The *New* Cold War

Time to get serious about China.

By Greg Mastel

In a recent speech, U.S. Trade Representative Katherine Tai revealed that China had not been living up to its promises in the agreement negotiated just months earlier in the closing months of the Trump administration. That really should have surprised no one, as it is difficult to find a trade agreement between the United States and China that Beijing has not violated. Depending upon how you define a trade agreement, the United States has negotiated at least four agreements on intellectual property protection with China; none of them have been enforced by Beijing beyond making "show" seizures.

Twenty years ago with much fanfare, President Bill Clinton helped to usher China into the largest trade agreement, the World Trade Organization with its many trading rules, in the hopes of furthering market reform in the Middle Kingdom. The United States issued a formal report on China's compliance in 2021 that summed the situation up concisely: "China's record of compliance with the terms of its WTO membership has been poor. China has continued to embrace a state-led, non-market, and mercantilist approach to the economy and trade despite WTO Members' expectations—and China's own representations—that China would transform its economy and pursue the open, market-oriented policies endorsed by the WTO."

Unfortunately, China's dismal record of compliance with trade agreements is more than just a problem of bad behavior by a series of Chinese officials. It is

Greg Mastel is a Senior International Trade Adviser at Kelley, Drye & Warren. From 2000 to 2003, he was the Chief Democratic Economist and International Trade Adviser on the U.S. Senate Finance Committee. He is working on a book about the trade and industrial policy dimensions of the current struggle with China.

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220 I Street, N.E., Suite 200
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Phone: 202-861-0791
Fax: 202-861-0790
www.international-economy.com
editor@international-economy.com

an inevitable result of expecting China to follow rules designed to promote “free trade” and “free markets” when China actively opposes those objectives.

CLASH OF SYSTEMS

The defining reality is simple: the People’s Republic of China is controlled by the Chinese Communist Party. While it is true that today’s China is not quite what was envisioned by Karl Marx, it is in many ways the opposite of the system dreamed of by Adam Smith.

The revered founder of the Chinese system—Mao Zedong—was a solid communist devoted to the economic theory and the powerful role of the government in making decisions. It is true that some of Mao’s successors, notably Deng Xiaoping, sought specific reforms and more opening to the West, but they remained committed communists. Attempting to make the functioning of the Chinese communist system more efficient is simply not the same as moving away from it. The state economic planning process has been dominated by five-year plans drafted by the Chinese Communist Party since 1949.

Since the Tiananmen Square Massacre in 1989, China has largely limited political engagement with the West and increased the level of state control and repression. China’s current president and general secretary of the Chinese Communist Party, Xi Jinping, has held the reins of power since 2013. He has led China on a course that is increasingly authoritarian, more supportive of state control of the economy, and much more hostile to the United States.

There is some diversity in estimates, but about 40 percent of China’s GDP is generated by state-owned enterprises. That includes more than 150,000 separate enterprises with about three-quarters of the Chinese companies in the Global Fortune 500 state-held. In China, many key sectors including energy, telecommunications, construction, mining, and most manufacturing are dominated by state-owned enterprises.

Those figures on state-owned enterprise presence in China actually underestimate the government role in the economy. Given the nature of China’s political system, the government has always held more sway in the “private sector” than can be imagined in the West. President Xi has spoken in recent years about the need to increase control of the private sector. Several Chinese “think-tanks”—that could not operate without support from at least major factions in the government—have called for reducing or eliminating the private sector.

State-owned enterprises have real costs for the Chinese economy. They also though allow the Chinese government to directly control much of the Chinese

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The Transition

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economy and provide employment for perhaps hundreds of millions of Chinese citizens. Those facts ensure that voluntary reform will never come.

More troublingly, the Chinese state-owned sector also imposes costs on the rest of the world. Enormous Chinese state-owned enterprise production of commodities such as steel leads to depressed global prices that cause unemployment in China's trading partners. It also guarantees that Western companies competing with state-owned enterprises within China are doomed to face a permanently unfair playing field. It is nearly impossible to compete against the government, which sets the rules, steals your technology, has likely compromised the security of internal communications, and controls the courts.

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AUTHORITARIAN GOVERNMENT

Some attempt to separate China's dismal record on respect for human rights and dissent from business and commerce. But the distinction is largely an illusion visible only to China apologists. Free trade and free commerce depend upon a degree of openness in association and action as well as protection from arbitrary government action. In short, free trade requires at least a degree of freedom that does not exist in China.

