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Manufacturing Discord

Growing Tensions Threaten the U.S.-China Economic Relationship

by Daniel Ikenson

Executive Summary

Frictions in the U.S.-China relationship are nothing new, but they have intensified in recent months. There is angst among the U.S. public, who frequently hear that China will soon surpass the United States in one economic superlative after another. Some worry that China's rise will impair America's capacity to fulfill or pursue its traditional geopolitical objectives. And those concerns are magnified by a media that cannot resist tempting the impulses of U.S. nationalism.

Realists understand that the objectives of the U.S. and Chinese governments will not always be the same, thus U.S. and Chinese policies will not always be congruous. Accentuating and cultivating the areas of agreement, while resolving or minimizing the differences, is the essence of diplomacy and statecraft. These tactics must continue to underpin a U.S. policy of engagement with China.

Although it may be fashionable to think of China as the country to which the U.S. manufacturing sector was offshored in exchange for tainted products and a mountain of mortgage debt, the fact is that the bilateral relationship has produced enormous benefits for people in both countries. Despite those benefits, Americans are more likely to be familiar with the sources of friction.

Ongoing frictions in the bilateral relationship are to be expected, as the world's largest economy and its fastest-growing economy make mutual accommodations. Despite occasional theatrics and fireworks, both governments have a mutual interest in harmonious economic relations. Our economies are extremely interdependent, and barring destructive policies, the pie should continue to grow larger.

This paper examines the economic relationship and some of its high-profile sources of friction, distills the substance from the hype, and concludes that although some policy tweaks would be beneficial, a more aggressive U.S. policy tack is unnecessary and unwanted. Much more can be done to cultivate our areas of agreement using carrots before seriously considering the use of sticks.

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Once-respected demarcations between geopolitical and economic aspects of the relationship have been blurred.

Introduction

Frictions in the U.S.-China relationship are nothing new, but they have intensified in recent months. Tensions that were managed adeptly in the past are multiplying, and the tenor of official dialogue and public discourse has become more strident. Lately, the media have spilled lots of ink over the proposition that China has thrived at U.S. expense for too long, and that China's growing assertiveness signals an urgent need for aggressive U.S. policy changes. Once-respected demarcations between geopolitical and economic aspects of the relationship have been blurred. In fact, economic frictions are now more likely to be cast in the context of our geopolitical differences, which often serves to overstate the challenges and obscure the solutions.

A sign of the times is a recent commentary by *Washington Post* columnist Robert J. Samuelson, in which he declares: "China's worldview threatens America's geopolitical and economic interests."[1] That statement would seem to support a course of action very different from the course implied by the same columnist 18 months earlier, when he wrote, "Globalization means interdependence; major nations ignore that at their peril."[2] That change of heart appears to be contagious.

This paper examines the economic relationship and some of its high-profile sources of friction, distills the substance from the hype, and concludes that although some policy tweaks would be beneficial, a more aggressive U.S. policy tack is unnecessary and unwanted. Even in a shifting geopolitical environment, U.S. policy toward China should continue to reflect Samuelson's earlier view because globalization does indeed mean interdependence. Thus, cooperation, not conflagration, is imperative.

Manufacturing Discord

One explanation for the change in tenor is that media pundits, policymakers, and other analysts are viewing the relationship through a prism that has been altered by the fact of a rapidly rising China. That China emerged from the financial meltdown and subsequent global recession wealthier and on a virtually unchanged high-growth trajectory, while the United States faces slow growth, high unemployment, and a large debt (much of it owned by the Chinese), is breeding anxiety and changing perceptions of the relationship in both countries.

There is no mistaking the sense of urgency in President Obama's exhortation that the United States is falling behind China in green technology: "Countries like China are moving even faster. . . . I'm not going to settle for a situation where the United States comes in second place or third place or fourth place in what will be the most important economic engine of the future."[3]

On alternative energy, Senator Lindsey Graham (R-SC) warns:

> Every day we wait in this nation China is going to eat our lunch. The Chinese don't need 60 votes. I guess they just need one guy's vote over there—and that guy's voted. He has decided to do two things. First, kind of play footsie with us on emissions control stuff but go like gangbusters when it comes to producing alternative energy. The solar and wind and battery-powered cars is an amazing thing to watch. And we're stuck in neutral here.[4]

New York Times columnist Thomas Friedman even sings the praises of autocracy in conveying what he sees as China's singularity of purpose to dominate the industries of the future:

> One-party autocracy certainly has its drawbacks. But when it is led by a reasonably enlightened group of people, as China is today, it can also have great advantages. That one party can just impose the politically difficult but critically important policies needed to move a society forward in the 21st century. It is not an accident that China is committed to overtaking us in electric cars, solar power, energy efficiency, batteries, nuclear power, and wind power. China's

leaders understand that in a world of exploding populations and rising emerging-market middle classes, demand for clean power and energy efficiency is going to soar. Beijing wants to make sure that it owns that industry and is ordering the policies to do that, including boosting gasoline prices, from the top down.[5]

Understandably, there is angst among the U.S. public, who hear frequently that China will soon surpass the United States in one economic superlative after another. Some worry that China's rise will impair America's capacity to fulfill or pursue its traditional geopolitical objectives. And those concerns are magnified by a media that cannot resist tempting the impulses of U.S. nationalism. Woven into stories about China's frantic pace of development are reminders that the Chinese have not forgotten their two-century slumber—a period of humiliation and exploitation by foreign powers. A recent *National Journal* cover story describing areas of bilateral policy contention—which the article laments as "frustrating" the fact that U.S. experts see "few alternatives to continued engagement" —features three menacing photographs of Chinese military formations, one picture of North Korean leader Kim Jong Il flanked by members of the Chinese military, and one photo of the Chinese foreign minister shaking hands with Iranian President Mahmoud Ahmadinejad.[6]

Subtly, and sometimes not, the media and politicians are brandishing the image of an adversarial China.

In Chinese reluctance to oblige U.S. policy wishes, we are told that China selfishly follows a "China-First" policy. In the increasing willingness of Chinese officials to criticize U.S. policies, we are told of a new "triumphalism" in China. In the reportedly shabby treatment of President Obama by his Chinese hosts on his recent trip to Beijing, we are told that the "Chinese have an innate sense of superiority."

