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CONGRESSIONAL TESTIMONY

The Most Important Chinese Trade Barriers

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Every nation has its trade barriers, and every nation struggles with how best to protect intellectual property. Still, there are better and worse trade partners. There are also bigger offenders—countries whose pure economic size means their policies matter more.

According to the United State Trade Representative, the People's Republic of China (PRC) is consistently among the worst countries with respect to infringing intellectual property. Beijing also has perhaps the world's most extensive system of subsidies, which block foreign access to the Chinese market. Add the fact that the PRC is now the world's-second largest economy and the combination is pernicious.

Weak intellectual property protection strikes at the heart of Sino–American trade. Unfortunately, it is not at all clear how best to improve that protection. Simple retaliation might be justified, but it would not be helpful.

It will thus be more productive to focus on Chinese subsidies, which are just as important to bilateral trade but more tractable. Concerning subsidies, the focus has been on artificially cheap Chinese exports flooding the U.S. In this case, however, American consumers benefit. Where subsidies are entirely harmful to U.S. interests is exports to the PRC. There, American goods and services are effectively blocked by subsidies, benefiting no one but certain Chinese firms. American efforts should focus on reducing barriers to the Chinese market created by subsidies.

In confronting Chinese trade barriers, Congress should:

1) Seek to create indirect incentives for progress in Chinese protection of intellectual property. One method is strong intellectual property provisions in the Trans-Pacific Partnership.

2) Make reducing Chinese subsidies the top economic priority in bilateral talks. In particular, basic anti-competitive regulations in a range of industries must be eased.

3) De-emphasize the exchange rate, as it is a minor factor compared to IPR and subsidies.

The problem of trade barriers extends well beyond the PRC, but it is toughest nut to crack and lower Chinese barriers will have positive ramifications around the globe.

IPR: Undermining the Trade Relationship

The Committee's focus on intellectual property is entirely justified. Incentives come from secure property rights, and the incentive to innovate comes from secure intellectual property rights (IPR). When IPR is weak, the incentive to innovate weakens.

This is crucial because America's comparative advantage is in innovation. Our comparative advantage is expressed in export of technology goods, focused on computing but also including medical and other advanced equipment. Innovation makes competitive a wide range of American services, from education to entertainment. This is true for U.S. trade with all countries.

The China angle: It is universally accepted that Chinese IPR protection in China is inadequate.[1] This reduces incentives for American individuals and firms to innovate in goods and services trade with the PRC. Beijing expects the U.S. to respect China's comparative advantage in assembly of consumer goods. In contrast, the American comparative advantage in IPR will be respected at some point in the future.

A standing Chinese complaint is that the U.S. restricts technology exports to the PRC.[2] Some restrictions are driven by national security, but most stem from a refusal by American firms: Who wants to export, only to see innovations stolen and reverse-engineered in short order?

Top U.S. Exports to China, 2011

Category	**Value ($ billions)**
Waste and scrap	11.5
Soybeans	10.5
Aircraft	6.4
Autos	5.3
Semiconductors	5.2
Organic chemicals	3.6
Plastics materials	3.1
Cotton	2.6
Meat and poultry	2.2
Computer equipment	2.0
Sub-total	52.4
All U.S. exports	103.9

Source: United States Department of Commerce, Census Bureau, *U.S. International Trade Statistics*, http://censtats.census.gov/cgi-bin/naic3_6/naicCty.pl.

With innovation thus blunted, American comparative advantage is distorted. Scrap metal is the leading export. Other top goods exports make sense but volumes are painfully small, such as for computer equipment. This is stark in comparison to Chinese exports to the U.S in 2011, where the top three categories are computers, communication equipment, and computer equipment, and just these were slightly larger than all American exports to the PRC. With IPR at risk, the U.S. does not export at volumes consistent with combined Sino–American GDP of over $22 trillion.

