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William Clarke

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CHAPTER VIII.

THE COMMERCIAL IMPLICATION OF NORMALIZATION

*William Clarke**

The President's announcement on December 15, 1978 of normalization of relations with the People's Republic of China (P.R.C.) set off a flurry of activity in our office, reflected by over 300 phone calls and letters a day, the necessary doubling of our staff (the bureaucratic aspect of my background) and requests for over 20,000 copies of our report, *Doing Business with China.*[1] These things are reflective of the sweeping interest in the country and of the potentially enormous new market for American firms. But the President's action and Chinese action on January 1, 1979 only normalized our political relations; it did not normalize our economic or commercial relations. There is still a long way to go.

The joint communiqué that emanated from the Deng visit with the President at the end of January, 1979 clearly set the stage for the normalization of our economic and commercial relations, and gave some impetus to moving quickly ahead with the resolution of the outstanding issues.[2] The communiqué called for a trade agreement between the two countries, a maritime agreement and an air agreement. During the visit, a cultural agreement was signed,[3] as was a consular agreement whereby we would have consulates in Shanghai and Canton, while the Chinese would have consulates in Houston and San Francisco.[4] Negotiations on that latter point are still underway.

At the end of February, Secretary of the Treasury, Michael Blumenthal went to China to convert our liaison office into an official embassy on March 1. During the visit, Secretary Blumenthal initialled a claims and assets

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* Director, People's Republic of China Affairs in the Bureau of East-West Trade, Department of Commerce.

1. *See* p. 148 *infra.*

2. *Joint Communiqué on the Establishment of Diplomatic Relations Between the United States of America and the People's Republic of China — January 1, 1979,* 18 INT'L LEGAL MATS. 274 (1979). *See* Appendix-Selected Documents p. 105 *infra.*

3. *Cultural Agreement Between the Government of the United States of America and the Government of the People's Republic of China — January 31, 1979,* 18 INT'L LEGAL MATS. 341 (1979).

4. *Agreement Between the Government of the United States of America and the Government of the People's Republic of China on the Mutual Establishment of Consular Relations and the Opening of Consulates General — 1979,* 18 INT'L LEGAL MATS. 337 (1979).

settlement[5] and reached an agreement on establishing a joint economic committee between the two governments for purposes of discussing trade problems as they arise in the future.

The past Secretary of Commerce, Juanita Kreps went to the P.R.C. in early May and continued the momentum that had been developed by the Deng visit here and by the Blumenthal visit to China. She was able to sign four scientific and technical accords[6] and to get an agreement from the Chinese to begin discussions on a civil air agreement. Drafts were exchanged on a maritime agreement which would contain cargo-sharing provisions. An agreement was negotiated with the Chinese on the exchange of trade exhibitions, and the first Chinese trade exhibitions in this country will be in New York, Chicago and San Francisco in 1980. Secretary Kreps signed the claims and assets agreement[7] which was a significant step in moving our commercial relationship forward. Most important, she was able to initial a trade agreement.[8]

There are quite a few complications in negotiating a trade agreement with the Chinese. The primary differences were not in principle; the problem was the difficulty the Chinese had in trying to understand the legal language we were forced to employ in the draft trade agreement by the Trade Act of 1974.[9]

The trade agreement is a significant step forward in improving our relations. It is the keystone around which the full normalization of our commercial relationship must be built; providing for nondiscriminatory, "most-favored nation" treatment of China, including tariffs on Chinese exports to the United States. The agreement also outlines measures to promote economic and commercial relations and to facilitate the conduct of business, easing the difficulties in establishing business offices in China. It also contains assurances relating to financial transactions regarding international payments and banking transactions. In addition, the two sides agreed to facilitate the availability of official export credits. Furthermore, the agreement endorses procedures for the prompt resolution of commercial disputes and deals with methods for resolving trade problems that might arise. Finally, there are provisions regarding the protection of patents, trademarks and copyrights.

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5. *Agreement Between the Government of the United States of America and the Government of the People's Republic of China Concerning the Settlement of Claims — May 11, 1979,* 18 INT'L LEGAL MATS. 551 (1979). *See* Appendix-Selected Documents p. 131 *infra.*

6. N.Y. Times, May 14, 1979, at 1, col. 5; N.Y. Times, May 16, 1979, at 2, col. 1.

7. *See Settlement of Claims supra* note 5.