But indignation among media and politicians over China's aversion to saying "How high?" when the U.S. government says "Jump!" is not a persuasive argument for a more provocative posture. China is a sovereign nation. Its government, like the U.S. government, pursues policies that it believes to be in its own interests (although those policies—with respect to both governments—are not always in the best interests of their people). Realists understand that objectives of the U.S. and Chinese governments will not always be the same, thus U.S. and Chinese policies will not always be congruous. Accentuating and cultivating the areas of agreement, while resolving or minimizing the differences, is the essence of diplomacy and statecraft. These tactics must continue to underpin a U.S. policy of engagement with China.

Despite occasional theatrics and fireworks, both governments have mutual interest in harmonious economic relations. Our economies are extremely interdependent. U.S. economic performance will continue to be a determinant of Chinese economic performance—and vice versa—and barring destructive policies, the pie should continue to grow larger. Much more can be done to cultivate our areas of agreement using carrots before seriously considering the use of sticks.

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Economic Benefits

Although it may be fashionable to think of China as the country to which the U.S. manufacturing sector was offshored in exchange for tainted products and a mountain of mortgage debt, the fact is that the bilateral relationship has produced enormous benefits for people in both countries, including most Americans. China is America's third-largest export market, and has been our fastest-growing market for a decade, providing 20.2 percent annual sales growth for U.S. businesses between 2000 and 2008, when overall annual export growth to all countries stood at just 6.8 percent.[7] Yet the fact of that stellar export growth fails to impress Sen. Arlen Specter (D-PA), who supports revoking China's "Normal Trade Relations" status on the grounds that "China has not lived up to its obligations to have its markets opened to us."[8]

American businesses, portfolio investors, and 401(k) participants also have benefited hand-

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somely from China's high rate of sustained economic growth. Likewise, American consumers have benefited from their access to Chinese goods. Imports from China have helped keep prices in check, raising real incomes and easing the strain on family budgets.

What is perhaps less well known—because they are often portrayed as victims—is that large numbers of American producers and workers benefit from the bilateral relationship, as well. This is the case because the U.S. economy and the Chinese economy are highly complementary. U.S. factories and workers are more likely to be collaborating with Chinese factories and workers in production of the same goods than they are to be competing directly. The proliferation of vertical integration (whereby the production process is carved up and each function performed where it is most efficient to perform that function) and transnational supply chains has joined higher-value-added U.S. manufacturing, design, and R&D activities with lower-value manufacturing and assembly operations in China. The old factory floor has broken through its walls and now spans oceans and borders.

Though the focus is typically on American workers who are displaced by competition from China, legions of American workers and their factories, offices, and laboratories would be idled without access to complementary Chinese workers in Chinese factories. Without access to lower-cost labor in places like Shenzhen, countless ideas hatched in U.S. laboratories—which became viable commercial products that support hundreds of thousands of jobs in engineering, design, marketing, logistics, retailing, finance, accounting, and manufacturing—might never have made it beyond conception because the costs of production would have been deemed prohibitive for mass consumption. Just imagine if all of the components in the Apple iPod had to be manufactured and assembled in the United States. Instead of $150 per unit, the cost of production might be multiple times that amount.[9]

Consider how many fewer iPods Apple would have sold; how many fewer jobs iPod production, distribution, and sales would have supported; how much lower Apple's profits (and those of the entities in its supply chains) would have been; how much lower Apple's research and development expenditures would have been; how much smaller the markets for music and video downloads, car accessories, jogging accessories, and docking stations would be; how many fewer jobs those industries would support; and the lower profits those industries would generate. Now multiply that process by the hundreds of other similarly ubiquitous devices and gadgets: computers, Blu-Ray devices, and every other product that is designed in the United States and assembled in China from components made in the United States and elsewhere.

The *Atlantic*'s James Fallows characterizes the complementarity of U.S. and Chinese production sharing as following the shape of a "Smiley Curve" plotted on a chart where the production process from start to finish is measured along the horizontal axis and the value of each stage of production is measured on the vertical axis. U.S. value-added comes at the early stages—in branding, product conception, engineering, and design. Chinese value-added operations occupy the middle stages—some engineering, some manufacturing and assembly, primarily. And more U.S. value-added occurs at the end stages in logistics, retailing, and after-market servicing.[10] Under this typical production arrangement, collaboration, not competition, is what links U.S. and Chinese workers.

Those are the benefits to U.S. producers, workers, consumers, and investors of the economic relationship. And that is what is threatened when we allow our fears to grow out of proportion, tensions to boil over, and politicians like Senator Specter to get their wishes.

Economic Frictions

Despite the enormous benefits of the bilateral relationship, Americans are more likely to be familiar with the sources of friction. Americans have heard that underhanded Chinese policies have had a deleterious impact on U.S. manufacturing. They have been told that China manipulates its currency to secure an unfair trade advantage; "illegally" dumps and sells government-subsidized products in U.S. markets; maintains policies that discriminate against imports and favor domestic industries; steals American intellectual property; treats its workers poorly; degrades the environment; sells us tainted products; and even caused the U.S. financial crisis by lending America too much money.[11]

There is some truth in some of those claims. But there is also a good deal of exaggeration, misinformation, and hypocrisy in them. Some ring hollow because the U.S. government—usually at the behest of the same interests clamoring for action against China—commits the same sins. All of the allegations require greater context and perspective to reduce the potential for conflagration, and to show that there is plenty of scope for resolving legitimate problems judiciously.

Manufacturing the Myth of Decline

Nefarious Chinese trade practices are often blamed for the decline of U.S. manufacturing. But the first problem with that presumption of causation is that U.S. manufacturing is not in decline in the first place. Until the onset of the recent recession (when virtually every sector in the economy contracted), U.S. manufacturing was setting new performance records year after year in all relevant statistical categories: profits, revenues, investment returns, output, value-added, exports, imports, and others. In absolute terms, the value of U.S. manufacturing has been growing continuously, with brief hiccups experienced during recessions over the past several decades. As a percentage of our total economy, the value of manufacturing peaked in 1953 and has been declining since, but that is the product of rapid growth in the services sectors and not—as evidenced by its absolute growth—an indication of manufacturing decline.[12]

The preponderance of Chinese and other imported goods on retail store shelves may give the impression that America does not make anything anymore. But the fact is that American factories make lots of things—in particular, high-value products that are less likely to be found in retail stores—like airplanes, advanced medical devices, sophisticated machinery, chemicals, pharmaceuticals, and biotechnology products. American factories are, in fact, the world's most prolific, accounting for 21.4 percent of global manufacturing value-added in 2008, while China accounted for 13.4 percent.[13] The main reason for continued American industrial preeminence is that the U.S. manufacturing sector has continued its transition away from labor-intensive industries toward higher value-added production.

