

SUSTAINING CAPITALISM

A series focused on nonpartisan reasoned solutions in the nation's interest to the central challenges we face in order to provide prosperity for all Americans.



The China Trade Challenge: Phase II

The signing of the Phase I US-China trade deal has eased trade tension in the short term but has also set the stage for discussions on the more important economic disputes in the US-China relationship, including the central US concerns on forced technology transfer and cyber theft of intellectual property (IP), industrial policies, state subsidies, and new technology. China's fast paced economic rise and its flouting of globally accepted market rules, combined with the unknown impact of the coronavirus (COVID-19) on the global economy, has put the Phase II negotiations near the top of the critical issues facing the US postelection. Then, tensions over China's alleged role in the creation of the pandemic, combined with the economic stresses the pandemic unleashed on China, knocked even compliance with the Phase I accords off track.

To meet this growing challenge, the US needs to reengage with China through a consistent, comprehensive, and strategic multilateral approach that realistically assesses US economic and security interests and combines firmness and conciliation to achieve a stable and mutually beneficial economic relationship—a constructive, though surely competitive, relationship that mitigates risk and avoids unnecessary conflict.

We are at a unique juncture in US-China relations. The US and the dominant post-WWII market-based economies have to deal and compete with a massive and coordinated non-market-based economic superpower.¹ In the past 50 years, China has advanced from the very first geostrategic opening of its doors to the US in 1972 to interacting with virtually every government and thousands of businesses around the world. Since China launched its economic reforms in 1979, the country's economic growth has been historic both in terms of magnitude and pace. In 1980, China did not even rank in the top 10 of the world's largest economies. By 2010, it had surpassed Japan as the second-largest economy, and by 2015, it had raised over 800 million people out of extreme poverty.

Recommendations

To succeed in the Phase II trade negotiations with China, the US needs a consistent and comprehensive trade policy that draws on all the levers of its power through the following actions:

- Establish a task force to undertake a comprehensive “decoupling assessment” of US-China trade relations to provide clear guideposts for how to further restrict harmful transfers of advanced technology to China through the Export Control Act, which supply chains should be decoupled for national or economic security, and in what areas trade can continue to grow without posing risk.
- Determine how US businesses and interests are restricted in China and gradually move to ensure that China’s interests in the US are similarly restricted until Beijing opens its economy in those spaces. In nonsensitive industries with reciprocal openness, Chinese investment should be welcomed.
- Hold China to WTO global standards, which include opening its borders to foreign direct investment and imported goods and services. This should be the basis for US agreements with China.
- Reexamine antimonopoly rules that prevent industries from standing as one against China’s demands to transfer technology in exchange for market access.
- Reach a common understanding among advanced-economy allies on a technology-security treaty before bilateral talks begin so that China cannot offer preferred terms to one nation or firm.
- Align tariffs with actions of Chinese state-sponsored entities that put US firms and US workers at a disadvantage.
- Unite the world trading community to repair, update, and upgrade the WTO treaty and related systems, especially enforcement procedures, including clearly defined penalties.
- Insist on “snap-back” provisions should China again fail to live up to its commitments.
- Treat IP theft and forced technology transfers as crossing “red lines” that result in severe economic penalties. All free-market nations should recognize that China would not have the leverage to demand surrender of IP as a condition of market access if China allowed direct foreign investment according to world rules, and negotiate accordingly.
- Involve European, Japanese, Korean, and Australian representatives in urging China to reform its approach to cross-border trade and investment.
- Immediately begin negotiating our re-entrance into the Comprehensive and Progressive Agreement for Trans-Pacific Partnership, or CPTPP. Expand efforts toward economic integration and support in the Indo-Pacific region.

For details, see *The Solution: Policy Recommendations*, page 8.

China became and remains a formidable geostrategic force, with a military rapidly and steadily increasing in capability and global reach. And China has often stretched international norms and rules to seek its own advantage. Consequently, addressing the China challenge in the second phase of the trade negotiations will demand the coordinated use of all of the levers of US power to ensure the continuation of a rules-based economic order.

