



# Free Trade Bulletin

No. 28 • May 7, 2007

## Growing Pains: The Evolving U.S.-China Trade Relationship

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U.S. actions toward China in early 2007 seem to signal a new trade policy tack for the Bush administration. After having initiated just two formal complaints against China within the World Trade Organization during that country's first five years as a member, the U.S. trade representative (USTR) has initiated three cases in the first four months of this year alone. In addition, the U.S. Department of Commerce ended its 22-year moratorium on applying the U.S. Countervailing Duty law to imports from so-called nonmarket economies when it imposed preliminary duties against allegedly subsidized imports of Chinese coated paper in late March.

The recent flurry of activity has caused angst and raised questions on both sides of the Pacific. Has the Bush administration changed course with respect to China? Will its actions ameliorate or exacerbate tensions in the relationship? Will it lead to resolution of the underlying U.S. complaints and deter Congress from doing something rash? Is a trade war likely? This brief paper offers answers, along with some of the context and perspective that has been absent from many news reports.

In the final analysis, the administration's trade actions of 2007 do not represent a departure from its longstanding China-trade policy but rather the next phase in a logical evolution. By using the WTO dispute settlement system to convey U.S. seriousness about achieving resolution, the administration should be able to keep Congress on the sidelines. If so, lingering issues are likely to get resolved and a trade war avoided. All bets are off, however, if Congress short-circuits the WTO process and passes punitive legislation that violates U.S. WTO commitments.

### Recent U.S. Actions in Perspective

For more than six years, the Bush administration has been a bulwark against an impatient, trigger-happy Congress, which continues to threaten provocative, anti-China trade legislation. China agreed to undertake massive economic reforms when it joined the WTO in December 2001, and the Bush administration reckoned that it would take some time to implement those commitments. Better to not bludgeon

China over slow-going reforms, as long as steady progress was evident. Otherwise China's taste for the multilateral, rules-based trading system might sour.

In its reports on China's record of compliance over the past few years, the USTR has acknowledged good overall progress alongside lagging implementation in some areas. But the administration has taken a big picture approach to the bilateral relationship, refusing to indulge every protectionist whim—although its record is not perfect, particularly with respect to U.S. textile and clothing restraints.

As the commercial value of the bilateral trade relationship has nearly tripled in a mere five years, from a substantial \$121 billion in 2001 to an immense \$343 billion in 2006, the space for disputes has expanded.<sup>1</sup> When the relationship is characterized by a large and growing current account imbalance (to which many policymakers attach exaggerated meaning) the spats can become politically charged, as they have.

Since the beginning of 2006, the USTR (and other agencies) has made it quite clear to its Chinese counterparts that the honeymoon period following China's accession was over and that it would soon endeavor to resolve disputes with China as it does with other major trade partners, through WTO dispute settlement procedures, if necessary. In the USTR's "Top-to-Bottom Review" of U.S.-China Trade Relations, the year 2006 marks the beginning of "Phase 3" of the relationship:

Now [2006] that the deadline for phase-in of most of China's WTO obligations has passed—and China has developed an initial track record as a new WTO member—we are entering a third stage in our bilateral trading relationship. At this point, the easiest obligations for China to meet have largely been fulfilled, and the hardest obligations are those that are still outstanding, precisely because their full implementation has proven especially difficult. Successfully addressing these remaining implementation issues will require serious attention and deliberate action by both governments.<sup>2</sup>

Consistent with its report, the USTR initiated a WTO complaint the following month (March 2006), alleging that certain Chinese policies discriminate against imported automobile parts and encourage consumption of domestically produced parts in the manufacture and assembly of automobiles in China. That complaint remains unresolved, as a dispute panel was convened in late 2006, and a report of its findings is expected later this year.

The auto parts case was only the second WTO dispute brought against China. In 2004 the United States contested a Chinese value-added tax on integrated circuits that was allegedly applied in full to imports only. During the consultations phase of the dispute, the Chinese agreed to change their law in a manner that was agreeable to U.S. negotiators, and the dispute was officially resolved.

In early February 2007 the United States filed its third WTO complaint against China, alleging that certain Chinese tax provisions amount to subsidies for Chinese exporters and encourage consumption in China of domestic products at the expense of imports.

