BOOK REVIEWS

Integrating China into the Global Economy
Nicholas R. Lardy
Washington: Brookings Institution Press, 2002, 244 pp.

China's total trade (the sum of its imports and exports) was \$20 billion in 1977 but by the end of the 20th century that figure had increased to \$475 billion. In his new book, Nicholas Lardy, a long-time senior fellow in the Foreign Policy Studies program at the Brookings Institution and currently senior fellow at the Institute for International Economics, presents a detailed study of China's integration into the global economy. He examines China's pre-reform trade regime and contrasts it with the substantial liberalization that took place after 1978, especially in the decade prior to China's accession to the World Trade Organization in December 2001. His central thesis is that the Middle Kingdom was well on its way toward global economic integration *before* entering the WTO. Lardy explains the expected benefits and costs of accession, why Beijing agreed to join even though certain conditions are discriminatory, and the implications for U.S.-China relations.

China's rapid economic growth since its opening to the outside world, which began with the 1979 law on joint ventures and the creation of special economic zones in 1980, has proven that economic freedom and wealth creation go hand in hand. Prior to joining the WTO, China already had significantly reduced its tariff and nontariff barriers and increased trading rights (that is, the right to import and export). By 2000, foreign-funded enterprises accounted for 48 percent of China's exports and 52 percent of its imports. In chapter 1, Lardy argues that China's long 14-year wait for entry into the WTO "reflects as much the rising bar imposed by members of the Working Party . . . as China's slowness to embrace the principles of the multilateral trading system" (p. 9).

The interesting question is, why were Chinese politicians willing to accept high short-run costs in return for distant benefits? The answer is that the Chinese Communist Party has made economic growth its primary policy goal—the survival of the party depends on continued growth in the standard of living. Jiang Zemin, Zhu Rongji, and other leaders recognized the importance of trade liberalization for achieving that goal.

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As Lardy notes, the party was merely acting in its self-interest. The dilemma, of course, is that, as the People's Republic of China moves closer toward a free-market system, people will demand greater political autonomy, which will undermine the CCP's monopoly on power.

Numerous problems plague China's market socialist economy, especially the inefficiency of state-owned enterprises (SOEs), the large amount of nonperforming loans held by the four big state-owned banks, high unemployment, and widespread corruption. If the leadership's goal is to achieve sustainable growth, those problems must be addressed. What is needed is institutional change that expands the role of the market and reduces the misallocation of resources endemic to the state sector.

China's leaders have come to accept the growing importance of the nonstate sector. Economic growth rates are much higher in the market-oriented coastal areas than elsewhere in China. According to Long Yongtu, vice minister of foreign trade, "China's economy must become a market economy in order to become part of the global economic system" (p. 21). Private ownership is now explicitly sanctioned in the PRC Constitution, although it is not afforded the same protection or status as state ownership. Reformers viewed accession to the WTO as an opportunity to expand the private sector and improve long-run growth.

China's WTO commitments include further reductions in tariff and nontariff barriers; extension of trading rights to foreign and domestic firms within three years of accession; greater market access for foreign telecommunications firms, banks, and insurance companies; direct distribution rights; and greater protection of intellectual property rights. China also agreed to discriminatory treatment under the so-called WTO-plus provisions designed to "safeguard" (i.e., protect) foreign producers.

There is no doubt that China will incur considerable costs as it complies with its WTO commitments. But Lardy thinks those costs may be overstated because of the significant progress China had already achieved during the 1990s in liberalizing trade and moving toward a market economy. Prior to joining the WTO, China had reduced the average statutory duty on imports to 15 percent (the actual rate was even lower), removed quotas and licenses on most imports, restructured many SOEs, and abolished most price controls.

The implications of China's accession to the WTO are profound. As Lardy notes, the PRC will have to revamp its legal system to comply with international norms, SOEs and state-owned banks will be forced to restructure, and foreigners will be able to enter many of China's markets for the first time. The increase in economic freedom is sure to have a positive impact on China's civil society and foster political reform, as was the case in Taiwan and South Korea. The key problem will be to deal effectively with the transition costs, in terms of unemployment and social unrest.

Prior to 1978, China's foreign trade sector was subject to strict central planning: the Ministry of Foreign Trade limited trading rights to a few large foreign trade corporations, imports and exports were fixed in physical terms, and the exchange rate was deliberately overvalued to subsidize imports and discourage exports. Under such an autarkic regime, China's share of world trade was only 0.6 percent by 1977. In chapter 2, Lardy contrasts that inward-looking regime with the 1978–2001 liberalization process that set the stage for China's entry into the WTO.