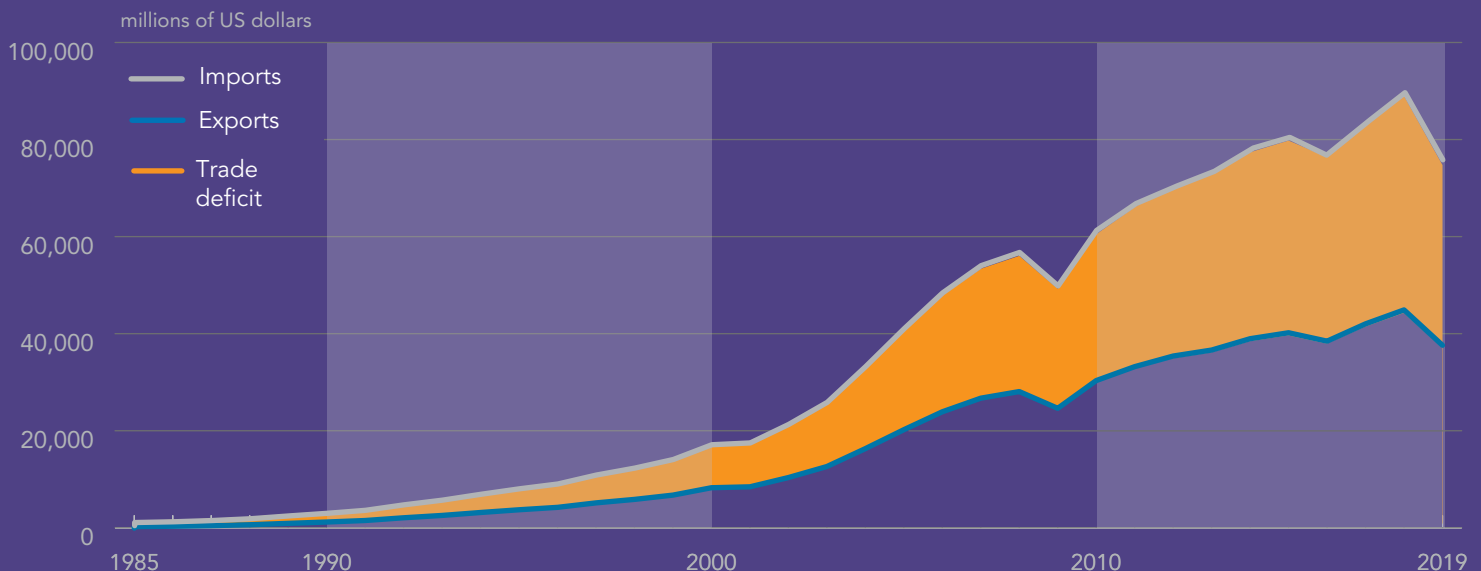
THE ISSUES

China's meteoric rise as an economic power has made China a major economic partner of the US. China is the US's largest merchandise trading partner, its biggest source of imports, and its third-largest export market. China is also the largest foreign holder of US Treasury securities; their purchases help fund the federal debt and keep US interest rates low. But as China's economy grew and its global economic influence expanded, China also made clear that its market reforms would be limited and that it would leverage state control of its economy to become a dominant global player in many sectors, including advanced technologies. Its form of capitalism would include mercantilist policies disadvantageous to the US.

In 2017, the Trump Administration launched a Section 301 investigation of China's innovation and IP policies deemed harmful to US economic interests, which was the first step in its efforts to recalibrate the US-China economic relationship. It subsequently raised tariffs by 25 percent on \$250 billion worth of imports from China, while China increased tariffs (ranging from 5 percent to 25 percent) on \$110 billion worth of imports from the US.