Regardless of manufacturing's operating performance, the metric that matters most politically is the number of jobs in the sector. That figure reached a zenith of 19.4 million jobs in 1979 and has been trending downward along roughly the same trajectory ever since. China's entry into the WTO and the subsequent increase in bilateral trade did nothing to accelerate the decline. Manufacturing job loss has very little to do with trade and a lot to do with changes in technology that lead to productivity gains and changes in consumer tastes. China has also experienced a decline in manufacturing jobs—in fact, many more jobs have been lost in Chinese manufacturing—for the same reasons. According to a 2004 study published by the Conference Board, China lost 15 million manufacturing jobs between 1995 and 2002, a period during which 2 million U.S. manufacturing jobs were lost.[14]

But these facts do not seem to matter to politicians like Senator Specter, who recently cited the heavily inflated claims of a labor-union-funded report when he asserted, "We have lost 2.3 million manufacturing jobs as a result of the trade imbalance with China between 2001 and 2007."[15] One of the many reasons that claim is inaccurate is that it is derived from a simple formula that approximates job gains from export value and job losses from import value, as though there were a straight-line correlation between the jobs and trade data. The flaws of those assumptions are many, but perhaps the easiest one to convey is that most of the value embedded in imports from China is not Chinese.

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of the value of U.S. imports from China comes from Chinese labor, material, and overhead. Official U.S. import statistics—which pay no heed to the constituent value-added elements—therefore overstate the Chinese value in those imports by 100 to 200 percent, on average. The cited job loss figures are based on import values that are unequivocally overstated because one-half to two-thirds of that value are the costs of material, labor, and overhead added in Japan, Taiwan, Korea, Singapore, Australia, the United States, and other countries.

The fact that China surpassed Germany to become the world's largest exporter last year—a milestone that prompted a string of "end-of-Western-civilization" newspaper commentaries—says less about Chinese economic might than it does about the extent of global economic integration. The global division of labor enabled by intricate transnational production and supply chains still assigns to China primarily lower-value production and assembly operations.[18] That alone speaks to the complementary nature of the U.S. and Chinese economies, underscores the meaninglessness of bilateral trade accounting, and magnifies the absurdity of predicating policy on the goal of reducing a bilateral trade deficit—to which we turn now.

Manipulating the Currency Issue

Allegations of Chinese currency manipulation have been a source of friction in the bilateral relationship for several years.[19] Various bills seeking to compel China to revalue its currency were introduced in each of the three previous Congresses, dating back to 2003.[20] Legislation under consideration in the current Congress is similarly misguided. It presumes that policymakers can know the true exchange rate, amounts to a regressive tax on Americans, runs afoul of U.S. WTO commitments, and invites similarly aggressive and damaging policy responses from Beijing.

Many economists believe that the Chinese currency, the renminbi (RMB), is undervalued, but there is disagreement about the magnitude. This disagreement stems from the fact that determining the value of a currency—short of allowing the currency to float freely and removing impediments to the interaction of supply and demand—is an inexact undertaking, subject to the various assumptions that economists are infamous for making. So, as Congress considers legislation to compel the Chinese to allow RMB appreciation under threat of sanction, a question worth asking is: "How will we know when we're there?"

For Congress, the issue is not the RMB's value per se, but the fact that the United States has a large bilateral trade deficit with China, which many attribute to the undervalued RMB.[21] The issue of currency revaluation for many policymakers is just a proxy for reducing the trade deficit. The president's recently unveiled National Export Initiative, with the goal of doubling U.S. exports in five years, combined with the incessant demands of U.S. import-competing interests that policymakers raise the costs of imports to American businesses and consumers, ensures that many in Washington will take the position that the RMB is undervalued as long as U.S. imports from China exceed U.S. exports to China.

Leaving aside the question of whether bilateral deficit reduction (rather than economic growth, attracting investment, and cultivating human capital) should be an explicit objective of policymaking in the first place, there is reason to be skeptical that currency revaluation would have the "desired" effect. Recent evidence suggests that RMB appreciation will not reduce the U.S. trade deficit.

Between July 2005 and July 2008, the RMB appreciated by 21 percent against the dollar—from a value of $.1208 to $.1464.[22] During that same period (between full year 2005 and full year 2008), the U.S. trade deficit with China increased from $202 to $268 billion.

U.S. exports to China, which were already on a similarly sloped upward trajectory when the RMB was pegged at 8.28 per dollar, increased by $28.4 billion, or 69.3 percent. But on the import side, the evidence that an appreciating RMB deters U.S. consumption of Chinese goods is not very compelling.

During the period of a strengthening RMB from 2005 to 2008, U.S. imports from China increased by $94.3, billion or 38.7 percent.

Americans actually *increased* their purchases of Chinese imports, despite the relative price increase of 21 percent. One explanation for continued U.S. consumption of Chinese goods in the face of price increases is that there may be a shortage of substitutes in the U.S. market for Chinese-made goods. In some cases, there may be no domestically produced alternatives. Accordingly, U.S. consumers are faced with the choice of purchasing higher-priced items from China or foregoing consumption of the item altogether. In other words, compelling RMB appreciation, as currency hawks in Congress are trying to do, is akin to reducing Americans' real incomes.

Something else is evident about the relationship from those 2005 to 2008 data. Chinese exporters must have lowered their RMB-denominated prices to keep their dollar-denominated prices steady for U.S. consumers. That would have been a completely rational response enabled by the fact that RMB appreciation reduces the cost of production for Chinese exporters—particularly those that rely on imported raw materials and components. As described earlier, one-half to two-thirds of the value of Chinese exports, on average, reflects the cost of material, labor, and overhead from other countries. China's value-added operations still tend to be low-value manufacturing and assembly operations, thus much of the final value of Chinese exports was first imported into China.

