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Is China Cheating?

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All systems either of preference or of restraint . . . being thus completely taken away, the obvious and simple system of natural liberty establishes itself of its own accord.

—Adam Smith (1776)

The more taboos and prohibitions there are in the world, the poorer the people will be. . . . Therefore the sage says: I take no action and the people of themselves are transformed. . . . I engage in no activity and the people of themselves become prosperous.

—Lao Tzu (6th century B.C.)

Asking the Right Question: Unilateral Free Trade or “Fair” Trade?

The question of whether China is cheating on its international trade commitments diverts attention from a more important issue: the complexity that surrounds the negotiations approach to trade liberalization. Trade agreements have generated a vast web of rules, regulations, and remedies that require a host of experts to interpret and an army of statisticians. There is a planning mentality that is at odds with a true liberal international economic order.

In contrast to the data-driven negotiations approach, with its emphasis on “unfair trade practices,” the unilateral approach to free trade rests only on the notion that voluntary exchange leads to mutual gains. The end of trade is to satisfy consumers’ preferences and to create wealth, not to protect jobs or to redistribute income to favored producers. Spontaneous coordination through market activity is the hallmark of a liberal international economic order resting on private property rights and freedom of contract.

Hong Kong has followed the principle of unilateral free trade and has prospered, as did England under Pax Britannia from 1850 to World War I. If the United States as the leader of the free world unilaterally adopted free trade, there would be a tsunami of economic liberalism around the globe. But that is unlikely to happen. Instead, we are faced with the prospect of creeping protectionism and a flurry of bilateral trade agreements, some of which may lead to net trade diversion.

The many exceptions to the implementation of the two guiding principles of the current global trading system—nondiscrimination and most favored nation—lead to inconsistency and injustice. The key developed countries that set the rules of the game often tilt those rules toward themselves to protect special interests. Trade is too often seen as a zero sum game with the prize being a trade surplus. That mercantilist attitude accounts for a large amount of the China bashing that is going on in Washington today.

The presumption is that China must be “cheating”—and doing so at the expense of U.S. jobs. After all, China is running a large bilateral trade surplus with the United States. Congressional committees hear that the yuan is undervalued and that there is widespread use of subsidies, cheap loans, tax relief, and other preferential treatment for Chinese firms, which allow them an unfair advantage against their U.S. rivals. The U.S. must retaliate with protectionist measures to “level the playing field” and correct the trade imbalance. Sen. Byron Dorgan, a Democrat from North Dakota, has even introduced a bill to end normal trading relations with China.

Yet all the hyperbole diverts attention from the significant progress China has made in its transition from plan to market, and the increase in economic and personal freedom the

Chinese people have acquired in the process. If China chooses to favor foreign invested enterprises (FIEs), which account for most of China's trade,

U.S. consumers surely benefit from the lower prices of imports. No one is forced to trade with China. As Bo Xilai, the minister of commerce, noted in responding to U.S. protectionist threats, "If they [American businesses] could not make money doing business with China, they would not have been doing it" (Xu 2007: 1).

The U.S. policy of engagement has worked relatively well, as has China's policy of "peaceful development." It would be a huge mistake to be overly zealous in penalizing China for departures from some ideal free-trade regime or to hold China to a higher standard than other developing countries in enforcing trade agreements. But that is exactly what the WTO-plus rules do.

It will take time for China to meet all its World Trade Organization obligations. Much progress has been made on market access and rules-based issues, but much remains to be done on enforcing intellectual property rights. To cheat requires intentionally breaking agreements one has made in good faith. China has never agreed to float its currency, but is moving in that direction. Yet Sen. Charles Schumer, a Democrat from New York, and Sen. Lindsey Graham, a Republican from South Carolina, have repeatedly threatened to impose punitive tariffs on Chinese imports unless the yuan (also known as the renminbi, RMB) is allowed to appreciate significantly against the dollar.

