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2006 Mid-Term Elections Analysis: Impact on U.S.-Asia Trade

By Scott M. Flicker, Hamilton Loeb and Larry R. Sidman

The overnight counts of the 2006 U.S. midterm elections are in, with dramatic results:

- *The Democrats have gained control of the United States House of Representatives, by a margin of 229 to 196, with 10 seats remaining to be decided.*
- *Control of the United States Senate appears likely to go to the Democrats, with Republicans holding 49 seats, Democrats with 50 (counting two Independents who will vote with the Democrats), and 1 contest in dispute (Virginia) but probably going to the Democratic candidate after the recount is completed. Net result: Democrats will have 51 seats and control over the committee staffs, floor agenda, and operations of the Senate.*
- *Democrats will now occupy the majority of Governors' mansions across the country (28 Democrats to 22 Republicans), essentially the inverse of the situation prior to the election.*

Even if Republicans retain the Virginia seat and thus maintain control of the Senate (Vice President Cheney has a vote in the Senate if there is a tie), the election results will usher in significant changes for the Bush Administration's handling of foreign policy in general and the Iraq war in particular. And although the issues that drove the election had little connection with U.S.-Asia trade matters, trade issues will be directly impacted by the power shifts that resulted.

The change to Democratic leadership in the Congress will provide fertile ground for stronger criticism of Chinese trade and currency practices in the House and Senate, although with the Senate closely divided and the White House remaining under Republican control, little effective change in U.S. policy will result. We do not expect much change in either the tone or substance of U.S.-Japan relations. Both relationships will be important to the continued handling of the North Korea nuclear issue, and the prominence of that issue will act as a constraint on those Democrats in both Houses of Congress who might otherwise

seek to escalate the level of criticism aimed at Asia's two strongest economies. The same dynamic will encourage continued close and good relations with South Korea.

Changes in Leadership

Here is a brief summary of the leadership changes and how they might affect U.S.-China, U.S.-Japan, and U.S.-Korea trade relations:

Speaker of the House

Dennis Hastert leaving. Outgoing House Speaker Dennis Hastert was reelected to his Illinois House seat, but has announced that he will not seek to remain the Republican leader in the House.

- Watch for Hastert to be appointed as U.S. ambassador to Japan. A few years ago, Speaker Hastert was contemplating stepping down as Speaker, but was persuaded to stay on by President Bush and House Republicans. Rumor then was that Hastert had expressed interest in serving as Ambassador to Japan. Our sources tell us recently that Hastert is still interested and an assignment as ambassador in Tokyo would be logical recognition by the President of his service during the Republican's majority period.

Nancy Pelosi arriving. The new Speaker of the House of Representatives for the Democrats, Nancy Pelosi of California, has been a visible critic on China matters. In part this may have reflected the local composition of her San Francisco district, which has one of the largest populations of Chinese and Taiwanese voters in the U.S.

Like many others in Congress, Pelosi has been critical of China's Intellectual Property Rights (IPR) practices. Last month, she joined 12 other senior Democrats in urging President Bush "immediately to file a broad-based challenge in the World Trade Organization (WTO)...us[ing] the WTO Agree-

ment on Trade-Related Aspects of Intellectual Property Rights (TRIPs) to challenge China's flagrant abuse of international rules governing intellectual property rights." She has also been vocal on human rights, labor and environmental issues, as well as arms proliferation issues, involving China. She has called on the European Union to maintain its arms embargo on China and urged the Chinese government to release the Tiananmen activists who remain imprisoned. She has urged Congress to "use economic leverage to improve the performance of the Chinese regime in regard to fairness and in trade with our country and to stop the proliferation of weapons of mass destruction by the regime to unsafeguarded countries."

This said, as Speaker, Pelosi is likely to adopt a somewhat wider perspective on China trade relations than she has exhibited as minority leader. Other Democrats will take the visible lead on criticizing China on trade and currency issues, but with a new level of support from the Speaker's office. In addition, Democrats will be looking for issues that can prove emotional wedges for the 2008 Presidential election, and they are likely to experiment with China trade as a means of connecting with middle-class anxieties about job security and trade competition. Speaker Pelosi may be inclined to permit legislation on this theme to reach the House floor – a marked difference from the Hastert regime in the House.

House Committees

With House control going to the Democrats, the chairmanships of all House committees will change.

House Ways and Means Committee. The chairmanship of the key House Ways and Means Committee, primarily responsible for trade issues, will shift to Charles Rangel of New York. (With the defeat yesterday of current Chair Clay Shaw, Republican from Florida, it is uncertain who will assume the position of ranking Republican on the committee.) Rangel comes from the liberal, urban wing of the Democratic party, which traditionally has been negative on free trade agreements and lowering of trade barriers, more vocal on labor and environmental protections, and quicker to resort to trade restrictions. As an example, Rangel has been a strong opponent of the Dominican Republic-Central American Free Trade Agreement (DR-CAFTA). Consistent with these positions, Rangel has supported legislation to lower trade barriers only where he has been convinced the measures will protect wages and raise living standards overseas.

