

CHINESE TRADE POLICY AFTER (ALMOST) TEN YEARS IN THE WTO: A POST-CRISIS STOCKTAKE

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ABSTRACT

This paper interprets China's overall trade policy since its accession to the World Trade Organisation (WTO) almost a decade ago, and more recently in the wake of the global economic crisis. The first section briefly summarises policy trends leading up to WTO accession, as well as recent trade and foreign direct investment (FDI) patterns. The second section looks at China in the WTO: its record of implementing WTO commitments; its participation in the Doha Round; and in dispute settlement. The next section looks at China's trade-related reforms outside the WTO, especially unilateral measures and preferential trade agreements (PTAs). Section Four highlights challenges for China's trade policy: in the context of domestic reforms; in the WTO; in PTAs; in its key bilateral relationships; and in the context of global macroeconomic tensions. Section Five puts Chinese trade policy in a bigger domestic political-economy and geopolitical context. Section Six concludes.

In sum: China has a mixed record on WTO implementation; a flurry of litigation has followed several years of diplomatic reconciliation in dispute settlement; and China has been passive in the Doha Round. In contrast, it has been very active with PTAs, setting off a “domino effect” in east Asia. But its PTAs are “trade light”, driven more by foreign policy than commercial considerations. Finally, unilateral liberalisation – the driving force of external opening in the 1990s – has stalled. There has been very little “WTO-plus” liberalisation, while measures of selective protection, especially related to foreign investment and industrial-policy targeting, have increased. China’s response to the global economic crisis has reinforced these trends, but it does not represent a dramatic increase in protection or fundamentally reverse China’s opening to the world economy.

China’s short-term challenge is to contain protection at home. That will send positive signals to contain protectionism worldwide. Beyond that, China’s challenge is to stimulate further unilateral liberalisation related to domestic structural reforms. That means tackling non-border, but still trade-related, regulatory barriers, especially in investment and services. Cleaning up PTAs and strengthening participation in the WTO are important auxiliary objectives. This should be seen in the context of further liberalising the Chinese economy and “rebalancing growth”. But this does not appear to be Beijing’s agenda today. Not least, such “second-generation” reforms strike much closer to vested interests at the heart of the Party State in China. Nevertheless, pro-market reformers should work to make it tomorrow’s, or the day-after-tomorrow’s, agenda. Finally, two-way “constructive engagement” in China’s key bilateral and regional trade relationships is vital to contain protectionism and smooth China’s further integration into the global economy. The US obsession with RMB undervaluation and China’s current-account surplus is not an exercise in constructive engagement – indeed quite the opposite.

Introduction

So much has changed since China joined the World Trade Organisation (WTO) in late 2001. China has powered through the crisis with a turbo-charged fiscal and monetary stimulus equivalent to almost 45 per cent of GDP in 2009. It is the leading contributor to post-crisis global growth. Other countries around the world export raw materials and capital goods to power China's continuing industrial revolution. That is also true of other east-Asian economies, who, in addition, export parts and components to China for assembly and export elsewhere. Increasingly, they are also gearing up to export finished goods to a booming Chinese consumer market. More than ever, the rest of Asia revolves around China.¹ Gradually, China is asserting itself in international organisations. And its footprint is ever-more visible elsewhere in the non-Western world – in its east-Asian backyard, and in south Asia, central Asia, Africa and South America.

China is now one of the Big Three in the global economy. Until recently, it imported “global order”: it absorbed policies, rules and institutions that materialised from decisions made elsewhere. That was what China did when it joined the WTO. China still imports global order; but, given its market size, and like the USA and EU, it now exports global order as well. Decisions made in China reverberate around the world. And they do so to a much, much greater extent than decisions made in the other BRICS. China accounts for about 60 per cent of BRICS' output, two-thirds of its foreign-exchange reserves and exports, and one-third of its inward investment. China plays in its own league among emerging markets. The other BRICS play in an inferior league; they are still much bigger net importers of global order.²

In the past decade China has become the leading regional power in Asia, and is on its way to becoming a “great power” in the wider world, alongside the USA. These trends have clearly accelerated in the wake of the global economic crisis. That is the broad context for assessing Chinese trade policy almost a decade after it acceded to the WTO.

The first section briefly summarises policy trends leading up to WTO accession, as well as recent trade

¹The central theme of Roach (2009).

