Backgrounder

Published by The Heritage Foundation

No. 2299
July 20, 2009

U.S.–China Trade: Do's and Don'ts for Congress

Derek Scissors, Ph.D.

A new bill on Chinese "currency manipulation" (H.R. 782) has been introduced in Congress. The 2007 version supposedly had enough votes to pass, despite the many gains derived from the U.S.–China economic relationship, if its own sponsors had not quashed it. Will a weaker U.S. economy and continued Chinese recalcitrance push Congress over the top this time?

Even if the latest currency bill does not make it through Congress, a set of other bills could have a similar effect. Congress identifies punitive actions as the principal means to change Chinese behavior. Present actions include simultaneous anti-dumping and countervailing duties and a spate of complaints to the World Trade Organization (WTO), but Members of Congress are seeking far more.[1]

The impact of such measures on the two economies and the bilateral relationship would not be what the sponsors imagine. The measures may or may not undercut China's share of the American marketplace, but will certainly harm the U.S. and perhaps enable the People's Republic of China (PRC) to retaliate with WTO approval.

Bilateral trade and investment brings diverse and considerable gains to both sides. Key problems associated with the relationship actually reside within the two economies, so altering the terms of relationship will accomplish little at perhaps a substantial cost. Sustained growth and competitiveness for both economies depends chiefly on sound domestic policy, not aggressive and distorting Chinese export

Talking Points

- The U.S.–China economic relationship is massive and multifaceted. The very considerable gains derived from the relationship should not be obscured by its acknowledged problems.
- Congress is correct to criticize the PRC as a nonmarket economy, but its proposed remedies are often misguided. The Chinese yuan climbed against the dollar for several years, but the trade deficit still set new records.
- Blocking Chinese imports would merely force production to relocate to other low-cost national producers. It would not bring jobs to the U.S.
- The best U.S. policy to address the economic imbalances with the PRC is to enhance American competitiveness by cutting and simplifying corporate taxes.
- The U.S. should also push the Chinese government to reduce support of its enterprises, especially subsidized financing and protection from competition.

This paper, in its entirety, can be found at:
www.heritage.org/Research/TradeandEconomicFreedom/bg2299.cfm

Produced by the Asian Studies Center

Published by The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002–4999
(202) 546-4400 • heritage.org

promotion or American retaliation. In this light, Congress should reconsider its aims.

A better approach would feature tax and fiscal changes that enhance American corporate competitiveness and national savings. In the Sino–American relationship, the U.S. should use bilateral and multilateral engagement to encourage renewed Chinese economic reform, treating the disease rather than the symptoms. Most important, market competition and prices—not competition and prices subverted by state regulatory and financial intervention—would empower genuinely competitive firms, including U.S. companies, and help to correct imbalances.

Sources of Tension

Not surprisingly, Congress sees a need to legislate on Sino–American economic relations. Enormous benefits come from such large trade and investment flows between two complementary economies, but the size of the relationship and stark economic differences breed multiple problems.[2]

The most obvious problem is the large, persistent trade imbalance ($266 billion in 2008). At the end of 2008, the PRC held $1.95 trillion in official foreign exchange reserves accumulated almost entirely over the 30 years since Deng Xiaoping initiated economic reform.[3] Over the past 20 years, China's trade surplus with the U.S. has totaled $1.86 trillion.[4] Thus, it can be argued that nearly all of China's external financial position rests on its relationship with the U.S.

The trade imbalance is sometimes painted as dollars leaving the U.S. for China and is often vilified as costing the U.S. jobs. Dollars are leaving the country, but goods are entering the U.S. This is a worthy trade, one that American consumers and companies make freely every day.

The loss of jobs is a more difficult issue, but is driven by changes in the domestic American economy, not by the U.S. relationship with the PRC. It is no longer economically sensible for the U.S. to make most clothing, furniture, and toys. The American workforce is too productive to be confined to such low-margin industries. Congressional attempts to shelter these industries will fail and detract attention from superior alternatives.