After 1978, China decentralized the foreign trade sector, increased trading rights, liberalized prices, reduced tariff and nontariff barriers, devalued the renminbi (which fell by more than 70 percent in real terms between 1980 and 1995), allowed convertibility for current-account transactions, and encouraged foreign investment and processing trade by foreign-funded firms. Private trading companies were authorized in 1998, and by 2000 more than 1,000 private enterprises had acquired the right to import and export, along with more than 150,000 foreign-funded firms. Those and other reforms helped link China to the world price system, allowed firms to specialize according to their comparative cost advantage, and helped consumers realize the gains from trade.

Once trade liberalization began, and the leadership allowed market prices rather than planners to guide exports and imports, trade flourished. As Lardy notes:

> Economic incentives to export such as a more realistic exchange rate, the rebate of indirect taxes on processed exports, the duty drawback on inputs used in processed exports, the reduction of barriers to export, and the growing role of foreign-funded firms as exporters fueled an explosion of Chinese exports. That in turn provided the foreign exchange to finance a dramatically higher volume of imports [p. 55].

By 2000, China had become the world's seventh largest trading nation and the second most important destination for foreign direct investment. But, as Lardy points out, China still maintained high levels of protectionism in selected sectors and was far from meeting international rules for protecting intellectual property rights. Joining the WTO would help open China's markets, further domestic economic reform, and bring China into closer compliance with the rules of a liberal international trading regime. In chapter 3, Lardy examines the nature of China's WTO commitments with respect to market access and various rules-based issues.

It is clear that foreign firms will benefit considerably over the next five years as China decreases its hold on domestic industry and provides greater access to a number of previously protected industries, such as automobiles, agriculture, telecommunications, and financial services (banking, insurance, securities, fund management). Foreign firms will also benefit as they acquire full trading rights and direct distribution rights. Tariffs on agricultural products will be cut to 15 percent, on average, and to 8.9 percent on industrial products. Most nontariff barriers will be phased out by 2005. Those and other changes are expected to increase the growth of exports and imports, and attract new foreign investment. Both China and its trading partners will benefit.

In addition to agreeing to further open its markets to global competition, China also agreed to abide by WTO rules. Those rules will require that China engage in legal reform to better protect intellectual property rights and afford foreign firms and investors national treatment, so that they can operate on a level playing field. By the beginning of 2007, foreign banks will have unrestricted access to the Chinese market. In certain areas, however, China agreed to discriminatory treatment to satisfy the United States, the European Union, and other WTO members who fear a rising volume of imports from the mainland. Lardy emphasizes that the "WTO-plus" terms that China agreed to, with regard to safeguards and antidumping, are "more onerous than those accepted by any other member" (p. 80).

Under pressure from the United States and the EU, China committed to rules that clearly violate the nondiscrimination principle, which is central to a liberal trading order. In China's protocol of accession to the WTO, the "transitional product-specific safeguard" clashes with normal WTO practice. Instead of having to show "serious injury" from PRC exports, members need show only "market disruption." U.S. trade law defines market disruption as an increase in imports, either absolute or relative, that is "a significant cause of material injury, or threat of material injury to the domestic industry" (p. 82). When a WTO member establishes this low level of injury, it may single China out and use a quota or other protective measure to slow the entry of Chinese goods into the domestic market.

The transitional product-specific safeguard is also inconsistent with the WTO's prohibition against voluntary restraint agreements. Instead of requiring an industry to prove "market disruption," the WTO-plus provision allows the government of the importing nation to negotiate directly with the Chinese. If China does not agree to a voluntary export restraint, the importing country may increase tariffs or impose quotas. The normal eight-year limit for such restrictive measures under the WTO Agreement on Safeguards does not apply. Finally, in the case of trade diversion, WTO members claiming market disruption can take restrictive actions without having to conduct any investigation.

The transitional product-specific safeguard will be in effect for 12 years following China's accession to the WTO. In a worst-case scenario, Lardy warns that

> China could face a quantitative restriction on its exports of a product for twelve years with no liberalization over time on the restriction. These restrictions would start in one country but likely quickly cascade to all significant markets. They could be imposed even if the increased inflow of Chinese goods were only displacing goods from other countries and when only the country initially imposing the safeguard had carried out an investigation establishing the existence or threat of material injury to the domestic industry [p. 84].

Until the end of 2008, the PRC also will be subject to a special textile safeguard, which allows WTO members to impose a limit of 7.5 percent per year on the growth of textile and apparel imports from China. Under the WTO Agreement on Textiles and Clothing, all quantitative restrictions on textiles and apparel were to end in 2004.

