Ogilvy Public Relations Worldwide

The Obama Administration & China: What Does the Future Hold?

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Dear clients and friends,

As the world anticipates President-elect Barack Obama's first few weeks in office, the U.S.-China relationship is a key issue on many peoples' minds. Arguably the world's most significant trading alliance, bilateral trade between the two countries exceeded US$380 billion in 2007.[i] The United States and China accounted for more than one-third of the global gross domestic product that year.[ii]

Now, the dynamics are changing. For the first time in more than a decade, net trade between China and the U.S. is expected to decline in 2009 against the backdrop of the global financial crisis. In addition, when President-elect Obama is sworn in on January 20th, China will be the largest owner of U.S. public and private debt to the tune of US$2 trillion. We are entering a new era of bilateral relations that will be shaped by unprecedented challenges, some of which we are only just beginning to understand.

In the midst of all the noise, there are a number of signals becoming clear that could have implications for your business in the years to come. These fall into four categories. We have also provided analysis of key Obama administration officials.

1. **Financial Turmoil – Challenge or Opportunity?** With both economies cooling and looking for new growth engines, China and the US are reevaluating their exposure to foreign markets. The deteriorating economic conditions will bring issues such as the trade deficit and currency manipulation back into the spotlight during the next strategic economic dialogue (SED). U.S. companies are beginning to allocate additional resources to their China operations, still a vibrant growth market, and at the same time Chinese companies are beginning to explore unbelievable bargains and expansion opportunities in the U.S. market.

2. **Protectionism – What to Expect and How to Break Through:** Conventional wisdom is that Republican presidents are economically favorable for China, as free trade is their

mantra. Many are expecting that Obama, as a Democrat, will pursue a more protectionist economic agenda. Watch carefully how the Obama administration handles inbound Chinese businesses and how China handles disputes surrounding intellectual property, joint venture agreements, and the country's new antimonopoly law.

3. **Public Diplomacy – The Image of the United States under President Obama:** Obama's election has significant symbolic value in China. Political experts believe this could lead to greater appreciation of U.S. culture and values, and in turn will increase American "soft power" in China. This may benefit U.S. businesses at first only on the margins, but in the long haul could bolster the overall trade environment between the two countries.

4. **The Changing Geopolitical Environment:** President-elect Obama will solicit China's support on issues relating to North Korea, Pakistan, Zimbabwe, and Darfur, among others. He may be able to get it, but China will be looking for more breathing room on Tibet, Xinjiang, and Taiwan. Fortunately for Obama, relations between Beijing and Taipei are warmer than ever. The same cannot be said about Tibet, which will remain a sticky subject. As always, choosing to pressure China here could have major repercussions. Obama's approach to these issues will be a clear test of his touted pragmatism.

5. **Key China Policy Players in the Obama Administration:** Secretary of State Hillary Clinton, Treasury Secretary Timothy Geithner, and U.S. Trade Representative Ron Kirk will all play prominent roles in shaping the new administration's approach to U.S.-China relations.

Despite the obstacles confronting U.S.-China cooperation, many believe that a new tone in Washington has come at a good time. As Obama has already indicated, "The relationship between the United States and China is the most important relationship on the current international stage." China President Hu Jintao assigns the same gravity to the U.S.-China ties, indicated in his congratulatory phone call to Obama following the election, "The Chinese Government and I myself have always attached great importance to China-U.S. relations. In the new historic era, I look forward to working together with you to continuously strengthen dialogue and exchanges between our two countries."

During the presidential campaign, the President-elect avoided making major political commitments regarding China, which should give the new administration time to develop a realistic approach to U.S.-China relations. The following will explore some the diverse prognostications and expectations for U.S.-China relations in the Obama administration, and will analyze the China-positions of the new key players on the U.S. side that will likely shape that relationship.

Financial Turmoil – Challenge or Opportunity?

Given the current economic realities, many in China predict that Obama will – at least in the short-term – focus on how the two countries can work together to reenergize the global economy. In the words of Huang Ping, Director of the Institute of Sociology at the Chinese Academy of Social Sciences, "With the financial crisis spreading to the real economy, Obama is likely to pay more attention to trade issues; bilateral trade relations with China will be highlighted."

