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It's Time to Negotiate a New Economic Relationship with China

by Simon Lester and Huan Zhu

When China completed its 15-year accession process and joined the World Trade Organization (WTO) in 2001, it was a rising power, but still clearly a developing country. Its GDP per capita was \$3,227,¹ and its share of global trade was only 4 percent.² By 2015, however, its GDP per capita had risen to \$14,450, and its global trade share to 11.9 percent. As China's economic power has increased, so has criticism of its market-distorting economic practices. The U.S. government has brought international trade complaints against China and used unilateral actions and threats, but U.S. businesses are unsatisfied with the results. While there have been some successes, the limits of the current approach to making China's economy more market-oriented may have been reached, as there are gaps in the existing international trade rules, and unilateral demands are of limited value against a powerful trading partner with its own domestic politics to contend with. Moreover, in the current political climate, an overly aggressive approach runs the risk of a serious U.S.-China trade war, which would cause great harm to both sides.³

But there is another option. If the United States wants to promote the liberalization of Chinese trade and investment policy, it needs to engage with China in a more positive way. To this end, it should sit down with China and negotiate a new economic relationship, one that goes beyond the terms of the WTO. In particular, the United States should initiate formal negotiations on a trade agreement with China. Negotiations of this kind will be a challenge, especially with a president who has been so critical of China. However, negotiations offer the best hope for addressing concerns about China's economic policies and practices.

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Using Trade Agreements to Liberalize the Chinese Market

Promoting liberalization in China through a trade negotiation would not be unprecedented. The first effort to use trade agreements in this way was the WTO accession process. The WTO contains a number of key obligations that have helped open China's market to foreign competition. To start with, through commitments to lower tariffs, China's simple average tariff rate came down from 15.9 percent to 9.7 percent.⁴ Beyond tariffs, the WTO includes detailed rules on disguised protectionism, so if China uses taxes, product regulations, or food safety standards as a way to favor domestic producers, countries can challenge such practices. The WTO also has strong rules on subsidies, border restrictions, intellectual property protections, commitments to open services markets, and disciplines on trade remedy measures. Since 2004 the United States has filed 21 WTO complaints against China on the basis of these and other obligations. According to a December 2015 report by the U.S. Trade Representative's Office, of the 17 complaints brought as of that time, 9 resulted in litigation wins, and others were resolved successfully without full litigation, with 3 still in progress.⁵

Of course, not all WTO litigation victories result in actual market opening. The WTO can do only so much to induce recalcitrant governments to comply. It should be noted that some of the responsibility for enforcement lies with the complaining governments. In two prominent cases (on electronic payment services and on distribution services for books, movies, and music) in which China has been criticized for insufficient compliance, the United States has not pursued enforcement as fully as it could have.⁶ Under the WTO's dispute procedures, after an adverse ruling, if a complainant believes the respondent has not complied properly, it can bring a follow-up complaint. If the measure in question is still in violation of the rules, the complainant can then request authorization to impose trade sanctions. The United States has not taken any of these steps in these cases.

The Trans Pacific Partnership (TPP) offered an opportunity to fill in some of the gaps in the WTO's coverage by opening markets beyond what has been achieved at the WTO. China was not a party to the TPP talks, but it was often mentioned as a possible candidate for accession. As part of this accession process, the United States could have demanded that China (1) take on obligations to lower tariffs, (2) ensure that its state-owned enterprises (SOEs) act in accordance with commercial considerations, and (3) strengthen its intellectual property protections. However, now that President Trump has withdrawn the United States from the TPP, the opportunity to use it as a tool to promote liberalization in China is gone.

Without the TPP or other regional trade initiatives, and with no comprehensive talks going on at the WTO, the best way for the United States to promote market liberalization in China is to go directly to China and negotiate bilaterally on issues related to Chinese restrictions on trade and investment. In the past, there have been discussions between China and the United States on a number of issues, but most of these talks have been merely "dialogues" that did not lead to concrete results. What is needed instead is a formal negotiation that leads to enforceable commitments.

With so many trade and investment issues to address, the task of negotiating may sound daunting, but keep in mind that other countries have already completed deals with China. Australia and New Zealand both have free trade agreements with China, signed in 2015 and 2008 respectively. In addition, Canada completed an investment agreement with China that entered into force in 2014 and has announced that it would explore the possibility of trade negotiations as well.