Likewise, even though Secretary of the Treasury Henry M. Paulson has initiated a Strategic Economic Dialogue to look at long-run issues and to promote engagement, he feels that he needs to instruct China on what is in its own best interests, with an implicit threat of retaliation if Beijing moves too slowly. In his recent testimony before the Committee on Banking, Housing, and Urban Affairs, Secretary Paulson (2007: 3) stated:

China *must* live up to its WTO commitments. It *must* protect and vigorously enforce intellectual property rights. It *must* increasingly open its markets to foreign competition—for its own good as well as for ours. And it *must* introduce greater transparency in regulation and observe the rule of law.

Although this approach is not equivalent to the gunboat diplomacy that the British used to force China to open its port cities in the Treaty of Nanjing in 1841, the injustices of the Opium War and Western bullying no doubt still cast a long shadow over China's view of the West, especially when the question "Is China cheating?" arises. The use of the "most-favored nation" clause in that treaty dictated that any concession China "granted" to other Western nations must also be given to Britain, regardless of how that privilege was obtained.¹

Policy decisions are always path dependent. The failure of central planning led Deng Xiaoping to embark on economic reform and liberalization. Even before China joined the WTO in December 2001, Beijing unilaterally reduced tariff and nontariff barriers (see Lardy 2002: chap. 2). China is now the world's third largest trading nation, but the legacies of central planning and a one party state constrain the transition process. Treating China as a normal rising power, not as an inevitable threat, and avoiding destructive protectionism will help bring about social and economic harmony.

In addressing the question "Is China cheating," one should recognize the pitfalls of the negotiations approach to trade liberalization compared to the benefits of unilateral free trade.

¹ For a discussion of the Nanjing Treaty, see Ebrey (1999: 239–40).

One should also question whether the rules themselves are fair to developing countries. This article examines those issues and offers some policy conclusions.

Pitfalls of the Negotiations Approach

The establishment of the General Agreement on Tariffs and Trade (GATT) after World War II and its successor, the WTO, in 1995 have led to an overall lowering of trade barriers. Likewise, Free Trade Agreements, such as the North American Free Trade Agreement, have often had positive effects, though bilateral trade agreements may divert trade from more efficient to less efficient producers. Regional organizations such as the Asia-Pacific Economic Cooperation (APEC) forum can also lead to more market-oriented development policies.

Nevertheless, the lack of progress on the Doha Round of negotiations points to the complexity of the current negotiations approach to trade liberalization and to the fact that entrenched interests in the developed countries often use the pretense of “fair trade” to extract concessions from developing countries that impede freer trade, especially in agriculture. Indeed, as Deepak Lal (2006: 40–41) has pointed out, the central principle of reciprocity that underlies the WTO is a radical departure from the unilateral free-trade principle that was a pillar of 20th century liberalism.

From a market-liberal viewpoint, “the principle objective and criterion of economic development” is to extend “the range of choice”—that is, to expand “the range of effective alternatives open to people” (Bauer 1957: 113). Trade is one of the most important ways to expand people’s choices. Imposing tariffs or quotas on China for deviations from some ideal model of perfect competition in order to protect U.S. producers harms U.S. consumers by reducing “the range of choice.”

The negotiations approach to free trade empowers third parties who are harmed by the voluntary exchanges of the trading parties and politicizes trade relations. Consumer sovereignty and economic freedom give way to “rent seeking” (competition for government favors) and protectionism.

U.S. textile and apparel producers demand “safeguards” to protect against a surge of cheap Chinese imports—even if China has a comparative cost advantage. U.S. senators threaten to impose a prohibitive tariff on all Chinese imports unless China appreciates its undervalued currency. China is labeled a “non-market economy” (NME)—even though most prices are now market determined. Trade “experts” decide how to calculate antidumping duties that correct for “unfair trade practices,” and so on. The problem with such a planned approach to trade liberalization, based on deviations from the competitive ideal, is that such actions tend to impede, rather than expand, globalization and exchange.

