Carnegie Endowment for International Peace

Discussion Paper on the Question of:

Do China's violations of international commercial norms, including exchange rate manipulation, IPR violations and non-tariff barriers require immediate forceful steps by its trading partners to make it play by the rules?

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China's international commercial behavior, foreign perceptions of that behavior, and how the United States and other major economic powers manage their commercial relations with China are by now enormously important and will only continue to be more so as China's growth and international integration continue. One hears a range of opinion between two quite different poles.

At one end of the spectrum, media opinion pages and various assertions by scholars, politicians and lobbyists assert that China has become a predator commercial agent, relying on export-led growth to fuel its rise and backing away from carrying through its fair share of WTO and other agreements. The conclusion is that China only responds to force and threat of force, and that forceful action is therefore what is needed immediately.

At the other end of the spectrum, the Chinese and certain other academics and commentators assert that China's behavior is understandable if not exemplary given its starting point, the pace of its progress and its general development limitations. They maintain that dialogue, negotiated progress on outstanding issues and mutual assistance in appropriate institution building are the best approach. They insist that forceful or punitive steps are wholly uncalled-for and, besides, would likely be seriously counterproductive.

A certain degree of credibility at both ends of the spectrum is lost because of obvious vested interests. China's spokespersons are going to work hard to give a favorable interpretation of their commercial relations with other nations. By the same token, certain U.S., European and Japanese industry and labor interests, seeking relief from their governments in the face of challenging competition and the impact of technical change, will naturally emphasize an image of Chinese malfeasance.

Despite credibility problems for certain voices at both ends of the spectrum, the range of opinions on China's commercial behavior in fact reflects two very different philosophies about regulation of international commercial activity.

Highly critical voices seeking immediate retribution hold that contracts are contracts, agreements are agreements, and committed signatories need to come into compliance. This perspective is deeply steeped in the strong criminal and civil legal traditions of developed economies, by which courts find non-compliance and mete out penalties and compensation. Its approach is one of negotiators or litigants whose job it is to extract the best deal they can get from the other side—in this case the Chinese side—based on the letter of the law and signed binding compacts.

The less critical voices emphasize the process of China's coming into compliance over time. This philosophy refers to findings and remedies in earlier comparable situations and the experiences of other countries at a development stage similar to China's today. The issue from this perspective is feasibility and collaboration with the goal of making progress in all directions as fast as is practically possible.

The two views don't necessarily contradict one another. They find common ground in the area of "business as usual" bilateral and multilateral commercial disputes and efforts to activate disciplinary remedies. The international commercial world is replete with informed and well designed complaints and with proper channels for seeing them through to ultimate adjudication and settlement. In this common ground, the underpinnings for responsible action are well substantiated findings of violations of international norms and orderly legal procedures for seeking justified redress.

In practical terms, therefore, investigation of China's commercial behavior must address these two aspects to the relationship with China: First, what are valid claims that China has violated international commercial norms? Second, what actions are appropriate for seeking remedy when claims of a violation appear credible?

In determining which claims are valid, we find a range of assertions, from detailed and well-documented claims based on solid facts and analysis to exaggerated assertions based in incomplete information and flimsy if not faulty logic. In determining which actions are appropriate, in the extreme we see a wide variety of proposed remedies, from toothless dialogue at one extreme to protectionist triggers risking trade war at the other extreme.

Closer to a balanced middle ground on possible actions, we still see a division between two different approaches relevant for the options we consider today. On one side, proposals stressing engagement would combine specific charges and time-consuming legal procedures with dialogue and collaboration designed to facilitate China's progress toward better compliance. On the other side, a range of proposed unilateral U.S. actions would avail themselves of potentially flexible provisions in international agreements. These unilateral steps would contend that China's progress toward compliance is so inadequate that American interests deserve immediate relief—whether or not the methods chosen are likely to be acceptable after adjudication by relevant authorities.

The remainder of this paper considers four main issues, applying the analytical approach outlined above.