8. N.Y. Times, May 14, 1979, at 1, col. 5; 18 INT'L LEGAL MATS. 1641 (1979).

9. [1974] 25 U.S.T. 720, T.I.A.S. No. 7821.

The agreement is now subject to review and approval by the two governments. Until that review is completed, I cannot make a firm prediction as to when the agreement will be signed and subsequently submitted to the Congress. We will, however, probably insist on a satisfactory conclusion of the textile negotiations before submitting the trade agreement to the Congress.

Let me give you a picture of trade with China in 1979. The first quarter figure of $500 million indicates that trade could reach a total of $2 billion this year. At a minimum, the figure would be $1.8 billion, a substantial increase over the 1978 total of $1.15 billion. More importantly, the favorable balance of trade would double from $500 million last year. These increases should, however, be kept in context — our trade with Taiwan was approximately $7.5 billion in 1978.

The sharp rise in the dollar amount of U.S.-China trade this year is primarily attributable to the return of China to the U.S. agricultural market. Secretary of Agriculture, Robert Bergland was told that the figure of Chinese grain purchases from the United States would run five to six million metric tons each year. In addition to wheat and corn, contracts call for sales of cotton, soybeans, oil, tallow, hides and skins, and breeding stock.

Presently, the ratio of agricultural to non-agricultural U.S. exports to China is about seven to three. Manufactured goods still have a long way to go. In the last twelve months, however, some interesting contracts and agreements have been signed, some of which are worth noting as they are reflective of the current market and Chinese priorities, and are indicative of where U.S. firms are competitive.

The Chinese have signed protocols or letters of intent with U.S. firms for a number of large transactions. United States Steel has signed a $1 billion agreement with the Chinese and Bethlehem Steel has concluded a deal for more than $600 million. Kaiser has also signed a protocol. Fluor Corporation has concluded an $800 million arrangement for a copper project. Both Hyatt and Intercontinental Hotels have negotiated agreements in excess of $500 million each. Kellogg has sold a plant to the Chinese. The Chinese have also ordered three Boeing 747 SP jets with an option to purchase two more, a deal worth more than $200 million. Commodities sales to China for the first quarter of 1979 include nearly $20 million worth of polyesters, almost $10 million of fertilizer, almost $4 million of pulp paper and more than $10 million worth of agricultural chemicals.

There have also been some significant sales of manufactured goods including nine Bell 212 helpicopters for more than $12 million; 700 Ford trucks for about $7 million; $7 million worth of Joy underground mining equipment; and other purchases of machinery of heavy equipment from General Electric, Caterpillar, Rexnord and others. Pfizer has sold a million dollar body scanner, and Control Data Corporation has sold $69 million worth of seismic data processing computers. Over $200 million of petroleum equipment has been sold to China since 1973, much of it by Continental Emsco and Armco International's National Supply Company. There has also been a significant amount of petrochemical and other technology involved in U.S.-China trade over the past six years. One of the most exciting and potentially most rewarding efforts now underway is the exploration by American and foreign companies for oil in the South and East China seas. The Chinese are pinning great hopes on successful developments there.

The bulk of imports from the P.R.C. have been in traditional commodities such as textiles, tea, fireworks, tin, tungsten and antimony, as well as nails, antiques, shrimp, feathers and down. Coastal States Gas has begun to import Chinese crude oil; the first $10 million shipment arrived in March. The deal's 5 million barrels represents, however, only one half day's supply of American oil imports.

Of course, Sino-American trade is still faced with the textile import problem and the continuing irritant of U.S. government controls on some American exports. Also, with the exceptions of the Coca-Cola and Schenleys' deals, there are no consumer goods in our exports to China. Basically, the Chinese will not spend their foreign exchange on the importation of consumer goods. Notable aspects of on-going negotiations with the Chinese anticipate American participation in coal mining developments, non-ferrous mines, steel plants, locomotives, diesel engines, trucks, and mining and construction equipment. The Chinese are also negotiating the purchase of a $500 million domestic satellite with earth stations.