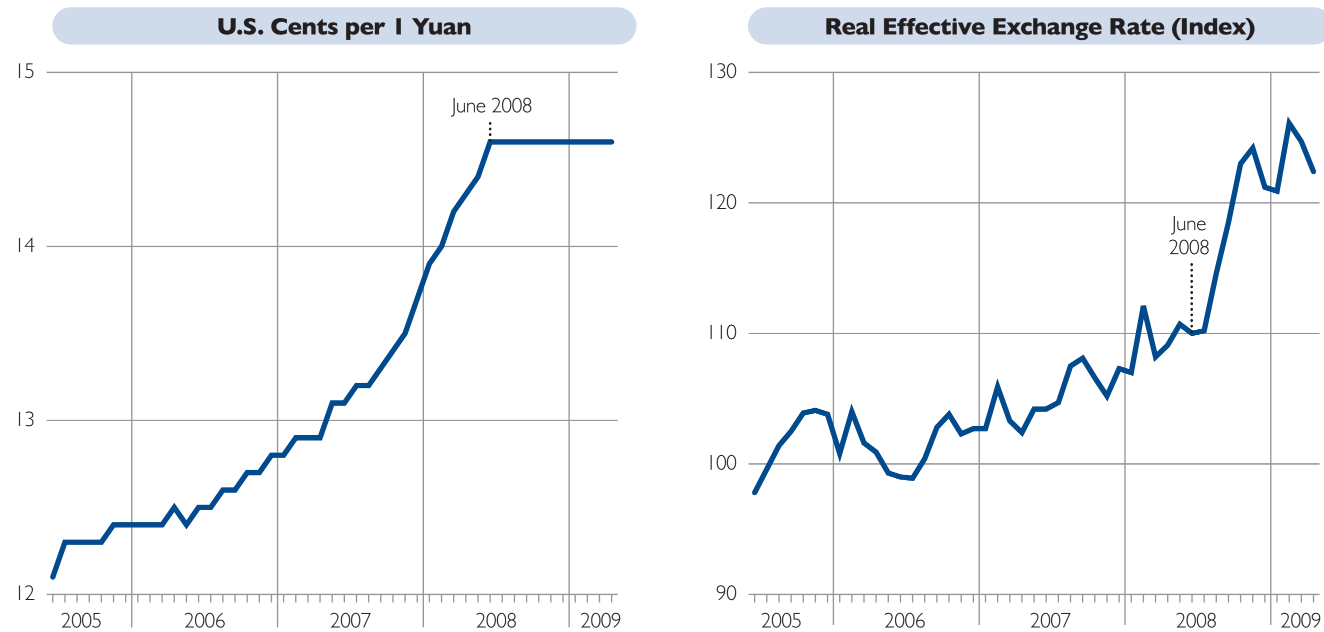
Yet the trade gap is not meaningless. It reflects economic imbalances within the two participating economies, specifically not enough saving in the U.S. and not enough consumption in the PRC. While temporary, large imbalances are not necessarily a cause for concern, the failure of the trade deficit with China to dampen over time suggests an economic distortion. A seemingly obvious culprit is exchange rate intervention, the main target of congressional wrath.

There is some confusion in the discussion of the yuan exchange rate. How the yuan is traded against the dollar can run counter to how it is traded against other currencies. In July 2005, the yuan saw a small across-the-board revaluation. Over the next three years, the yuan appreciated 18 percent against the dollar in nominal terms and 11 percent in real terms against all currencies.[5]

This was widely hailed, not so much because it was sufficient, but because it was viewed as a sign of more progress to come. Regrettably, the ensuing

1. For a list of bills introduced in the 111th Congress through June, see U.S.–China Business Council, "111th Congress, First Session Legislation Related to China," June 26, 2009, at *http://www.uschina.org/public/documents/2009/111th_congress_chinalegislation.pdf* (June 29, 2009).
2. This paper focuses on trade. For Chinese investment, see Derek Scissors, "Chinese Foreign Investment: Insist on Transparency," Heritage Foundation *Backgrounder* No. 2237, February 4, 2009, at *http://www.heritage.org/Research/AsiaandthePacific/bg2237.cfm*.
3. People's Republic of China, National Bureau of Statistics, *China Monthly Statistics*, Vol. 205, No. 1 (2009).
4. U.S. Census Bureau, Foreign Trade Division, Data Dissemination Branch, "Trade with China: 1995," at *http://www.census.gov/foreign-trade/balance/c5700.html#1995* (June 29, 2009).
5. ONADA, FXHistory: Historical Currency Exchange Rates, at *http://www.oanda.com/convert/fxhistory* (June 29, 2009), and Bank for International Settlements, BIS Effective Exchange Rate Indices, at *http://www.bis.org/statistics/eer/broad0905.xls* (June 29, 2009).

Two Exchange Rates for China's Yuan



Sources: ONADA, FXHistory: Historical Currency Exchange Rates, at *http://www.oanda.com/convert/fxhistory* (June 29, 2009), and Bank for International Settlements, BIS Effective Exchange Rate Indices, at *http://www.bis.org/statistics/eer/broad0905.xls* (June 29, 2009).

Chart 1 • B 2299 heritage.org

progress has been unbalanced. Since July 2008, the yuan's real effective exchange rate has climbed another 11 percent, but the yuan has remained stalled against the dollar, rekindling punitive congressional resolutions.

Beyond the exchange rate, the Obama Administration and Congress have introduced climate change as a new bilateral negotiating topic, and it could have critical trade implications. Senior U.S. government officials have emphasized climate cooperation in trips to Beijing, but until now brought with them only lofty rhetoric.[6] A genuine move to cut carbon emissions could generate significant economic tension because the PRC has accounted for two-thirds of the growth in global emissions since 2000.[7] One suggested, misguided solution to an impasse with China over voluntary reductions is carbon tariffs.[8]

Other, more conventional trade matters chiefly concern the quality of the goods involved and Beijing keeping its WTO commitments. China has had repeated product safety problems with exported goods over the past four years, most recently with drywall, but also with dangerous children's toys and lead paint.[9] The very size of Sino–American trade guarantees that there will be some

6. Hillary Rodham Clinton, Todd Stern, and Jack Wen, "Dialogue on U.S.–China Partnership on Clean Energy," at Taiyang Gong Power Plant, Beijing, February 21, 2009, at *http://www.state.gov/secretary/rm/2009a/02/119433.htm* (June 29, 2009), and Reuters, "Pelosi Says Climate Change Could Change U.S.–China Game," May 26, 2009, at *http://www.reuters.com/article/topNews/idUSTRE54P1HK20090526* (June 29, 2009).
7. Steven Mufson, "Power-Sector Emissions of China to Top U.S.," *The Washington Post*, August 27, 2008, p. D1, at *http://www.washingtonpost.com/wp-dyn/content/article/2008/08/26/AR2008082603096.html* (June 29, 2009).
8. Canadian Press, "Proposed U.S. Carbon Tariffs Would Hurt Trade: Prentice," CTV News, May 14, 2009, at *http://www.ctv.ca/servlet/ArticleNews/story/CTVNews/20090513/prentice_tariffs_090513* (June 29, 2009).

quality issues, just as with items made and sold within the U.S.