1. Currency Manipulation for Unfair Advantage

The most widely repeated assertion in recent years is that China's currency is undervalued as a result of intentional Chinese manipulation to gain unfair advantage. The logic is straightforward: If China succeeds in intervening in its currency markets to keep the dollar price of its currency cheap, all of China's export products will be cheap. It can accomplish this end by purchasing much of the dollar revenues that exporters earn and then selling domestic bonds to absorb the excess Chinese currency that these purchases introduce into the economy, avoiding inflationary pressures. The result is that the Yuan price of the dollar stays high and the dollar price of the Yuan stays low.

This is a simple, attractive story for parties seeking redress from competitive and technological challenges in their industry that can be attributed to China.

The problem is that on closer examination, none of the arguments and analyses claiming to support this assertion holds up. Let's look at them one by one.

The most-often cited reason, perhaps the one most easily dismissed, contends that China's large bilateral surplus with the United States proves China's currency is pegged at an unfair value. On its face, this argument is fallacious. Let's make this very clear—it does not matter what a country's *bilateral* trade balance is with any single country. One needs to look at China's *total* trade balance. Yes, every month the Commerce Department releases its headline trade data saying the U.S. deficit with China is so large. If we are interested in the truth about China's trade practices, we must ignore these data and look instead at China's global trade balance.

When the China currency controversy began in late 2002, China's total trade surplus was small, because while it sold a lot to the United States, much of the parts and raw materials came from other countries—especially other East Asian countries.

What about China's total trade surplus? It stayed small until late 2004 and then suddenly grew very large. What happened? Did its exchange rate practices cause this surge? No. China's economy had started to overheat because of economic steps to fight the impact of SARS, the epidemic that struck East Asia in 2003. Government steps to cool overheating dampened import demand. That is why a larger trade surplus appeared in late 2004.

But there is a more important analytical point here—and it is crucial to evaluating China's currency practices. Many factors *besides* the exchange rate affect China's trade balance. Economists know this but simple calculations of price effects, that is, exchange-rate effects, don't take it into account. In China's commercial experience, this is more important than for most countries because China recently joined the WTO, causing enormous shifts in a range of factors that affect its trade—none of them related to the exchange rate. It is natural for China's trade balance to be unstable for quite some time as these changes work themselves through. To put all the causal analysis on the exchange rate is at best premature and more accurately just plain wrong—and will continue to be for quite some time to come.

The importance of other, non-currency, factors is especially relevant in China's case because the first early response to agreements assuring China's WTO membership set off a rash of foreign and domestic investment programs targeting exports. Why? Because finally Chinese trade with the United States was to be free of annual risks that the U.S. Congress would annul China's most favored nation status. Foreign investment targeting capacity for export to the U.S. suddenly became much less risky.

In contrast, WTO changes that open up China to faster imports, while proceeding very fast, take longer to mature. We will have to wait until at least 2010 before we can be sure that all these changes have worked through.

On this point, other Commerce Department data emphasize and support this perspective. China' is the U.S.'s fourth largest export market behind Canada, Mexico and Japan. What is more, exports to China are growing faster with China than any other country—by far. U.S. exports were up 150% over the past 4 years, way ahead of other leading markets, markets which are also much smaller than China.

The pace of change in China's overall trade is extremely rapid and hard to predict. To insist that all change has to do with the exchange rate not only violates fundamental economic principles, it borders on the unreasonable in an every-day common sense way. China's trade surplus surged in the past two years—but the exchange rate hadn't changed. Other factors are responsible, and those factors have not finished their powerful swings back and forth.

Additional recent Commerce Department data emphasize just how misguided it has become to put the blame for America's trade deficit on China. Over the recent medium term, since 1997, China's share of the U.S. deficit has remained unchanged. More importantly, the share of the American deficit due to East Asia has *declined* dramatically, from over 70 percent to 45 percent. The share of the U.S. deficit coming directly from East Asia outside of China has declined so sharply, from 43 percent to 17 percent, in part because these other countries are channeling their exports to America *through* China, so it looks like its coming from China.

But what about those economic models at famous economic research institutes that purport to show a strong revaluation of China's currency is needed to correct Chinese trade imbalances? They have fallen into the same trap of ignoring non-exchange-rate factors. They design their models so that the main variable that could explain trade balances is the exchange rate. These researchers are true believers. They love to explain the world through exchange rates. That is how they design their models. When they run the models and look at the results, *quel surprise!* Exchange rates come out as the major factor and large revaluations as the only solution. The final result was built into the initial design of the model.