[1] "China Reaffirms Its Consistent Position on IPR Protection," China Central Television, June 20, 2012, http://english.cntv.cn/20120620/111409.shtml.

[2] Xinhua, "Relax High-tech Restrictions," May 8, 2012, http://news.xinhuanet.com/english/indepth/2012-05/08/c_131573738.htm.

Comparative advantage is fundamental. A secondary but ugly problem is economic espionage. Espionage is only one way to violate IPR and erode American comparative advantage, but it is egregious. Even if the U.S. suspended trade, economic espionage would continue. Many countries practice economic espionage, but the PRC may be the most aggressive. Worse, Chinese economic espionage seems to be intensifying, rather than easing as the country develops its own technological capabilities.[3]

The effects of weak IPR are unpleasant. Americans want more trade but not necessarily free trade.[4] For some time, the single biggest concern has been China. The public is perceptive: The extremely powerful mutual gains argument for trade is partly undermined in the Chinese case because American comparative advantage is thwarted. Sino–American trade relations seem "wrong" because in a sense they are: The U.S. is not receiving the gains from trade that it should.

China is making progress in IPR, but it is slow and skewed to areas where Chinese firms have intellectual property. Unfortunately, there is no magic solution. Retaliation is risky, both because it could rebound against the U.S. and because it might have little effect on Chinese treatment of IPR. But there is a fact for American and Chinese policymakers to contemplate: While China's IPR protection is weak, the U.S. commitment to the trade relationship will remain in question.

Subsidies: Blocking American Goods and Services

It almost seems fortunate that there is another major trade problem, because this one is easier to solve—not easy, but easier.

The subsidies problem starts with the World Trade Organization (WTO). The WTO definition of what constitutes a harmful subsidy is too narrow. It focuses on financial contributions yet is difficult to apply when dubious financial practices are widespread but not universal, as with preferential bank lending. WTO violations are much easier to establish when trade is directly involved than when trade is inhibited indirectly, but losses in the latter case can be massive.[5]

Many countries take advantage of this flawed definition, including the U.S. The U.S. has also had clashes with many partners over foreign subsidies that are difficult to pin down under WTO rules. The PRC is far from alone as a subsidy abuser, but it stands out in the size and nature of subsidization. Subsidies are both huge and directed almost entirely to state-owned enterprises (SOEs). The status of SOEs (in any country) is itself at issue under the WTO, making it that much harder to come to grips with the subsidies these enterprises receive.[6]

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[3] Derek Scissors, "Chinese Commercial Espionage: U.S. Policy Recommendations," Heritage Foundation *Issue Brief* No. 3564, April 9, 2012, http://thf_media.s3.amazonaws.com/2012/pdf/ib3564.pdf.

[4] "Americans Are of Two Minds on Trade: More Trade, Mostly Good; Free Trade pacts, Not So," Pew Research Center for the People and the Press, November 9, 2010, http://pewresearch.org/pubs/1795/poll-free-trade-agreements-jobs-wages-economic-growth-china-japan-canada.

[5] "WTO Subsidies Agreement," Trade Compliance Center, http://tcc.export.gov/Trade_Agreements/Exporters_Guides/List_All_Guides/WTO_subsidies_AG_guide.asp.

[6] Duane W. Layton and Paulette Vander Schueren, "WTO Appellate Body Issues Ruling on US Definitive Anti-Dumping and Countervailing Duties on Certain Products from China," The Mayer Brown Practices, March 21, 2011,

China has multiple sources of genuine competitive advantage, but these are often suppressed to ensure the dominance of SOEs, whose advantages are not market-based. Subsidies take the form of below-cost land, energy, and other inputs, implicit financial transfers, and regulatory protection. Because it is not financial in nature, regulatory protection is barely touched by WTO rules. It is also hard to measure. Yet it is the most important subsidy that Chinese SOEs receive because it suppresses competition, including competition from imports.