Figure 1

US trade with China has grown dramatically since the 2000s



Source: US Census Bureau

The trade dispute continued to escalate as the trade relationship became more hostile. The accumulated measures sharply decreased bilateral trade in 2019 and disrupted global supply chains. US exports to China dropped by nearly \$30 billion, while imports from China fell by over \$70 billion, for a decline of over \$100 billion in total trade.²

In January 2020, the US and China signed an initial Phase I trade deal which reduced some US tariffs on Chinese goods in exchange for Chinese pledges to purchase \$200 billion of American farm, energy, and manufactured goods. The Chinese also pledged to avoid currency manipulation, crack down on IP theft and forced technology transfers, and establish an enforcement system to ensure implementation. In the wake of the conflict over the COVID-19 pandemic, the implementation of the Phase I agreement is left in doubt.

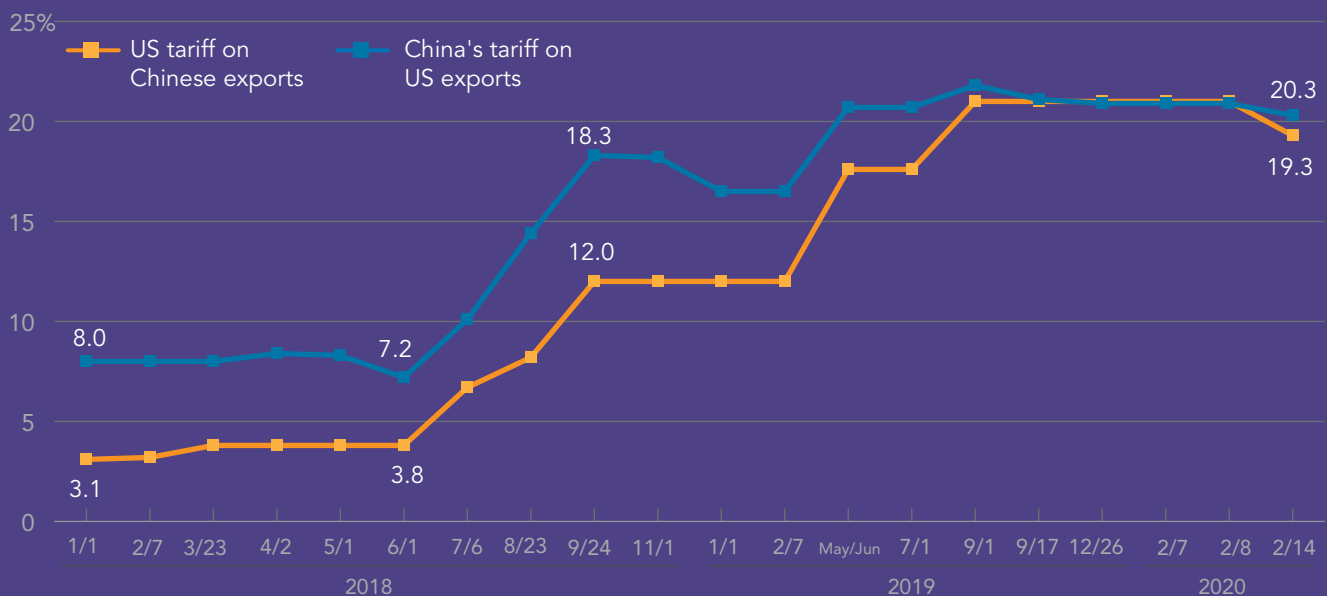
But even assuming full implementation of the Phase I trade deal, that agreement left unaddressed the following issues that the US seeks to resolve in the expected Phase II talks:

State capitalism As China grew and emerged to assume a global role in the 1990s, some public and private US actors, as well as global players, clearly presumed that China would become more democratic, more market-oriented, and more commercially open.

But China's development has taken a different course. Its state capitalist system controls all critical sectors of the economy. It owns many large firms and decides which businesses will receive subsidies, favorable loans, and protections in the marketplace—in contrast to market economies, where open competition generally determines economic outcomes.