Almost from the moment of China's WTO accession in late 2001 there have been questions about its adherence to commitments. From the outset, it has inhibited the expansion of foreign banks in various ways, defying the principle of national treatment. Its compliance with WTO decisions, such as the determination in the auto parts dispute, has also been criticized. Finally, the PRC seems to flaunt WTO principles. For example, it has given local competitors the authority to regulate their multinational peers, as occurred in the financial news sector.[10]

The same is true across most major sectors. Centrally controlled enterprises are as much representatives of the state as government ministries, their main stakeholders. They frequently exchange personnel with the corresponding ministry at the behest of the central government and receive regulatory protection from foreign and private competition, heavily subsidized loans from state banks, and free land. The long arm of the Chinese state is behind most of the sore spots in U.S.–China trade—WTO violations, the controlled exchange rate, and even ostensible Chinese stimulus that has induced increases in China's overall trade surplus.

Misguided Congressional Responses

Some Members of Congress want to take dramatic action. Even prior to the economic crisis, some Members wanted to suspend the standard trade privileges granted to the PRC as part of its WTO membership,[11] and others proposed barring essentially all bilateral economic activity, including the issuance of visas to Chinese nationals.[12]

The Exchange Rate. The economic crisis and the persistent U.S. trade deficits have broadened the appeal of punitive measures directed at the PRC. The standard-bearer is legislation retaliating for Beijing's allegedly unfair currency practices. The Fair Currency Act of 2007 (H.R. 782) predated the crisis and has been superseded by the Currency Reform for Fair Trade Act (H.R. 2378) and its Senate equivalent (S. 1027).[13] These bills seek to act on findings of currency manipulation by imposing punitive duties and treating an undervalued currency as an illegal subsidy. Because the U.S. Department of the Treasury has been unwilling to find currency manipulation, they designate the Department of Commerce to make the determination.

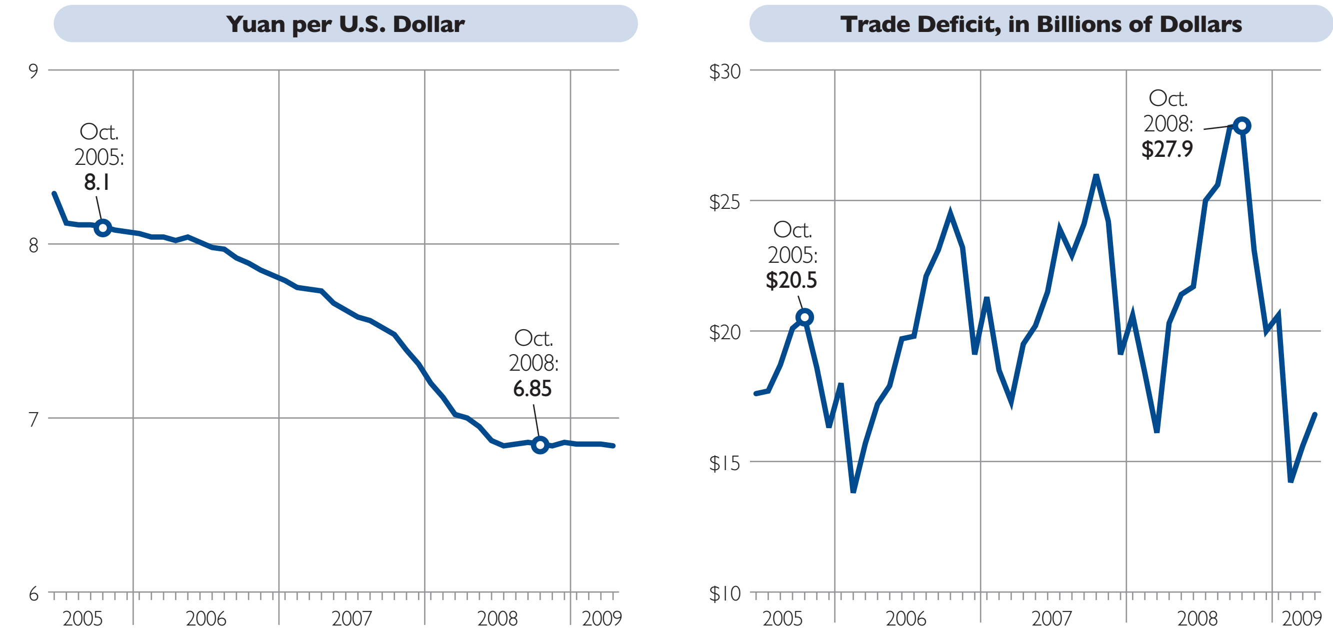
The obvious goal is to force a Chinese revaluation. However, the connection between exchange rates and the trade surplus is not as obvious as it appears, and the legislation will not have the anticipated results.