With pressure from the United States, the EU, and other WTO members, Beijing also agreed, as part of its protocol of accession, to being treated as a nonmarket economy (NME) for 15 years after joining the WTO. In so doing, China faces the risk of being shut out of those markets in which it has a comparative cost advantage. Dumping occurs when a country sells in a foreign market at a price below the "normal value" or price in the home market, or in a third country, and causes, or threatens to cause, material injury. If a country can show material injury, it can impose antidumping duties on the imported goods. Treating China as a NME allows WTO members to "construct" normal value by using input prices in market economies and adding a markup for profit, or simply to use product prices in surrogate countries. Those methods, however, tend to increase antidumping margins and the likelihood that WTO members will take action against the PRC, even when there is no actual dumping.

Although the United States has criticized China for not moving fast enough toward a market economy, the prolonged use of NME methodology in antidumping cases will slow reform and harm the private sector. There is a strong case for dropping the NME classification altogether rather than extending it for 15 years.

Under the Agreement on Subsidies and Countervailing Measures, China agreed to forego being classified as a developing country and, thereby, became ineligible for favorable treatment of subsidies associated with privatization. China will not be allowed to treat debt-for-equity swaps as "nonactionable" subsidies; newly privatized firms therefore face the possibility of countervailing duties. The West's insistence on this issue undermines the privatization process in China and clashes with the primacy of property in a market-liberal order. China also agreed to be subject to an "alternative benchmark" in countervailing duty cases involving subsidized loans or swaps. That approach is similar to the NME methodology used in antidumping cases, but unlike that methodology, there is no time limit.

The United States and the EU also used WTO-plus provisions to game the rules for agricultural subsidies in their favor. While American and EU farmers receive a number of transfer payments other than price supports, Chinese farmers rely exclusively on government price supports. The WTO Agricultural Agreement includes only price support payments in calculating allowable domestic agricultural subsidies. China agreed to limit its domestic agricultural subsidies to 8.5 percent of the value of agricultural output and to completely eliminate agricultural export subsidies.

The WTO-plus concessions reflect China's willingness to engage the West and integrate itself into the global trading system, even at the risk of considerable short-term costs. The size of those costs will depend on how quickly China opens its markets; how strictly the transitional product-specific safeguards, antidumping, and other WTO-plus provisions are enforced; and how successful China is in reforming its moribund banking system. Lardy addresses these issues in chapter 4 and considers the efficiency gains from China's accession to the WTO.

The short-run costs of China's accession include job losses in import-competing industries (especially in SOEs), social unrest, and a possible liquidity crisis as deposits are moved from state-owned banks to foreign financial institutions. Lardy believes the transition costs may be overstated because China has already made substantial progress in growing the nonstate sector and integrating itself into the global economy. Foreign-funded firms account for the bulk of China's global trade, and SOEs produce less than one-third of the value of industrial output. China's weakest sector is banking. The four big state-owned banks are technically insolvent, with nonperforming loans possibly as high as 40 percent of outstanding loans. For the full efficiency gains to be had from China's WTO entry, there must be a radical transformation of the financial sector.

There is a huge waste of capital in China, with about two-thirds of state bank loans going to SOEs, most of which are highly inefficient. Meanwhile, the private sector is starved of capital, few investment alternatives exist, and the stock markets are more like casinos than real capital markets. Nearly all the tradable shares are those of SOEs, and most shares are nontradable.

China's market-access agreements, if implemented, will place the financial sector under increasing pressure to conform to international standards or face losing business to foreign firms. Lardy does not think that a liquidity crisis is inevitable. State-owned banks may lose some deposits, but various restrictions during the first five years after China's accession will limit the size of those outflows. When foreign banks receive national treatment and have full market access, competition for deposits will increase, but foreign banks will still have to meet capital adequacy requirements and find suitable borrowers.

It is essential that China stop using state-owned banks to provide soft policy loans that misallocate capital. Banks must be put on a commercial basis, interest rates must reflect market forces, and discrimination against the private sector must end. How successful China is in realizing the gains from further trade liberalization under the WTO will depend, in Lardy's opinion, on significant financial reform. The gains from trade liberalization will also fail to be maximized if foreign governments attempt to prosecute every infraction of the trade agreement rather than concentrate on significant cases. China, no doubt, will challenge unfair procedures and use its influence to side with developing nations in the fight to reform antidumping laws. At the same time, China must honor its agreements or risk weakening the WTO.