RMB appreciation not only bolsters the buying power of Chinese consumers, but it makes Chinese-based producers and assemblers even more competitive because the relative prices of their imported inputs fall, reducing their costs of production. That reduction in cost can be passed on to foreign consumers in the form of lower export prices, which could mitigate the intended effect of the currency adjustment, which is to reduce U.S. imports from China. That process might very well explain what happened between 2005 and 2008, and is probably a reasonable indication of what to expect going forward.

Another reason China may be averse to rapid RMB appreciation is that it owns around $800 billion of U.S. debt. A 25 percent appreciation in the RMB would reduce the value of those holdings to approximately $640 billion. That's a high price for China to pay, especially in light of the fact that U.S. inflation is expected to rise in the coming years, which will further deflate the value of those holdings. Likewise, mass dumping of U.S. government debt by Chinese investors—the much ballyhooed "leverage" China allegedly holds over U.S. policy—would precipitate a decline in the dollar, as well, which also would depress the value of Chinese holdings.

The world would be better off if the value of China's currency were truly market-determined, as it would lead to more optimal resource allocations. But compelling China to revalue under threat of sanction could produce adverse consequences—including reductions in Americans' real incomes and damaged relations with China—without achieving the underlying policy objective.

There are less provocative alternatives.

If it is desirable that China recycle some of its estimated $2.4 trillion in accumulated foreign reserves, U.S. policy (and the policy of other governments) should be more welcoming of Chinese investment in the private sector. As of the close of 2008, Chinese direct investment in the United States stood at just $1.2 billion—a mere rounding error at about 0.05 percent of the $2.3 trillion in total foreign direct investment in the United States. That figure comes nowhere close to the amount of U.S. direct investment held by foreigners in other big economies. U.S. direct investment in 2008 held in the United Kingdom was $454 billion; it was $260 billion in Japan, $259 billion in the Netherlands, $221 billion in Canada, $211 billion in Germany, $64 billion in Australia, $16 billion in South Korea, and even $1.7 billion in Russia.[23]

Some of China's past efforts to take equity positions or purchase U.S. companies or buy assets or land to build new production facilities have been viewed skeptically by U.S. policymakers, and scuttled, ostensibly over ill-defined security concerns. But a large inflow of investment from China would have an impact simi-

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lar to a large increase in U.S. exports to China on the value of both countries' currencies, and on the level of China's foreign reserves.

In light of China's large reserves, its need and desire to diversify, America's need for investment in the real economy, and the objective of creating jobs and achieving sustained economic growth, U.S. policy should be clarified so that the benchmarks and hurdles facing Chinese investors are better understood. Lowering those hurdles would encourage greater Chinese investment in the U.S. economy and a deepening of our mutual economic interests.

Dumping Is Not Illegal, but Current Antidumping Rules Should Be

Allegations of "unfair" trade and the import restrictions that those allegations produce are constant sources of friction in the bilateral relationship. Though trade remedy laws exist and are used by industries in both the United States and China, most of the friction stems from the far more numerous U.S. allegations and findings against Chinese exporters. As of November 2009, U.S. antidumping and countervailing duty measures against China totaled 94 (out of 302 measures against all countries).[24] Since 2007, U.S. industries have brought a total of 58 antidumping and countervailing duty cases against Chinese exporters.[25] Last year, U.S. industry brought 24 cases—the most ever—against China.

With each case initiation, one preliminary decision is issued by the U.S. International Trade Commission concerning whether the domestic industry is injured, and another preliminary decision is issued by the U.S. Department of Commerce regarding the estimated amount of dumping or subsidization. When those two preliminary decisions are affirmative (i.e., when there is a reasonable indication of dumping or subsidization, and the domestic industry is likely materially injured), two final decisions are rendered several months to more than one year later. If an antidumping or countervailing duty measure is imposed after the year-long-plus investigation, an additional announcement of the antidumping or countervailing duty order is made.

Thus, 24 case initiations can produce 120 official *Federal Register* announcements of trade remedy actions, which over the course of a year amounts to one notice every three days. This frequency starts the rhythm of the media drumbeat, which provides the atmospherics for angry union bosses and self-righteous trade lawyers to rant about the ravages of unfair trade and the need for tougher laws and more rigorous enforcement. Should it be surprising, then, that antidumping and countervailing duty activity creates the impression that the United States and China are moving inexorably toward a trade war?

The number of antidumping and countervailing duty actions is indeed regrettable, but it does not portend a trade war. Trade remedy measures—"slapping" on import duties, as it is weightily described in the press—tend to increase during and following economic downturns. The law is designed to be most accessible to industry when it has experienced economic difficulties. In order to "win" relief from import competition, domestic industries need to demonstrate that they are materially injured. Evidence of material injury includes declining revenues and profits, reduced capacity utilization, falling output, declining investment, job attrition, and the like. The conditions of material injury are very much the same conditions experienced during economic contractions. As the United States was in deep recession during 2008 and part of 2009, it is no accident that the number of cases against China reached a record high in 2009.

Unfortunately, the law is not particularly demanding with respect to the requirement that material injury be caused by dumped or subsidized imports, as opposed to other factors, such as changing consumer demand, new technologies, bad decisionmaking, or the business cycle. Nor is the law dependable at curbing systemic methodological abuses in the calculation of dumping and subsidy margins, particularly in cases involving imports from China.[26]

The trade remedy laws are on statutory autopilot, which means that cases are filed on behalf of domestic industries by trade lawyers when conditions are optimal for "winning" relief from import competition. Although the media typically assert that "Washington" or "the Obama administration" slapped duties on China, the fact is that trade remedy actions do not require the participation or endorsement of U.S. policymakers—even though such measures create problems for import-consuming industries, U.S. exporters, and consumers, as well as complicate overall trade relations. Essentially, with these trade laws, Congress has given to industry certain tools that Americans believe are used only under extraordinary circumstances. But the fact is that, like tax credits or alternative energy subsidies or tax deferment options, the trade laws are used strategically and at the discretion of industries, as part of their overall business strategies.