² I owe the insight that China is now one of the three big exporters of global order to a lecture given by Martin Wolf at the London School of Economics.

and foreign direct investment (FDI) patterns. The second section looks at China in the WTO: its record of implementing WTO commitments; its participation in the Doha Round; and in dispute settlement. The next section looks at China's trade-related reforms outside the WTO, especially unilateral measures and preferential trade agreements (PTAs). Section Four highlights challenges for China's trade policy: in the context of domestic reforms; in the WTO; in PTAs; in its key bilateral relationships; and in the context of global macroeconomic tensions. Section Five puts Chinese trade policy in a bigger domestic political-economy and geopolitical context. Section Six concludes.

1. Trends up to WTO accession; trade and FDI patterns³

China's "Reform" and "Opening" started in 1978. But its decisive external opening, and with it sweeping industrial and agricultural restructuring, belong more to the post-Tiananmen phase, especially since 1994. China undertook enormous trade and FDI liberalisation during the 1990s -- *before* WTO accession in 2001 -- followed by another big dose of liberalisation in line with its WTO commitments. Its WTO commitments are very strong; they exceed those of most other developing countries by a wide margin. This holds for disciplines on border and non-border restrictions in goods and services. In addition, there are detailed commitments on transparency procedures to make sure trade-related laws and regulations are implemented, backed up by administrative and judicial-review procedures to which individuals and firms are supposed to have recourse.

It is important to note that the primary liberalisation thrust, especially in the 1990s, was *domestic* and *unilateral*, coming from the Beijing leadership. The latter used WTO-accession negotiations as a strategic lever to consolidate and accelerate national reforms. China's WTO commitments, and its participation in the WTO after accession, can be read as more the consequence than the cause of its sweeping unilateral reforms. Furthermore, Chinese unilateral liberalisation followed in the footsteps of unilateral liberalisation by the northeast and then the southeast-Asian Tigers from the 1960s to the 1980s. This is how China inserted itself into regional and global manufacturing supply chains (e.g. in electronics, sport footwear, televisions and radio receivers, office equipment, electrical machinery, power and machine tools, cameras and watches, and printing and publishing). That said, the momentum of further liberalisation has stalled in recent years (of which more later).

3 This section draws on Greene *et al* (2006), Lardy (2002), Ianchovichina and Martin (2001), Mattoo (2003), Bhattasali, Shantong and Martin (2004), Athukorala and Hill (2008), and WTO (2010).

The simple average tariff has come down from about 40 per cent in 1985 to under 10 per cent today. Tariffs accounted for just 2.5 per cent of total tax revenue in 2009. All China's tariffs are bound in the WTO at very close to applied rates, with an overall bound tariff of 10 per cent. The maximum applied MFN tariff is 65 per cent. China's weighted average tariff is just over 4 per cent -- low-ish by developing-country standards and the lowest among large developing countries (e.g. compared with other BRIICS – Brazil, Russia, India, Indonesia and South Africa) (Table 1). This is partly due to numerous duty exemptions and other measures to encourage exports. Trade liberalisation also whittled down the impact of border non-tariff barriers (NTBs) to about 5 per cent on the eve of WTO accession. Trading rights have been fully liberalised; most quotas, licenses, specific tendering arrangements and price controls have been removed; and there are strong disciplines on state trading enterprises, remaining subsidies and other NTBs. Import quotas were eliminated by 2005; and China agreed to abolish all export subsidies, including those in agriculture, as part of its WTO commitments. Overall, border barriers on goods trade have come down to southeast-Asian levels, and have been locked in by much stronger WTO commitments.

China's GATS commitments are very strong. On paper, the impact of WTO accession should be to cut services protection by half. In practice, China remains more protected in services than it is in goods trade. It is also generally more restrictive towards FDI. In terms of the OECD FDI Regulatory Restrictiveness Index, it is on a par with India and more restrictive than Russia and Brazil. Above-average levels of restrictiveness appear in key services sectors such as fixed telecoms, banking, air and maritime transport, and electricity (Figure 1).

China ranks 79th overall in the World Bank's Ease of Doing Business Index for 2011 – a low score, but clearly ahead of Russia, India, Brazil and Indonesia (Table 2). For "trading across borders" it is way ahead of South Africa, Russia and India. It scores much better than the other BRIICS on the cost of importing and exporting. China also occupies 48th position in the World Economic Forum's Enabling Trade Index, which combines indicators on market access, border administration, transport and commercial infrastructure, and the business environment into an overall index that ranks 118 countries. It scores better than Indonesia (68th), South Africa (72nd), India (84th), Brazil (87th) and Russia (114th). Ahead of China are OECD countries and more advanced emerging markets in eastern Europe, Latin America, east Asia and the Middle East (the non-OECD group being nearly all small, open economies) (Table 3).

