’s growth engine? An appreciated currency, raising their real incomes? Higher interest on their deposits? Higher wages? Lower prices? China has always put producers first, and all of these options would sap the power of China’s industrial sector.

Section Three documented China’s increasingly assertive role in global governance. China is beginning to enjoy a voice at the table commensurate with its rising economic power. In the WTO copyright enforcement case, China effectively retained policy space tailored to its needs. It will likely increasingly pursue WTO dispute settlement channels to push back against aggressive U.S. and European challenges. China’s renewed use of a dollar peg in 2008, and strong government ER intervention since then, breaks a trail for smaller countries such as Malaysia who might otherwise have trouble standing up to the IMF on this issue.
All of this means no more cakewalk for the United States and Europe in multilateral forums. China has built up significant goodwill throughout the developing world using its soft power, investment, and non-onerous treaty provisions. Gridlock between developed and developing countries across a number of multilateral forums (WTO, WIPO, Kyoto Protocol) has chased the United States and Europe out of multilateral forums to pursue plurilateral, regional, and bilateral routes to achieve their goals. Multilateral forums no longer accurately reflect the underlying world power distribution.

Developing countries may find a new leader in China, yet so far its multilateral engagement has been more supportive than leading and its preferences have been more reformist than radical. Competition between the BRICS will increase over time, but for now some of these countries have been effective champions for some developing countries’ IP and ER concerns. China and India have supported access and benefit sharing agreements and prior informed consent for those seeking to exploit their biological diversity. China also has joined in the push back against ACTA and TRIPs-plus approaches to IP. The ongoing Trans-Pacific Partnership Agreement (TPP) negotiations, with their TRIPS-Plus IP provisions and uncertain consequences for the balance of economic power in Asia, surely will raise China’s hackles.

However, in both IP and ER, we concur with Ren Xiao and others contributors to this research initiative. As China’s power and participation grow, it will seek greater institutional power, both for its own purposes and to advance a broader global governance agenda. It will be a status quo power, promoting reform, not radical, change.
Notes

1 We gratefully acknowledge the support of the Indiana University Research Center for Chinese Politics & Business, and Scott Kennedy for his leadership and assistance both in Bloomington and Beijing.


5 Ibid, 338.


7 Xue and Liang, “Relationships between IPR and technology catch-up,” 325-326.

8 Ibid, 324.

9 Ibid, 325.

10 Ibid, 335.

11 Ibid, 336.


13 Ibid.


18 Xue and Liang, “Relationships between IPR and technology catch-up,” 349.

19 Ibid, 344-345.


21 Ibid, 3.


27 Xue and Liang, “Relationships between IPR and technology catch-up,” 355.
Xue and Liang, “Relationships between IPR and technology catch-up,” 348.
Ibid.
Ibid, 26, 28.
Chen “Western ways, good and bad,” 1; Suttmeier and Yao, “China’s IP transition: rethinking intellectual property rights in a rising China,” 13.
Xue and Liang, “Relationships between IPR and technology catch-up,” 350.
Interviews 1, 2, 15, 20, 27, 32, 33.
For an authoritative study, documenting the primacy of U.S. imbalances, see Olivier Blanchard and Gian Maria Milesi-Ferretti, “Global Imbalances: In Midstream?” (IMF Staff Position Note SPN/09-29, 22 December 2009).

Interview 32.

Interviews 2, 7, 14, 22, 29.

Interview 22.

Wright, 2009: 221-225.


Interviews 1, 6, 15, 20, 23, 29, 32, 33.

Interview 19.

Personal communication from Albert Keidel.

Interview 12.


This is a rather “realist” view of Chinese motivations. One could imagine a Chinese meta-goal: strengthening global governance as a whole, in order to stabilize the world environment which enables rapid Chinese growth. We assume that this motive is at best a minor factor in explaining Chinese behavior within global governance.


Yang, “Bringing the question of Chinese IPR enforcement to the WTO under TRIPS,” 12.


Yang, “Bringing the question of Chinese IPR enforcement to the WTO under TRIPS,” 13.

Excerpt from China’s intervention at the WTO TRIPS Council meeting held from October 26-27, 2010. Available at: http://kieonline.org/node/1001


At an October 2008 Asia-Europe international financial system conference, China supported the European view that weak financial regulation led to the world crisis, and must be strengthened. In March 2009, PBOC governor Zhou Xiaochuan called for an international reserve currency “disconnected from individual nations” and suggested SDRs as an option. In June 2009, Liu Mingkang, the head of the Chinese Bank Regulatory Commission, laid out lessons for the West in prudential bank management.