A Bone-Headed Move

By Greg Mastel

The unfortunate case of permanent most-favored nation status for China.

So if you believe in a future of openness and freedom in China, you ought to be for this [China WTO accession] agreement. If you believe in a future of greater prosperity for the American people, you certainly should be for this agreement. If you believe in a future of peace and prosperity for Asia and the world, you should be for this agreement. This is the right thing to do. It's an historic opportunity and a profound American responsibility.

—**President Bill Clinton,** May 2000, speaking on extending permanent MFN status to China and China's membership in the WTO

As President Clinton's remarks demonstrate, in 2000 U.S. policymakers thought that they had "solved" China. In a single stroke, granting China permanent most-favored nation trade status (a promise of low tariffs and good trade treatment) and ushering Beijing into the rules set by the World Trade Organization would force China to open its markets, live by international trade rules, and set in motion an inevitable process of reform in China.

Nearly two decades on, it appears that every part of that positive vision was dead wrong. As demonstrated with the current disputes over China's technological blackmail and its destruction of the global steel market, trade problems with

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THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
220 I Street, N.E., Suite 200
Washington, D.C. 20002
Phone: 202-861-0791
Fax: 202-861-0790
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Chinese Premier **Zhu Rongji** *visits the United States in April 1999, and gains President* **Bill Clinton's** *support for China's accession to the WTO.*

China have grown far worse since 2000. Membership in the WTO, which permanent MFN made possible for China, has proven unable to discipline China's many trade sins. It has, in fact, allowed China to attack critical trade policies of Washington and Brussels, like the use of anti-dumping laws to blunt Chinese mercantilism. Political oppression in China has by many measures grown worse and certainly has not disappeared. From a security perspective, China's aggressive actions with regard to Taiwan and in the South China Sea suggest that the trillions of dollars worth of trade and investment made possible by MFN has, in part, funded Beijing's military ambitions.

Even the most cursory examination of the record suggests that granting MFN to China is a tragically failed policy. Unfortunately, identifying a policy failure does not always immediately suggest a solution. It is difficult to "unscramble an egg," particularly eighteen years after breaking the shell. But as some of the Trump Administration's moves toward China have suggested, it is possible to begin reversing the permanent MFN decision.

Granting MFN to China is a tragically failed policy.

THE BIRTH AND NURTURING OF A BAD IDEA

When described in stark terms like those used above, it is difficult to fathom what policymakers were thinking on China in 2000. It is first important to recognize that the turn of the century was a unique time for American foreign policy. The Soviet Union—the global adversary of the United States for nearly half a century—had suddenly imploded a decade earlier. This led to a crumbling of the Soviet bloc and a seemingly instant near-global recognition that free markets had beaten communism. A few countries, such as China and Cuba, held on to some version of Karl Marx's vision, but there seemed almost an inevitability that they would soon fall into line.

Against this background, Beijing's Politburo appeared just an anachronism desperately willing to oppress its people to hold off the inevitable for a few years. At times, China seemed more a country worthy of sympathy than a global rival. This led U.S. policymakers in both political parties and in both the executive and legislative branches to think in terms of easing China's transition rather than confronting China on key issues. After all, the hardliners in Beijing were sure to be swept away by reformers in a few years just as their counterparts in Moscow had been.

In signing into law the legislation to grant China MFN, President Clinton repeated many of the now discredited notions that formed the foundation of the widely held view of China at the time. In fairness to President Clinton, it is important to acknowledge that he did not conceive the policy. In fact, he entered the White House critical of it. But he became a supporter as the new "Washington consensus" was established. There were certainly a few critics of the pro-China viewpoint, but there was also a seemingly endless list of Chinese apologists across the political spectrum ready and willing to dismiss any concern with fearless (and ultimately baseless) predictions of all of the good things to happen in China.

It took two decades for there to be any serious rethinking of U.S. policy toward China. On major issues with China, both President George W. Bush and President Barack Obama simply followed the basic

A Managed Trade Solution?