Prior to China's small revaluation in July 2005 and the three-year window for the yuan to climb against the dollar, it was thought that a 20 percent appreciation would significantly reduce the bilateral trade deficit. The bilateral imbalance for the 12 months before the yuan began to rise was $186 billion. With the yuan 19 percent higher against the dollar, the 12 months in 2007–2008 prior to the financial shock saw an imbalance of $261 billion.[14] The exchange rate matters, but it does not seem to matter that much to the bilateral trade imbalance.

The reason for this odd result is the nonmarket nature of the Chinese economy, which Congress has identified in other legislation. A controlled

9. Reuters, "FACTBOX: Scares and Scandal to Plague 'Made in China' Brand," September 18, 2008, at *http://www.reuters.com/article/topNews/idUST9613820080918* (June 29, 2009).
10. The financial information case involves a core foreign criticism. The PRC appointed Xinhua, a state-run news agency, to oversee Dow Jones, Thomson Reuters, and other financial news services. WTO complaints were made, and Beijing moved formal regulatory authority away from Xinhua. This is a difference without substance. The new regulatory authority will be so tightly enmeshed with Xinhua that distinguishing between the two will be impossible. European Commission, "Chinese Treatment of Foreign Financial Information Providers—EU WTO Request," EUbusiness, March 3, 2008, at *http://www.eubusiness.com/China/financial-information* (June 29, 2009).
11. H.R. 1958, 110th Cong., 1st Sess.
12. China Democracy Act, H.R. 5777, 110th Cong., 1st Sess.
13. Currency Reform for Fair Trade Act of 2009, S. 1027, 111th Cong., 1st Sess.
14. U.S. Census Bureau, U.S. International Trade Statistics, at *http://censtats.census.gov/sitc/sitc.shtml* (June 29, 2009).

The Yuan and the U.S.–China Trade Deficit



Sources: ONADA, FXHistory: Historical Currency Exchange Rates, at *http://www.oanda.com/convert/fxhistory* (June 29, 2009), and U.S. Census Bureau, Foreign Trade Division, Data Dissemination Branch, "Trade with China: 1995," at *http://www.census.gov/foreign-trade/balance/c5700.html#1995* (June 29, 2009).

Chart 2 • B 2299 heritage.org

exchange rate is just one tool at the disposal of the PRC State Council. It has other, more powerful tools that can fairly easily counter the effects of the yuan appreciating against the dollar.[15]

This puts the spotlight on the PRC's inevitable response to any congressional action on exchange rates. If Beijing is compelled to revalue the yuan against the dollar, the most obvious countermeasure is to raise export tax rebates, as it has already done extensively since the economic crisis savaged global demand.[16]

To pursue its objectives, Congress would then need to legislate American retaliation against the tax rebates. This is exactly the kind of protectionist spiral feared by American business and U.S. trade partners. Making matters worse, China's tax rebates to date have been WTO-compliant while at least some proposed congressional retaliation is not. Because many countries manage exchange rates, U.S. trading partners may wonder if they will be the next targets.[17]

China's exchange rate controls also have benefits. During the present economic crisis, most East Asian

15. Of course, this is only true for a limited range of yuan appreciation. At one yuan to the dollar, China would no longer be able compensate. However, at 5.5 yuan to the dollar (another 20 percent appreciation), it is entirely possible that the bilateral imbalance would continue to expand.
16. Chao Xiao, "China Raises Tax Rebates to Shore Up Exports," Xinhuanet, June 8, 2008, at *http://news.xinhuanet.com/english/2009-06/08/content_11509630.htm* (June 29, 2009).
17. For an evaluation of different exchange rate systems, see Golan Benita and Beni Lauterbach, "Policy Factors and Exchange Rate Volatility: Panel Data Versus a Specific Country Analysis," *International Research Journal of Finance and Economics*, Issue 7 (January 2007), pp. 7–23, at *http://www.eurojournals.com/IRJFE%20ISSUE%207%20benita.pdf* (June 29, 2009).

countries permitted their currencies to depreciate sharply against the dollar. As during the Asian financial crisis in the late 1990s, China's obsession with currency stability has helped to prevent a round of competitive devaluations that would have harmed the economies of the U.S. and its allies.[18] Punishing the PRC for its currency interventions is a dangerous path that, in light of the past few years, may have no real benefit.

Safety Concerns. Congress deems other Chinese behaviors as worthy of retaliation. H.R. 2155 would block imports of steel, cement, and drywall that do not meet product quality standards.[19] This is the latest in a series of congressional responses to safety issues involving Chinese goods.[20] Senators have introduced 11 product safety resolutions with China implications in just the first four months of the 111th Congress, and they will certainly introduce more.

To this point, it has been impossible to keep legitimate safety concerns from morphing into protectionism. In the case of H.R. 2155, problems have been recently documented with cement and drywall,[21] but steel was added because of industry demands for protection from competition. This illustrates the dangerous tendency of legitimate safety questions to mutate into simple trade discrimination. Indeed, the PRC has done this consistently over time.[22]

The Nonmarket Chinese Economy. The third class of congressional actions is broader, striking at the basic principles of bilateral trade. For example, the Nonmarket Economy Trade Remedy Act of 2009 (H.R. 499) sees the structure of the Chinese economy itself as distorting trade and seeks to apply general tariffs.[23] The bill includes a number of impositions on the authority of the administrating body, again suggesting that some Members of Congress are unwilling to let the executive branch determine whether the trade relationship is being conducted properly. Among these impositions is a prohibition against treating some firms as genuinely commercial operations if they operate primarily within a nonmarket economy.

