FORGING AN ALTERNATIVE ECONOMIC STRATEGY FOR DEALING WITH CHINA

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EXECUTIVE SUMMARY

America's economic relations with China have deteriorated under the Trump administration. U.S. exports and imports are both down, primarily because of the tariffs that the U.S. has imposed. Investment in both directions is also down. The U.S. policy was aimed at increasing exports to China and changing various Chinese trade practices, but so far it has failed. The "managed trade" approach of specific export targets has not worked and should be scrapped in favor of a focus on structural issues in the Chinese economy: non-tariff barriers; restrictions on foreign investment in some sectors; poor protection of intellectual property rights; forced technology transfer; extensive role in the economy of state-owned enterprises; and subsidies to develop specific technologies. The impact of these policies is to limit the exports coming from American firms and workers, exports both to China and to third countries. Bringing China up to advanced country norms would open new trading opportunities and raise American incomes.

The key components of an alternative economic strategy for dealing with China are:

(1) Negotiate down the U.S. tariffs on Chinese products in exchange for a "phase 2" agreement focused on the structural issues above; realistically, China will be willing to change some but not all of its policies;

(2) Stop the talk about exchange rate and trade imbalances, which are distractions from the main issues;

(3) Coordinate our China economic policies with allies. This will involve dialogue with the EU as well as with Japan and South Korea to agree as much as possible on priorities for specific Chinese reforms. Ideally, the U.S. will rejoin TPP and push hard to include new members (South Korea, more ASEAN countries, and even the UK). At the moment, the U.S. risks being left out in the Asia-Pacific region as RCEP and TPP proceed without it.

(4) Negotiate with China over its role in the international economic institutions. For example, if China were to join the Paris Club, the United States could support a greater Chinese standing in the IMF. Similarly, the U.S. could trade a greater weight for China in the World Bank if it were to join the Development Assistance Committee and make its BRI loans more transparent and concessional, with competitive procurement for projects. The general point is that if the United States wants changes in Chinese behavior, it must be willing to anchor those changes in a role in the international institutions commensurate with ours.

(5) Rationalize our policy in the national security sphere. Slowing China's growth or killing Huawei are not realistic national security objectives. China is likely to catch up with the U.S. in terms of overall GDP within 15 to 20 years. Consequently, the U.S. is going to have to live with a large China that has a very different system from our own. Clearly, America needs to protect technologies with national security implications through export and investment controls. But if the parts of the economy affected are defined too widely, then important dynamism is cut off. Most of the economy should be open to trade, investment, joint research, and student exchanges. The U.S. has enormous strengths. If there is a level playing field, American firms and workers can be expected to do very well and to benefit from trade and investment with China.

THE PROBLEM

The main problem that the United States has with China is a set of trade and investment practices that are outside the norms of advanced economies. China likes to think of itself as a developing country, based on its per capita GDP, but it is the second largest economy in the world and the largest trading nation, and the U.S. would like to see it move quickly to advanced country standards. The specific policies in question are: extensive non-tariff barriers, such as arbitrary and changeable standards; restrictions on foreign investment in some sectors; poor protection of intellectual property rights; forced technology transfer through various coercive means; extensive role in the economy of state-owned enterprises that have favorable access to land and credit; and subsidies to develop specific technologies. These policies limit the exports coming from American firms and workers, including exports both to China and to third countries. Bringing China up to advanced country norms would open new trading opportunities and raise American incomes.

Aside from these practices that directly affect the United States, China is also out of step on global norms for lending to poor countries, which will have important indirect effects on the U.S. economy and foreign policy. China's Belt and Road Initiative has been lending about $50 billion per year to developing countries, primarily to construct transport and power infrastructure. The initiative has the potential to be beneficial, as developing countries need this infrastructure. However, the Chinese loans lack transparency, so it is hard to know which projects are financed and on what terms and whether the overall amount for a particular country is leading to unsustainable debt. What is clear from available information is that the loans are mostly commercial. As a result of the COVID-19 pandemic and recession, many countries, especially in Africa, are falling into debt distress. China did join the G20 in calling for a debt moratorium for the poorest countries this year, but it is not a member of the Paris Club of official creditors, so providing further debt relief is going to be complicated and perhaps insufficient.