China has climbed up the world rankings for trade and FDI with lightning speed (Figures 2&3). It first displaced Japan as the world's second-largest trading nation (third-largest if the EU is counted as one), and then Germany as the world's leading exporter of merchandise goods, with almost 12 per cent of world merchandise exports by 2009 (Figures 4&5). This is streets ahead of the other BRICS; and even ahead of India in world services trade (Figure 10). China's trade-to-GDP ratio was 56 per cent in 2009, down dramatically from 74 per cent in 2007 as a result of the crisis (Figure 6). This was still higher than for Brazil and India, and still rather high for such a populous country. Nevertheless, *net* exports are much lower – about one sixth of GDP before the crisis. That is because they are mostly produced by labour-intensive assembly of imported components, and generate modest local value-added.

China had a 3 per-cent share of global inward FDI stock in 2009, again ahead of the other BRICS (Figure 7). It has been the second-largest recipient of FDI in the world since 2000. Inward FDI was USD 110 billion in 2008, a massive increase from 2007, though it came down to about USD 95 billion in 2009 (Figure 3). Investment is still mainly in manufacturing, but it has increased rapidly in services, accounting for over 40 per cent of total FDI. The government estimates that over 90,000 foreign-invested enterprises (FIEs) have established in services sectors in China, with investments of over USD 160 billion.

China's outward FDI has also been increasing rapidly. It reached almost USD 50 billion in 2009 (Figure 8). The government's "Go Out" or "Go Global" policy has spurred the foreign expansion of Chinese firms, mainly state-owned enterprises (SOEs). This outward reach is very recent, so China's stock of outward FDI remains minuscule, especially compared with that of the EU and the USA (Figure 9).

Exports and imports shrunk when the crisis hit, battered by the collapse in global demand for consumer goods. Exports declined by 19 per cent from mid-2008 to mid-2009, before picking up smartly. Exports fell by 16 per cent and imports by 11 per cent, and the current account surplus almost halved to 5.8 per cent, in 2009.

China, unlike India, has successfully exploited comparative advantage in labour-intensive manufactures; and it has done so with a tight interlock between trade and FDI. China now accounts for about 40% of manufacturing exports from developing countries. Multinational enterprises (MNEs) account for almost 60% of merchandise exports and imports. About half of China's trade is "processing

trade”: raw materials and components are imported and assembled for export of final goods all over the world. MNEs account for 84 per cent of exports and imports involved in China’s processing trade. Until the crisis hit, the fastest rates of export growth were in finished consumer goods such as garments and toys, and in ICT products. In the latter category, as well as in assorted transport-and-machinery products, China has become the final-assembly point in east-Asian trade and FDI networks in parts and components, linked in turn to final export markets in the West. In contrast, China’s share of world trade in services is still well below its share of world trade in goods (Figure 10).

In sum, China has succeeded more than most developing countries, including the other BRICS: first in generating very high rates of growth; and second in translating the latter into employment, poverty reduction and human-welfare improvement for a broad section of the population. High rates of saving and investment have driven this process, but trade and FDI have also been important, especially in ramping up labour-intensive manufactured exports. China still has high regulatory barriers that waste resources, restrict internal trade and generally stifle domestic sources of growth. Tackling these barriers is the next big challenge.

2. China in the WTO

In the end-phase of China's accession negotiations, many players and observers feared China might play a spoiler role once inside the WTO. Would it use the WTO as a foreign-policy football? Would it indulge in power plays and provocative rhetoric? Would it undermine multilateral rules?

On balance, the answer to these questions is No. The strength of China's unilateral reforms and WTO commitments, and its integration into the world economy, have made it keenly aware of its stake in well-functioning multilateral rules – more so compared with most other developing countries. China is a textbook example of how WTO accession works in tandem with national market-based reforms. It has become a strong WTO stakeholder, active in multilateral rule-enforcement and dispute settlement. For example, it has been very active in the WTO's regular committees, particularly on core rules issues. Arguably, the embedding of China in the WTO has defused manifold international trade tensions that might otherwise have got out of hand; and it has smoothed China's rapid integration into the world economy. In short, China’s accession is the WTO’s biggest success by far, and the world trading system’s most important milestone since the end of the Uruguay Round. It contrasts very favourably with continued deadlock in the Doha Round.