Notwithstanding the attention paid to the exchange-rate legislation, H.R. 499 goes to the heart of the bilateral trade relationship and congressional attempts to improve it. It has the important redeeming feature of being on-point, targeting the nonmarket nature of the Chinese economy as a whole, but it does not demonstrate sufficient understanding of that nature.

The U.S. will not benefit from competing with the PRC on which country can interfere the most in the marketplace. Beijing and provincial capitals will almost certainly counter the new tariffs in H.R. 499 by increasing various forms of subsidies. The resolution explicitly punishes those enterprises unable or unwilling to secure subsidies, effectively eliminating the incentive for Chinese firms to operate independently of the government. This leaves only the incentive to overcome the tariffs with nonmarket means. The natural response to that would be for Congress to push for even higher U.S. tariffs, continuing the protectionist cycle. H.R. 499 would move the relationship in exactly the wrong direction.

Core Issues. Despite the complexity of the Sino–American economic relationship, basic trade princi-

18. Patricia Lui, "Asian Central Banks to Seek Competitive Devaluation, RBS Says," Bloomberg, January 19, 2009, at *http://www.bloomberg.com/apps/news?pid=20601083&sid=atqsxuWIi9Q4* (June 29, 2009).
19. Press release, "Stupak Introduces Legislation to Prohibit Import of Sub-Standard Building Materials," Office of Representative Bart Stupak (D–MI), May 20, 2009, at *http://www.house.gov/apps/list/speech/mi01_stupak/morenews/20090520cbp.html* (June 29, 2009).
20. Geoffrey S. Becker, "Food and Agricultural Imports from China," Congressional Research Service *Report for Congress*, updated October 9, 2007, at *http://www.cnie.org/NLE/CRSreports/07Nov/RL34080.pdf* (June 29, 2009).
21. Jason Hanna, "Chinese-Made Drywall Ruining Homes, Owners Say," CNN, March 18, 2009, at *http://www.cnn.com/2009/US/03/18/chinese.drywall/index.html* (June 29, 2009).
22. FoodNavigator.com, "US Optimistic over China Soybean Trade Dispute," October 24, 2001, at *http://www.foodnavigator.com/Financial-Industry/US-optimistic-over-China-soybean-trade-dispute* (June 29, 2009), and China CSR, "China's AQSIQ Claims American Soybeans Contaminated by Pesticides," December 29, 2008, at *http://www.chinacsr.com/en/2008/12/29/4014-chinas-aqsiq-claims-american-soybeans-contaminated-by-pesticides* (June 29, 2009).
23. Nonmarket Economy Trade Remedy Act of 2009, H.R. 499, 111th Cong., 1st Sess.

ples still apply. All import restrictions, even when justifiable under WTO rules or created in response to predatory behavior by foreign firms, ultimately cost consumers. Indeed, the interests of American consumers may already be getting short shift when China is involved.

2009 ITC Trade Findings

1. Barium carbonate to face continued anti-dumping duties
2. Uncovered innerspring units to face anti-dumping duties
3. Small diameter graphite electrodes to face anti-dumping duties
4. Refined brown aluminum oxide to continue to face anti-dumping duties
5. Welded stainless steel pressure pipe to face anti-dumping and countervailing duties
6. Polyvinyl alcohol to face continued anti-dumping duties
7. Malleable cast iron pipe fittings to face continued anti-dumping duties
8. Some steel threaded rod to face anti-dumping duties
9. 1-Hydroxyethylidene-1,1-Diphosphonic Acid (HEDP) to face anti-dumping duties
10. Front-seating service valves, used in cooling units, to face anti-dumping duties
11. Some circular-welded carbon quality steel line pipe to face anti-dumping duties and continued countervailing duties.
12. Citric acid and some citric salts to face anti-dumping and countervailing duties
13. Saccharin to face continued anti-dumping duties
14. Oil country tubular goods, a steel product, to face anti-dumping and countervailing duties[1]

1. U.S. International Trade Commission, "2009 News Releases," Web site, at *http://www.usitc.gov/ext_relations/news_release/2009/NewsReleases_2009.htm* (June 16, 2009).

In just the first five months of 2009, the U.S. International Trade Commission (ITC) made 14 determinations to add or continue duties on Chinese goods. This is more determinations than for all other countries combined. In no instance did the ITC determine that duties should not be applied. These determinations include simultaneous anti-dumping and countervailing duties, which the WTO will likely find illegal.[24] The ITC has even made a preliminary ruling in favor of a labor union that Chinese tires have damaged American producers, even though the tire producing firms disagree and no dumping or subsidies were alleged.

Some of these decisions are inherently unwise. Further action risks putting the U.S. clearly on the wrong side of international trade negotiations, thus undermining American attempts to open markets globally. Nor would imposing "corrective" tariffs have the impact that Congress desires.

China's size and crucial place in the global supply chain extends the usual free-trade debate of lower prices for all versus jobs for some. First, imports from the PRC generally compete on price, so punitive tariffs would take money primarily out of the pockets of poorer consumers. Second, because of their importance, competition with China-based manufacturers is a powerful, positive force in sharpening the global competitiveness of American companies.