Figure 2

Higher US and China tariffs persist despite the Phase I deal



Source: Peterson Institute for International Economics (PIIE)

China's economic success has strengthened its confidence in its system as a model, particularly after the global financial crisis. And since 2012, with the transition of power from the Deng years, China has increased its internal control and repression; rejected some of the most important political reforms, including term limits for its head of state; and openly unveiled an ambitious strategy to become the leading global power by 2050.

When China entered the global commercial community with its accession to the World Trade Organization (WTO) in 2001, it was already one of the world's largest economies, a unique occurrence for a "newborn" trading nation. In 2000, China ranked sixth among nations in gross domestic product (GDP), just ahead of Italy. Today, China's GDP either approaches or already exceeds that of the US, depending upon the method chosen to adjust for the two nations' different currencies.³ China is already the world's largest exporter, selling about twice the dollar value of goods as the US. It is the second-largest importer, buying about three-fourths of the dollar value of US imports.⁴ It ranks in the world's top-two countries for both undertaking and receiving foreign direct investment and is the second-biggest spender on research and development at some \$300 billion last year.

China has a large and growing private sector, rooted in its entrepreneurial culture and stimulated by economic reforms in 1978. That economic strength allowed it to avoid fallout from the collapse of communism in Europe. China's private sector, surprisingly to some, produces most of its gross domestic product (GDP)—70 percent by some estimates. Nevertheless, some large private companies, and in particular the giant Chinese tech companies, have very close ties with Beijing, often appearing to their overseas rivals as virtual arms of the state.⁵

China's old-line, state-owned enterprises (SOEs) produce less but provide more domestic jobs than the private firms because of their inefficiency. The SOEs rely on a broad range of government support, including public subsidies and loans from state-owned banks, to compete with often more efficient private businesses around the world. China's central government controls more than 50,000 SOEs employing more than 20 million people.⁶

China places a high priority on maintaining state control of critical sectors of the economy (such as petroleum and mining, telecommunications, utilities, transportation, and various industrial fields) through its SOEs, which are subsidized and shielded from competition in violation of WTO rules.⁷ China violates a wide range of other WTO rules and broader norms, including determining which foreign sellers and investors are allowed entry into its domestic markets and perpetrating extortion and outright theft of foreign businesses' advanced technology.⁸ Under the current ruling group of President and Chinese Communist Party Secretary Xi Jinping, economic market reforms have slowed, and the Party is leveraging the country's economic strength to promote an authoritarian, state-capitalist economic model at home and abroad, driven by strict government planning and market management.

Technology extortion and theft In explicit violation of WTO regulations, China has engaged in ongoing violations of copyrights and patents (often referred to collectively as IP), sometimes extorting IP in exchange for access to markets, and sometimes obtaining IP through cyber misdeeds that likely are, in many instances, state-sponsored cyber thefts. Curbing this behavior has been a long-standing US goal, and progress was recently achieved in the US China Phase I Trade Deal. The deal makes it easier to identify and punish IP theft and counterfeiting. But enforcing these agreements and extending the provisions will be an important part of continuing negotiations with China.

Noncompliance with WTO rules According to the United States Trade Representative (USTR), the US has brought 23 WTO challenges against China, covering a wide range of important policies and practices: 1) local content requirements in the automobile sector; 2) discriminatory taxes in the integrated circuit sector; 3) hundreds of prohibited subsidies in a wide range of manufacturing sectors; 4) inadequate intellectual property rights (IPR) enforcement in the copyright area; 5) significant market access barriers in copyright-intensive industries; 6) severe restrictions on foreign suppliers of financial information services; 7) export restraints on numerous raw materials; 8) a denial of market access for foreign suppliers of electronic payment services; 9) repeated abusive use of unjustified trade “remedies;” 10) excessive domestic support for key agricultural commodities; 11) opaque and protectionist administration of tariff-rate quotas for key agricultural commodities; and 12) discriminatory regulations on technology licensing. While the US has routinely prevailed in these WTO disputes, they take years to litigate, consume significant resources, and often require further efforts when China resists complying with panel or appellate body rulings.⁹