The current trade stand-off between Washington and Beijing may not be resolvable in traditional terms. China may well be unwilling—perhaps even unable—to scrap its state planning apparatus that directs and limits foreign trade. The United States probably cannot and should not live with a system where the Chinese government dictates the terms of trade.

But perhaps there is a solution. In the 1960s as part of the agreement to bring Poland and Romania into the General Agreement on Tariffs and Trade (now the WTO), those countries agreed to quantitative targets to increase imports from other market economies by fixed minimum amounts. In the 1980s, Japan agreed to guarantee U.S. semiconductor manufacturers a minimum share of the Japanese market as an assurance of a more open Japanese market. Obviously, these were not purely market-based solutions, but they were successful in addressing the immediate trade objectives and in laying the groundwork for future market-oriented reform.

A similar solution may be possible between the United States and China. As an immediate step, China could agree to increase imports from the United States (or perhaps reduce the bilateral trade imbalance) by a fixed amount. As these commitments were fulfilled, the United States could phase out or phase down its tariffs on imports from China. In the longer term, these transitional steps might be replaced by more sweeping systemic reforms and—at the very least—the pressure of meeting targets could catalyze the process of market opening in China.

—G. Mastel

policy template set by Clinton. It was really not until President Trump took office in 2017 that there were truly major—if sometimes inconsistent—changes in U.S. policy toward China.

AN ASSESSMENT OF RESULTS

It turns out that those hardliners in Beijing were indeed swept away in the next eighteen years. But instead of being replaced by the survivors of the student revolution so brutally oppressed at Tiananmen Square in 1989, they were replaced by an even harder-line, more-nationalistic generation of leaders led by President Xi Jinping. These predictions made at the time about the benefits of permanent MFN status/WTO membership for China simply never materialized.

■ **China will be a better trading partner and be more open to U.S. exports.**

> *…[T]his agreement is the equivalent of a one-way street. It requires China to open its markets—with a fifth of the world's population, potentially the biggest market in the world—to both our products and services in unprecedented new ways. All we do is to agree to maintain the present access which China enjoys.*
>
> —President Clinton, May 2000

There is no doubt that permanent MFN has been a boon to the Chinese economy, as it has been able to maintain near-double-digit growth through the intervening years. This growth was largely driven by new investment in China encouraged by MFN and explosive growth in Chinese exports, particularly to the U.S. market. China was the world's third-largest economy in 2000; now it rivals the United States to be the largest economy. In 2013, Beijing became the world's largest trading power.

The U.S. trade deficit with China was $84 billion in 2000. In 2017, it stood at $373 billion—a more than four-fold increase. U.S. exports to China have grown, but Chinese exports to the United States have steadily outpaced them to preserve a 3.5-to-1 trade advantage for China. The U.S. trade deficit with China is now, by far, the largest of any country with another in human history.

China remains a largely non-market economy. It is true China has endorsed limited market reforms, but vast sectors of the Chinese economy are still controlled by the state and President Xi has suggested increasing control of China's "private" sector. The right of workers to bargain is greatly limited, the state controls many key inputs such as energy, and state-owned enterprises dominate basic industries. Even in theory, true free trade is impossible with Beijing because the visible hand of the government, not the invisible hand of the market, drives economic decisions in China.

China remains a largely non-market economy.

In 2015, China released its "China 2025" industrial plan, which is essentially a systematic effort to tilt the playing field in favor of Chinese industry and against U.S. and other non-China industries in ten key sectors.

Membership in the WTO has not driven positive change in Chinese trade behavior. The WTO's transparent, rule-of-law–based system has demonstrated fundamental difficulty dealing with a Chinese system that is neither. China is the largest target for U.S. complaints at the WTO, but the challenges are often over minor issues that do little to change the core economic system.