The zero-sum mentality that underlies the negotiations approach to freer trade endangers the very liberalism that approach is intended to promote. Political considerations tend to outweigh economic logic, and short-run expediency often triumphs. Economic logic, for example, tells us that foreign subsidies and other policies that artificially reduce costs benefit U.S. consumers, while imposing a tariff on such imports harm them. Yet the political class will focus primarily on the losses that a few U.S. producers suffer as a result of the cheap imports. The result is that the negotiations approach “instead of limiting the scope of politics, as a free market is supposed to do, broadens it” (Yeager and Tuerck 1966: 282).²

² Yeager and Tuerck (1966) present a detailed analysis of the case for unilateral free trade as opposed to the piecemeal approach to freer trade under “reciprocity.” More recent works that make the case for an international liberal economic order and expose the pitfalls of the negotiations approach to freer trade are Lal (2006), Sally (1998), and Irwin (1996, 2002).

Sir John Cowperthwaite, Hong Kong's financial secretary in the 1960s, adopted the unilateral free-trade principle to turn Hong Kong into a dynamic open economy that now has a higher standard of living than Britain and is the world's freest economy. Cowperthwaite welcomed cheap goods from abroad, regardless of the reason for their cheapness. He did not fall into the mercantilist mentality and was not concerned about the balance of trade. Indeed, he thought it was dangerous for developing countries to rely too much on meaningless trade statistics and recommended abolishing the "Office of National Statistics" (Singleton 2006: v).

In addition to adhering to open markets, Hong Kong has been consistent in limiting government power, protecting property rights, and embracing the rule of law. Those liberal virtues reflect Hong Kong's "Big Market, Small Government" vision, a vision that is slowly spreading to China. In a recent poll covering 20 countries, GlobeScan (2005) found that China had the highest proportion of respondents (74 percent) agree that the "free market economy is the best system on which to base the future of the world."

That outcome is remarkable given that only a short time ago Beijing touted central planning as the key to China's future. In a separate poll, the Chicago Council on Global Affairs (2006) found that 87 percent of those surveyed in China thought "globalization, especially the increasing connections of their country's economy with others around the world, is mostly good for their country." That result compares with 60 percent in the United States and 54 percent in India.

The passage of the new Property Law on March 16, 2007 by the National People's Congress (NPC) is another positive step in China's transition from plan to market. As Premier Wen Jiabao said in his December 10, 2003 speech at Harvard, that transition has led to the "gradual lifting of the former improper restrictions, visible and invisible, on people's freedom in choice of occupation, mobility, enterprise, investment, information, travel . . . and lifestyles" (Wen 2003).

By giving greater security to private property rights, the law gives substance to Article 13 of the PRC Constitution, which the NPC amended in 2004 to proclaim: "The lawful private property of citizens is inviolable." More important, by making property rights more transparent, the law will widen the scope for market exchange, thereby increasing freedom and prosperity.

While some of China's progress is due to WTO accession, significant trade liberalization occurred *before* December 2001. In 1978 only 12 large state-owned enterprises had the right to engage in foreign trade. By 2001 there were more than 150,000 foreign-invested enterprises with trading rights along with 35,000 domestic firms, including more than 1,000 private firms. Today virtually any firm is free to enter the import-export business. The average level of tariffs fell from 56 percent in 1982 to 15 percent in 2001. Even more impressive, tariff revenue as a percentage of the value of imports fell from 13 percent in 1982 to 4 percent in 2000. Progress was also made in lowering the range of quotas and licensing. In 1996 the yuan was made convertible for current-account transactions. Those and other liberalization measures made China one of the most open of the emerging market economies prior to joining the WTO.³

China's goal of joining the WTO no doubt helped promote unilateral trade liberalization. But such liberalization was also in China's interest. By 2001 China's state-dominated trade sector had been significantly marketized, but there was still much to do. The concessions China made to finally enter the WTO in December 2001 have led to an explosion of trade,

³ These and other data on the degree of China's openness prior to WTO accession can be found in Lardy (2002: chap. 2; 2003).

but the growing trade surplus with the United States has led to a wave of anti-China sentiment and calls for protectionism.