Global influence As China’s GDP grows, so do its sales to and purchases from its neighbors and nations around the world. Potentially, the more dependent other countries become on either selling to or buying from China, the greater the dilemma for those countries when confronted with the choice between supporting China or the US geopolitically.¹⁰

Figure 3

China increases global influence through its Belt and Road Initiative



Source: World Bank

China's "Belt and Road Initiative" (BRI), an ambitious infrastructure project launched by President Xi in 2013, is potentially one of the geopolitical game-changers of the 21st Century. But infrastructure is only one of BRI's five components which also include strengthened regional political cooperation, unimpeded trade, financial integration, and people-to-people exchanges.¹¹

BRI is one of the main pillars of China's bold and assertive strategy. While there has been pushback against the Chinese by various participating or potentially participating nations, over 60 countries accounting for over two-thirds of the world population have signed on or indicated interest.¹² The project has been estimated to cost over \$1 trillion dollars by 2027, which is more than 10 times the size of the Marshall Plan.

Technological dominance China is willing to make massive inefficient investments, even for very low returns, to dominate a market and win the technology competition. For example, China is attempting to establish the global standard for 5G communications, which will enable its companies to start out ahead in building the infrastructure hardware necessary for first-mover implementation and domination of future generations of hardware and software.¹³ Technology dominance also has important national security implications for China, potentially allowing them hidden access to data and information otherwise not available to them. To this end, China has not only financed enormous R&D (Huawei reportedly outspent Apple, falling short only of Amazon among individual enterprises¹⁴), which may prove to have been premature and unproductive, but also provided substantial credit subsidies to prospective customers to get its "foot in the door." This is the kind of advantage that was contemplated in the controversial "Made in China 2025" initiative, which many in the US and around the world saw as a bold statement of China's intention to dominate every key field of technology development. Despite these efforts, China still relies heavily on American companies to provide cutting edge technical infrastructure for both hardware and software. Huawei and ZTE, despite being globally competitive megaconglomerates, were on the verge of collapse when disconnected from their US suppliers.¹⁵

National security threat China's strategy has gone beyond economic competition to areas that challenge stability and security—witness their building out of their navy, increased aggressiveness in dealing with Southeast Asia territorial rights, and engaging in war-game operations with Russia. China has manufactured islands in the South China Sea, encroaching on the sovereign territories of regional claimants.¹⁶ With respect to actual military activity, China's intentions in either the short or especially the long term are, of course, matters of speculation. However, according to at least some scholarly opinion, China is consolidating its position in its own region while apparently biding its time as its capability grows to match its larger ambitions.¹⁷ According to this perspective, China recognizes that its current strength does not allow it to compete with the US as a globally present superpower. Its immediate ambition, therefore, is to leverage its "soft power" to create a broader presence and look toward future opportunities as its military might grows.¹⁸

THE SOLUTION: POLICY RECOMMENDATIONS

The challenge today, in a global economy and a US-China relationship deeply impacted by the COVID-19 pandemic, is for US policymakers to maintain the benefits of free and fair market competition, uphold the values that have stood the free-world community in good stead since World War II, and convince China that it has a stake in this system that propelled their advancement and growth.

The Phase II negotiations, when they begin, will encompass critical challenges to both US national security and economic policies. To prepare for and succeed in these negotiations, the US needs a consistent and comprehensive trade policy toward China that draws on all of the levers of its power.