Most SOEs, from large and centrally controlled to the many smaller provincial firms, can never be outcompeted because they cannot go bankrupt. They have effectively no obligation to creditors or any non-state shareholders. When failing, they are typically merged with other SOEs, with no downsizing and therefore no market share made available to non-state entities.[7]

When market concentration is high, Beijing acts to preserve it. The PRC is 151st of 183 countries on the World Bank measure of the ease of starting a business. In industries with a higher number of competitors, there is a broad program to shrink that number while retaining large state entrants.[8] This is occurring most famously in rare earths, but also in autos, cement, steel, and many other industries. The desired result is a few large state-owned firms, just a small step short of a state monopoly. These national champions are also intended to expand for the purpose of winning overseas markets.[9]

But the best protection from competition is by direct order of the central government. The state must own all participating firms in oil and gas, petrochemicals, electric power, and telecommunications. In aviation, coal, and shipping, the state must control the sector as a whole. In autos, construction, machinery, metals, information technology, and environmental technology, the state is to expand until it controls the sector. SOEs also comprise nearly all of insurance, the media, railways, and the huge tobacco industry. Most important, nearly all banks are state-owned, a lever to control the rest of the economy.[10]

State control/dominance is undefined, but it plainly blocks a market-leader role for foreign firms either based in or exporting goods and services to the PRC. For instance, the foreign share in

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http://www.mayerbrown.com/publications/wto-appellate-body-issues-ruling-on-us-definitive-anti-dumping-and-countervailing-duties-on-certain-products-from-china-03-21-2011/.

[7] Interview with Yan Qiong, "Mergers, Acquisitions, and Restructuring of State-Owned Enterprises," King & Wood's Publication Group, October 2010, http://www.kingandwood.com/article.aspx?id=Mergers-Acquisitions-and-Restructuring-of-State-Owned-Enterprises&language=en (accessed July 16, 2012), and Nie Peng, "Steel Merger Will Become China's Biggest," *China Daily*, April 19, 2010, http://www.chinadaily.com.cn/bizchina/2010-04/19/content_9747309.htm (accessed July 16, 2012).

[8] The World Bank, "Doing Business: Economy Rankings," 2011, at http://www.doingbusiness.org/rankings (accessed July 16, 2012), and Katie Cantle, "Global Competition," *Air Transport World*, November 1, 2011, http://atwonline.com/airline-finance-data/article/global-competition-1109 (accessed July 16, 2012).

[9] Xinhua, "China to Drive Consolidation of 8 Industries Over Next 5 Years," July 7, 2011, http://news.xinhuanet.com/english2010/china/2011-07/07/c_13971925.htm (accessed July 16, 2012), and Bruce J. Dickson, "Updating the China Model," *The Washington Quarterly*, Vol. 34, No. 4 (Fall 2011), pp. 39–58, http://csis.org/files/publication/twq11autumndickson.pdf (accessed July 16, 2012).

[10] Zhao Huanxin, "China Names Key Industries for Absolute State Control," *China Daily*, December 19, 2006, http://www.chinadaily.com.cn/china/2006-12/19/content_762056.htm (accessed July 16, 2012).

telecom and oil is trivial. Foreign banks and insurers have less than 2 percent of sector assets.[11] The mandate that SOEs must come to control the domestic market kept auto imports below 5 percent of total sales even when Chinese automakers were backward. The current target for import displacement in favor of domestic production is environmental technology.

The Stateen: 18 Sectors the State Must Lead

Autos	Information technology	Petrochemicals
Aviation	Insurance	Power
Banking	Machinery	Railways
Coal	Media	Shipping
Construction	Metals	Telecommunications
Environmental technology	Oil and gas	Tobacco

There can be no better subsidy than an assured share—in this case, an assured share of a very large market. When the market share for American goods and services is tightly limited from the outset, other policies make little difference. Yet the WTO cannot address this.