The poor economic climate in the United States directly affects the Chinese economy. China is already heavily invested in the U.S. economy, on many different levels. The Chinese government holds billions of U.S. dollar reserves and the China Investment Corporation (CIC), China's government-funded investment arm, is heavily invested in financial institutions such as Morgan Stanley and Blackstone. In fact, the CIC recently increased its holdings in both entities. The future, however, for government-sponsored foreign investment does not look bullish; China's State Administration of Foreign Exchange (SAFE) recently announced that it will reduce investment in foreign equity in 2009.

China's Deputy Prime Minister, Wang Qishan, expressed his concerns for Chinese investments during Treasury Secretary Henry Paulson's recent visit to China, saying that the U.S. must work to stabilize its economy to "ensure the safety of China's assets and investments in the US." [iii] In addition, Gao Xiqing, President of the CIC, has said that the Chinese people are not happy with the government's investments in U.S. financial institutions. "People here hate it. They come out and say, 'Why the hell are you trying to save those people? You are the representative of the poor people eating porridge, and you're saving people eating shark fins!' "[iv]

On a broader level, the financial turmoil will likely change the discussion surrounding China's currency practices, which has typically been a priority issue for the U.S. at the SED. As Obama wrote in his China-position paper of October 2008, "Central to any rebalancing of our economic relationship with China must be change in its currency practices… This is not good for American firms and workers, not good for the world, and ultimately likely to produce inflation problems in China itself."[v] It is important to note that much progress on this issue was made over the last two years. The RMB had been appreciating steadily against the dollar – about 18% between July 2005 and August 2008 – until global financial markets were destabilized by the financial crisis.

On the China side, exports are slumping, and any further increase in the RMB's value would be problematic for domestic producers. During the Paulson visit, the RMB's value conspicuously fell 1% against the dollar, perhaps a signal that Chinese leaders are less willing than ever to tolerate preaching about currency manipulation. Now it seems that China is the one giving economic advice, as Zhou Xiaochuan, Governor of China's central bank, issued a statement saying, "The United States should speed up domestic adjustment, raise its savings rate and reduce its trade and fiscal deficits."[vi]

American consumers buy billions of dollars worth of Chinese products each year and more and more Chinese consumers are buying American. In fact, China is the third largest importer of U.S. products, following Mexico and Canada, recently bypassing Japan. In this economic climate, both sides will be looking to take measures to boost consumption, creating pressure to loosen export controls and lift trade barriers in ailing industries. U.S. companies will likely shift more resources towards their higher-potential China operations, while many Chinese companies will see this period as a good opportunity to acquire or merge with ailing U.S. companies.

All the while, Obama will be under increased pressure from domestic constituents to create jobs at home. As Rahm Emanuel, incoming White House chief of staff, said recently: "Our No. 1 goal: jobs. Our No. 2 goal: jobs. Our No. 3 goal: jobs."[vii] This focus will make protectionist measures politically tempting, though many would argue that they would be counter-productive to long-term economic prosperity in both countries.

Protectionism – What to Expect and How to Break Through:

Many in China are nervous that the Obama administration will pursue protectionist policies that would hurt industries already impacted by the economic slowdown. That's the concern of Shi Yinhong, Director of the Institute of International Relations at the People's University, "During the campaign, Obama criticized China's trade practices, and accused China of 'dumping goods into our market.' We can infer that Obama is a protectionist on trade issues."

Sun Zhe, Director of the Center for American Studies at Tsinghua University, shares the same fear: "The news that Obama does not support U.S. firms investing and operating overseas shows his protectionist tendencies."

During the campaign season, both incoming Secretary of State Clinton and President-elect Obama frequently criticized NAFTA and other free trade agreements. But at the same time, Obama is quick to point out that the real source of U.S. economic woe is decreasing competitiveness, which he sees as a consequence of economic inequality, poor education, and deteriorating national infrastructure. Regardless of his political position, he will be under pressure from a vocal portion of his own party to punish China for so-called unfair trade practices.