Creeping Protectionism

The expanding U.S. trade deficit with China, which reached \$233 billion in 2006, is causing increased tension in U.S.-Sino relations. China's rapid rise as a trading nation and its role as a world manufacturing platform have led to a dangerous coalition between hawks on Capitol Hill, who see the world's largest communist country as a security threat, and protectionists, who blame China for "stealing" American jobs by unfair trade practices.

Imposing trade restrictions on China, however, would embolden the hardliners in the Chinese Communist Party (CCP), lead to crude nationalism, harm both U.S. and Chinese consumers, slow globalization, and increase the risk of conflict. Correcting trade imbalances requires flexibility, not rigidity, which is why Alan Greenspan (2004: 11) warned: "It is imperative that creeping protectionism be thwarted and reversed."

A country's overall balance of payments must always balance as a matter of simple double-entry accounting. Countries that run persistent current account deficits must be running surpluses in their capital accounts. The fact that China is running a large current account surplus with the United States means saving must exceed investment in China, and the excess savings are being used to finance the U.S. twin deficits. In effect, China is providing "foreign aid" to U.S. consumers and taxpayers, allowing them to live beyond their means.

The primary reason for the growing U.S. trade deficit with China is not an undervalued yuan or unfair trade practices, but rather the fact that China has become the world's manufacturing platform (Lardy 2003). Foreign-invested firms now account for the bulk of Chinese exports. The clear winners are U.S. consumers, including industrial users of Chinese products, as well as domestic firms that have benefited from increased demand as consumers switch to U.S. goods with a comparative cost advantage.

Although U.S. manufacturing is still the most productive in the world and the American economy continues to create millions of jobs, the U.S.-China Economic and Security Review Commission (also known as the U.S.-China Commission) asserts: "China's undervalued currency has contributed to a loss of U.S. manufacturing, which is a national security concern" (USCC 2005: 201). The truth is that net job losses in U.S. manufacturing since 2000 have been due largely to the sharp increase in U.S. productivity, not to Chinese imports or an undervalued yuan.⁴

The Commission further argues, "China is an authoritarian regime and has a non-market, command economy still controlled by the Communist Party" (USCC 2005: 19). The Commission, no doubt, would be surprised to learn that there is a statue of Adam Smith on the campus of the Southwestern University of Finance and Economics in Chengdu, and that GlobeScan found more support for the free market in China than in the United States. Moreover, most prices in China are market determined and, for the first time, the five-year plan's title has been changed to "program." Two of the main goals of the 11th Five-Year Program are to deepen economic reforms, including trade liberalization, and to build a "harmonious society" (Li & Fung Research Centre 2006: 1-2).

Although China is still a market socialist economy and has not yet grasped the "Big Market, Small Government" model of Hong Kong, it is clearly not the "non-market, command economy" assumed by the U.S.-China Commission. Yet that type of hyperbole is often

⁴ Griswold (2006: 8) estimates that annual net job losses in the United States due to imports from China "account for only about 1 percent of overall job displacement."

heard today on Capitol Hill. There are legitimate concerns about China, but it is best to look at concrete actions rather than try to divine intentions. Indeed, it is dishonest to use the guise of national security to protect U.S. interest groups when there is no real security threat.

In his dissenting opinion on the 2005 USCC Report, Commissioner William Reinsch criticized the majority's view for its "negative tone":

The Report's perspective is simple and simplistic: we are right; China is wrong; the only issue is how to force them to do what we want. The recommendations are equally simplistic—we should tell them what we want them to do and then sanction them if they don't do it. The Report consistently implies the Chinese deserve blame for acting in their own interest rather than ours. . . . Despite overwhelming evidence that unilateral sanctions fail to achieve their objectives and at the same time impose significant costs on the sanctioning nation, the Commission continues to recommend their imposition or expansion [USCC 2005: 218].