In general terms, however, the United States still trails Western Europe and Japan in obtaining a normal share of the China trade. The P.R.C. buys primarily on the basis of price, quality, and terms, and we have to compete on that basis. With the January 1st recognition of China, the United States is no longer discriminated against for political reasons, but there are significant factors which continue to operate against us. These include the lack of adequate financing of deals with China, and our lack of knowledge and experience in dealing with the Chinese, as well as our lack of sufficient competitiveness which, when coupled with our occasional impatience, is a significant hindrance to trade. It also must be remembered that U.S.-Chinese economic and commercial relations have yet to be normalized. The trade agreement has only been initialled, not yet signed, and the Export-Import Bank has yet to open its window to China.

As I have indicated, our feelings about trade in 1979 are upbeat; the final figure could reach $2 billion. To consider prospects beyond 1979 we must look more closely at the Chinese market and their plans for modernization of their economy. In fact, we should look at China itself more closely. On the one hand, one sees a nation which has detonated nuclear devices and launched earth satellites. China is a nation which ranks fourth in the world in energy production and is one of the world's largest textile producers, with a low inflation rate. It is a nation which extends economic aid to others, and is succeeding in controlling its birthrate and eradicating, or at least controlling, most major diseases. On the other hand, one's perception of China must also include an awareness that eighty percent of its people are engaged in agricultural pursuits, surely a hallmark of a developing country; seventy percent of its railroads are still powered by steam, and China's per capita consumption of power is on a par with that of Bolivia. There are no privately-owned cars in China and no intercity commerce by truck. Bicycles, rather than automobiles, cause traffic jams on city streets, and cotton cloth is rationed. We are only now seeing the beginnings of a tourism industry in China and the first advertising by foreign companies in the Chinese media. These contrasts in the perceptions and realities of modern day China suggest a unique economy.

Any discussion of the trade picture beyond 1979 must make reference to the current ten year plan outlined by Chairman Hua in 1978 and subsequent events affecting that plan. As outlined by Hua, the parameters of the plan encompassed a projected eight year capital investment picture that would be equal to the total investment of the past twenty-eight years. The plan looked to an annual agricultural growth rate of four to five percent, which is twice the rate of agricultural growth from 1952 to 1976. With 120 key projects earmarked for development, industrial growth was slated to increase at a rate of more than ten percent each year. To accomplish these goals, Peking clearly contemplates a major infusion of foreign plants and technology.

This plan, however, appears to be in serious trouble. It is clearly too ambitious. Some people say that the Chinese, realizing this, are presently "retrenching." In our meeting with him, Vice Premier Deng made it clear that the actions the Chinese are currently taking are merely a "readjustment," a compensation for the loss of balance in the Chinese economy over the past ten years. The purpose, Deng said, is to speed up modernization, looking both toward the short and the long run.

It is important to understand the constraints and problems that have led the Chinese leaders to make this readjustment, because the success they have in controlling them will determine the strength and shape of the market for American firms in the 1979–85 period. With twenty-two percent of the world's population subsisting on only seven percent of the world's arable land, agriculture is, of course, China's number one priority. Each year, feeding this enormous population requires the use of over $1.5 billion in foreign exchange reserves on the purchase of grain alone. China is also faced with the socio-economic problems of putting management back in control of production, maintaining work force discipline and providing material incentives to the work force without arousing an uncontrollable demand for consumer goods.

There is also the problem of just how much technology China is capable of absorbing at the present time. Scientific education and a generation of scientists and engineers was lost during the Cultural Revolution. There is also a great contrast between the level of technical skill of cadres in Peking and those in the countryside. The current program of sending students to the West for scientific and technical training is an attempt to rectify these problems, but this will take time. The power, coal, steel and transportation industries are presently serious bottlenecks to economic modernization. As much as twenty percent of Chinese productive capacity is inoperative owing to power shortages. There is the question of military modernization, which was highlighted by the recent incursion into Vietnam. The omnipresent issue of political stability of the Chinese government is also a factor in the success of the modernization plan. The Deng leadership, however, appears to be as stable as can be expected in the immediate post-Mao period.

Planning and financing the modernization effort have also presented major problems. There is evidence suggesting that the Chinese leadership did not fully comprehend the technological complexity of their Ten Year Plan or their ability to pay for it. We therefore see the cancellation or renegotiation of what were thought to be firm agreements, and the Chinese reducing the number of projects under simultaneous construction. It is probable that the Chinese leadership over-estimated the return from off-shore petroleum developments and under-estimated the costs of importing plants and technology.