As a sign that protectionist policies may be on the horizon, the Obama administration recently indicated that the new administration will consider the inclusion of a "buy America" clause in the pending economic-stimulus legislation.[viii] Protectionist measures could also manifest in quotas, tariffs, or taxes, in pressuring China on currency valuation, or through legal restrictions. Any such moves could set off a trade war that would likely harm the interests of U.S. companies in China, Chinese companies in the U.S., and raise prices for all consumers. This would thwart many of the growth opportunities available for countries on both sides of the Pacific.

It is unclear how the U.S. government will respond to inbound Chinese firms, and how severely the Committee on Foreign Investment in the United States (CFIUS) will scrutinize foreign investment in industries relevant to U.S. national security. Lenovo's now-famous acquisition of IBM's PC unit was considered by some to be detrimental to U.S. national security interests, but the deal was ultimately approved. The Obama administration will have to carefully balance economic opportunities and political sensitivities as more and more Chinese companies expand to the U.S. market.

China's new anti-monopoly law – which came into effect last August – could potentially limit the growth of U.S. companies in China. It is allegedly designed to promote free trade but questions remain as to how it will be enforced and whether it will favor domestic enterprises. Some legal experts say the impact will be minimal as long as foreign companies are bringing added-value. Steve Dickinson of the chinalawblog predicts: "China will remain remarkably open to foreign investment. However, the fundamental principal is that foreign investment is expected to contribute something new to China. If nothing new is contributed…then the investment will not be approved."[ix] Coca-Cola's planned acquisition of China Huiyuan Juice Group Ltd. is currently under review, and this will be the first major test of the legislation.

Joint venture partnerships between multinational corporations and Chinese partners will slow in certain sectors this year. One reason is economic uncertainty. Companies are putting off investment until business picks up, such as Japanese semiconductor company Elpida Memory which recently announced it will delay its manufacturing JV with a Chinese venture capital group. The U.S. car company Chrysler recently ended its joint venture with China's Cherry Automotive. Some analysts believe that there remains a cultural divide between East and West.

But not all of the JV news is bad. The financial services industry received a boost this month after Credit Suisse received approval from to go forward with a JV with Chinese partner Founder Securities. It joins Goldman Sachs and UBS as the only global investments banks working with local securities firms. Morgan Stanley and Citigroup are awaiting approval for similar deals, which could further expand the investment banking sector for foreign financial institutions.

Intellectual property rights (IPR) are another key issue in China in 2009. Although the situation has improved since 2002, as China labors to comply with its World Trade Organization obligations, challenges persist. The Bush administration made IPR a major priority in the SED and the issue received increased attention from foreign media in the run up to the Beijing Olympic Games. And it seems that anti-piracy efforts remain a major government focus in China today; in January, domestic media reported on the harsh sentence given to 11 people convicted of running an international piracy ring.

Product safety disputes could become a vehicle for economic protectionism in 2009. Initial questions about the safety of Chinese imports surfaced in March 2007 when the U.S. Food and Drug Administration (FDA) linked tainted imports of Chinese pet food to pet deaths from kidney failure in the United States. In August 2007, toy companies Mattel and Fisher-Price recalled millions of toys manufactured in China due to high levels of lead paint. In September 2008, concerns began to mount about infant formula and milk powder in China tainted with melamine, an industrial chemical that appears to make products more protein-rich.

Leaders in Beijing are concerned about the impact that product recalls may have on Brand China. Over the last two years, China has taken a number of steps to ensure the quality of its exports, including nation-wide product and factory inspections as well as harsh penalties for those who endanger consumers through negligence or by dangerously cutting corners. At the same time, China insists that product safety concerns should not be used as an excuse for protectionism. Li Changjiang, Director of the General Administration of Quality Supervision, Inspection and Quarantine, said in late 2007, "China strongly opposes some countries using product quality as a pretense to practice trade protectionism."[x]

Most analysts expect scrutiny of Chinese-made products to increase with the incoming administration, as a result of public demand and union pressure. But Obama’s views on the subject aren’t entirely clear. In December 2007, he said that as president he would stop the importation of all toys from China. Soon after, his campaign clarified the statement that “any ban was meant to apply only to toys containing lead,” and instead suggested that the U.S. send its own inspectors to Chinese toy factories. Watch carefully how the FDA and the Consumer Product Safety Commission (CPSC) handle import and product safety disputes in the first year of the Obama administration.