Since 2000, China has greatly expanded its capacity to produce steel and aluminum—both heavily state-owned sectors in China. There is simply no evidence that China had a Ricardian comparative advantage in these sectors and global production consistently exceeded demand for both products. Yet China has now expanded its steel capacity through government intervention to the point that more than half of all steel produced in the world is Chinese steel. Almost all of that growth occurred after China joined the WTO in 2001. The excess production is dumped on foreign markets creating depressed market prices and layoffs in open markets like the United States and Europe. It is no exaggeration to say that China is the cause of the current global steel crisis.

The Trump Administration has recently taken China to task and imposed roughly $250 billion in trade sanctions on Beijing for its policy of demanding technology transfer to China as a price of doing business there. These policies are estimated by the Administration to have inflated the imbalance in trade between the United States and China by hundreds of billions of dollars over the years.

■ Permanent MFN will promote political liberalization in China.

> *…China is not simply agreeing to import more of our products; it is agreeing to import one of democracy's most cherished values: economic freedom. … And when individuals have the power, not just to dream but to realize their dreams, they will demand a greater say.*
>
> *There is no question China has been trying to crack down on the Internet. Good luck! That's sort of like trying to nail jello to the wall.*

—President Clinton, May 2000

China took over political control of Hong Kong shortly before permanent MFN was granted by the United States. Since that time it has dismantled what had been a working free press, essentially outlawed democratic opposition, and recently taken to kidnapping publishers that have criticized Beijing. It is literally hard to imagine things in Hong Kong having gone much worse from the perspective of a free society.

China continues to oppress religious groups with the most attention-grabbing efforts now aimed at "re-educating" Muslims. The right of workers to organize is severely limited. The most recent U.S. State Department report on human rights in China suggests little if any overall improvement.

Internet usage has expanded greatly in China from 6–7 million in 2000 to over 800 million today, but so have state efforts to suppress dissent and free exchange of ideas.

There is no doubt that permanent MFN has been a boon to the Chinese economy.

Western internet/technology companies seeking to operate in China have been forced to accept China's numerous restrictions as a price of operating in China. Chinese censors have erected a system of online repression referred to as the "Great Firewall" to control dissent on the internet.

■ Permanent MFN will make China a more reliable international partner.

> *[Denying WTO membership to China] would be a gift to the hardliners in China's government, who don't want their country to be part of the world; the same people willing to settle differences with Taiwan by force, the same people most threatened by our alliance with Japan and Korea, the same people who want to keep the Chinese military selling dangerous technologies around the world … If we want to strengthen their hand within China, we should reject the China-WTO agreement.*

—President Clinton, May 2000

China continues to provide economic and political support to the rogue regime in North Korea. In 2016, a major Chinese telecommunications company known as ZTE with direct ties to the Chinese government was found to be violating multilateral trade sanctions on North Korea. As the U.S. Commerce Department found, ZTE has an established history of trading with international pariah states.

Continued on page 67

Continued from page 43

China's efforts to intimidate its neighbors and establish bogus territorial claims in the South China Sea to give Beijing control of oil reserves and navigation rights have accelerated. China has taken to literally building new islands to support its claims to Chinese territory. In 2016, the Court of International Justice in The Hague found China's claims meritless. Beijing dismissed the Court's well-reasoned decision out of hand. Recent confrontations between U.S. and Chinese naval vessels in territorial disputes in the region suggest that this situation could easily flare into a military conflict.

Though there is more direct contact between Beijing and Taipei, military threats against Taiwan have grown more strident and provocative. Beijing has recently demanded that U.S. airlines stop listing flights to Taiwan unless they directly acknowledge that China controls Taiwan.

In summary, permanent MFN has not solved problems with China. Most of the challenges identified in 2000 have actually gotten worse. It is difficult to find a single major success that can be reasonably attributed to permanent MFN or WTO membership.