Negotiating U.S.–China Trade and Investment Agreements

There is little doubt that talks between China and the United States would be more complex and contentious than China's deals with other countries, but they will not be impossible. It will just take creativity, resolve, and the willingness of both sides to compromise.

If we were starting from scratch today, we might deal with both trade and investment together, as modern trade agreements usually do. However, trade and investment issues were originally dealt with in separate international negotiations, and there is an existing U.S.-China investment negotiation that has been ongoing for almost a decade. (During the Obama administration, President Xi and Treasury Secretary Jack Lew both expressed hope that the talks would be concluded, but that did not happen.)⁷ For the sake of continuity, it may make sense to keep the investment and trade aspects separate. In addition, it can be simpler to divide issues into smaller, more manageable packages. At the same time, there are a number of considerations that point to a unified approach that deals with all the issues at once: the Trump administration may prefer to set its own path rather than carry over an Obama negotiation; some of the issues fall within both the trade and investment categories; an investment treaty will require the support of two thirds of the Senate, which might be harder to obtain in the

current anti-China political climate than the simple majority needed for a trade agreement; and a broader trade agreement could include more issues, which would make it possible to bring in support from a wider range of interest groups. On balance, a single agreement covering both trade and investment makes the most sense at this time.

However the negotiators decide to proceed, the key will be the substance of the agreement. For both trade and investment, there are a number of long-standing issues for negotiators to discuss. On investment, there are sectors of the Chinese economy that are still closed to investment, there are many requirements imposed on foreign investors, and there have been allegations that China is using its anti-monopoly law against U.S. business in an abusive way. And on trade, some of the main issues are high tariffs, regulatory barriers, services trade barriers, noncommercial behavior by state-owned enterprises, weak intellectual property protection, cyber theft and security, and allegations of currency manipulation.

The two main investment-related issues are restrictions on foreign investment in particular sectors and certain types of performance requirements imposed on foreign investors. On the former, the Chinese market is often restrictive toward foreign investment, with nearly 100 sectors still having barriers.⁸ China's latest liberalization proposal covered about 40 sectors but fell short of U.S. demands.⁹ One area where the United States could push for more access is the finance sector. China's State Council released a statement earlier this year that it would open up this sector to foreign investment, but did not provide further details. Negotiations on this issue could push China to act more quickly in this regard.

Even in the sectors to which foreign investors do have access, there are sometimes performance requirements imposed by the Chinese government that hinder the investors' operations. One example is that China has demanded that investors turn over their technology to local partners. A trade agreement can impose constraints on China's use of such requirements.

China's application of its anti-monopoly law to foreign investors is another concern of the American business community. These issues could be addressed in a trade agreement, perhaps by focusing at the outset on basic principles such as transparency and due process in China's application of this law.

Turning to trade, a fundamental issue is the imbalance in tariffs. As President Trump himself has said, "we're being hurt very badly by China . . . with [China] taxing us heavy at the borders when we don't tax them."¹⁰ China's average tariff is 9.7 percent. The U.S. average tariff is 4.0 percent.¹¹ Any trade agreement will have to bring China's tariffs down significantly. Zero tariffs on all products imported into both countries may be too much to ask for, given the realities of interest group influence, but the goal should be to get as close to zero as possible.

Another objective will be taking on regulatory barriers faced by U.S. agricultural and industrial products in China. In this regard, Trump's pick for ambassador to China, Iowa governor Terry Branstad, has said that access for beef and

biotech products will be among his top priorities once he takes office.¹² Last year, a Chinese agency lifted a ban on some U.S. beef products, but other products, such as beef from cows older than 30 months, are still subject to this ban.¹³ Trade negotiations will provide a platform for the two parties to address these kinds of issues, and a trade agreement will be a great vehicle to establish some concrete and enforceable commitments.

As discussed above in relation to WTO complaints against China, services trade is also important. As noted, the U.S. complaint about access to the credit card service market in China is still outstanding. Other services for which there are restrictions include films and audio-visual services, banking, telecommunications, insurance, and express delivery. New commitments could help open these service sectors.