The frequency with which trade remedies are used gives the impression that China's "cheating" is endemic—that Chinese exporters, as a matter of course, "illegally" dump or benefit from government subsidies, and that something more needs to be done. But the fact is that Chinese exporters are ripe targets because, in many industries, China is the primary source of imports. And under the calculation methodology employed by the Commerce Department in Chinese cases—the "non-market economy" (NME) methodology—it is very easy to generate margins of dumping, even when the exporter is not selling at prices in the United States that are below the cost of production or lower than the prices charged at home.

This is true because under NME methodology, the U.S. prices of Chinese exporters are not compared to their home market prices or their own costs of production, as they would be for exporters subject to the market economy methodology.[27] Instead, Commerce creates a surrogate normal value—an estimate of what the price would have been in China if China were a market economy—by considering all of a company's factors of production and then assigning values to those factors based ostensibly on the costs of those inputs in other countries—usually India or Indonesia. Thus, dumping margins calculated in Chinese cases (if the Commerce Department does not simply rely on the inflated margins alleged in the antidumping petition) measure the extent to which the U.S. price charged by a Chinese exporter is lower than the price that the exporter likely would have charged if his inputs, expenses, and profit experience reflected that of an average Indian firm in a similar industry. But how can the Chinese exporter have any idea that his U.S. sales would be determined to be made at dumped prices when the benchmark—a convoluted calculation based roughly on the average costs to a roughly average Indian firm—is a figure about which he has no knowledge and over which he has no control?[28] This is the unfair trade that is so full-throatedly denounced by politicians, labor representatives, and lobbyists for import-competing industries, as they demand more rigorous enforcement. But, really, what is more unfair: dumping according to this methodology or the methodology itself?

Taking this farce to the next level, petitioning industries and their representatives habitually claim that the Chinese are guilty of "illegally" dumping, as if the Chinese exporters—given the methodology—could even know that their sales practices would generate affirmative dumping margins. But the claim of illegality is bogus, serving to further demonize China in the public's mind. There is nothing illegal about dumping. Charging different prices in different markets or selling products at prices below cost are often the most rational, profit-maximizing choices. According to the definition of dumping, U.S. companies do it frequently in the United States by charging different prices in different regional markets, or by selling at prices below the full cost of production for any number of rational, legitimate reasons. In the international context, U.S. exporters are subject to dozens of foreign antidumping measures for having sold their products in other countries at prices below normal value. Are they cheaters? Are they breaking the law? Is dumping illegal?

Under WTO rules, member countries are permitted to use antidumping and countervailing duty laws to redress dumping and subsidization. But dumping and subsidization are not illegal. Dumping and the kind of subsidization that is deemed countervailable do not violate

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any WTO agreements. Thus, applying antidumping or countervailing duties is not akin to "enforcing" our agreements; it is better characterized as exercising our rights. But they are rights that, when exercised, generate costs in both the imposing and targeted country. Some WTO member countries choose not to apply or even maintain antidumping and countervailing duty laws because of those costs. Indeed, in recognition of the disruptions caused by the use of antidumping laws, the WTO Antidumping Agreement contains language recommending that members who have and use such laws do so in a manner that reduces collateral damage. The agreement suggests that WTO members, if and when applying antidumping duties, use a so-called lesser duty rule. Article 9.1 of the Antidumping Agreement reads:

> The decision whether or not to impose an antidumping duty in cases where all requirements for the imposition have been fulfilled, and the decision whether the amount of the antidumping duty to be imposed shall be the full margin of dumping or less, are decisions to be made by the authorities of the importing Member. It is desirable that the imposition be permissive in the territory of all Members, and that the duty be less than the margin if such lesser duty would be adequate to remove the injury to the domestic industry.[29]

That is, members are asked to apply a duty that is the lesser of the amount required to offset domestic injury or the margin of dumping calculated. Unfortunately, the United States declines to use a lesser duty rule, and as a result, import-consuming industries and consumers are burdened well in excess of what would be considered a remedial amount of duty.

Bilateral tensions are the products of U.S. industry availing itself of certain weapons that Congress placed on its doorstep.

The antidumping and countervailing duty laws are called "unfair trade" laws because they are permitted to offset the effects of practices that are presumed to bestow unfair advantage on foreign exporters. That presumption and the fairness of the rules administering those laws, however, are both highly dubious.

What is also misleading—even slanderous—is the practice of referring to the China-specific safeguard law ("Section 421") as an unfair trade law, or describing last September's imposition of duties on Chinese tires pursuant to Section 421 as "enforcing the law," as President Obama and others do. The China safeguard is distinctly not an unfair trade law. The law, which was agreed to by China when it acceded to the WTO, is a safeguard provision that enables domestic industry to gain temporary relief from Chinese competition if there has been a surge of imports that has caused a "market disruption." That is, it is a law intended to ease market transitions, not to identify and punish "unfair" Chinese behavior. Allegations of unfairness or wrong-doing on the part of Chinese exporters do not play a role in determining whether temporary restrictions are imposed. Instead, the domestic industry, fully aware that its request for relief, if granted, would be an imposition on other U.S. businesses and consumers, should express some humility and contrition instead of the sense of victimization and entitlement that has become the hallmark of Washington's anti-trade lobby.

Bilateral tensions related to the rise in antidumping, countervailing duty, and China safeguard cases are the products of U.S. industry availing itself of certain weapons that Congress placed on its doorstep. Rather than begrudge industry for using those weapons, it is more appropriate to remind Congress that it has a responsibility to minimize the collateral damage from the indiscriminate use of those weapons. And there should be no question that U.S. antidumping, countervailing duty, and China-specific safeguard actions are serious contributors to rising bilateral economic tensions, which threaten to cause a great deal of collateral damage to the relationship. That condition—the added tension—does not counsel in favor of a more strident U.S. policy toward China. Yet, there are some in Congress pushing for lowering the evidentiary standards in trade remedies cases and rescinding the president's discretion when it comes to applying the China-specific safeguard. Indeed, movement is afoot in Congress to compel the Commerce Department to apply the countervailing duty law against imports that benefit from the effects of currency manipulation. None of those ideas, if implemented, would help reduce tensions or improve chances that China will cooperate in trying to resolve some of the legitimate sources of friction.