We cannot afford to base American economic policy toward China on these kinds of exercises. It is interesting that I have found other economic researchers at the same institutes who privately don't agree with these results, but these analysts remain by and large silent. Indeed, the reluctance of most serious analysts and practitioners to call for revaluation is interesting. Instead they call for "greater flexibility." Do not be fooled by this wording shift. Greater exchange rate flexibility is a policy proposal with much more credibility, but it refers not to trade matters. It refers to financial flows. If, and we must stress "if," a country like China *were* to have free flowing short-term international capital transactions, then it is a clear conclusion that its exchange rate must be free to go up and down. Otherwise, China's monetary policy would be a slave to world interest rates.

First of all, China does not allow free international financial transactions—and its ability to enforce this policy has been adequate so far. Hence, the need for flexibility according to this theory is not yet relevant. More importantly, this financial flow logic says nothing about whether a currency is undervalued or not. Nothing. So, good economists can feel comfortable with this "flexibility" recommendation, because while it is routinely misinterpreted in the media, in a technical sense under "what if conditions," it cannot be faulted. But it does not mean China's currency is undervalued.

What about China's rapid accumulation of foreign exchange reserves? This last topic is important when discussing claims that China manipulates its currency to leave it undervalued in order to gain unfair commercial advantage. The casual impression is that these increases in reserves must have all come from unfairly acquired trade surpluses. This is hardly the case.

China's reserves first started climbing because despite China's small trade surplus at the time, speculative flows began leaking into China just as political pressure for revaluation was building. I saw this pressure first-hand, in the form of lobbyist assertions, during the year I directed the Treasury Department's Office of East Asian Nations, in 2002-2003.

The speculators' purpose is to wait for a large revaluation and then get the money out again—at a huge profit. This began an unholy speculator's dream: speculative money increased China's reserves, and consequently appeared to validate lobbyist pressure on Washington politicians to insist on Chinese revaluation. As this pressure upped the volume in the Washington debate on revaluation, speculators were encouraged to find ways to move more client money temporarily into China, to wait for the big pay-off. And so it went until recent trade surpluses became more significant than capital flows. It will end when speculators either think the game is up or that they have gotten as much revaluation as they can. They will then try to take their money back out of China, and then the so-called "market" pressure will be for *devaluation*, not revaluation.

An additional comment on currency intervention is important. Many claims assert that the mere act of large and sustained one-way intervention in currency markets is proof of unfair manipulation to maintain an undervalued currency. But this is hardly the case. A relatively stable exchange rate, adjusted for inflation, contributes valuable predictability for a developing economy. Large and sustained intervention is often necessary in circumstances just like China's, and like Hong Kong's during the 1997-98 Asian Financial crisis, to fend off speculative attacks on the currency meant only to capitalize on movements induced by the speculative attack itself.

Many commentators incorrectly assert that IMF rules make sustained large intervention proof of manipulation for unfair advantage. These assertions are misinformed if not disingenuous. IMF rules say that such intervention is a reason to take a close look at a country's currency practices, but they do *not* prove unfair manipulation. Indeed, China's large sustained intervention has invited intense scrutiny from both the IMF and the U.S. Treasury Department, but, based on more thorough investigations, both agencies conclude that China is not unfairly manipulating its currency

In conclusion, on claims that China's currency is unfairly manipulated to keep it cheap, the arguments, however simple and comfortable they appear, are fatally flawed and have no place at this juncture in forming the basis for American commercial policy toward China.

These conclusions will not convince true believers, and so it is important also to point out that dramatic measures to pressure or force an abrupt and major revaluation of China's currency will be counterproductive and harm America's national interests. This is the second important dimension in the U.S. response to China's commercial practices. Dramatic and preemptive forceful actions in this matter are wholly uncalled for.