The danger is that the Democratic controlled 110th Congress might actually take the USCC's advice.

Has China Honored Its WTO Commitments?

To be called a "cheater," one must intentionally violate agreed upon rules. The rules must be transparent and not negotiated under duress. In its WTO protocol, China did agree to a number of provisions regarding market access and rules regarding intellectual property rights, subsidies, dumping, and other trade-related issues. But China never formally agreed to float its currency.

No Currency Commitment

One of the biggest complaints by China trade skeptics is that the yuan is significantly undervalued against the U.S. dollar, which amounts to an implicit subsidy of Chinese exports. That claim does have some merit, as evidenced by the massive amount of foreign exchange reserves held by the People's Bank of China (PBC), but there are no legal grounds to view that practice as an actionable subsidy under the WTO Agreement on Subsidies and Countervailing Measures (Magnus 2006).

It would be much more fruitful for the United States to focus on the issue of capital freedom than on the narrow question of the optimal yuan/dollar exchange rate. China has a repressed financial system and tightly controls capital outflows (Dorn 2006). In order to slow the accumulation of foreign exchange reserves, which now exceed \$1 trillion, Beijing is beginning to gradually relax capital controls. The foreign currency regime was reformed in July 2005, and the yuan has been slowly appreciating. To avoid inflation as a way of adjusting the real exchange rate, the PBC will have to let the nominal exchange rate continue to move upward. The speed of that adjustment will depend on political as well as economic factors.

The danger is that Congress may be too impatient to wait for a transition to a fully convertible and flexible yuan, blame the U.S. bilateral trade deficit with China on the undervalued yuan, and use protectionist measures to try to force a change in policy. During the 1997 Asian financial crisis, everyone congratulated China for its commitment to a firm peg to the dollar. Now Congress wants China to float "for its own good." What will Congress say in the future if the yuan floats down rather than up against the dollar?

China's WTO Commitments

China has made substantial progress since December 2001 in keeping its WTO commitments to further lower tariff and nontariff barriers, provide better access to its markets, including opening its financial services sector, and better protect intellectual property rights (IPRs). Franklin Lavin, U.S. undersecretary of commerce for international trade, recently summarized China's record by saying that Beijing has "by and large honored its WTO commitments," but that "a cluster of issues" remain (Ang 2007). That assessment is widely shared.

In his March 29, 2007 speech to American entrepreneurs in Beijing, Lavin said, "There are an enormous number of market-access barriers, impediments that make it more difficult for U.S. business operating in the market." He also pointed to China's undervalued currency and argued that it harms U.S. manufacturers by giving Chinese exporters an unfair advantage. (Of course, it also discriminates *in favor* of U.S. consumers.) The "perception," said Lavin, is "not just that there are trade barriers . . . but somehow the Chinese aren't playing a fair game or . . . dealing with the U.S. in a way that friendly trading countries ought to deal with each other" (Ang 2007).

That statement contrasts sharply with economic liberalism and its emphasis on individual traders rather than on "countries." The negotiations approach to trade liberalization puts politics—and, hence, governments—at the center of the trade liberalization process, which is a complex step-by-step endeavor. One need only examine the various WTO agreements and U.S. trade law to appreciate the headaches created in trying to unravel the details.

China's market-access commitments are similar to other recent entrants to the WTO,⁵ but its rules-based commitments on safeguards and antidumping are clearly discriminatory—subjecting China to "WTO-plus requirements" that exceed the norms applied to other members (Lardy 2002: 80). The United States and other key members of the WTO pressured Beijing to accept those stringent conditions in order to protect their own markets, not to promote a liberal global economic order.