Public Diplomacy – The Image of the United States under President Obama:

Obama’s election is hugely symbolic in China. In addition to representing change – in terms of political party and overall legislative approach – it affirmed the notion that in America, anyone can ascend to the country’s highest echelons of power.

As described by Mr. He, a former Chinese diplomat to the U.S., “The election of Obama represents the beginning of new era of U.S. history. There is no other country in the world that can compare to [the] U.S.A. In such a great country, a minority candidate . . . armed with confidence, courage, personality, passion, and intelligence, can be elected President. This is the real story of the American Dream, and Chinese people also appreciate the advantages of U.S. democracy."

Obama will take office following what is clearly acknowledged to be one of the least popular U.S. administrations, both domestically and abroad. The incoming administration has indicated that restoring America's image abroad will be a top foreign policy priority. A boost in U.S. soft power could be valuable in helping both sides to get off on the right foot, and may help to create more favorable conditions for U.S. businesses operating in China.

The Changing Geopolitical Environment

North Korea, Iran, Pakistan, Sudan, Zimbabwe; these are just some of the tumultuous regions where the U.S. has a political agenda and where China has influence. The U.S. will continue to need China's leadership in managing North Korea. In addition, look for Obama to solicit China's support in bringing stability to the Middle East, particularly in Pakistan. China and Pakistan have historically celebrated close relations, as Pakistan was among the first countries to officially recognize the People's Republic.

One region that could become more central to U.S.-China relations is Africa, where China is becoming an increasingly active investor and a key player in solving some of the continent's most challenging humanitarian crises, such as the situations in Darfur and Zimbabwe. Given Obama's Kenyan heritage, many in China believe this could become a fresh point of discussion.

The former Chinese diplomat He Weiwen affirms, "As a son of Kenyan, Obama could be more inclined to pay more attention to Africa than all other Presidents. The president-elect once remarked, '[paraphrased] China's role in Africa is as impressive as the U.S.'s absence in Africa.' In the Obama administration, there will likely be more interaction between China and the U.S. about Africa."

Obama will be pressured to take a stand on key regional issues that China considers to be questions of national sovereignty. The two most high-profile conflicts – Tibet and Taiwan – are going through dramatic transformations. Relations between Beijing and Taipei are warmer than ever, and Taiwan is becoming a less-likely flash point. Tibet could become increasingly tumultuous as the Dalai Lama publicly abandons his peaceful drive for "meaningful autonomy" and recedes from the international spotlight.

China will continue to receive criticism on human rights, ranging from media censorship to its record on environmental protection to its treatment of dissidents. As Dr. James Feinerman of Georgetown University recently wrote in the *Washington Post*, "China's stunted judicial system remained pervasively corrupt and ineffective… Free expression lacked protections; arbitrary arrests and detentions persisted."[xi] And as usual, China will not be interested in soliciting international opinions on any of these topics, particularly so on Tibet and Taiwan. If Obama were to make these issues a priority, the bilateral trade environment would likely deteriorate. This will be a clear test of Obama's touted pragmatism.

Key China Policy Players in the Obama Administration

One of President-elect Obama's earliest cabinet nominations was Sen. Hillary Clinton. Obama is likely to be tied up for some time in efforts to revive the domestic economy, and his selection of the capable and internationally-recognized Clinton seems to underscore the importance of having a steady hand steering the State Department ship during this period of extraordinary international volatility.

The Obama transition team and Clinton are reportedly planning to enhance the funding, staffing, and missions of the State Department in order to address the global economic crash and specific conflicts in the Middle East, the Persian Gulf, and Central Asia. But the proposals also reflect a new emphasis on diplomacy – Americans voted last year for a different kind of foreign policy, one that is oriented more toward diplomatic conflict resolution and less toward military force. Expect to see this change in tone reflected throughout U.S. foreign policy during the next four years.