To reduce bilateral tensions and foster greater cooperation from China with respect to market access, intellectual property theft, and other legitimate U.S. concerns, the United States should offer to reform its punitive trade remedies practices toward China. Ending the practice of treating China as a non-market economy in antidumping cases would probably do more to improve bilateral economic relations than just about any other possible reform. That this reform is not under serious consideration is testament to the shortsightedness of policymakers or the absolute stranglehold that advocates of protectionism have over trade policy.

Perhaps the most important economic reform the United States could offer would be termination of China's NME status. China has made no secret of its desire to be designated a market economy. In essence, China's NME status is an asset to U.S. policymakers—but a rapidly depreciating one. In accordance with the terms of its WTO accession, China's economy cannot be treated as an NME after 2016, so U.S. policy will have to change in six years anyway. If U.S. policymakers want anything of value from China in exchange for designating it a market economy, that designation has to come soon. The longer this inevitable reform is delayed, the less valuable it becomes.

Short of graduating China to market economy status, U.S. policymakers could reduce bilateral tensions by addressing another systemic, methodological problem that results in Chinese exporters being penalized twice for the same alleged infraction. Since the Commerce Department resumed applying the countervailing duty law to non-market economies in 2007 (after a 22-year moratorium), it has failed to account for the problem of "double-counting" in cases where imports are subject to both the antidumping and countervailing duty laws. Under NME methodology, a Chinese exporter's U.S. prices are compared to a surrogate value based on costs in a third country, such as India. Any difference between the U.S. price and that surrogate accounts for both the dumping and subsidy margin because the surrogate represents a non-dumped, non-subsidized price. However, U.S. practice has been to treat that difference as reflecting only the margin of dumping, while calculating an additional margin to reflect the subsidy only. Both the dumping margin (which already reflects the amount of the subsidy) and the subsidy margin are applied as duties on Chinese imports, resulting in a double counting of the countervailing duty.

The Hypocrisy of U.S. Allegations

Claims are numerous that China maintains discriminatory policies that impede imports and foreign companies. Indeed, some of those claims have been substantiated and remedied. Others have only been substantiated. And still many more have been merely alleged.

The United States maintains formal and informal channels of communication with the Chinese government through the Strategic and Economic Dialogue, the Joint Commission on Commerce and Trade, and other venues, through which sources of economic and trade friction are discussed and often defused. On eight occasions, the United States decided that bilateral process alone was insufficient, and lodged official complaints with the WTO Dispute Settlement Body about various Chinese practices. Outcomes in two of the cases are still pending, but six of the eight cases produced satisfactory outcomes from the perspective of the U.S. government: either China agreed during consultations to change its rules or practices, or a dispute panel affirmed most of the U.S. complaints and issued opinions requesting that China bring its practices into conformity with the relevant WTO agreements.

It is difficult to find merit in the suggestion that U.S. trade policy toward China should change tack and become more unilateral, when the WTO dispute settlement system has worked well as a venue for resolving U.S. complaints. The United States has brought 19 cases against Europe in the WTO, but there is not

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much talk about adopting a more strident trade policy toward the EU.

The fact is that China has made substantial progress since beginning its reforms to join the WTO. Nevertheless, some trade barriers and subsidy programs still exist or have emerged that, if challenged, likely would be found to violate China's various WTO commitments. And China should be held accountable to its market liberalizing commitments. Still, it is up to the USTR, in conjunction with other stakeholders, to evaluate the evidence and weigh the costs and benefits before deciding whether and when to lodge official WTO complaints.

One of the costs of bringing cases against Chinese market barriers or policies that favor domestic firms would be the exposure of U.S. hypocrisy. The U.S. government subsidizes chosen companies and industries, too. The past 18 months is littered with examples, such as General Motors and Chrysler. The U.S. government maintains opaque technical barriers in a variety of industries, which hampers and precludes access to the U.S. market for foreign food products, in particular. Though the U.S. business community is concerned about the emergence of "Indigenous Innovation" rules favoring companies that develop the intellectual property for new products in China, the United States maintains "Buy American" provisions to govern the U.S. procurement market.

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By and large, though, the Office of the U.S. Trade Representative, in its December 2009 report to Congress about the implementation of China's WTO commitments, strikes the right tone and reassures that the economics of the relationship can and should be shielded from the vicissitudes of politics:

> China has taken many impressive steps over the last eight years to reform its economy, while implementing a set of sweeping WTO accession commitments that required it to reduce tariff rates, to eliminate non-tariff barriers, to provide national treatment and improved market access for goods and services imported from the United States and other WTO members, to protect intellectual property rights, and to improve transparency. Although it still does not appear to be complete in every respect, China's implementation of its WTO commitments has led to increases in U.S. exports to China, while deepening China's integrations into the international trading system and facilitating and strengthening the rule of law and the economic reforms that China began 30 years ago.[30]

Is Intellectual Property Theft a Special Exception?

Intellectual property (IP) theft in China is no doubt an expensive problem for U.S. businesses. The U.S. copyright industries estimate 2008 losses from piracy in China in the music recording and software industries alone to have been \$3.5 billion.[31] The U.S. government has pressed China on this issue for many years, and in 2009 a favorable ruling from a WTO dispute panel affirmed U.S. complaints about the inadequacy of Chinese IP laws and enforcement of those laws. China subsequently agreed to bring the measures at issue into compliance by March 2010.

But intellectual property piracy is likely to continue to be a problem in China—even after legal reforms and ramped-up enforcement techniques are introduced. The problem cannot be solved—only managed. The U.S. government can do its part to ensure that China abides by its obligations under the WTO Agreement on Trade-Related Aspects of Intellectual Property (TRIPS Agreement), but U.S. businesses will have to explore alternatives that dissuade intellectual property theft. Piracy is a cost of doing business, and like other costs, it is incumbent upon firms in affected industries to minimize their business costs. If the legal framework is insufficient for deterring theft, business needs to consider alternatives, such as educating Chinese businesses about the importance of intellectual property protection or building deterrence into contracts.