Discriminatory Treatment

China agreed to a number of conditions that violate the spirit of the nondiscrimination principle and the most-favored nation clause in order to join the WTO.⁶ The transitional product-specific safeguard, which applies for 12 years after China's entry, prevents China from freely selling its products even when there is no evidence of unfair trade practices. Instead of serious injury, a country only has to show "market disruption" and can single China out in violation of the normal WTO Agreement on Safeguards. The importing country can unilaterally impose a quota or tariff on China, without a specific time limit for its removal or liberalization, or Beijing can "voluntarily" restrict its targeted exports. Both actions are contrary to WTO norms, as is the special textile safeguard that China agreed to until the end of 2008.

China also agreed to be treated as a non-market economy (NME) in antidumping (AD) cases for a period of 15 years after accession, which makes it much easier to impose AD duties on Chinese exports and, thus, to protect domestic producers.⁷ Unlike other transition

⁵ See Lardy (2002: 65–80) for a discussion of China's market-access commitments.

⁶ This section draws on Lardy (2002: 80–105) for a discussion of safeguards, antidumping, and subsidies.

⁷ U.S. antidumping law, as administered by the Department of Commerce (DOC), is fraught with difficulties. As Ikenson (2005) points out: It cannot determine whether selling below cost or engaging in price discrimination are legitimate or unfair trade practices. Moreover, the NME methodology for determining "normal value" is fatally flawed: The DOC constructs pseudo prices of targeted Chinese firms using "a fictitious hodgepodge of estimated components serving as a proxy" for home market prices. The law favors U.S.

economies, China was not given the opportunity to treat debt forgiveness associated with privatization as a nonactionable subsidy. One would think that the United States would favor privatization of state-owned enterprises (SOEs) rather than use the WTO to slow that process. Nor is China allowed to exempt broad-based subsidies not specifically aimed at exports, as are the United States and the European Union (EU). China agreed to allow subsidies to SOEs to be actionable if those subsidies were “disproportionately large.”

Many Chinese firms receive low-cost loans from government-owned banks, engage in debt-equity swaps involving government support, and receive favorable tax treatment (e.g., export tax rebates or duty free imports of component parts). Those actions expose Chinese firms to countervailing duties (CVDs) under current law. Also, China agreed to allow the use of an “alternative bench mark” (similar to the NME methodology) in determining subsidies, which could be used in CVD cases involving soft loans.

The March 30, 2007 decision of the DOC to use CVDs for the first time against a NME to stem the surge of glossy paper imports from China, based on a petition by NewPage (a unionized firm) that unfair subsidies constitute a violation of U.S. trade law, opens a Pandora’s box for further cases (see Green 2007a, 2007b). It is blatantly unfair that the DOC will not recognize China as a market economy even though China is more open than many WTO members who have market economy status, yet will now treat China as a market economy in bringing CVD cases. China is being caught in a vice grip.

Finally, under strong pressure from the United States and EU, China agreed to end all agricultural export subsidies upon entry to the WTO. Yet little progress has been made to lower U.S. and EU subsidies under the Doha Round. Moreover, WTO rules allow members to omit direct payments to farmers in determining the “aggregate measure of support,” but price supports must be included. That provision allows the United States and the EU to increase their farm subsidies while discriminating against China, which relies heavily on price supports because of the administrative costs of direct subsidy programs.

Those and other discriminatory practices against China, as detailed in Lardy (2002: chap. 3), reflect the complex and unfair nature of the current global trading system, in which the United States and other developed countries dominate the rule-making process and use that power to protect their home turfs.

Intellectual Property Rights: Broken Commitments or Transition Lags?

China has come a long way since Mao Zedong admonished people to “Strike hard against the slightest sign of private ownership” (Becker 2000: 157). Private property is now considered “inviolable” and on a level with state property. The provisions of the new Property Law should make it easier to forge ahead with China’s WTO commitments on IRPs.