Third and most important, protectionism aimed at the PRC will not create jobs in the U.S. If Sino–American trade were forced toward balance, imports from Mexico, Vietnam, and other competing producers would quickly surge. For most goods supplied from China, production in these other countries would still be cheaper than making them in America. Jobs would relocate from China to slightly higher cost areas,[25] and prices for American consumers would rise a bit. Stringent sanctions against the PRC can reduce the bilateral deficit, but will simply displace it to other trade relationships.

24. Office of the U.S. Trade Representative, "United States—Definitive Anti-Dumping and Countervailing Duties on Certain Products from China (DS379)," Web site, updated June 10, 2009, at *http://www.ustr.gov/trade-topics/enforcement/dispute-settlement-proceedings/wto-dispute-settlement/definitive-anti-dump-1*(June 29, 2009).

It follows that shortly after acting against China, Congress will hear calls to act against other U.S. trade partners. Protectionism against one country in a globalized economy accomplishes nothing but harm, not even securing benefits for the chosen few to be protected. Furthermore, protectionism against China would provoke Chinese trade retaliation against U.S. exports.

A Better Path for the U.S.

Should the U.S. do nothing then? In fact, Congress has correctly identified the main flaw on the Chinese side—the nonmarket nature of the PRC economy. Improvement on this front would bring further gains for both partners. However, the proffered congressional remedies would not encourage market-oriented reform in China or make the needed reforms in the U.S. economy. Congress needs to redirect its attention to the home front.

Several bills at least point in a better direction. H.R. 2310 attempts to help small business export to the PRC, which is better than restricting Chinese imports. H.R. 2312 seeks to promote energy and environmental cooperation, especially in developing carbon sequestration technology.[26] Cooperation on carbon sequestration is certainly superior to carbon tariffs or other means of restricting trade in the name of halting climate change.

Congress is also correct to want to improve quality control. The volume of U.S. trade with China increased from less than 1 percent of U.S. GDP in 1998 to nearly 3 percent in 2008.[27] This is akin to the birth of a major new industry. In this light, it is surprising that there have been so few safety incidents, which is most likely because multinationals are heavily involved in China-based production.

However, more incidents are inevitable and could become tragic without a sound quality control regime. Enduring some minor trade friction now due to new regulatory requirements would be better than risking popular outrage later. Just as with a new industry, better product safety in China trade is both politically expedient and necessary to ensure long-term business expansion.

Still, the main event is bilateral economic restructuring. Problems with the relationship are largely generated by flaws within the two domestic economies. At home, Congress needs to improve corporate competitiveness, increase the incentive to save, and improve the quality of the U.S. workforce. A sustained reduction in the overall U.S. trade deficit will require increasing national savings. Congress should formulate tax changes and interest rate policy in part to achieve trade goals by encouraging higher saving.

Along these lines, American companies can compete more effectively with Chinese imports and offer superior goods and services in Chinese markets with just one stroke: reduced and simplified corporate taxes.[28] If the bilateral and aggregate trade deficits are a major priority, this is the obvious and best solution. It would not affect the progressivity of the personal income tax, but it will reduce the trade deficit and create jobs at home without ongoing government intervention.

Helping workers does require government action and can be done without distorting markets. Some labor-intensive industries are no longer viable in the U.S. because American labor is relatively expensive. For the moment, such goods are imported chiefly from China, but other national suppliers are emerging, so targeting the PRC is no solution. Instead, education and training can maxi-

25. One way to cast the Sino–American economic relationship is that Chinese statism hurts workers in countries like Bangladesh while making it easier for the U.S. government to run deficits. The intervention redirects to the PRC production that serves American consumers, and Beijing has left itself no choice but to return accumulated trade surpluses to the U.S. bond market, chiefly Treasuries. See Derek Scissors, "China Is a Banker over a Barrel," Heritage Foundation *Commentary*, March 16, 2009, at *http://www.heritage.org/Press/Commentary/ed031609b.cfm*.

26. United States–China Market Engagement and Export Promotion Act, H.R. 2310, 111th Cong., 1st Sess., and United States–China Energy Cooperation Act, H.R. 2312, 111th Cong., 1st Sess.

27. U.S. Department of Commerce, Bureau of Economic Analysis, "Gross Domestic Product, 1 Decimal," updated, June 25, 2009, at *http://research.stlouisfed.org/fred2/data/GDP.txt* (June 29, 2009).

28. Douglas Holtz-Eakin and Gordon Gray, "Global Competitiveness and the Corporation Income Tax," Heritage Foundation *Backgrounder* No. 2265, April 30, 2009, at *http://www.heritage.org/Research/Taxes/bg2265.cfm*.

mize the number of workers in sectors of long-term U.S. comparative advantage.

In terms of direct trade measures with the PRC, the WTO is indispensable. The U.S. should exhaust WTO options before taking any punitive steps. This includes filing claims under existing WTO rules and, to the extent possible, formalizing WTO principles into clear rules in the current Doha Round. As was done with financial information services, existing WTO rules can be used to constrain Chinese state intervention into the market. Even a modest WTO rule change embodying existing principles on subsidies would strengthen the multiple American cases that could be brought before dispute panels.

If the Administration and Congress eventually agree that unilateral steps are required, they should feature both incentives and punishments. Treating entire Chinese industries as monoliths is usually inaccurate and always self-defeating because treating commercial entities and state tools equally eliminates any incentive to switch to a for-profit orientation. Any unilateral steps should be aimed at the largest Chinese distortions. This would require Congress to change its emphasis.