REPEALING PERMANENT MFN STATUS

Unfortunately, it is not an easy matter to undo permanent MFN and WTO status for China. As some recent steps by the Trump Administration have demonstrated, however, progress is possible. As is often the case, what is required is really political will to make the change.

The United States could remove permanent MFN status for China by repealing the legislation passed in 2000. This would allow it to broadly or selectively impose trade sanctions on China in response to trade, foreign policy, human rights, or other concerns. The Trump Administration has taken concrete steps in this direction.

There has been heated debate over President Trump's recent moves to impose trade sanctions in response to Chinese protectionism. At times, the relatively low approval ratings of President Trump seem to inspire editorial writers and critics to dismiss all Trump initiatives.

Membership in the WTO has not driven positive change in Chinese trade behavior.

With regard to China, however, President Trump has an undeniable point. Chinese exports to the United States are more than three-and-a-half times greater than U.S. exports to China. A cut-off or sharp reduction in bilateral trade due to U.S. trade sanctions on China would absolutely harm parties in both countries, but it is mathematically guaranteed to harm Chinese industries much more than U.S. industries. There would be consumer impacts in the United States, but they are likely small from the perspective of individual consumers and transient as alternative sources to China would appear.

In the medium or longer term, this advantage probably only increases for Washington. It is difficult to imagine that China could find other markets to replace the $570 billion or so it now annually exports to the United States. Europe and Japan—for both political and economic reasons—would certainly not absorb those Chinese exports. Over time (in some cases, a very short time), the United States could replace Chinese imports with domestic production and, more commonly, with imports from developing countries in Latin America, Asia, and around the world. There would likely be an increase in prices on goods that were formerly imported from China, but there would also be advantages from bolstering more democratic countries that with rising incomes could purchase more from the United States. Such a shift in world trade away from China would potentially devastate Beijing's economic and political ambitions, and would support U.S. policy goals in numerous ways.

Thus, despite all of the nationalistic bluster now coming from Beijing that is dutifully reported with little analysis in U.S. news coverage, China really has little alternative to making concessions to the United States in the face of trade sanctions. The alternative would inflict much more damage to China and, possibly, set in motion commercial and political changes that could permanently damage Chinese interests.

One of the complications is that—as noted—in conjunction with granting permanent MFN, the United States supported China's accession to the WTO in 2001. That was a serious policy mistake. Trade sanctions against China are now likely to run afoul of WTO dispute settlement panels. Ideally, China could be expelled from the WTO for reasons explained above. But in reality, the expulsion process is untested and gathering necessary international support would be extremely difficult and ultimately probably a waste of valuable time and energy. China is almost certain to remain in the WTO for the foreseeable future with options to challenge U.S. trade policy.

In this context, though—as long as the United States maintains its resolve—the WTO would be of little practical impact. The United States has a number of options to escape WTO dispute settlement by, for example, identifying the measures it takes as national security measures for which all WTO members have wide latitude. Even if all such strategies failed after a number of years (years during which China would face the impact of U.S. trade sanctions), an adverse WTO ruling would merely allow China to impose equivalent sanctions on the United States. That is a step Beijing could and almost certainly would take anyway leading to essentially the same trade stand-off—in which the United States would hold a decisive edge—just discussed. The WTO would be irrelevant for all practical purposes.

Make no mistake, dropping MFN for China and confronting Beijing with trade sanctions is not a painless strategy. China has already demonstrated that it will retaliate and, in a free society, those hurt will undoubtedly voice their complaints. Those same complaints will not be visible in China because the cost of dissent is often prison. Washington though can take steps to limit damage to U.S. interests through targeted exceptions to tariffs, subsidies, and potentially other regulatory measures. And the underlying imbalance in economic leverage in favor of Washington is impossible to deny.

The United States has tried for almost two decades granting China the benefits of free trade through unconditional MFN. That experiment has demonstrated little in the way of results. It is time for the United States to shake off the constrictions of MFN for China and begin to apply U.S. economic strength to problems with Beijing. ◆