In late March, the U.S. Commerce Department levied preliminary countervailing duties against imports of Chinese coated paper, breaking with its informal 22-year policy of not applying the U.S. Countervailing Duty (CVD) law to imports from so-called nonmarket economies.

Then, in April, the United States launched two new WTO cases, one alleging inadequate protection for American intellectual property rights holders under Chinese laws and the other concerning market access barriers for copyright industry products.

The administration's actions have been criticized by trade supporters and critics alike, but for different reasons. Some who support trade suggest that the U.S. actions are unwarranted, hypocritical, and likely to provoke retaliation from China. Meanwhile, trade skeptics suggest that WTO dispute settlement takes too long and often fails to resolve the underlying complaint, and that unilateral measures are warranted. Neither assessment is correct.

### **Defense in Principle of U.S. Actions**

One misconception that permeates media accounts of the recent U.S. actions is that, by bringing these WTO cases and by applying the U.S. CVD law, the United States is acting provocatively, unilaterally, and in a manner that somehow violates China's rights under the WTO. A recent *Washington Post* column wrongly equates the U.S. CVD action to pre-WTO unilateralism:

Today such bashing is relatively rare, because such sanctions run afoul of WTO panels. But the unilateralist urge remains: Look at the imposition of trade sanctions Friday on Chinese paper.<sup>3</sup>

A unilateralist action would be one that is not sanctioned by the WTO. The duties levied against Chinese coated paper, *in principle*, do not run afoul of WTO rules. Even if one finds fault with the countervailing duty law or other laws that can lead to higher import duties (as this author does),

trade remedy duties are, unfortunately, explicitly sanctioned exceptions to the most favored nation principle that underlies the WTO system.

About the CVD decision, a *Los Angeles Times* editorial went so far as to say "the decision to impose a 10–20% import penalty could be the opening shot in a trade war between the world's largest economy and its fastest growing."<sup>4</sup> Again, this is a bit dramatic given that, under WTO rules, trade remedy restraints are permitted and unilateral retaliation is not.

Counseling the administration that alternatives would "do more good than starting a trade war," a recent *New York Times* editorial misled its readers about the implications of the recent trade actions:

The [decision to launch WTO cases on intellectual property and market access for copyright industries] came less than two weeks after the Commerce Department said it would impose duties on two Chinese paper makers that it says got an unfair boost from China's government. Experts say such duties could expand to steel, plastic and beyond unless China reins in subsidies. In February, the U.S. opened another subsidy case at the W.T.O.<sup>5</sup>

True, other U.S. industries can petition for relief from subsidized competition under the countervailing duty law, but there is nothing automatic about it. Those industries have to demonstrate that they are materially injured by reason of subsidized imports, which would be a stretch for many industries in the highly profitable U.S. manufacturing sector, particularly steel. And the subsidy case brought to the WTO in February is not a U.S. CVD case, but is actually a complaint challenging certain Chinese tax laws that allegedly discriminate against U.S. producers. Seeking resolution of trade issues through the multilateral WTO is a commendable alternative to unilateral sanctions.

There is nothing especially provocative in the Bush administration's assertion of U.S. rights in its WTO complaints. This is how WTO members resolve their differences after informal negotiations prove unsuccessful and domestic political pressure for resolution builds. Although some characterize the U.S. turn to the WTO as demonstrative of a new strategy of litigation and enforcement, the fact is that WTO dispute settlement encourages dialogue and favors negotiated settlement over formal adjudication. And when disputes require formal adjudication from a dispute panel or the Appellate Body, resolution is almost always achieved without trade sanctions.

Bringing formal complaints at the WTO and invoking measures under permissible domestic trade laws really are not extraordinary actions demanding extraordinary conclusions. WTO members have rights and obligations according to their domestic laws and international treaties. Diverging views about those rights and obligations have inspired 363 formal complaints to the WTO Dispute Settlement Body since 1995 (about 30 per year).<sup>6</sup> Retaliatory actions have been authorized in only six cases.

The three recent U.S. WTO actions are all about encouraging China to open its market further in accordance with its commitments and are not complaints on behalf of import-competing interests seeking to frustrate Chinese access to the U.S. market. In that regard, the WTO cases are progressive; they seek to liberalize real or perceived barriers to trade. Whether the United States succeeds, either through formal consultations or dispute adjudication, remains to be seen.