A Better Path for China

For the PRC, inaction of the past few years[29] leaves a host of reform tasks, some germane to Sino–American trade. The exchange rate fix is simple. China needs to loosen the peg to the dollar in practice, not just in theory, with the longer-term goal of freeing the yuan completely.

Beijing claimed that it loosened the peg in July 2005, but that was obviously and immediately false as the yuan tracked the dollar's movements against the euro. Through most of the present crisis, senior Chinese officials have complained about the dollar.[30] The first step to easing the PRC's dependence is to loosen the yuan's tether. On the American side, simply seeking revaluation would be a mistake. As long as the People's Bank dictates the daily movement of the yuan, gains against the dollar can be summarily halted or reversed, as seen since summer 2008. Congress has correctly identified China's nonmarket economy as the problem, and the market solution is a freer yuan.

The exchange rate is the most easily identified area for liberalization, but not the most important. The biggest distortion in Sino–American trade is availability of various kinds of subsidies for state-controlled Chinese firms. This includes essentially zero-interest loans, free land,[31] controlled prices for other inputs,[32] and regional monopoly profits derived from government regulation.[33] Many Chinese firms offer exceptionally low prices, either on goods shipped to the U.S. or on goods and services sold at home in competition with American imports, yet they remain profitable because their costs are artificially low.

The largest subsidy is from state banks. At present, the cost of capital is high, but that was not the case before the economic crisis. The real cost of borrowing was near zero for those borrowers who actually repay the principal. Earlier, capital had merely been inefficiently cheap. As with the exchange rate, the People's Bank's hold on the interest rate must be loosened. Yet a market interest rate will accomplish little if loans are rolled over when-

29. Derek Scissors "Deng Undone," *Foreign Affairs*, Vol. 88, No. 3 (May/June 2009).

30. Dexter Roberts, "China Talks Tough with Call to Dump Dollar," *BusinessWeek*, March 25, 2009, at *http://www.businessweek.com/globalbiz/content/mar2009/gb20090325_407723.htm* (June 29, 2009).

31. Zhu Keliang and Roy Prosterman, "Securing Land Rights for Chinese Farmers: A Leap Forward for Stability and Growth," Cato Institute, Center for Global Liberty and Prosperity *Development Policy Analysis* No. 3, October 15, 2007, at *http://www.cato.org/pubs/dpa/DPA3.pdf* (June 29, 2009).

32. Shu-Ching Jean Chen, "Price Controls Again in Vogue Among China's Planners," *Forbes*, January 17, 2008, at *http://www.forbes.com/2008/01/17/china-price-update-markets-econ-cx_jc_0117markets08.html* (June 16, 2009), and Rujun Shen and Jim Bai, "Update 2—China Tightens Coal Price Controls, Shortages Stay," Reuters, July 24, 2008, at *http://www.Reuters.com/article/governmentFilingsNews/idUSPEK1598020080724* (June 16, 2009).

33. Tang Zheng, "Chalco Aluminum Monopoly Proves Difficult to Break," *Caijing*, August 20, 2004, at *http://english.caijing.com.cn/2004-08-20/110030204.html* (June 29, 2009).

ever the State Council orders credit to flow. The bulk of China's stimulus has been a surge in lending,[34] even as the economy weakened. Many of these loans cannot be repaid, but bank priorities are political.

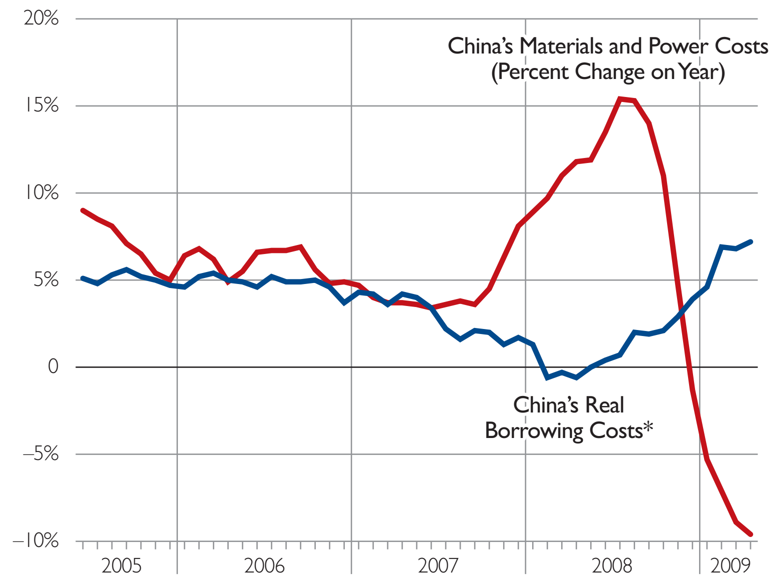
The problem projects well beyond the stimulus. For instance, in the first four months of 2009, large state banks extended to AVIC, the national aviation company, nearly $50 billion in loans,[35] the approximate worth of its assets. AVIC will turn no profit for an indefinite period. Truly commercial banks would not front such money to AVIC, nor would they support other inefficient manufacturers. Such refusals, in turn, would open market share to American goods and services.