Imposing U.S. sanctions or some other penalties on China for its failure to significantly curtail intellectual property piracy would burden other U.S. businesses and consumers without introducing incentives to deter piracy that business cannot do itself. We should avoid socializing the enforcement costs when the benefits of IP protection accrue primarily to the IP holder. Bilateral tensions over intellectual property do not constitute grounds for a change in U.S. policy tack.

Geopolitical Context

China is a sovereign nation. It should not be surprising that its government pursues objectives that it believes to be in its own self-interest—even if those pursuits are not in the interests of its own people. (Indeed, U.S. government policies are often incongruous with the interests of the American people.)

However, the Chinese government, like other governments, will not always know what policies are in its best interest. One might expect that, in a globalized world of interdependence, where China's fortunes can change with U.S. policies, the Chinese government would have greater respect for the power of U.S public opinion and the winds of U.S. politics.

But recent Chinese actions and policies have given the U.S. press a lot of ammunition to make the case that China is cause for concern. Evidence of Chinese government complicity in the incidents of hackings into Google's databases has blurred the distinction between the geopolitical and economic realms and reminded Americans that the Chinese government does not embrace the same set of values. China's reported obstructionism at Copenhagen—regardless of truth or merit or purpose—reinforces perceptions of China as a pariah. Outbursts from China's Premier Wen Jiabao over Taiwan, Tibet, and currency manipulation have been described by some analysts as part of an effort to test the new U.S. president. But the danger of testing President Obama is that he is not politically vested in a close relationship, as was his predecessor. Furthermore, his party generally supports tougher economic policies toward China. And finally, President Obama has already distinguished himself as the only president to personally impose trade restrictions against China, as he did last September in the tires case.

Though Chinese officials are probably playing to a domestic audience as well, where it usually pays politically to show toughness against the United States, this seems a pretty bad time to be raising the stakes with the U.S. economy in the doldrums, U.S. confidence on the ropes, and politicians looking for scapegoats.

A common concern expressed about China's rise is that it could frustrate U.S. geopolitical objectives, such as nuclear nonproliferation, spreading democracy, honoring security commitments, isolating rogue governments, and preserving the global economic order and its institutions, to name some. With potential flashpoints such as Taiwan, Tibet, Iran, North Korea, climate change, and the competition for natural resources, these concerns are not trivial.

But none of those concerns changes the fact that Americans engage commercially with Chinese and the Chinese engage commercially with Americans because it is in our mutual interests to engage. U.S. commercial engagement with China is not a favor or some manifestation of U.S. benevolence that can be rescinded without cost should China no longer appear to be deserving. Yet that false notion seems to underlie the calls for a more assertive U.S. policy posture.

An uncharacteristic paranoia or lack of confidence among U.S. opinion leaders seems to be driving the discussion about U.S.-China relations. As put succinctly by Steven Mufson and John Pomfret in a recent *Washington Post* op-ed, "A nation with a per capita income of $6,546—ensconced above Ukraine and below Namibia, according to the International Monetary Fund—is putting the fear of God, or Mao, into our hearts."[32] But for Americans who have been spooked by the tales of China's inexorable rise, the op-ed continues: "The notion that China poses an imminent threat to all aspects of American life reveals more about us than it does about China and its capabilities.

U.S. commercial engagement with China is not a favor or some manifestation of U.S. benevolence that can be rescinded without cost should China no longer appear to be deserving.

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The enthusiasm with which our politicians and pundits manufacture Chinese straw men points more to unease at home than to success inside the Great Wall."[33]

Elizabeth Economy of the Council on Foreign Relations concurs:

> We have completely lost perspective on what constitutes reality in China today. There is a lot that is incredible about China's economic story, but there is as much that is not working well on both the political and economic fronts. We need to understand the nuances of this story—on China's innovation, renewables, economic growth, et cetera—to ensure that all the hype from Beijing, and from our own media and politicians, doesn't lead us to skew our own policy.[34]

Conclusion

The economic frictions in U.S.-China relations are resolvable or manageable within the structure of engagement that already exists. A change in policy toward a more strident tack is likely to provoke reactions that will be costly without achieving resolutions to legitimate issues.

Policymakers should keep in mind that—despite tales of Chinese economic advantages resulting from lower labor and environmental standards—U.S. businesses are far more advantaged by operating in a predictable business climate, where contracts are honored, the rule of law is abided, the workforce is highly skilled, access to capital is unmatched, and business and regulatory processes are largely transparent.

Ongoing frictions in the bilateral relationship are to be expected, as the world's largest economy and its fastest-growing economy make mutual accommodations. But the use of carrots within the successful multilateral and bilateral framework is far better than taking a unilateral tack and reaching for sticks. Policymakers should take a collective breath, distill the substance from the hype, and recognize that issues related to currency, antidumping, intellectual property, and market access can all be resolved or alleviated within the current framework.

As Robert Samuelson once observed: "If we do nothing, China's economic nationalism may weaken the world economy—but if we retaliate by becoming more nationalistic ourselves, we may do the same. Globalization means interdependence; major nations ignore that at their peril."[35]

Notes

1. Robert J. Samuelson, "The Danger Behind China's 'Me First' Worldview," *Washington Post*, February 15, 2010, http://www.washingtonpost.com/wp-dyn/content/article/2010/02/14/AR2010021402892.html.

2. Robert J. Samuelson, "The Real China Threat," *Washington Post*, August 20, 2008, http://www.washingtonpost.com/wp-dyn/content/article/2008/08/19/AR2008081902256.html.

3. Steve Mufson and John Pomfret, "The New Red Scare," *Washington Post*, February 28, 2010.

4. Remarks of Senator Lindsey Graham, "Business Advocacy Day for Jobs, Climate and New Energy Leadership," Washington DC, February 3, 2010.

5. Thomas L. Friedman, "Our One-Party Democracy," *New York Times*, September 8, 2009, http://www.nytimes.com/2009/09/09/opinion/09friedman.html.

6. Bruce Stokes, "Chinese Checkers," *National Journal*, February 20, 2010.

7. U.S. Department of Commerce, Bureau of the Census, Foreign Trade Statistics, http://www.census.gov/foreign-trade/balance/c5700.html#2009. China was the fastest-growing market among America's top 25 largest export markets between 2000 and 2008. In 2009, overall U.S. exports declined 12.9 percent, but exports to China held steady, declining by just 0.23 percent.