The problem has been the difficulty of enforcing IPRs in a country of 1.3 billion people without an independent judiciary, with little accountability, and without a transparent legal system that protects fundamental rights. Economic liberalization has led to rapid growth of the private sector and a demand for greater protection of property rights. As Chinese entrepreneurs create intellectual property, they will demand protection—and there will be a greater synergy with foreign entrepreneurs who demand equal protection under the law.

That transition process, however, could take a long time. To resolve present violations of IPRs, private parties should create incentives for improving the enforcement mechanism,

petitioners, is unfair to uninvestigated companies (including private firms in China), and fosters protectionism. See also Lindsey and Ikenson (2003).

including alternatives to the WTO dispute settlement process. China's leaders recognize the need for better enforcement of IPRs for future development. In his Harvard speech, Premier Wen (2003) stated, "Without effective protection of the citizens' right to property, it will be difficult to attract and accumulate valuable capital." If the new Property Law is fully implemented, economic life will become less politicized, and civil society will benefit from the autonomy that private ownership creates.⁸

Many U.S. firms are working patiently to bring about better protection of IPRs in China.⁹ But Washington is growing impatient and the Bush administration has just filed two IPR cases against China with the WTO. Those cases contend that China has been negligent in policing the piracy of movies, music, and books, and that distribution rights are overly restrictive. While the U.S. motion picture and music industries support taking action against China, other industries do not. Major U.S. software companies, such as Microsoft and Apple, and leading drug manufacturers oppose having Washington interfere. As Neil King (2007) points out, "Both sectors have made their own market-access and antipiracy advances and don't want to see that work disturbed."

Private cooperation with local officials does work, and Beijing is paying attention. What China needs is a system of justice based on the rule of law and on the protection of private property rights to bring about social and economic harmony, not top-down planning. In a one-party system traditionally opposed to markets and property, that transition will not be easy. For the U.S. government to think otherwise and to threaten retaliation if China fails to fully comply with the letter of the law may be counter-productive. A strategic long-run approach that helps China appreciate the importance of law and liberty for economic development would be more fruitful. As Wu Jinglian, one of China's leading reformers, stated, "If we don't establish [a] fair rule of law and don't have clear protection of property rights, then this market economy will become chaotic and corrupt and inefficient" (Reuters 2006).

Who Is China Cheating?

The view seems to be "that the United States is the only fair trader and that everyone else indulges in unfair trade" (Lal 2006: 75). China has the largest bilateral surplus with the United States and is a communist country; therefore, China must be the biggest cheater. But is China really "cheating" the United States by running a large trade surplus? That zero-sum, mercantilist mentality diverts attention from the net gains from voluntary exchanges between individual traders and the increases in U.S. consumption made possible by indirect production—that is, production in China. Moreover, as Lal notes, to ask the PRC to reduce its trade surplus with the United States is to ask the Chinese "not to send their savings to the United States."

If the U.S. Congress were to impose prohibitive tariffs on Chinese goods—and interfere with consumer choice—China would likely retaliate. The Chinese market is America's fastest growing export market; cutting off trade with China to protect U.S. interests would be economic suicide. Yet that danger is enhanced by the present negotiations approach to trade liberalization.

Emphasis should be on wealth creation flowing from voluntary exchange and the international division of labor, which increases as markets open, and not on protecting jobs at any cost. The focus on "cheating" and "unfair trade practices" under the negotiations approach to freer trade diverts attention from the fact that U.S. consumers gain whenever

⁸ On the importance of the new Property Law and its provisions, see Li & Fung Research Centre (2007).

⁹ The difficulty of preventing piracy of movies is seen by the fact that France has the second largest amount of piracy, estimated at \$1.5 billion in 2005. China is first, costing the U.S. movie industry an estimated \$2.7 billion in lost revenues. See King (2007).

the cost of imports is cheaper than home production, regardless of the reasons for that cheapness.¹⁰

China's liberalization has benefited many more people than it has harmed. Concentrating on the harm to specific U.S. producers misses the larger benefits that have accrued to U.S. consumers and U.S. producers using China as a manufacturing platform. The dynamic gains from trade, in terms of giving the Chinese people new opportunities and choices and exposing them to new ideas and cultures have had far-reaching affects and invigorated civil society.