As mentioned above, U.S. exports to China are growing at a high rate from a large base compared to other major trading partners. Spectacular legislative actions intended to force China to implement immediate and dramatic revaluation of its currency do not have respected factual underpinnings and will be viewed around the world and especially in China as capricious and politically driven. China will feel justified in, and will receive international sympathy for, taking steps to retaliate. The winners will be America's competitors in Europe and Japan.

Let us remember that the certified experts in this field, the IMF and the U.S. Treasury Department, both refuse to rule that China's currency is unfairly manipulated to gain a trade advantage. Their analysis is rich and robust. Efforts to legislate micromanagement of how these decisions are made or to engineer revisions to the IMF charter to micromanage its analysis will backfire. Such intrusions into a complex analytical world will only lower global respect for America's role in developing and strengthening international norms for commerce and finance.

2. Intellectual Property Rights (IPR) Violations

Adequate protection of intellectual property rights has to be a major basis for American competitiveness going forward, given the vitality of our entertainment industries and our creative scientific and engineering inventiveness. The goal should be to maximize medium-term and long-term protections so they are as good as they can be, especially when the fundamental capabilities of developing countries like China to accomplish full compliance in the short term are so weak.

What are global norms for IPR protection? In a legalistic sense, all countries should be "in compliance" with WTO and bilateral agreements. In fact, however, developing countries around the world don't have the resources or political cohesion to accomplish full compliance any time soon. IPR violations are a rampant fact of life throughout the developing world—and not mostly with regard to foreign or American intellectual property. Developing countries face indigenous counterfeiting and intellectual property theft for everything from pharmaceuticals to infant formula to beer and vehicles. Violations of these domestic property rights by unscrupulous businesses have life-threatening and widespread damaging impacts.

In the face of these practical circumstances what are the right and wrong ways to go about handling IPR violations in a country like China? Clearly, draconian punitive measures affecting whole classes of products will have no beneficial impact if China's capabilities for redressing the issue on a large scale are inadequate because of obvious resource constraints and inefficiencies of China's political, legal and administrative regulatory systems.

It is a common fallacy to think that, because China's political system is overseen by an all-powerful party and run along corporate rather than federal lines, central authorities can just snap their fingers and local officials jump into compliance with all manner of directives, regardless of their deleterious short-term impact on the local economy and the near-term career prospects of local officials. Central authorities in China only have so much political capital to expend in forcing local government compliance with their wishes.

Consequently, spectacular and dramatic U.S. policy steps, including legislation enabling or encouraging immediate forceful actions carry a double jeopardy. First, they will not be effective in achieving much progress because China is limited in its capabilities to respond. Second, what opportunities for medium-term and longer-term bilateral collaborative progress are under way for strengthening central and local government capabilities will be adversely affected. This has been made clear by spokespersons for the U.S. Chamber of Commerce in China. The Chamber has programs working with local governments to strengthen administrative and legal procedures regarding IPR protection, based on the agreed understanding that this is a time-consuming difficult development job. Strong-arm IPR moves by the United States have reportedly damaged the collaborative success of these projects.

Rather than immediate forceful action, the best approach is a steady mix of narrowly targeted and well researched formal charges concerning specific infractions, coupled with strong bilateral engagement for the purpose of Chinese institution building to support IPR protection in favor of both domestic and international IPR. To this end, the Congress should revise if not eliminate U.S. legal restrictions on U.S. foreign aid programs directed at China. American commercial interests and, more broadly its economic security interests, would be well served by a robust assistance program to China in a range of vital areas such as IPR protection.

3. Subsidies and Countervailing Duty (CVD) Remedies

A very recent development is the U.S. pursuit of industry claims that China subsidizes certain specific industries, implying that imports of related products from China therefore deserve to be taxed with duties that compensate for these subsidies. Such countervailing duties are intended to "level the playing field."

How valid are these claims? We must remember that weakly supported or flimsy claims in handling commercial relations with China will ultimately harm American interests by weakening international and Chinese respect for such actions and inviting retaliation from China that is viewed sympathetically by other international actors.