In the final chapter, Lardy considers the effects of China's WTO membership on world trade, the international trading system, and U.S.-China relations. It is likely that over the next decade China will become the world's second largest trading nation, after the United States, and the world's leading producer of labor-intensive goods. The growth of Chinese trade will increase world trade and redistribute it.

The natural course will be for China to acquire a larger share of the world's apparel and other labor-intensive commodity markets as trade barriers are lowered and comparative cost advantages are revealed in relatively lower market prices for Chinese goods. Investment opportunities will expand in China, and overseas Chinese will stand to gain.

Lardy expects China to have a mixed record in complying with its WTO commitments. The WTO-plus provisions impose costly changes on China that will not be easily implemented; China still has a very weak legal system that will make it difficult to comply with WTO rules in a timely fashion, especially in the area of intellectual property protection; and China's new leaders may decide to slow the pace of reform in order to satisfy special interest groups. Nevertheless, Beijing has already promulgated a number of laws and regulations that will bring China into closer compliance with WTO norms, and there is increasing domestic demand for better protection of private property rights.

China will try to use its membership in the WTO to assist other developing nations in their effort to prevent developed countries from using trade laws for their own advantage—especially as they apply to antidumping, agricultural subsidies, environmental regulations, and labor standards. In the case of agricultural subsidies, Lardy notes:

> The United States is able to subsidize at a nearly 100 percent rate because most of its subsidies take the form of direct payments to farmers rather than price subsidies. . . . The United States and other developed countries, which largely controlled the Uruguay Round negotiations, wrote the rules so that their preferred form of subsidies was not limited [pp. 156–57].

The WTO should strive harder to adhere to the nondiscrimination principle and to create a truly liberal international order.

On the topic of U.S.-China relations, Lardy argues that the policy of engagement has been fruitful and should continue: "U.S. policies that have given rise to the perception in China that the United States seeks to delay or even block China's emergence as a major economic power must be abandoned" (p. 167). Moreover, "the United States should be extraordinarily judicious in exploiting the three highly protectionist measures [the transitional product-specific safeguard, the special textile safeguard, and the NME methodology in antidumping cases] that U.S. negotiators insisted China agree to as a condition for WTO membership" (p. 168).

Lardy also criticizes the argument that the U.S. bilateral trade deficit with China reflects Chinese protectionism. The truth is that China has significantly liberalized its foreign trade sector, especially in the 1990s, and America is running a *global* trade deficit that is due to the low U.S. savings rate relative to domestic investment. To fill that gap, the United States must rely on foreigners to run trade surpluses and extend credit. Lardy expects the U.S. trade deficit with China to increase as trade barriers are removed and Chinese apparel and other labor-intensive products gain ground in the U.S. market, largely at the expense of other developing countries. Prior to China's entry to the WTO, U.S.-China trade had expanded from $1 billion in 1978 to $116 billion in 2000, and that upward trend will continue.

If the United States wants to reduce its global trade deficit, it will have to increase its savings rate or reduce domestic investment. Moreover, as Lardy notes, "Selective trade liberalization abroad only affects the country-by-country distribution of the U.S. global trade deficit, not its overall size" (p. 158). Those are points worth remembering whenever deficit hawks seek to single China out as a threat to U.S. national security.

The key challenge, according to Lardy, "will be to maintain open markets in advanced industrial countries. . . . China's prospects of adjusting to more imports from the West will be dim if developed market economies impose restrictions on products for which they are unlikely to have a comparative advantage" (p. 176). That is a message worth repeating.

Those who wish to understand the complexity of the international trading system and the growing importance of China in the world economy will do well to read Lardy's fascinating book.

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Globalization and Its Discontents
Joseph E. Stiglitz
New York: W. W. Norton & Company, 2002, 282 pp.

A more accurate title for this book should have been, *Joseph Stiglitz and His Discontents.* What could have been an enlightening look at globalization by one of the nation's best-known economists proves instead to be a score-settling exercise distorted by the author's own political prejudices and personal animus.

The book is all the more disappointing because Joseph Stiglitz is an economist's economist. He's written acclaimed textbooks on public finance and contributed enough to the profession to earn a Nobel Prize in 2001. He served in key advisory positions during what the Chinese would call interesting times, first as chairman of President Clinton's Council of Economic Advisers and then as chief economist at the World Bank during the East Asian financial meltdown and its aftermath.

The author pays lip service to the power of free trade and markets to promote growth and reduce poverty, but then devotes the rest of the book to an attack on "market fundamentalism." The immediate object of