8

Conclusion

Complaints against China in 2006 largely reflect the accusation that the renminbi is undervalued, though several other disputes dance just offstage. Conflicts over textiles and clothing, intellectual property rights (IPRs), semiconductor chips, automobile parts, antidumping measures, and Chinese acquisitions of US companies threaten to counteract the positive effect of US-China relations even if China revalues its currency. The individual industry disputes are also harbingers of future disputes as Chinese firms begin to compete in new industries and expand their world market share in established lines of trade. Trade disputes will likely become even more intense when the US economy slows down from its brisk growth and unemployment creeps above 5 percent. Geopolitical disagreements—punctuated by China's rapidly expanding military arsenal—have every prospect of sharpening economic tensions.[1] In short, however difficult 2006 may seem in US-China commercial relations, looking back from the vantage of 2008, the current era may seem placid. For the foreseeable future, trade disputes cannot be avoided—but they can be managed.

From the US perspective, complaints against China add up to widespread concern about the loss of manufacturing jobs and the pace of adjustment. But China has more than an export stake in settling disputes. More than a decade ago, under Chairman Deng Xiaoping, China decided to use membership in the WTO, and globalization more broadly, as levers to transform its economy from state-run to market-driven. Enormous

1. The Pentagon's 2006 Quadrennial Defense Review emphasized China's acquisition of precision missiles and conventional and nuclear submarines. See Dan Blumenthal, "Get Serious about China's Rising Military," *The Washington Post,* May 25, 2006, A29.

progress has been made, but the task is far from complete. The Chinese leadership has a major political investment in avoiding trade clashes with the United States, since acrimonious disputes could call into question China's larger commitment to domestic reform.

Comparison with Japan

The history of US trade frictions with Japan (summarized in appendix C) may foreshadow the rocky path ahead with China. Postwar limits on textile and clothing imports started in 1957 when President Dwight Eisenhower negotiated a "voluntary" restraint agreement (VRA) with Japan. The next large Japanese trade dispute was over steel: In 1968 President Lyndon Johnson negotiated another VRA. During the Tokyo Round of multilateral trade negotiations (1974–79), Ambassador Robert Strauss held heated talks with his Japanese counterparts over access to Japanese beef and other agriculture markets. In the 1980s, under President Ronald Reagan, the United States imposed VRAs on semiconductors, steel, and automobiles and also initiated a round of market access negotiations. The intensity of US trade disputes with Japan abated only in the mid-1990s, as the US economy boomed and the Japanese economy slumped.[2]

In comparing current US-China frictions and past US-Japan frictions, four key political and economic factors should be considered. One factor that does not augur well for managing future disputes is the absence of a security alliance. The US-Japan postwar security alliance, cemented in the Treaty of Mutual Cooperation and Security (1960), lowered the decibel level of US trade complaints. Obviously no such alliance exists with China; in fact, future security tensions could inflame trade disputes (Bergsten et al. 2006).

Another factor not in China's favor is the import-to-export ratio. As table 8.1 shows, the bilateral ratio between US imports and US exports is significantly higher for China today than for Japan at its peak in 1986—a ratio of six versus a ratio of three. To close the absolute dollar size of the bilateral trade gap, US exports to China must grow more than six times as fast as imports, whereas the comparable benchmark for Japan was more than three times as fast. The implication is that the absolute size of the US-China bilateral trade deficit will very likely expand for a considerable period.

The openness of the Chinese economy compared with Japan, however, is a key plus. The ratio of external trade (imports plus exports) to GDP provides a broad measure of openness. As shown in table 8.1,

2. In 1988 Clyde Prestowitz published the classic book on the Japanese "threat," titled *Trading Places.* In 2001 C. Fred Bergsten, Takatoshi Ito, and Marcus Noland (2001) explained why US-Japanese relations turned around so decisively.

Table 8.1 Comparison between US-Japan and US-China trade, 1986 and 2005

Country	**US imports from** (billions of dollars)	**US exports to** (billions of dollars)	**US import to export ratio**	**Trade to GDP ratio**[a]	**Inward stock of FDI** (billions of dollars)[a,b]	**FDI to GDP ratio**[a]	**Share of world merchandise exports** (percent)[a]
China							
1986	4	4	1.0	.22	37	0	1.4
2005	243	42	5.8	.67	702	.42	6.6
Japan							
1986	82	27	3.0	.10	7	0	9.9
2005	138	51	2.7	.21	97	.02	6.0

FDI = foreign direct investment

a. 2005 figures are for 2004.

b. Includes inward FDI from Hong Kong.

Sources: USITC Dataweb Version 2.7.1 for US imports and exports; UNCTAD's *World Investment Report*, 2005, for inward stock of FDI; IMF's *World Economic Outlook,* April 2005, for GDP in current prices; WTO statistics database, 2005, for Japanese, Chinese, and world exports.

China's trade to GDP ratio increased from 22 percent in 1986 to 67 percent in 2004. By comparison, Japan's trade to GDP ratio increased from 10 to 21 percent over the same period. Another measure of China's openness is the ratio of foreign direct investment (FDI) stock to GDP. The figure for China increased from less than 1 percent in 1986 to 42 percent in 2004. By comparison, the Japanese figure increased from less than 1 percent in 1986 to only 2 percent in 2004. A third measure is the size and persistence of global trade surpluses. Japan has run large surpluses for more than 30 years; China began to run large trade surpluses only in the past four years.

A final factor is the size of Japan and China as players in global trade. In 2004 the Chinese share was nearly 7 percent of world exports; at the height of export-led growth, Japan reached 10 percent in 1986. China may surpass Japan's erstwhile share of world exports, but for now, China is not shaking world markets to the same degree that Japan did in the mid-to-late 1980s.