- Partner Hamilton Loeb of our Trade group has worked with Rangel on trade issues over the years, and we expect

him and the Democratic majority on Ways & Means to seek to more actively intervene in trade relationships, particularly U.S.-China trade. It remains to be seen whether the committee will address Japan or Korea trade issues with any regularity.

House Committee on International Relations. The House International Relations Committee has broad jurisdiction over issues involving relations with foreign nations, international economic policy, U.S. export controls and trade sanctions, and diplomatic matters. The committee often asserts authority over matters that affect U.S. relations on trade, economics and security. Tom Lantos, a long-serving Democrat from California, will likely taking over leadership from Republic Henry Hyde of Illinois, who is retiring.

Lantos is a leading advocate on human rights issues (he was a survivor of the World War II Holocaust in Europe) and has staked out a strong position against expanded trade with China on this basis. He led an initiative earlier this year blasting U.S. tech companies (Yahoo, Microsoft, Google and Cisco Systems) for declining to appear at a briefing addressing restricted Internet access by China, an issue that received publicity when reports surfaced that some of these companies accepted restrictions as a condition to receiving authorization to offer service in China.

Senate Committees

Senate Finance. With the Senate apparently heading for Democratic control, the chairmanship of the Senate Finance Committee will go to Max Baucus (D-Montana), a well-known figure in the trade field. Baucus has worked in a cooperative and bipartisan manner with the senior Republican on the committee, Charles Grassley (R-Iowa), and there is a tradition of bipartisanship in the Finance Committee that both Baucus and Grassley indicated they would continue regardless of which party won Senate control in this election.

Senate Foreign Relations. Sen. Joseph Biden (D-Delaware) will chair the Foreign Relations Committee, taking over from Sen. Richard Lugar (R-Indiana). Biden and Lugar work closely together and will continue to do so. The Foreign Relations Committee's agenda for the next two years will be dominated by hearings reviewing the U.S.'s options and conduct in the Iraq war, but there will be additional attention to the handling of North Korean nuclear talks and to China's initiatives to extend its influence in Africa. Sen. Jay Rockefeller (D-W.Virginia) will play a key role in the majority on the Foreign Relations Committee with respect to Japan and other Asian trade issues.

Trade Issues in the Mix

Democrats will contend with two contrary impulses as they move into control of the House and Senate.

On one hand, the new Democratic leadership used its first hours post-election to stress a commitment to cooperative, bipartisan working with the White House – an approach driven by the public disaffection with the dysfunctional, overly partisan atmosphere that has prevailed in Washington for the past few years. On the other, the Democrats want to establish a basis for consolidating their Congressional control in the 2008 elections and for fueling a successful run at the White House. To do so, they will look for issues that can differentiate them from the Republican position and force President Bush to compromise or to take extreme positions in opposition to the Democratic initiatives.

Most of the attention will be on non-trade issues: the Iraq war, national security/terrorism, North Korea and Iran, extension of tax cuts adopted by the Republicans, the deficit, and domestic economic issues. Areas in which “wedge” issues can be developed will include tax cuts and stem cell research. Some areas that have created hostility in recent years – such as selection of judges – will likely quiet down as the Bush White House faces the reality that it will need to send moderate candidates to the Judiciary Committee if it wants them confirmed.

In this environment, trade issues – which have occupied a reduced role in national election politics since the U.S.-Japan trade relationship settled down in the mid-1990s – may prove a tempting source of differentiation for the Democrats. Watch for early efforts in the trade subcommittees of Ways & Means and Finance to frame a few trade initiatives that will fill out the Democrats’ profile as active Congressional leaders (in contrast to the now-ending 109th Congress, which met for fewer days and passed less legislation than any in modern memory). A few predictions:

China Trade

IP enforcement. There is strong sentiment (with bipartisan support from Republicans) for the U.S. to exercise greater leverage on China to enforce intellectual property rights in the Chinese market. We expect early Congressional hearings on this topic, with the Democrats seeking either a new set of actions by China to lower the boom on trademark and copyright piracy or new legislation to penalize Chinese access to the U.S. market until the Chinese comply.