The validity of this most recent action by the U.S. Commerce Department runs into serious trouble on two counts. First, because most of the world, including the United States, insists that China is a "non-market economy" (NME), how possible is it to know whether any specific arrangement in China encompasses all the non-market forces affecting the price of the products in question? Long-standing analysis dating to the early 1980s established firm procedures that ruled it impractical to determine whether any set of arrangements appearing to favor an industry in an NME actually ends up giving it an unfair price advantage. There are just too many non-market factors involved.

Consequently, trade law and the WTO allow a second procedure under anti-dumping provisions to evaluate price fairness based on comparable third countries where similar products are produced in a market environment. This is the proper basis for relief if pricing from an NME is deemed to be unfairly set.

Is China really an NME? One of the advantages for the United States of continuing to designate China as an NME is that it can then continue to rely heavily on third-country comparisons to evaluate Chinese pricing, including reliance on certain curious calculation oddities that minimize the impact of third-country prices that show no unfairness. But could it be that particular industries in China operate in a fully market-based environment, even if the country as a whole is still deemed to be an NME? This is the implication of recent actions reversing more than 20 years of Commerce Department practice disqualifying CVD actions against NMEs.

China is still a classic NME for two reasons. First, many non-market factors impinge on enterprise management, even for private firms. Informal but effective requirements, often through local communist party influences, frequently result in unprofitable expenses to support local infrastructure, or maintain employment rolls. Informal fees outside the legal taxation structure still proliferate at the local level, again informally disciplined through the pervasive guidance of local party linkages. At the same time, some large firms receive generous loans from state-controlled banks (while other smaller firms rely on more expensive retained earnings and equity contributions). Value-added tax rebates for exports, legal by international convention, have at times been reduced by Beijing as a way to moderate export flows—but this departure from international standard "fair" practice harms Chinese exporters . How does all this balance out? It is devilishly hard to say, even if one could do in depth research of relevant companies' accounts (and with confidence that the accounts one examined were accurate).

As a practical matter, one still cannot in China today say with any assurance what the actual net impact is of one or several observed financial relationships. China would like to lose its status as an NME, because this would relieve it of some of the treatment it receives under anti-dumping provisions, but as a practical matter, this is unlikely for some time, for precisely the reasons enumerated above.

There is a second reason why China is an NME. China hasn't achieved 10-percent growth (as officially measured) for fifteen years by relying solely on market forces. Nor has its growth rate accelerated in recent years because it has laid aside non-market efforts to accelerate growth in public spending for large projects like infrastructure, or strategic industries like steel and energy products. China's approach is similar to that of the United States when it pulled itself out of the Great Depression in the early 1940s, motivated by the need to gear up for war.

For a rapid catch-up industrialization effort like China's, non-market actions are necessary. This has been the secret of other successful modernizing economies in the rest of East Asia as well. Such multi-pronged non-market instruments as those China uses do distort costs and prices in a variety of complex ways. To single out one or several as actionable under CVD provisions risks serious loss of American credibility in the world of international commercial regulation.

This non-market behavior is especially obvious in a sector like steel, for which American steel interests are also seeking CVD relief. China's domestic steel consumption on a per-capita basis is only one-third that of South Korea's. What are China's likely steel consumption needs in the near and medium-term? They are going to be much more than they are now. What is more, a great deal of Chinese steel capacity still produces poor quality product, when what its modernizing economy needs is high-quality steel. Chinese efforts to make sure that steel requirements in the near and medium term don't slow its growth require a range of non-market inducements to increase the quantity of good-quality steel output. Is this non-market behavior? Yes, it is. What is its effect, given all the other non-market costs and requirements also placed on the steel sector by government and communist party officials? This is impossible to say, and hence immediate and forceful CVD actions by the United States are not only unjustified, they would do serious damage to U.S. commercial interests precisely because their international credibility, and especially their credibility with the Chinese, would be so weak.

The weak credibility of immediate and forceful CVD actions is further damaged by the obvious weaknesses in supporting analysis of what attempts petitioners do make to justify their requests. A good example is the U.S. industry effort, adopted by the Commerce Department, to calculate some kind of bank loan interest rate advantage for a Chinese firm, using comparisons with other countries but without correcting for the impact of inflation in other countries on their nominal interest rates. These averages of *nominal* interest rates come up with a figure of roughly 15 percent, which is extremely high. Chinese interest rates (in large part because of lower inflation) are claimed to be unfair. When looking at *real* interest rates, that is interest rates corrected for inflation, Chinese firms must pay significant positive interest rates on there loans. This effort to justify CVD action is worse than flimsy and damages American credibility world-wide.