A recent example of the impossibility in separating these issues arises from the Chinese prison/work camps in Xinjiang, China, that hold as many as 1.5 million mostly religious dissenters. In the main, these work camps seemed to focus on agricultural production of goods like cotton. Recently, U.S. Customs and Border Protection began vigorously enforcing U.S. laws prohibiting imports of goods produced with forced labor. Initially, CBP actions focused largely on apparel and fabric linked to Xinjiang, but as the CBP investigation expanded, it blocked products using silicon, seafood, non-ferrous metal, and more. Notably, some solar panels manufactured in China were found to be produced with forced labor. Reports now circulate that groups of prison workers are sometimes "rented" out to factories in other regions of China. The machinery of state repression in China is integrally involved in "normal" commerce.

In the United States and most of the West, courts are seen as independent arbiters capable of limiting the excesses of government officials. It is widely not understood in the West, however, that Chinese courts are specifically subservient to the Chinese Communist Party, not independent arbiters. Though they have many trappings of Western courts and many judges and officials educated in the United States, Great Britain, or Japan, they are not meant to provide a fair forum in disputes with the Chinese government. The success of Chinese "private sector" companies like Huawei in China in winning sweeping intellectual property victories in Chinese courts demonstrates that these courts are just another part of the Chinese authoritarian system.

HOSTILE FOREIGN POLICY

Beyond the commercial problems caused by state ownership and authoritarian control, there are rapidly growing broader tensions between Beijing and Washington that suggest they are already in a new cold war. Sharp accusations continue to be exchanged on China's role in the Covid-19 outbreak. The U.S. fleet has taken to monthly patrols down the Taiwan Strait in response to China's

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military threats to invade Taiwan. Similar tensions are high due to China's decidedly aggressive territorial claims in the South China Sea. Chinese hackers regularly attack both U.S. government and private sector computer systems. The list could easily continue.

This movement in China is obvious to anyone who tracks the increasingly nationalist and anti-U.S. headlines in *China Daily,* the chief English language instrument of Chinese propaganda. The ranting of its sister publication, the *Global Times,* on such topics as the U.S. military creating Covid-19 and secretly introducing it into China provides valuable insight into the picture that Xi Jinping's government is attempting to paint of the United States.

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This is all several notches short of actual military conflict, but it makes anything like a normal relationship impossible. The United States imposes various retaliatory tariffs on more than $350 billion in imports from China, and China imposes sanctions of its own. Western companies doing business in China face the prospect of boycotts in both the United States and in China if they trigger one of many political trip wires. U.S. investment in China dropped sharply during the Trump administration in recognition of political realities. At some point, U.S. companies may be forced to simply write off much of the estimated $124 billion invested in China.

AN ECONOMIC RELATIONSHIP IN A COLD WAR

There is no realistic possibility that China will suddenly decide to mend its ways and become a Jeffersonian democracy with open markets. And for many good reasons, few Americans would aspire for the United States to become more like China. The result is that a conflict is built into the relationship between Washington and Beijing.

In the long Cold War between the United States and the Soviet Union, economics played a minor role because there simply was not much economic interaction. The United States and China, however, are the two largest economies in the world with an enormous trade and investment relationship. The economic fundamentals of this cold war are very different from the last. The basics of maintaining a strong military, protecting allies, and doing what can be done to promote human rights in China remain consensus items. The shape of the new economic relationship is really still uncharted territory. There are, however, two elements that are essential: managing the trade relationship, and boosting key U.S. industries.

MANAGED TRADE RELATIONSHIP

The current U.S. strategy for trade with China still relies heavily upon the World Trade Organization. The WTO is an organization dedicated to enforcing market trading rules on its members. It works reasonably well in policing trade between generally market-oriented countries that maintain a relatively transparent policy process. But China is not market-oriented. As noted, it remains a proudly communist country. The Chinese policymaking system is also so opaque that it is often difficult to even determine what policy is from the outside. The WTO with its assumption of a reliable, transparent rule of law is utterly out of its depth. How can one challenge the policies of a country that are often difficult to even discern? Even senior WTO officials have suggested publicly that the task of transforming China's system is beyond the WTO. Another approach is clearly required.