The WTO definition of subsidies indicates it should be easier to break down barriers that result from financial subsidies, but that is not true in the Chinese case. The European Union recently inched forward on addressing Chinese financial subsidies in telecom, provoking threats from Beijing, which does not want light shone on its practices.[12]

The chief financial subsidy is bank lending by state banks to state firms at below-market interest rates. Banking dominates Chinese financing: From 2009 to 2011, bank lending totaled $3.7 trillion. State banks control over 90 percent of banking assets.[13] Unsurprisingly, they make as much as 80 percent of loans to SOEs, with even the central government concerned about the amount and cost of credit going to private firms.[14] For SOEs, the People's Bank has kept real (adjusted for inflation) interest rates near or below zero for years. And since SOEs do not truly go bankrupt, even trivial interest payments can be ignored.

This is not an export subsidy; it is an *existence* subsidy. Chinese SOEs do not borrow in order to dump on foreign markets, though that happens; they borrow in order to maintain or expand their position at home. The WTO has not been able to address this, but it obviously leaves less space for foreign goods and services in the Chinese market.

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[11] Wang Xiaotian, "Foreign Banks Remain Optimistic over Expansion in China," Xinhuanet, October 20, 2011, http://news.xinhuanet.com/english2010/china/2011-10/20/c_131202001.htm (accessed July 16, 2012), and PricewaterhouseCoopers, "Foreign Insurance Companies in China," September 2010, http://www.pwc.be/en/china-desk-newsletter/Assets/Foreign-insurance-companies-in-China.pdf (accessed July 16, 2012)

[12] Paul Mozur, "China Hits EU over Trade Spat," *The Wall Street Journal*, July 12, 2012, http://online.wsj.com/article/SB10001424052702303740704577521963892808818.html.

[13] Michael F. Martin, "China's Banking System: Issues for Congress," Congressional Research Service *Report for Congress*, February 20, 2012, http://www.fas.org/sgp/crs/row/R42380.pdf. Outside of banking, SOE-dominated sectors accounted for nearly 85 percent of stock exchange capitalization at the end of 2011. The biggest participant in the "corporate" bond market has been the Ministry of Railways.

[14] Jialin Zhang, "China Backpedals," *Hoover Digest*, 2011 No. 1, January 12, 2011, http://www.hoover.org/publications/hoover-digest/article/62771 (accessed July 16, 2012), and Xinhua, "Chinese Premier Urges Financial Support for Cash-Strapped Small Businesses," October 5, 2011, http://news.xinhuanet.com/english2010/china/2011-10/05/c_131175191.htm.

There are other subsidies. The state owns all land, and SOEs often receive it for free. In contrast, acquiring land is difficult and expensive for non-state companies. Non-state firms also suffer from insecure ownership: Local governments can evict them for reasons that include reducing competition for SOEs. The size of this subsidy has grown because land costs have soared in the past decade. Other inputs to production, such as power, are also subsidized.

General policy support of SOEs is essentially guaranteed. At the orders of the Communist Party, SOE officers move back and forth from policymaking positions. Further, many are closely related to high-level Party cadres.[15]

The results are stunning. The International Monetary Fund (IMF) puts China's 2011 *per capita* income lower than Namibia's. Nonetheless, with the lion's share of the domestic market guaranteed, Chinese state-dominated steel and coal production is approaching half the world total.[16] State banks and telecoms are, on some measures, the world's largest.[17] The PRC has the second-most companies in the global *Fortune* 500 at 73, now ahead of Japan despite being far poorer. Almost all of the entrants are SOEs, and three SOEs are in the world's top 10.[18] American companies face artificially inflated giants.

A firm contemplating the Chinese market should find it daunting. If labeled strategic, an entire sector can be closed. Foreign interest bears on whether a sector is so labeled - machinery became suddenly more valuable when an American company tried to become a major player.[19] The newest strategic sector, environmental technology, did not exist in China until just a few years ago and was identified largely due to foreign activity.