In the mid-2000s China was also out of step in that it had an undervalued exchange rate and a large overall trade surplus, the broadest measure of which is the current account. But this problem was corrected during the Obama administration; China's currency has appreciated 35% since 2007, on a trade-weighted basis, and its current account surplus has fallen from above 10% of GDP to less than 1%. This macroeconomic success takes one issue off the table and demonstrates that it is possible, through dialogue and incentives, to bring China up to global norms.

Within the category of IPR protection and forced tech transfer, a special concern is theft of technologies that have military applications. Any IPR theft from American firms makes us poorer, but theft of military technologies also undermines our security. Hence, special policies are needed to protect national security.

A final problem in the economic relationship is that Trump administration policy has completely lacked realism, and the examples are endless. The administration imposed a 25% tariff on most imports from China, a tax paid by American consumers and firms, in order to get China to negotiate. This succeeded in bringing China to the table, but the U.S. side over-estimated its leverage. U.S. trade is simply not that important to China anymore (it conducts more trade with ASEAN than with the U.S.). So, China was not willing to make significant structural reforms. It did agree to purchase more from the U.S., but the specific targets in the phase 1 deal also proved to be unrealistic. As of mid-2020, China was only buying about half of what would be required to meet the targets. This is partly because of the COVID-19 pandemic, but the experience shows the failure of managed trade with China. The U.S. policy also showed a lack of understanding of how global value chains work. Faced with the U.S. tariffs, some final assembly shifted to countries like Indonesia and Vietnam. But China's exports of machinery and components to those countries increased, so its overall exports did not decrease. The U.S., in turn, imported more from Southeast Asia. As a result, American consumers paid more but trade patterns did not change in any fundamental way. The China tariffs also did not account for the fact that U.S. firms use imported parts and components to make their production more competitive. Even before the virus hit, Trump's China tariffs had cost the U.S. a net loss of 175,000 manufacturing jobs. A final example of the lack of realism came in the summer of 2019 when President Trump designated China as a "currency manipulator," an accusation that was simply not true. As the Trump administration comes to an end, the U.S. is left with a confused and unrealistic economic policy towards China.

SOBJECTIVES

China should move as quickly as possible to developed-country norms for trade and investment. Specific features of this evolution could include stronger penalties for IPR violations; redress mechanisms for firms that feel subject to forced technology transfer; discipline of state enterprises; and changes in laws and policies to make R&D subsidies WTO compatible. This should be codified in various ways. Initially, this could be a bilateral agreement, similar to what was envisaged for phase 2 of a U.S.-China agreement. But changes in policies will have more force if they are included in larger agreements, ideally with Asian and/or European partners, and eventually in reformed WTO rules.

China should integrate more into global economic institutions. China is a member of the IMF, World Bank, and WTO, but not part of the Paris Club. However, its weight in the IMF and World Bank (which are shareholding institutions) is far below what any reasonable assessment of its role in the world economy would dictate. The U.S. in recent years has resisted increasing the weight of China and other developing countries in these institutions. But recognizing their growing influence is necessary if they are expected to follow global rules and norms. The Paris Club may need to be renamed and relocated, but it will be important to invite China and other emerging creditors into the club. The objective here is to bring Chinese development lending into line with global practices and to have China at the table when coordinated debt relief is necessary (as probably will happen with many poor countries hit by the pandemic and global recession).

The U.S. should sharpen and strengthen national security protections. The U.S. has the tools to restrict exports and inward investment for products that have obvious national security implications. The trick is to distinguish genuine concerns from bogus ones; for example, a tariff is being imposed on washing machines on national security grounds. The WTO provides wide latitude for countries to define their national security needs, but America invites abuse of the system when it abuses the system itself. What Hank Paulson has called, “small yards with high fences,” should be the goal. In other words, define a small number of national security technologies to face serious restrictions, but otherwise allow trade, investment, joint research, exchange of students and researchers — all of the foundations of an open innovation regime.