As for SOEs, the TPP rules in this area provide a good framework. A U.S.-China negotiation will have to start fresh, but the core TPP principles of nondiscrimination, no market-distorting subsidies, and acting in accordance with commercial considerations are sound. The inclusion of these principles could help address Chinese oversupply in the steel and aluminum industries, as this is mainly caused by government subsidies and other forms of state intervention. If these SOEs begin to operate on a commercial basis, the current market saturation will be reduced as supply and demand come into balance.

And on intellectual property, there is a long-standing complaint that China does not do enough to crack down on counterfeit goods. A WTO complaint was supposed to help address this issue, but U.S. industries remain concerned. Beyond the WTO, the United States and China have been using the U.S.-China Strategic and Economic Dialogue platform to address these issues. Through this mechanism, China has promised to develop new legislation and improve the enforcement of existing laws.¹⁴ These commitments could be incorporated into a trade agreement.

Along the same lines, with regard to accusations of cyber hacking being used to steal secrets from U.S. businesses, in 2015 President Obama and President Xi signed a cyber agreement in which both sides agreed not to support or conduct any cyber theft of intellectual property, trade secrets, or other commercial information. After the agreement, it has been reported that there have been positive changes regarding cyber espionage activities. The cyber agreement or an updated version could be included in a trade agreement.

Another emerging issue relates to China's new laws governing information and communication technology (ICT). Recent legislation, including the National Security Law (2015), Counterterrorism Law (2015), and Cybersecurity Law (2016), all raise concerns over unnecessary restrictions on, or discriminatory measures against, foreign ICT products on the grounds of cyber security. In the draft of the Counterterrorism Law, for example, there was a requirement for ICT providers to turn over encryption codes to the government. The requirement was later dropped in the final text, but there are concerns over whether the same requirement is effectively embedded in

the term "secure and controllable," which appears in drafts for banking and insurance regulatory guidelines. To address these issues, a provision on encryption similar to one in the TPP could be included in the agreement with China.

Finally, on the long-standing accusations of currency manipulation by China, there have been recent suggestions that the United States may revise its countervailing duty law to allow the imposition of duties in response to currency manipulation.¹⁵ This approach to the issue may make negotiating a U.S.-China trade agreement easier. Economists have pointed out that China is now trying to prevent the value of its currency from falling, rather than keeping it undervalued, so perhaps duties would not even be imposed on China under the new law.

Understanding China

If the United States wants to improve its economic relationship with China and reach agreement on some of the trade and investment issues mentioned above, it is essential for U.S. negotiators to understand how China sees itself and its relationship with the United States. In this regard, China has particular cultural and political characteristics that need to be taken into account.

Traditionally, "saving face" is a defining quality of Chinese culture. In this context, "face" implies the receipt of an appropriate level of respect that correlates with a person's social status. As a rising power (and the world's second largest country in terms of GDP), China expects respect and reciprocity from the United States. These expectations are reflected in the new phrase that Chinese leaders have used to describe U.S.-China relations—"a new model of major power relations" (新型大国关系). China has described these relations as "no conflict, no confrontation, mutual respect, and win-win cooperation."¹⁶ In essence, China will respect the United States and its interests, but it expects the same level of respect in return.

Also implicit is that the United States will accept China's status as a major power. That means China will not subordinate itself to the United States and will not follow U.S. demands when they are not in China's interest. A hostile and aggressive approach by the United States may be considered a breach of such a relationship. If it feels disrespected or embarrassed, China may have less incentive to work with the United States. By contrast, if the United States takes a positive and constructive approach, the Chinese will be more likely to engage in negotiation and concede on certain issues.

To illustrate this point, if this is to be a negotiation, China will have demands, too. One of these is likely to be that the United States begins treating China as a market economy in its antidumping calculations. This will be difficult for the United States to accept. However, if the United States can get enough concessions in other areas (such as SOEs and overcapacity in steel production) and can impose some additional disciplines on China's own abuses of antidumping measures, perhaps it could go along with this demand.

Similarly, there has been talk of revising the review of foreign investment carried out by the Committee on

Foreign Investment in the United States (CFIUS) so as to broaden its scope. Chinese companies have previously challenged CFIUS decisions blocking their investment,¹⁷ and expanding the scope of this review is likely to be of concern. As part of a negotiation on trade and investment, the United States could commit to maintaining the existing focus for reviewing Chinese investments and keeping the review process from being abused.