Any downturn is a further threat to multinationals. Low- or no-cost borrowing means that SOEs can defy the pressure of a shrinking market, overproducing even as demand fades.[20] Subsidies ensure there is no market of 1.3 billion for American exports, American firms based in China, other foreign firms, and even domestic private firms. There is only what SOEs leave behind.

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[15] Chen Jialu, "CEO Reshuffles Signal New View of Watchdog," *China Daily*, August 24, 2010, http://www.chinadaily.com.cn/bizchina/2010-08/24/content_11194717.htm (accessed July 16, 2012), and "China's Power Families," *Financial Times*, July 10, 2012, http://www.ft.com/intl/cms/s/2/6b983f7a-ca9e-11e1-8872-00144feabdc0.html#axzz20RpPdY6G.

[16] Press release, "World Crude Steel Output Increases by 6.8% in 2011," World Steel Association, January 23, 2012, http://www.worldsteel.org/media-centre/press-releases/2012/2011-world-crude-steel-production.html (accessed July 16, 2012), and World Coal Association, "Coal Statistics," August 2011, at http://www.worldcoal.org/resources/coal-statistics/ (accessed July 16 2012).

[17] Philip Lagerkranser, "China Banks Surge to World's Largest May Be Too Good to Be True," Bloomberg, April 29, 2009, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aueh06DOY37A (accessed July 16, 2012), and Janet Ong, "China Tells Telecom Companies to Merge in Overhaul (Update 1)," Bloomberg, May 25, 2008, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aYQg0d5NANkM (accessed July 16, 2012).

[18] "Global 500: Our Annual Ranking of the World's Largest Corporations," *CNN Money*, July 2012, at http://money.cnn.com/magazines/fortune/global500/2012/countries/China.html.

[19] Xinhua, "Carlyle Abandons Xugong Dream," July 24, 2008, http://news.xinhuanet.com/english/2008-07/24/content_8760203.htm.

[20] Embassy of the People's Republic of China in Negara Brunei Darussalam, Economic and Commercial Counsellor's Office, "70% of China's Products to Be in Oversupply," August 1, 2005, http://bn2.mofcom.gov.cn/aarticle/chinanews/200508/20050800219859.html.

The WTO has been utterly unable to come to grips with this. It is therefore up to the U.S. to act, but American action will be ill-considered and likely harmful until a proper understanding and measurement of subsidies is in place.

The Exchange Rate: Overrated

The IPR and subsidies discussions should make it clear that the dollar-to-yuan exchange rate is a trivial factor. IPR violations rob the U.S. of comparative advantage, subsidies effectively seal off most of the Chinese market—the exchange rate cannot compare.

Even the extent of the RMB's undervaluation against the dollar cannot be determined. The IMF in mid-2011 offered an unhelpful range of 3 percent to 23 percent.[21] Beijing intervenes so much it is impossible to determine the market-driven exchange rate. Further, the PRC's exchange rate policies are aimed, not at the U.S., but at peer producers such as Mexico. The effect of the yuan's peg a weak dollar does not fall against the yuan. Instead, they fall in tandem. The disadvantage is inflicted on countries which see both the dollar and yuan weaken against their currency. Breaking the peg would shift Chinese jobs to these countries, not the U.S.