Managed trade is still a somewhat ill-defined term in the United States. It generally refers to a strategy in which Washington manages its imports, exports, and investment with tariffs and other policy tools for the purpose of maintaining security, establishing equitable trade, and promoting other policy objectives. It is by definition less efficient than allowing the market to determine trade flows—at least when there is an actual market on both ends of the trading relationship. Unfortunately, there is no true competitive market in China. At least until recently, the status quo amounts to allowing Beijing to manage the trade relationship with Washington while Washington waits for the invisible hand of the marketplace to intervene.

Over the last few years, however, Washington has begun to take the first steps toward managing the trade relationship with China. The United States has taken action against Chinese imports of products such as steel and aluminum which endanger core industries. Most imports from China are now subject to duties imposed by the Trump administration in the hopes of changing Chinese trade behavior. The Biden administration has been willing to follow the same course and even contemplate more actions. Numerous anti-dumping, safeguard, and other actions have been applied or contemplated on Chinese imports. The result is that most U.S. trade with China is already managed through one of several policy tools.

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Realistically, this kind of market pressure is the only tool available to Washington to counter Beijing's mercantilist trading strategy. The WTO has failed. Simple persuasion seems less likely to succeed than relying upon "wishing hard." And even if they can only influence Beijing to a limited degree, tariffs and other policy tools limit capital flows to Beijing to support its other policy objectives.

And there are other benefits. Even the presence of tariffs on Chinese goods has convinced many U.S. importers to seek alternative suppliers based in the United States or other friendlier governments. Simply shifting a large portion of U.S. imports produced in China to imports from Mexico, Haiti, Europe, or many other countries serves U.S. interests and helps to build a better world. U.S. dollars are better spent in commerce with almost any other country save perhaps Russia and Iran.

This is not meant to suggest an embargo on Chinese products. There are some products that are likely to always be logical for the U.S. importers to source from China and vice versa. But there is real merit to sourcing products that are available from sources outside of China.

PROMOTING KEY INDUSTRIES

Industrial policy has been a dirty word in some circles in the United States and branded as the government "picking winners and losers." In a world of free markets, that criticism has considerable merit. Unfortunately, in a world where other trading partners—now a list headed by Beijing—pursue their own aggressive and sweeping industrial policies, it is a true recipe for disaster.

The semiconductor industry provides an excellent example. Semiconductors are essential elements of virtually all electronic products from cell phones to military drones. The U.S. semiconductor industry is still the world leader, with almost a 50 percent global market share. When the Trump administration moved to come down on Huawei, it cut off exports of high-tech chipsets to the company. That dealt a heavy blow to the Chinese telecom giant from which it has not yet recovered.

Unfortunately, that example may provide more comfort than is warranted. China still is not a leader in top-end chip production, but it is making progress. The structure of the industry is also changing. Intel—the largest U.S. maker—is an integrated producer of chips from design to manufacturing, but increasingly semiconductor manufacturers focus on high-end design work, leaving the rest of the production chain to specialty producers, some of which are in China.

In an important wrinkle, the largest chip maker in the world is Taiwan Semiconductor based in Taiwan. A Chinese invasion of Taiwan would be a horror for many reasons, one of which is that it would immediately provide China with the semiconductor technology it has sought for decades.

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Recognizing these problems, the U.S. Senate in 2021 passed the United States Innovation and Competition Act, which would provide about $250 billion to counter China's efforts in key technologies. About $52 billion of that would go to bolster U.S. semiconductor research and development and manufacturing. This legislation has not yet become law, but does seem to enjoy wide and bipartisan support. It is an example of common-sense steps the United States can take to support key industries and could provide a valuable foundation for promoting an industrial policy to counter China.

Controlling the flow of key technologies to China is also a part of this policy. The Trump administration took steps to confront and bar reckless Chinese companies, such as Huawei, from U.S. technology. It certainly makes sense for Washington to continue to carefully protect the technology contained in U.S. exports. U.S. technology should not boost Chinese weapons systems or increase Beijing's formidable abilities to conduct surveillance. Dozens of Chinese companies, in addition to Huawei, have already been put on various sanction lists. Control of technology directly complements other economic measures suggested here.

At its peak, the Soviet Union was a military and geopolitical rival for the United States. It never posed much of an economic threat and its economic weakness was its ultimate undoing. In the current cold war with China, an entirely different set of rules apply. China is actually a more serious economic rival than it is a military or geopolitical rival. Confronting China's mercantilist expansionism is every bit as essential as countering Chinese military threats. The United States has the economic tools it needs to confront China. It is a matter of using them as part of a unified strategy to protect U.S. long-term interests. ◆