There is no doubt that China has cheated in the sense of not completely fulfilling the numerous agreements it negotiated under its WTO protocol. But many of those agreements were discriminatory and others (such as rules governing IPRs) were unrealistic given the high costs of transition. With regard to the complex issue of subsidies, China faces mounting retaliatory measures. Yet, in providing soft loans, tax rebates on exports, and tax preferences for FIEs, China has helped expand its trading sector, grown the nonstate sector, and increased domestic pressure for protection of private property.

While foreign producers may be harmed by China's unfair trade practices, the real losers from China's "cheating" are the Chinese people. The use of subsidies and nontariff barriers to trade prevent the Chinese people from extending their range of choice. Soft loans to SOEs divert funds from the private sector; undervaluing the yuan and holding billions of dollars worth of U.S. government debt at the PBC harm the Chinese people, not U.S. taxpayers.

The real issues are how to help China in its transition to a market economy and, equally important, why the United States, as the leader of the free world, should focus more on the principles of economic liberalism and less on the minutiae of the negotiations approach to trade liberalization.

Economic Liberalism and China's Future

The "central concept of liberalism," writes F. A. Hayek (1967: 162), "is that under the enforcement of universal rules of just conduct, protecting a recognizable private domain of individuals, a spontaneous order of human activities of much greater complexity will form itself than could ever be produced by deliberate arrangement." The great Chinese philosopher Lao Tzu recognized the principle of spontaneous order long before Adam Smith. His emphasis on freedom and nonintervention (*wu wei*) as the ideal path to prosperity and social harmony should not be lost sight of as China's leaders seek to build a harmonious society.

Premier Wen Jiabao has said that, in his view, "democracy, the rule of law, freedom, human rights, equality, and fraternity are not something peculiar to capitalism, [they] are also the common values that we as human beings all pursue" (Hutzler 2007). History has taught that the best way to achieve those goals is through spontaneous market coordination resting on limited government, private property, and freedom of contract. China is making progress on the path to market liberalism, but the CCP's power rests on maintaining market socialism.

The problem for China, according to Wu Jinglian, is that "the visible foot is treading on the invisible hand." Government corruption stems from the lack of a clear rule of law that protects property rights and limits the intrusion of public officials in private markets. "At issue," says Wu, "is whether we want a true market economy or bureaucratic capitalism" (Reuters 2006).

¹⁰ See Yeager and Tuerck (1966: 199 n.4); Lal (2006: 69–70).

Internal politics will largely determine the pace of reform in China, but the United States can play a constructive role by practicing the market-liberal values it preaches. Secretary Paulson recognizes that “closer economic ties between nations help promote international peace and prosperity by creating common interests and raising the costs of conflict.” He therefore cautions both the United States and China to avoid being “captured by harmful political rhetoric or those who engage in demagoguery.” Instead, we should realize that constructive U.S.-Sino relations require “a long-term strategic economic engagement on our common issues of interest” (Paulson 2006).

A positive approach requires that U.S. policymakers:

- Treat China as a normal rising power, not as a probable adversary;
- Recognize the positive contributions economic freedom and engagement have had for advancing personal freedom in China and the dangers of protectionism;
- Extend market status to China as soon as possible to end the arbitrary and unfair antidumping methodology currently used under China’s “nonmarket” classification;
- Be judicious in holding China to its WTO commitments and encourage further liberalization through Strategic Economic Dialogue;
- Adhere to the rule of law, limited government, and the principle of freedom.

Progress toward a liberal international economic order will be advanced more by keeping in mind the virtues of unilateral trade liberalization than in practicing the vices of protectionism. Calling China a “cheater” when many of the rules sanctioned by the WTO allow restrictive practices that benefit the developed countries, which in many cases have fashioned the rules for their own advantage, is a dangerous game.

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