Currency revaluation. Influential Democrats such as Sen. Charles Schumer (D-New York) have been pushing for legislation that would force China to revalue the yuan so as to

encourage exports to the Chinese market and make it more difficult for Chinese goods to undersell U.S. producers’ prices in the U.S. market. The Bush Administration has been able to blunt this through bilateral negotiations led by Treasury secretaries Snow and Paulson. Democrats are now in a position to force a currency bill through the committees and onto the legislative floor. It is not clear that they will have the votes actually to pass a currency bill that does more than make cosmetic changes to the law, and it is likely that the President would consider vetoing any bill that got the Beijing government unduly upset. (President Bush has used his veto power only once in his six years – on a stem cell research bill – but that will change as the Democrats produce legislation the White House does not like.

Foreign investment restrictions. We also expect to see changes to the regulations governing CFIUS, the interagency committee that implements the U.S. Exon-Florio statute on foreign investment in sensitive U.S. industries. CFIUS was the focus of attention last year in connection with China National Overseas Oil Company’s bid for U.S. oil company Unocal, and again this year with the proposed Dubai Ports acquisition of U.S. port assets. There is as much Republican concern on these issues as Democratic, and tweaking the CFIUS process is likely to be something on which the two sides can find common ground.

Antidumping filings. After several years of growth, the volume of new antidumping cases against China (and against all imports) has been on the decline. China has been hit with multiple high-margin dumping orders that, on balance, have been effective against the specific products covered, but that have done little to reduce the overall penetration of the U.S. market by Chinese products. This will not change with the Democrats taking over Congress.

Subsidy cases against China. China has been exempt from challenges under the subsidy law, due to a 25-year old Commerce Department policy of not applying subsidies rules to non-market economies. Some Democrats have been pushing to apply subsidy analysis to Chinese goods, and a congressional effort to force Commerce to revise its practices in this area would make for good headlines for Democrats while not affecting a large number of products as a practical matter.

Turning the IP tables. Chinese producers have quietly been amassing new patents in the U.S. and overseas, and many U.S. and European companies have located major R&D facilities in China. The next few years will see the beginning on affirmative use by Chinese plaintiffs of these IP protections in the U.S. courts. It will be a surprise to many industries that China has been collecting such significant patent power, and that their Chinese competitors can use the U.S. court system

to leverage their competitive position in the U.S. market just as forcefully as U.S. plaintiffs do. There will not be much the Congress can do about this – under the “sauce for the goose, sauce for the gander” principle, since China will simply be using the strong enforcement system that the U.S. has hailed as the global model – but that will not keep some in the Congress from asserting that China should not be able to use U.S. enforcement processes until it has equivalent processes in place and functioning in China.

U.S.-Japan trade

Return to the agenda. After 15 years of increasing decibel levels on U.S.-Japan trade – remember the Gephardt Amendment? – things went relatively quiet in the mid-1990s as Japanese industrial production moved to China and other Asian locations, the yen revalued against the dollar, and the Japanese economy continued to drift. The return of the Democrats to congressional power will not change that dramatically: the strategy of many Japanese industries to invest in U.S. production (most notably demonstrated by the Japanese automakers) has neutralized both the tone of the trade debate and the sources of anti-Japanese criticism, many of whom now have Japanese plants in their states. We do expect, nonetheless, for a few hiccups to arise in the U.S.-Japan trade universe.

Food trade. After some years of sparring, the landscape has recently calmed on the issue of Japan bans on U.S. food imports. Beef imports remain a sensitive topic, with reports that Japan has again halted some shipments for lack of proper documentation. We believe these “heartland” issues may garner heightened attention in the new Congress.

U.S.-Korean trade

Nukes overhang. U.S.-Korean trade issues will play a tertiary role, as will everything else on the bilateral agenda other than containing the nuclear ambitions of Kim Jong Il.

Services access. A number of U.S. and European services companies, ranging from law firms to banks, are eager to enter the Korean market but continue to be stymied by restrictive Korean regulations. Outside law firms, for example, have been promised the right to operate in Korea for several years, but the deadlines for relaxing the restrictions have been postponed on a number of occasions. The new Democratic Congress may take up a few of these issues where the U.S. interests push for it, but there is minimal political gain to legislators from Korean trade issues and great pressure to avoid irritants to the central diplomatic and military concerns. So we expect little practical change on the U.S.-Korean trade front.

U.S.-Korea Free Trade Agreement Negotiations. Bilateral negotiations in connection with a possible U.S.-South Korea free trade agreement are set to continue in December. From the U.S.’ perspective, the goal is to conclude an agreement by the end of the year so that congressional approval of a final agreement before presidential trade negotiating authority expires in June 2007.

If you have any questions regarding this alert, please do not hesitate to contact:

Scott M. Flicker 202-551-1726
scottflicker@paulhastings.com

Hamilton Loeb 202-551-1711
hamiltonloeb@paulhastings.com

Larry R. Sidman 202-551-1729
larrysidman@paulhastings.com

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