8. Office of the United States Trade Representative, "President Obama Discusses China, Trade, and Jobs with Democratic Senators," USTR Press Office Blog, February 3, 2010, http://www.ustr.gov/about-us/press-office/blog/2010/february/president-obama-discusses-china-and-trade-democratic-senato.

9. Production of Apple iPods is the quintessential example of the benefits of transnational production and supply chains. The degree of international col-

laboration embedded in the value of an iPod has been described in a few other Cato publications, including Daniel Ikenson, "Made on Earth: How Global Economic Integration Renders Trade Policy Obsolete," Cato Institute Trade Policy Analysis no. 42, December 2, 2009.

10. James Fallows, "China Makes, the World Takes," *Atlantic*, July/August 2007, http://www.theatlantic.com/doc/200707/shenzhen.

11. It is particularly ironic to hear this last accusation from spendthrift members of Congress who overlook the fact that their own profligacy is what brought China to the U.S. debt markets in the first place.

12. For more comprehensive treatments refuting the myth of manufacturing decline in the United States, see Daniel Ikenson, "Thriving in a Global Economy: The Truth about Manufacturing and Trade," Cato Institute Trade Policy Analysis no. 35, August 28, 2007; Daniel Ikenson and Scott Lincicome, "Audaciously Hopeful: How President Obama Can Help Restore the Pro-Trade Consensus," Cato Institute Trade Policy Analysis no. 39, April 28, 2009, pp. 12–16; and Daniel Griswold, "Trading Up: How Expanding Trade Has Delivered Better Jobs and Higher Living Standards for American Workers," Cato Institute Trade Policy Analysis no. 36, October 25, 2007.

13. United Nations Industrial Development Organization, "National Accounts Main Aggregates Database, Value Added by Economic Activity," (2008 data are the most recent available), http://unstats.un.org/unsd/snaama/resQuery.asp.

14. Yuan Jiang et al., "China's Experience with Productivity and Jobs," Conference Board Report Number R-1352-04-RR, June 2004, http://www.conference-board.org/publications/describe.cfm?id=809.

15. USTR Press Office Blog, February 3, 2010.

16. Lawrence J. Lau et al., *Estimates of U.S.-China Trade Balances in Terms of Domestic Value-Added*, Stanford University working paper no. 295 (October 2006; updated November 2006).

17. Robert Koopman, Zhi Wang, and Shang-jin Wei, "How Much of Chinese Exports Is Really Made in China? Assessing Foreign and Domestic Value-Added in Gross Exports," U.S. International Trade Commission, Office of Economics, working paper no. 2008-03-B, March 2008.

18. For a more comprehensive treatment of this topic, see Daniel Ikenson, "Made on Earth: How Global Economic Integration Renders Trade Policy Obsolete," Cato Institute Trade Policy Analysis no. 42, December 12, 2009.

19. For a recent, comprehensive analysis of the currency issue, see Daniel Ikenson, "Appreciate This: Effect of Chinese Currency Adjustment on Trade Deficit will be Negligible," Cato Institute Free Trade Bulletin no. 41, March 24, 2010.

20. None of the bills became law for a variety of reasons, including: incompatibility of the proposed legislation with U.S. WTO commitments; impracticability of administering the law; lack of congressional support; lack of presidential support; China's decision to allow gradual appreciation beginning in July 2005; and recognition that a weaker dollar would only exacerbate food and fuel price inflation that was underway in 2007 and 2008.

21. Of course there are many other important determinants of the trade account besides relative currency values.

22. Federal Reserve Board, *Federal Reserve Statistical Release G5.A, Foreign Exchange Rates (Annual)*, Release Dates January 4, 2010 and January 2, 2009. Since July 2008, the value of the RMB against the dollar has not changed measurably.

23. Bureau of Economic Analysis, "Foreign Direct Investment in the United States: Selected Items by Detailed Industry of U.S. Affiliate," 2004–2008, http://www.bea.gov/international/xls/LongIndustry.xls.

24. U.S. International Trade Commission, "Antidumping and Countervailing Duty Orders in Place as of November 19, 2009," http://info.usitc.gov/oinv/sunset.nsf/AllDocID/96DAF5A6C0C5290985256A0A004DEE7D?OpenDocument.

25. Statistics on initiations compiled from data on the website of the U.S. International Trade Commission (www.usitc.gov). In 2007, the U.S. Department of Commerce lifted its moratorium on application of the countervailing duty law (anti-subsidy law) to imports from so-called nonmarket economies.

26. For a broader and deeper discussion of the nuts and bolts of U.S. antidumping policy, see Brink Lindsey and Daniel J. Ikenson, "Antidumping 101: The Devilish Details of 'Unfair Trade' Law," Cato Institute Trade Policy Analysis no. 20, November 27, 2002, and Daniel J. Ikenson, "Nonmarket Nonsense: U.S. Antidumping Policy Toward China," Cato Institute Trade Briefing Paper no. 22, March 7, 2005. For a catalog of the Cato Institute's work on anti-dumping policy, please visit: http://www.cato.org/research/subtopic_pub_list.php?topic_id=92&pub_list=1.

27. Exporters from China, Vietnam, and a few former Soviet republics are subject to the NME methodology in U.S. antidumping cases.

28. For a detailed discussion of NME methodology, see Daniel J. Ikenson, "Nonmarket Nonsense: U.S. Antidumping Policy Toward China," Cato Institute Trade Briefing Paper no. 22, March 7, 2005.

29. WTO Antidumping Agreement, Article 9.1, World Trade Organization, http://www.wto.org/english/docs_e/legal_e/19-adp.pdf.

30. United States Trade Representative, *2009 Report to Congress on China's WTO Compliance*, December 2009, p. 4.

31. Ibid., p. 5.

32. Steven Mufson and John Pomfret, "The New Red Scare," *Washington Post*, February 28, 2010.

33. Ibid.

34. Ibid.

35. Robert J. Samuelson, "The Real China Threat," *Washington Post*, August 20, 2008, http://www.washingtonpost.com/wp-dyn/content/article/2008/08/19/AR2008081902256.html.

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