- The US should establish a high-level task force to undertake a comprehensive “decoupling assessment” of US-China trade relations and dependencies to 1) clearly delineate for domestic regulators how to further strengthen the Export Control Act to restrict transfer of advanced technology to China, which ultimately harms US prosperity and national security; 2) determine which supply chains need to be decoupled for national or economic security reasons; and 3) identify the areas of commerce where trade can continue to grow without posing risk. Such an effort will provide clearer guideposts for US trade and economic policy and a more predictable playing field for business.
- Prior to launching the Phase II negotiations, the US should reach a common understanding among allies with advanced economies on a technology-security treaty. Discussions are underway but require a common set of principles between the US and its allies before bilateral talks with the Chinese begin. The common set of principles should include technologies which all firms and nations will refuse to share with China, so that China cannot offer preferred trade and investment terms to one nation or firm to obtain technology that threatens the security of all.
- Policymakers should reexamine antimonopoly rules that prevent industries from standing as one against Chinese government pressure. Resisting demands to transfer technology in exchange for market access would be easier if US companies were allowed to agree with one another that no one would take such a deal.
- A careful survey should determine where and how US businesses and interests are restricted in China, with gradual moves to ensure that China’s interests in the US are similarly restricted until Beijing opens its economy in those spaces. Conversely, in nonsensitive industries with reciprocal openness, Chinese investment should be welcomed.
- China should be held to global standards set forth in the WTO rules which include opening its borders to foreign direct investment and imported goods and services. This should be the basis for US agreements with China and should mirror the terms and conditions in global multilateral organizations, including the WTO.

- The White House and Congress should unite the world trading community to repair, update, and upgrade the WTO treaty and all its related systems, especially enforcement procedures. Clearly defined penalties (e.g., restriction of access, fines, and the like) with proscriptive timetables, benchmarks, and oversight processes will improve effectiveness.
- The US should treat IP theft and forced technology transfers as crossing “red lines” that will result in severe and immediate economic penalties. All free-market nations should recognize that China would not have the leverage to demand surrender of IP as a condition of market access if China allowed direct foreign investment according to world rules and norms, and negotiate accordingly.
- US negotiators should involve European, Japanese, Korean, and Australian representatives in urging China to reform its approach to cross border trade and investment.
- To counter China’s expansion of its economic and political influence through the BRI and strengthen the US effort to ensure China’s adherence to global rules in trade and commerce, the US Trade Representative should immediately begin negotiating our re-entrance into the TPP-11 (now called the Comprehensive and Progressive Agreement for Trans-Pacific Partnership, or CPTPP). To further these objectives and counter BRI, the US and its regional and global allies should also expand and strengthen their efforts toward economic integration and support in the Indo-Pacific region.
- Where tariffs are used, the US should align them specifically with areas where Chinese state-sponsored entities are putting US firms and US workers at a disadvantage.
- The US should also insist on “snap-back” provisions should China again fail to live up to its commitments.

Endnotes

- 1 While the prior Soviet Bloc was formidable, it never developed nor did it maintain the economic strength, the necessary organizational effectiveness, or the geostrategic acumen of China today. As indicated by its ultimate collapse, the Soviet Union's best moments were not maintained long enough to achieve the prominence of China's current place in the world, despite episodes of effective leadership. (Stalin was arguably internally and organizationally effective, and Soviet leadership was geopolitically effective at times for most of the Cold War until Afghanistan and the impact of aging leadership and a failing economy.)
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- 17 Oriana Skylar Mastro, "[The Stealth Superpower: How China Hid Its Global Ambitions](#)," *Foreign Affairs*, January-February 2019.
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SUSTAINING CAPITALISM

Achieving prosperity for all Americans could not be more urgent. Although the United States remains the most prosperous nation on earth, millions of our citizens are losing faith in the American dream of upward mobility, and in American-style capitalism itself. This crisis of confidence has widened the divide afflicting American politics and cries out for reasoned solutions in the nation's interest to provide prosperity for all Americans and make capitalism sustainable for generations to come. In 1942, the founders of the Committee for Economic Development (CED), our nation's leading CEOs, took on the immense challenge of creating a rules-based post-war economic order. Their leadership and selfless efforts helped give the United States and the world the Marshall Plan, the Bretton Woods Agreement, and the Employment Act of 1946. The challenges to our economic principles and democratic institutions now are equally important. So, in the spirit of its founding, CED, the public policy center of The Conference Board, will release a series of 2020 Solutions Briefs. These briefs will address today's critical issues, including health care, the future of work, education, technology and innovation, regulation, China and trade, infrastructure, inequality, and taxation.



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