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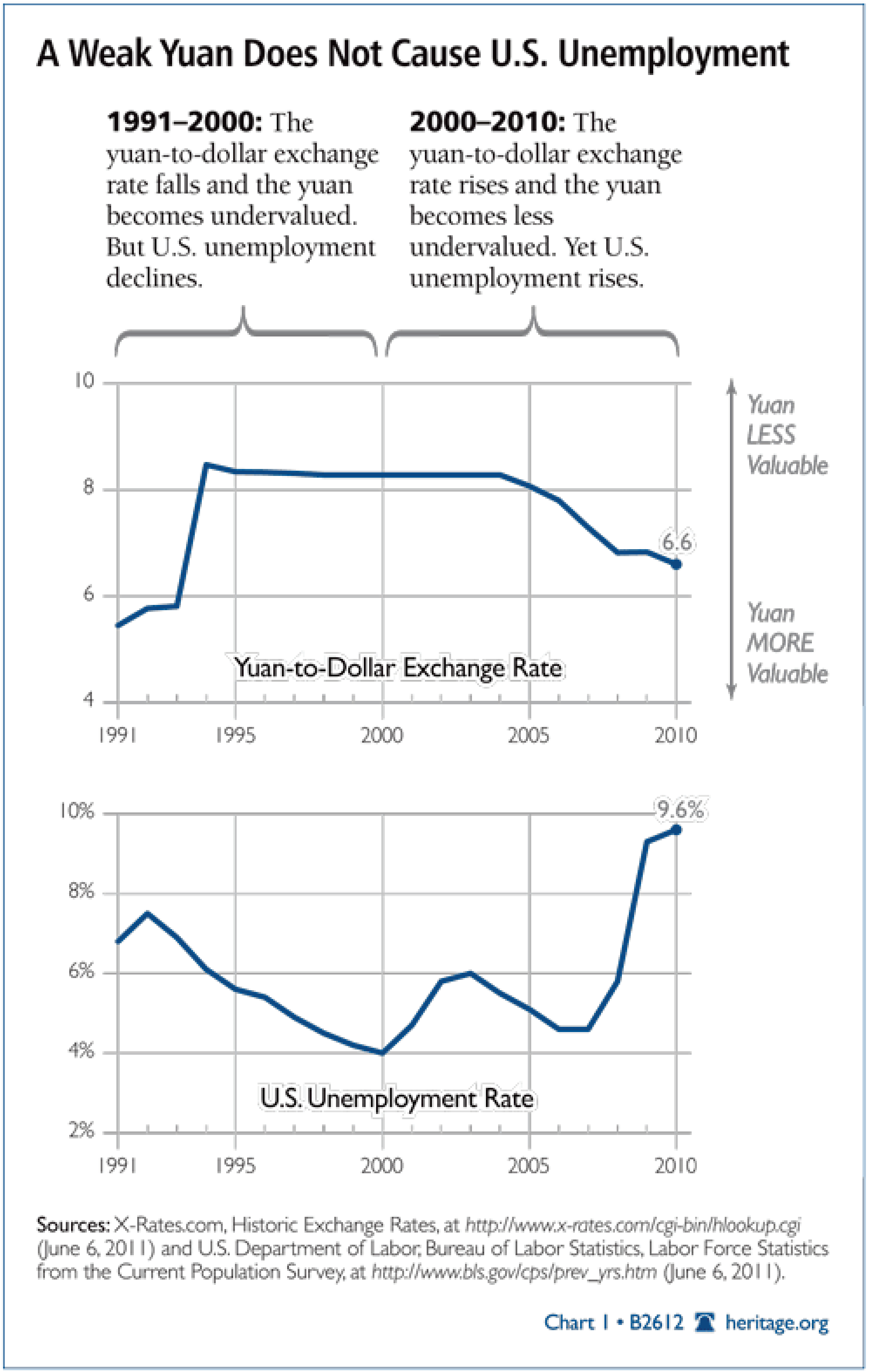
[21] Reuters, "IMF Says Property Bubble in China a Concern; Yuan Still Undervalued," July 20, 2011, http://www.reuters.com/article/2011/07/21/imf-china-idUSS7E7FQ01820110721.



Unsurprisingly, there is no evidence that a weaker yuan causes U.S. unemployment and a stronger yuan means more American jobs. The evidence actually seems to say the opposite. This is because it is our policies that drive our unemployment; the yuan simply does not matter.

The Best American Response

It follows immediately that the American emphasis on the exchange rate has been wasteful. Along these lines, making eight demands of China at each high-level meeting has accomplished little. The exchange rate should be dropped from the list of U.S. priorities, and Congress should not impede that change.