Lessons from History

Based on the history of US-Japan trade friction, modulated by the four factors just discussed, we foresee decades of US-China trade friction. The intensity could be sharp when the US economy experiences a downturn and unemployment rises, especially if a difficult economy coincides with geopolitical tension (Bergsten et al. 2006). China will continue its export push into foreign markets, adding higher-technology products to the familiar mix of textiles, clothing, toys, and furniture. This push will ensure a long string of trade cases. At the same time, China's openness and rapid growth will ensure that China remains an exceedingly attractive market for financiers, direct investment, commodity exports, and a wide range of manufactured and service exports. Security alliances will not shelter China, but commercial considerations will dampen the excesses of trade protection. Against that background, we offer a few recommendations for managing disputes over the next few years.

Chinese Policies

Based on its huge domestic market, its high saving rate, its entrepreneurial skills, and its pool of cheap and often skilled labor, China has enormous competitive advantages. To realize the full value of its competitive strengths, however, China needs an open world trading system that can not only absorb a growing volume of Chinese exports but also supply raw materials, such as oil, copper, and soybeans, and manufactured goods, such as electrical equipment, aircraft parts, and medical instruments, that China does not produce at competitive costs.

In its best long-term interests, China should take several measures to foster an open world trading system in the years ahead. It should

- revalue the renminbi and eventually adopt a floating exchange rate, so that the Chinese "basic balance," including inward direct investment, is approximately zero over China's business cycle.[3]
- not wait for lengthy WTO negotiations to liberalize access to its own markets. Instead it should take the lead and launch its own program of unilateral liberalization, thereby challenging other WTO members to invigorate the Doha Development Round. Industrial tariffs capped at 5 percent sharply reduced agricultural barriers, and an open market for financial services akin to what now prevails in Hong Kong would be an excellent place for China to start.
- announce the progressive phaseout of domestic subsidies and incentives for infant industries, such as that for semiconductors, and eliminate them altogether in industries that have demonstrated their prowess in export markets, such as textiles and clothing.

3. As long as FDI enters China, a zero "basic balance" means that China will incur a trade deficit.

- strengthen and streamline its system for protection of IPRs. Among other measures, China should devise a system of incentives that encourage private citizens and public officials to report IPR violations and enforce IPRs.

US Policies

For their part, US leaders should publicly declare that expanding trade relations between the United States and China serves US economic interests, even when China has a bilateral trade surplus. Economic criticism leveled at Chinese policies should focus on China's trade balance with the world, exchange rate equilibrium, market access barriers, and unwarranted subsidies—not China's bilateral surplus with the United States.

- In industries where Chinese imports are rising rapidly and genuinely injure domestic US firms, the United States should apply time-limited safeguards. WTO paragraph 241 safeguards are preferable to paragraph 238 safeguards. Both safeguards violate the WTO nondiscrimination principle in that they can be imposed solely against Chinese exports. However, unlike the automatic process of paragraph 238, paragraph 241 safeguards require an initial investigation to determine whether Chinese exports inflict some degree of injury on domestic firms.
- Ahead of the 2013 date for the expiration of WTO paragraph 241 safeguard actions, the United States should shift to normal safeguards when domestic industries face injury. Unlike paragraph 241 safeguards, normal safeguards apply to all imports except those of free trade agreement partners; they cannot single out China for discriminatory trade restrictions.
- Ahead of the 2016 expiration of the nonmarket economy designation, the United States and other WTO members should phase out the application of this discriminatory status against Chinese exports.
- To effectively address the impact of Chinese imports on US manufacturing jobs, the US government should reshape its trade adjustment assistance (TAA) program, focusing on wage insurance and health benefit initiatives. Safeguard measures, including antidumping duties that are imposed against Chinese and other imports, should be accompanied by TAA relief. The emphasis of US measures should shift from product to job markets.

Joint China-US Policies

President Hu Jintao's visit in April 2006 underscored China's preference for *ad hoc* meetings with friendly US firms and "shopping bag diplomacy" rather than formal obligations on IPR or market access issues.[4] Rather than negotiating concrete IPR agreements with the US government, President Hu promised Microsoft Chairman Bill Gates that the Chinese government would enforce its policies against software piracy.

Although President Hu may prefer such government-to-business contacts, to deal with trade tensions systematically, the United States and China also need to build upon the framework of the Joint Commission on Commerce and Trade (JCCT). The April 2006 JCCT meeting was constructive, if limited. China agreed to improve market access, notably by joining the WTO Government Procurement Agreement, albeit at an uncertain date, and to improve its IPR enforcement efforts. In a similar fashion, future semiannual meetings can address the rolling agenda of commercial disputes that will remain a core feature of US-China relations.

The Bottom Line

The United States and China cannot duck the prospect of multiple commercial disputes in the years ahead, ranging from the renminbi-to-dollar exchange rate to export restrictions and import liberalization. The challenge facing both Beijing and Washington is to resolve these disputes, case by case as they arise, in a manner that strengthens open markets and the multilateral trading system. Whatever their geopolitical differences, both countries share an enormous stake in fostering open trade and investment. Both countries risk losses running to hundreds of billions of dollars of GDP annually if their commercial relations are engulfed by a wave of protection and recrimination. By the same token, however, both China and the United States can share gains in the hundreds of billions of dollars if their joint policies ensure the continued expansion of world trade and investment.

4. Leading up to President Hu's visit, China signed 106 purchase contracts with US firms totaling $16 billion, including a deal to purchase 80 aircraft from the Boeing Company, valued at $4.6 billion. However, it is hard to know whether these purchases will represent additional US exports or simply accelerated US exports of sales that would have occurred anyway. See "Growing Expectations for Hu Jintao's Visit to the United States," *Asia News*, April 10, 2006, available at www.asianews.it.