Clinton makes a strong case that global economic developments are more than ever tied to geopolitics, and therefore the State Department should have a major role in discussions with other countries on economic policy. Currently, the Treasury Department manages the Strategic Economic Dialogue with China. Given that China has accumulated a surplus of nearly US$2 trillion while the United States is drowning in debt, that dialogue has far-reaching implications. The Clinton State Department will likely have a seat at the table when U.S. and Chinese officials discuss China's pursuit of energy resources in places like Sudan, Burma, or Iran.

Clinton has settled on choices for a number of top positions, including Kurt Campbell, a former Clinton administration Pentagon official, to be Assistant Secretary for East Asian and Pacific affairs. The incoming secretary of state plans to name former U.N. ambassador Richard Holbrooke to be special adviser for Pakistan and Afghanistan and is almost certain to appoint former Middle East negotiator Dennis Ross to be her special adviser for the Middle East and Iran. Clinton will retain career diplomat William Burns in his current position as Under Secretary of State for Political Affairs, the department's third-highest ranking job, and keep on Under Secretary of State for Management Patrick Kennedy, who oversees the department's worldwide operations.

Timothy Geithner, the head of the Federal Reserve Bank of New York and Barack Obama's nominee for U.S. Treasury Secretary, was seen by many as the ideal candidate for the job. A proponent of major reform in the financial system in order to avoid further turbulence, he is no stranger to the Treasury, where he served as Under Secretary for International Affairs toward the end of the Clinton Administration. Before joining the Federal Reserve Bank of New York, Geithner also worked for the International Monetary Fund.

His new position and his experience in salvaging America's financial markets will be critical, and his involvement with the Lehman Brothers collapse and the Wall Street bailout have given him a head start on his new job.

Geithner's personal and professional experience in Asia runs deep. His father was a development specialist who opened the Ford Foundation's China office, and he has lived in India, Thailand, China, and Japan. Geithner speaks Japanese and Mandarin, and led the Center on Indian Affairs at University of Pennsylvania. A 20-year public servant, Geithner has never worked in the private sector, a departure from recent tradition. But he has strong personal ties to Goldman Sachs, the gold standard of U.S. investment banks and the former home of current Treasury Secretary Henry Paulson, former Clinton Treasury Secretary Robert Rubin, New Jersey Governor Jon Corzine, and others. During his tenure in government, Geithner has often turned to Goldman alumni to fill important positions, and many analysts expect this trend to continue.

Obama tapped former Dallas Mayor Ron Kirk to be his U.S. Trade Representative, a surprise pick after at least one high profile candidate turned down the position. While Kirk has been in public life for most of his professional career – serving as an aide to former Sen. Lloyd Bentsen (D-TX), and as the first black mayor of Dallas from 1995 to 2001, and the Democratic nominee for U.S. Senate in 2002 - his specific views on trade are a blank slate and largely drawn from his 2002 Senate campaign.

As a past supporter of the North American Free Trade Agreement (NAFTA) and China Permanent Normal Trade Relations (PNTR), Kirk will face close scrutiny as he assumes the responsibility for delivering on Obama's pledges to fix existing trade agreements and create a new trade policy that benefits more people. Kirk's vocal opposition to Fast Track during his 2002 U.S. Senate race puts him in line with the majority view in Congress and positions him well to deliver on Obama's campaign pledge to replace Fast Track with a process that provides a greater role for Congress in the process.

Among Kirk's challenges as U.S. Trade Representative will be to obtain modifications to existing agreements to both add improved labor and environmental standards and to remove numerous provisions that conflict with Obama's priority non-trade policy goals on health care, climate change, energy independence, and more. To create the political space needed for Obama to succeed in these areas, aspects of the World Trade Organization agreements must be modified, including provisions covering procurement policy, service-sector regulation (including financial services and health care), food and product safety, and access to affordable medicines.

Kirk, who chaired Obama's campaign in Texas, is currently a partner at the law firm Vinson & Elkins LLP, where he focuses on finance and public policy, according to the firm's Web site. If confirmed, Kirk will be the first African American to hold the U.S.T.R. position.

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