So, as Deng says, China is in a period of readjustment that will not be complete until 1981. To date, this readjustment has been manifested by the suspension of thirty contracts, with Japanese firms totalling $2.7 billion, the slowdown of ongoing negotiations and a great debate on whether to redirect the bulk of investment into agriculture and light industry and away from steel and other heavy industries. Deng told us, however, that readjustment will not result in a cutback of imports. Indeed, some of the Japanese contracts have already been renegotiated. Based on the original plan, we estimated a Chinese import bill of $65 to $80 billion. Even when the estimate is scaled down to account for the current slowdown, we still estimate import expenditures of over $40 billion. Indeed, we can see a good part of this development in agreements and contracts already concluded which have jumped from $7 to $30 billion.

It is no wonder that we see the Chinese pulling out all stops to maximize traditional exports, using counter-trade, participating in joint equity projects, encouraging tourism and attempting to speed up the development of oil and other new exports. Even with these efforts, we foresee a cumulative trade deficit of more than $15 billion from 1979 to 1985. Li Xiannien, China's top economic manager, has put the figure at $20 billion, which, by the way, is still less than the U.S. trade deficit for 1978.

We think the gap between earnings and expenditures could be financed. For instance, the British have offered a $1.2 billion line of credit, the Japanese have put together a twenty bank syndication extending $2 billion in credit, and the French have offered $7 billion. Credit has also been extended by the Canadians and the Italians. But while China is considered a good credit risk whose purchases could be financed, the Chinese, expressing their typically self-reliant character, are more concerned over whether they can pay it back.

The important question is how these changes will affect the economic chances for American firms in the Chinese market during the modernization period. The brightest outlook is for agricultural products and petroleum equipment and technology. There are still many opportunities in the iron ore, coal and steel industries. Other opportunities exist in the areas of non-ferrous metals, mining and construction equipment, hydroelectric technology, machine tools and locomotives, agricultural chemicals and equipment, electronics such as computers and advanced medical instruments, and transportation. There may also appear to be good chances for architect-engineers, engineering contractors and those offering management advisory services to enter the China market.

The Chinese interest in what we have to offer is strong. Presently, there are over forty Chinese delegations in the United States. But make no mistake, the Chinese are here to learn as much as they can. They intend to copy where feasible, to license where they cannot, and to buy American hardware only when they have to. It is our job, therefore, to assist them, but at the same time, to maximize the return to us in doing so. We should not offer the Chinese a free ride at our expense.

American firms need to understand the Chinese market and approach negotiations with a willingness to discuss financing, buy-back compensation, and even equity participation. Our current view of Sino-American trade is one of measured optimism, not euphoria. Perhaps our two-way trade total will reach $4–5 billion annually by 1985. The United States will realize some of these big projects I have talked about, but there is no question that without Export-Import Bank financing, we will be unable to overcome our present competitive disadvantage with Western Europe and Japan.

Of course, after the Chinese have run through the first round of billion dollar loans in the fixed interest range of 6 1/2–7 1/2 percent, there will be less of that money available for further financing. Banks will be taking a much harder look at Chinese performance and interest rates will probably be considerably higher. Even then, however, we will remain at a disadvantage without Export-Import Bank loans and guarantees in the picture.

Of course, I believe it is the opinion of our banking experts that Japan and Western Europe cannot or will not be willing to provide all the credit China requires without the participation of the U.S. banking community. The picture is not all bleak, but putting the Export-Import Bank into the picture is essential if we are going to be able to approach our overall potential for trade with the P.R.C. As a result of Secretary Kreps' efforts in getting a trade agreement initialled, I am heartened that we will eventually be able to get the Export-Import Bank window open for the Chinese.

In summary, here is where we stand today in our attempt to normalize Sino-American economic and commercial relations. Trade for 1979 could reach $2 billion. Beyond that, the market for American goods and services depends on the degree of success the Chinese have with their program of readjustment. It is estimated that two-way trade between the United States and the P.R.C. could reach $4–5 billion annually by 1985. We must bear in mind, however, that the market for American goods and services depends largely on full normalization of our economic and commercial relations so that we can compete fully and equally with Western Europe and Japan.