While use of domestic trade remedies laws tends to raise barriers to trade and is thus ill-advised, WTO members are permitted to have and to apply them. The United States did not violate any WTO obligations by applying the countervailing duty law to Chinese goods, as long as that process complied with its obligations under the WTO Agreement on Subsidies and Countervailing Measures.

What is unusual about this case and perhaps explains the vast media speculation about a trade war is that the CVD law has not been applied to so-called nonmarket economies since 1984. While the Commerce Department has always had the discretion to apply the CVD law to Chinese companies, it has foregone doing so because even the DOC appreciates the absurdity of attempting to measure the benefits of a subsidy in an economy where the government is deemed to control the means of production and prices and costs are presumed to be fictitious. How can Commerce calculate a subsidy benefit to countervail by comparing numbers that it officially deems meaningless? What is the meaning of a government subsidy in itself?

The change in policy might have been inspired by any number of developments. First, the Chinese economy has become much more market-oriented, and thus prices and costs in many sectors now are reflective of supply and demand. Second, until recently China had not fulfilled its obligation of notifying the WTO of its subsidy programs. Now that it has largely complied and done so, there is more information available to U.S. industries and the Commerce Department to conduct a reasonable (by their standards) assessment of the accruing benefits of those subsidies. Third, U.S. industries have been complaining about competition from subsidized Chinese industries for a long time, and that message is having an impact on Capitol Hill. The timing of the administration's action may have been intended to head off legislation that would remove executive branch discretion and mandate application of the CVD law to nonmarket economies.<sup>7</sup>

The trade remedy laws are problematic in that they raise barriers to trade. But there is nothing especially objectionable about subjecting China to the U.S. CVD law. Imports from all other countries (that are not deemed nonmarket economies) are subject to the law, and China should be treated like all other major trading partners. But if China is to effectively be considered a market economy for purposes of the CVD law, then it should be treated as a market economy under U.S. antidumping law. China's current de facto status as a market economy under CVD law alongside its explicit status as a nonmarket economy under the antidumping law is internally inconsistent, is punitive, and likely violates the terms of China's WTO accession protocol. HR 1229 would

mandate application of the CVD law to China, but it would also make it harder for China to receive market economy status under the antidumping law. As such, HR 1229 would be unlikely to withstand WTO scrutiny.

### **Trade War Is Unlikely**

Although some suggest that recent U.S. actions will spark a trade war with China, such an outcome is unlikely. For starters, tit-for-tat trade wars between WTO members are unheard of. The WTO was created, in part, so that trade wars would be relegated to history. Under the rules-based system of trade, members can retaliate in response to an action or inaction of another member only when such a course has been authorized by the Dispute Settlement Body, and only in measured proportions.

Despite complaints about the three U.S. WTO cases, the United States hasn't done anything that is even challengeable within the WTO. The United States has not suspended concessions with respect to Chinese imports. It has merely notified the WTO that it believes certain Chinese policies create a disadvantage to U.S. exporters in a way that violates China's obligations.

Only the CVD action against Chinese coated paper can be challenged by China in the WTO. Although no such challenge has been issued, it wouldn't be surprising if the Commerce Department, in its zeal to combat import competition, violated U.S. law or U.S. WTO obligations.<sup>8</sup>

Barring improper application of the law, China (as a WTO member) has no legitimate recourse to retaliation. Ultimately, China could retaliate legitimately only if it went through the formal channel of challenging the U.S. action and convinced a WTO panel (or, eventually, the WTO appellate body, if the case were appealed) that the United States violated its WTO obligations and then refused to make proper amends. And, even though the WTO dispute settlement system sanctions retaliation under certain circumstances, members don't reach for their billy clubs every time they feel they've been wronged—a fact that seems to elude rabid China-bashers in the Congress. Picking battles judiciously and engaging in dialogue is the essence of WTO dispute settlement.

Furthermore, China would be foolish to retaliate against U.S. actions unilaterally. If China were to retaliate without a green light from the WTO, it would be in violation of its own WTO commitments. Such actions, apart from being economically damaging, would render China a WTO renegade. And, given the growing temptation in other countries (see, for example, legislative proposals in the 110th U.S. Congress) to ignore WTO rules to hammer Chinese imports without limit, that is a precedent China does not want to set.