Domestic Chinese politics are another important consideration, and are a reason that a negotiation may hold more promise than some might think. Working with the United States is in China's best interest from a domestic perspective. President Xi is facing a reelection and needs to demonstrate to the party that he is in command and can establish good relations with other major powers. Also, China needs stability and a plan for long-term economic growth, which a trade agreement with the United States can help provide.

In addition, with the continued modernization of China's economy, there are more common interests between the United States and China. For instance, China hopes to climb the manufacturing value chain, which requires it to continue engaging with the global market and strengthening its IP protection. As a result, China has an incentive to work with the United States on many of the issues noted above.

Amidst the populist movements in the United Kingdom and the United States, countries are turning toward China to exhibit leadership on globalization. China's President Xi Jinping and Premier Li Keqiang have advocated publicly for open markets and have committed to continue liberalizing China's market for trade and investment. Some may not have much confidence in such statements, as China has not really lived up to the promises it has made in the past (such as those related to IP enforcement and preferential policies toward local innovation and technology). In some instances, China took steps to reform its economic and market structure, but the market reaction caused the government to pull back. As a result, some pro-liberalization Chinese leaders may welcome an international negotiation, so as to use external forces to support and accelerate domestic reforms.

Finally, China may be more serious about reform than people give it credit for. The influence of market-oriented thinking within the government may indicate that Chinese economic policy will be more liberal than in the past. President Xi's top economic adviser, He Liu, a U.S.-educated advocate for economic liberalization, has long pushed for disciplining SOEs and reducing trade barriers.¹⁸ Liu seems to have a significant influence on the economic reforms within the government and was behind multiple five-year plans and national industry policies in recent years. He is also the originator of new reform ideas such as supply-side structural reform (供给侧结构性改革, which includes tax reduction and loosening government intervention) and top-down design for economic reform (顶层设计, which means providing a general plan in which details can be integrated later). Many of these ideas have been emphasized in government documents and President Xi's speeches. More importantly, he has a close relationship with President Xi, who has openly expressed that Liu is an

important adviser.¹⁹ It has been speculated that Liu will be the next premier.

Of course, this does not mean that negotiations with China will be easy. But there are enough positive signs that it is worth attempting engagement on issues of concern to the United States.

Looking Ahead

During the presidential campaign and the early stages of the Trump administration, we have seen a great deal of criticism of China's trade practices. Some of the administration's key officials are known for their strident criticism of China and may not be willing to engage at all. Famously, Peter Navarro, the head of the White House Trade Council, is the producer of a documentary called "Death by China." If these views prevail, a negotiation on trade and investment with China may have to wait for a new administration.

Nonetheless, despite the concerns about an aggressive U.S. trade policy toward China under President Trump, there are some positive signs as well. Trump's appointment of Iowa governor Terry Branstad as the ambassador to China offers some hope, as Branstad has a long-term relationship with China and President Xi. The history between the two can be traced back 30 years, when Branstad was the Iowa governor and Xi was a local government official who came to Iowa to learn about farming technology. Branstad, still waiting on confirmation, has expressed his intention to keep a "win-win" relationship with China and sees potential for increased Chinese investment in the United States. And recently, Treasury Secretary Steven Mnuchin expressed the hope for a "healthy" relationship with China.²⁰ If this is how the White House intends to approach relations with China, there is a great opportunity to negotiate a new U.S.-China economic relationship.

While there has been trade tension between the United States and China in recent years, and to some extent it will surely continue, their interests are often complementary rather than conflicting, and it is in the interest of both countries to maintain a close economic relationship. Trade threats and trade wars will only do both sides harm. It would be great if the Trump administration would realize this and put the U.S.-China relationship on a positive path. If they do not, and the current model of tension, litigation, and threats continues, the task of negotiating with China will simply be passed on to some future administration.

Notes

1. Figures are GDP per capita, adjusted for purchasing power parity (current international \$). World Bank, International Comparison Program database, <http://data.worldbank.org/indicator/NY.GDP.PCAP.PP.CD?locations=CN>.
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