The U.S. should undo the mistakes of the Trump administration with as little damage as possible to the U.S. economy. One of the challenges of dealing economically with China over the next few years will be that the current policy is confused and unrealistic. Many changes need to be made: eliminating the tariffs, which have hurt American firms and consumers; moving away from managed trade; encouraging China to play a larger role in global economic institutions, not a smaller one; protecting genuine national security concerns while removing the crude protectionism implemented in the name of national security. Yet it is not a good idea to make all these changes on day one. The Trump administration alone is not responsible for the poor state of U.S.-China economic relations. China bears responsibility as well for dragging its feet for years on needed reforms. The diplomatic challenge will be to negotiate the removal of U.S. protectionism in return for structural reform.

RECOMMENDATIONS

Negotiate away the import tariffs aimed at China in exchange for a phase 2 agreement that addresses the structural concerns. The U.S. will have to be realistic; China is not going to completely change overnight, and the U.S. has overestimated its leverage. But there are reformers in China who would like to make significant changes to non-tariff barriers, investment restrictions, IPR protection, state enterprises, and subsidies, because they believe these measures are necessary for China’s sustained growth. Significant advances are certainly possible.

Recognize that managed trade has failed and that purchase targets were unrealistic and will not be met. But send a strong message at the presidential level that the U.S. will be closely monitoring actual export flows. Given China’s rapid growth and a more open economy, American exports should be increasing rapidly (in contrast to the decline of the last few years). Policymakers could consider an indicative range for expected growth of U.S. exports, but they should definitely discard the product-by-product targets.

Stop the talk about trade balance and the exchange rate. The level of the exchange rate is fine. The bilateral trade balance is not important. China does not have a large overall surplus. The U.S. current account deficit has also decreased significantly; if there are worries about it, then the solution lies in macroeconomic tools, not trade policy. (In particular, the U.S. would have to reduce consumption and increase savings, which is not really a political winner.)

Coordinate American economic policies on China with allies. This will involve dialogue with the EU as well as with Japan and South Korea to agree as much as possible on priorities for specific Chinese reforms. Ideally, the U.S. will rejoin TPP and push hard to include new members (South Korea, big ASEAN countries, and even the UK). The main reason for the next administration to rejoin TPP is to preserve an open global trading system centered on the U.S. The direct effect of TPP membership on the American economy will be minor, but it is important for our allies. In a truly ideal world TTIP would proceed simultaneously, and the two mega-agreements would set similar standards and policies. China would have to join this trade agreement or risk being left out. At the moment, the U.S. risks being left out in the Asia-Pacific region as RCEP and TPP proceed without it. Ambitious Asia-Pacific agreements could be the foundation for an updated WTO agreement.

Negotiate with China over its role in the international economic institutions. For example, if China were to join the Paris Club, the United States could argue for greater Chinese standing in the IMF (relocating and renaming the Paris Club should not be a big issue). Similarly, the U.S. could trade a greater weight for China in the World Bank if it were to join the Development Assistance Committee and make its BRI loans more transparent and concessional, with competitive procurement for projects. The U.S. joining AIIB could be another incentive for China to do more through multilateral fora than bilaterally. The general point is that if the United States wants changes in Chinese behavior, it must be willing to anchor those changes in a role in the international institutions commensurate with ours.

Finally, in the national security sphere, the United States needs to rationalize its policy. Slowing China's growth or killing Huawei are not realistic national security objectives. Huawei has been set back by the policies targeting it, but it will redouble its efforts and survive with less technology input from the U.S. China is likely to continue to grow at least moderately well. It does not have to do particularly well to catch up with the U.S. in terms of overall GDP, since it has four times as many people. Consequently, the United States is going to have to live with a large China that has a very different system from our own. Clearly, America needs to protect technologies with national security implications through export and investment controls. But if the parts of the economy affected are defined too widely, then important dynamism is cut off. The notion that offshore manufacturing production can be brought back to the U.S. through trade protectionism is naïve. The Trump tariffs had no impact in this direction; if anything, they encouraged more investment in China, not less, because multinational firms are there primarily to serve the domestic market.

Most of the economy should be open to trade, investment, joint research, and student exchanges. The U.S. has enormous strengths in its labor force, universities, IPR protection, deep capital markets, and flow of immigrants. If there is a level playing field, American firms and workers can be expected to do very well and to benefit from trade and investment with China.