### **Quieting the Provocateurs**

Although cynics suggest that the administration is acting now only because it seeks to improve its chances of winning renewal of trade promotion authority from Congress, the more likely explanation is that the administration believes the time has come to treat China like any other major trading partner. Concern about the possibility that Congress will ignite a powder keg by enacting provocative, anti-Chinese

legislation also factors into the equation. Keeping Congress on the sideline is a perfectly justifiable motivation given the items on the Congressional agenda.

Some Members of Congress and sundry trade policy observers have staked out the position that our disputes with China cannot be resolved in a timely and satisfactory manner within the WTO. Instead of submitting to that multilateral process, the United States would be better off fending for itself on its own terms according to its own timetable.

In accordance with that aggressive posture, several pieces of legislation have been introduced in the 110th Congress, which aim to punish China. HR 1229 is one of those bills. While it contains several provisions that would likely violate U.S. WTO commitments, it is among the less rabid anti-China bills before Congress.<sup>9</sup>

HR 1002 is the House version of the Schumer-Graham bill from the previous Congress, which would impose at 27.5 percent tariff on all goods from China unless and until the Chinese currency appreciates against the dollar by an amount deemed sufficient by the Congress. HR 571 would subject imports from China (and other “nonmarket economies”) to higher rates of duty, while S. 571 would strip China of its Permanent Normal Trade Relations status. Each of those bills (and other proposed legislation) would violate U.S. WTO obligations. The bills are so egregious that, despite the costs to both economies, they could invite instant retaliation from China.

In other words, if the United States were perceived as blatantly violating its WTO obligations by passing provocative anti-China legislation, China just might retaliate and a trade war ensue. But there is no good reason for the Congress to take this tack. There is no evidence that U.S.-China trade disputes cannot be resolved under the WTO dispute settlement system. The semiconductor tax issue was resolved during consultations in 2004 and the auto parts case awaits a dispute panel decision. It is quite possible that agreeable solutions to the three recent cases can be reached during bilateral consultations, as well.

## Conclusion

The Bush administration has not changed its strategic assessment of the trade relationship. Nor has it really

changed course. Its recent actions are apropos of the logical next phase in a vitally important relationship. And that should come as no surprise to Chinese officials, who have been kept more than adequately apprised of U.S. political developments and their tactical implications through high-level exchanges with U.S. cabinet members.

Official anger and incredulity aside, this new phase of the trade relationship is likely to lead to greater mutual understanding, a reduction in U.S. congressional pressure, and a stronger trade relationship. The WTO dispute settlement system was designed to foster resolution of trade disputes and to minimize prospects for trade wars. Congress should refrain from enacting punitive sanctions and give the WTO a chance to help resolve U.S.-China trade disputes.

1. U.S. Department of Commerce, Bureau of the Census, Foreign Trade Statistics, <http://www.census.gov/foreign-trade/statistics/highlights/top/index.html#2007>; figures account for goods trade only.
2. United States Trade Representative, “U.S.-China Trade Relations: Entering a New Phase of Greater Accountability and Enforcement, Top-to-Bottom Review,” February 2006, [http://www.ustr.gov/assets/Document\\_Library/Reports\\_Publications/2006/asset\\_upload\\_file921\\_8938.pdf](http://www.ustr.gov/assets/Document_Library/Reports_Publications/2006/asset_upload_file921_8938.pdf).
3. Sebastian Mallaby, “Free Trade: Pause or Fast-Forward?” *Washington Post*, p. A15, April 2, 2007.
4. *Los Angeles Times*, editorial, March 31, 2007.
5. *New York Times*, editorial, April 10, 2007.
6. For a list of World Trade Organization disputes, including complainants, defendants, and issues, see [www.wto.org](http://www.wto.org).
7. See HR 1229, The Non-Market Economy Trade Remedy Act of 2007.
8. Commerce Department actions are no strangers to the U.S. courts or the WTO dispute settlement system. See Daniel Ikenson, “Abuse of Discretion: Time to Fix the Administration of the U.S. Antidumping Law,” Cato Institute Trade Policy Analysis no. 31, October 6, 2005.
9. For a good critique of HR 1229, see Daniel L. Porter, partner, International Trade Group, Vinson and Elkins LLP, Testimony Before the Subcommittee on Trade of the House Committee on Ways and Means, March 15, 2007, <http://waysandmeans.house.gov/hearings.asp?formmode=view&id=5689>.