Land is heavily subsidized. Local state enterprises systematically acquire land well below market prices, often from state-controlled rural cooperatives. National enterprises are handed large swaths of the land on the basis that the state owns both the enterprises and the land. A genuine market price for land would reduce rural–urban income inequality and undercut domestic firms that are surviving on political connections, creating opportunities for others.

In China, a number of very large national enterprises (for example, electric power, oil and petrochemicals, and telecommunications) are protected by statute from competition. This simultaneously bars American goods and services and puts government-generated rents in the hands of a few blessed domestic entities. Permitting competition with state giants would benefit China as well as American companies.

Behind China's Competitiveness

Until the global crisis drove prices down sharply, real borrowing costs for Chinese firms were very low. This has been a key factor in China's competitiveness.



* One-year loan rate net retail price inflation.

Source: Trading Economics, "China Interest Rate," at *http://www.tradingeconomics.com/Economics/Interest-Rate.aspx?Symbol=CNY* (June 16. 2009), and People's Republic of China, National Bureau of Statistics, *China Monthly Statistics*, Vols. 163–209 (2005–2009).

Chart 3 • B 2299 heritage.org

Sector-specific Chinese government intervention also warps trans-Pacific trade. Non-tariff barriers against American farm goods, such as purchasing quotas, and the remaining 25 percent tariff on cars are well-known examples.[36] Completely opaque Chinese anti-dumping investigations are concentrated in chemicals, another area of American comparative advantage. China also intervenes extensively in steel. The central government is forcing consolidation using financial subsidies. A state-directed merger between Laiwu Steel and Jinan Iron came with a $35 billion credit line to add Rizhao Steel to the merger,

34. Wen Xiu, Fang Huilei, and Wu Ying, "China's Loan Binge: Stimulus or Insanity?" *Caijing*, May 6, 2009, at *http://english.caijing.com.cn/templates/inc/webcontentens.jsp?id=110160775&time=2009-05-06&cl=104* (June 29, 2009).

35. Philip Lagerkranser, "China Banks Surge to World's Biggest May Be Too Good to Be True," Bloomberg, April 29, 2009, at *http://www.bloomberg.com/apps/news?pid=20601109&sid=aueh06DOY37A* (June 29, 2009).

36. Wayne M. Morrison, "China and the World Trade Organization," Congressional Research Service *Report for Congress*, updated April 5, 2001, at *http://www.cnie.org/NLE/CRSreports/economics/econ-42.cfm* (June 29, 2009).

further reducing the number of domestic competitors[37] and making the resulting entity, Shandong Iron & Steel, a more formidable exporter.

These distortions make Chinese exports artificially competitive and, more troubling, block American products. If the exchange rate shifts, subsidization of Chinese firms could be increased to compensate. The true solution is more competition, more commercialization, and less rigid control of domestic prices for capital.

Improving the Economic Relationship

The most important steps to improve the Sino–American economic relationship can be taken individually by the two countries. The U.S. should also consider how best to encourage renewed reform in the PRC.

- Congress should reduce and simplify U.S. corporate taxes. The Treasury Department and Congress should also investigate changing the tax system to encourage saving without making the code more complicated.
- Businesses in areas of U.S. comparative advantage will naturally seek workers. Congress should, therefore, reauthorize the Workforce Investment Act funding job training, but pare the federal bureaucracy to a minimum and replace its role with local business participation in identifying needed skills.
- In WTO disputes, the U.S. Trade Representative (USTR) and other involved departments should emphasize minimizing state intervention rather than narrower concerns. As far as possible, the American position in the Doha Round should include stronger WTO rules limiting state intervention. The USTR should keep Congress apprised of progress in this area and its implications for bilateral economic relations.
- As a preventive measure, more resources should be devoted by the Department of Agriculture, Department of Health and Human Services, Customs and Border Protection, and Consumer Product Safety Commission to ensure the quality of imports from China. This may involve bilateral negotiations to permit more U.S. inspections of PRC production sites.
- Any legislation addressing the impact of nonmarket features of the PRC economy should target state-controlled enterprises instead of entire sectors, to avoid harming firms that already operate on market principles and to encourage other Chinese firms to commercialize.
- To promote growth and to deliver benefits to consumers, the PRC should increase competition, not reduce it. This could be a discussion point in bilateral negotiations.
- To limit waste, China should reduce the scope of government price-setting, especially in the financial sector. As needed, the USTR and Treasury could raise this issue in bilateral talks.
- The People's Bank should widen the yuan's trading band against the dollar, regardless of short-term movement in the exchange rate. Any congressional legislation should focus on a wider band rather than on "manipulation."

Conclusion

The complexity of the Sino–American relationship is plain, especially to Members of Congress confronted with its positive and negative impacts on their constituents. However, congressional solutions tend to seriously underestimate the benefits of the relationship and assume that the costs can be easily rectified. Neither holds true.

Congress has correctly identified the most important part of the affliction—China's nonmarket economy—but is addressing only the symptoms, which will not produce the desired results. The U.S. should first pursue reform in its own economy. The PRC also needs to restructure, and Congress should take care to encourage that process.

—Derek Scissors, Ph.D., is Research Fellow in Asia Economic Policy in the Asian Studies Center at The Heritage Foundation.

37. First Financial Daily, "Shandong Steel Obtains Credit Line of CNY 239.5 Billion from 12 Banks," China Mining Association, April 14, 2009, at *http://www.chinamining.org/Companies/2009-04-14/1239686975d23552.html* (June 29, 2009).