Intellectual property is far more difficult, a core issue but one with no apparent solution in the Chinese case. Retaliation can be justified but offers little hope for progress. For some countries, bilateral investment treaties or free trade agreements can include IPR provisions that induce progress. With the PRC, that would be a high-risk strategy. It is likely that Beijing would adhere to an agreement but also use its many policy tools to find other ways to continue to limit IPR. This has happened with a number of the terms of China's WTO accession.

An indirect approach, not targeting China or any country, may be more helpful. The WTO has considerably improved the global climate for IPR as compared to a generation ago. Much more work must be done, but the WTO has shown it can improve upon bilateral pressure. The catch, of course, is that the WTO itself is moribund, and there is even a possibility the entire process has run its course. More options are needed in case the WTO remains stuck.

The U.S. has sought multilateral arrangements with a smaller number of like-minded countries. Examples are talks with the EU and attempts at a Western Hemisphere free trade area. The lead initiative at present is the Trans-Pacific Partnership (TPP). One goal of the TPP is to create incentives for countries such as China to change behavior in order to join. Since IPR is central to U.S. comparative advantage, Congress should ensure the TPP includes provisions that, if Beijing did join, would considerably strengthen Chinese protection of IPR.

On the more tractable matter of subsidies, the U.S. has taken the first step, if belatedly. The United States Trade Representative in fall 2011 finally notified the WTO of nearly 200 subsidies that China should have reported but did not.[22] Little progress has been made since, in part due to obvious Chinese recalcitrance but also in part due to the narrow WTO subsidies definition.

The U.S. should therefore move beyond both the PRC and the WTO by measuring Chinese subsidies independently. Regulatory protection against competition must be included, which will be difficult, inexact, and controversial at the outset. But if it is not included, subsidies will be seriously underestimated and considerable harm will continue to be inflicted on American firms. Estimates will improve over time, and the process could force either the PRC to provide its own information on subsidies or a change in WTO practice.

Bilateral pressure must be brought through presidential summits, the Strategic and Economic Dialogue, and all other tools, including appropriate legislation. This pressure should be focused on the regulatory protection SOEs receive. America currently approaches China with numerous,

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[22] Press release, "United States Details China and India Subsidy Programs in Submission to WTO," Office of the United States Trade Representative, October 2011, http://www.ustr.gov/about-us/press-office/press-releases/2011/october/united-states-details-china-and-india-subsidy-prog.

vague demands which are never met. A measurement of subsidies would allow the U.S. to make concrete proposals and, more important, assess progress over time. Also, a sound subsidies measurement is needed to ensure that American action is corrective, not protectionist.

Land ownership is the heart of Communist ideology and will not change. Interest rate reform is critical but will accomplish nothing if SOEs can ignore repayment. Nor will it be possible simply to eliminate regulatory protection. However, the number of "strategic" sectors can shrink, and the extent of state dominance in these sectors rolled back. For instance, machinery should never have been included. Beijing can also limit the required market share. In petrochemicals, 51 percent should be enough. In admittedly sensitive industries such as oil, 75 percent state control is far better than 95 percent. Just clarifying the target state share would be a useful first step.

Sustained American demands for the smallest possible role for Chinese SOEs translate into the largest possible share for American goods and services. The U.S. so far has failed to act along these lines. Congressional legislation aimed at Chinese trade barriers should focus on curbing the regulation that enables SOEs to avoid competition. The first step is to document the effects of this regulation.

It should be said that the principle of reducing regulation to encourage competition plainly does not apply only to China. It can apply to a wide range of American partners that create regulations with one eye on disadvantaging foreign products.

It also applies to the U.S. itself. The U.S. should be ready to reduce our own regulatory barriers to competition. This will not only establish our credentials in negotiation with foreign partners, but also make American companies more competitive against Chinese SOEs and everyone else. Congress obviously has a key role to play here.