Similarly, associated industry and Commerce Department claims, asserting that Chinese efforts to strengthen their banking systems by recapitalizing them amounts to unwarranted subsidies subject to CVD action, fly in the face of international norms that encourage governments to ensure adequate capitalization for their evolving banking systems as an important process in strengthening not only domestic economic stability but international stability as well.

Even less credible would be Congressional steps to make unfair currency manipulation equivalent to a subsidy and subject to CVD actions. The Federal Reserve staff who produced Chairman Bernanke's early-release written comments for a speech in China last year clearly erred when they included a statement equating currency undervaluation with a subsidy. The Chairman wisely deleted the statement in his actual spoken remarks. Treatment of currency questions should rest on international consensus about appropriate remedies. Precipitous and forceful unilateral action by the United States—even if manipulation is found by the Treasury Department as it was in the early 1990s—would risk harming not only U.S. interests but the strength of the international commercial system.

In sum, the Commerce Department's shift in allowing consideration of CVD action based on flimsy and incomplete analysis of all the forces relevant in an NME like China's invites an immediate flood of similar forceful efforts to hit China with CVDs on a wide range of products. This approach risks severe damage to American interests, as China, with the sympathy of the international community, shifts its purchases to other sources as part of its retaliatory strategy.

4. The U.S.-China Strategic Economic Dialogue (SED)

What should be the U.S. strategy in the recently created strategic economic dialogue (SED) between U.S. Treasury Secretary Henry Paulson and Chinese Vice Premier Wu Yi? Their second session is scheduled for Washington at the end of this month, roughly a week after this debate.

Again, there are two basic approaches. The first seeks to use the SED to accomplish immediate compliance by China on a range of issues, under threat of forceful action by the Congress and various Administration agencies if China does not agree to do so. The second approach is to emphasize the critical need for the United States and China to collaborate and manage the medium-term and long-term relationship when the organizational structures of their two governments are so different that bureaucratic mismatch makes agency-to-agency collaboration problematic.

Under the first approach, the SED is a communication mechanism and a deadline apparatus meant to force China to announce and follow through with immediate and dramatic actions meeting the demands of various U.S. commercial interests. There is no doubt that the SED provides an invaluable avenue of communication to the very top of China's governmental structure, so that diverse interests and agencies in the United States can be sure that their concerns are conveyed accurately and to the relevant parties. However, given the weak justification for many U.S. demands, and the inappropriate nature of many recommended immediate and forceful steps, using the SED as part of such a proposed high-pressure exercise risks undermining the intended medium-term and long-term opportunities the SED offers.

The SED is better seen as a dual-purpose institution. In the short-term, communication concerning well documented and appropriately channeled U.S. actions is extremely useful. This is all the more so when these communications are coupled with the SED's second purpose of helping devise collaborative bilateral studies, programs and prepared solutions for a range of existing and predictable pending commercial difficulties in both bilateral and multilateral commercial developments.

China's government is organized very differently when compared to the U.S. administration. What is more, not all official "counterpart" relationships are ideal for handling bilateral and other issues. Frequently, two or more agencies in one government need to sit down together with two or more different agencies in the other. This kind of connection is by far the greatest potential offered by the SED, because both leaders of the SED, the U.S. Treasury Secretary and a Chinese vice premier, have close to the highest positions of authority in the two government's respective cabinets. China's ministers are actually sub-cabinet agencies whose leaders report to members of China's cabinet, the State Council, while in the U.S. case the actual cabinet is much larger than China's with different members focused on more specialized responsibilities than is the case for China. The SED provides the cross-communication necessary to develop more effective collaboration and problem-solving procedures than otherwise would be the case.

Hence, rather than a high-pressured push-and-shove negotiating arrangement, the SED should be developed to capitalize on its most important potential in the medium and long term, all the while contributing to steady progress on short-term issues when they are well documented and pose reasonable options for seeking redress.