Nevertheless, China's record in the WTO has not been without controversy – not surprising given such a huge and complicated accession. Implementation of WTO commitments has been mixed. A raft of sensitive cases against China, mostly prosecuted by the USA, has been working its way through dispute settlement. China has stayed conspicuously on the sidelines of the Doha Round. At the WTO mini-ministerial meeting in July 2008, it was partly responsible for blocking an overall deal. Now I turn to these elements of China in the WTO in more detail.

2.1. Implementation of WTO commitments⁴

On balance, China has been serious about implementing the bulk of its WTO commitments in timely fashion. That is true of phased tariff reductions, including the elimination of tariffs on goods covered by the Information Technology Agreement (ITA); phasing out import quotas, licenses and other border NTBs; and expanding trading rights. The revised Foreign Trade Law, issued in April 2004, provides for trading rights to be granted automatically through a registration process for all domestic and foreign enterprises and individuals. This became effective six months before scheduled full liberalisation required by China's Protocol of Accession to the WTO. After pressure from the USA, tariff-rate quotas (TRQs) on protected agricultural products were expanded in line with WTO obligations. China has undertaken a huge programme of aligning national technical standards with international standards. In 2005 it reported that 1,416 national standards had been abolished as a result. It has also revised its laws to better protect intellectual property rights in line with the WTO's Trade-Related Intellectual Property Rights (TRIPS) agreement.

On the other hand, the USA, and to a lesser extent the EU, have led loud and vociferous complaints about China's implementation record. Indeed, US complaints have increased and broadened in scope. To quote the US Trade Representative's National Estimate on China's trade barriers in 2008:

In 2007, US industry began to focus less on the implementation of specific commitments that China made upon entering the WTO and more on China's shortcomings in observing basic obligations of WTO membership, as well as on Chinese policies and practices that undermine previously implemented commitments. At the root of many of these problems is China's continued pursuit of problematic industrial policies that rely on excessive government intervention in the market through an

4 This section draws on WTO (2010) and USTR (2010).

array of trade-distorting measures.⁵

To list some major complaints made by the USA and other WTO members: Many WTO commitments are not uniformly applied in China. One example is uneven application of the WTO Customs Valuation agreement by customs officials at Chinese ports. Application of technical regulations, conformity-assessment procedures and sanitary and phytosanitary (SPS) measures is arbitrary and inconsistent, with inadequate notification of new or revised measures under the terms of the WTO's Technical Barriers to Trade (TBT) and SPS agreements. WTO notification of Chinese government subsidies was overdue and remains incomplete, as it does not cover subsidies from state-owned banks and local governments. IPR laws remain weakly enforced, particularly on copyright protection of a range of goods and services. There are substantial infringements of the Agreement on Trade-Related Investment Measures (TRIMS). China agreed not to make import and investment approval conditional on export-performance, local content, foreign-exchange balancing and technology-transfer requirements. But officials continue to “encourage” such measures without formally requiring them. This can amount to *de facto* requirements, especially as officials have substantial discretion in investment-approval procedures. It is also alleged that China is not living up to its WTO transparency obligations. Ministries and agencies responsible for drafting new or revised laws and regulations often do not circulate them for public comment – which is supposed to include foreign enterprises – and do not provide enough time for public comment before enactment. Finally, USTR reports note that foreign enterprises remain sceptical about the adjudication of trade-related commercial disputes in designated Chinese forums, such as the China International Economic and Trade Arbitration Commission (CIETAC).

2.2: Dispute settlement

An indication of China's serious commitment to the WTO has been its assiduous tracking of dispute settlement. Since its accession it has been a third party to 69 cases, in addition to being a complainant in 7 cases and a respondent in 11 cases – a dramatic increase in the last three years.⁶

However, for the first five years of its WTO membership, China and other major players exercised mutual restraint in taking China-related cases to court. China viewed dispute settlement as a political-diplomatic mechanism to resolve differences through compromise and conciliation, before adversarial

5 USTR (2008): 1.

6 http://www.wto.org/english/tratop_e/dispu_e/dispu_by_country_e.htm

legal procedures kicked in. The USA, EU and others also generally refrained from testing China in court. In three cases -- VAT-Integrated Circuits, EU-Coke Exports and Anti-Dumping Kraft Linerboards⁷ – China made major concessions and settled during the consultation phase, i.e. out of court (Gao 2005; Gao 2007a; Gao 2007b).

Mutual restraint seemed to end in about 2006. The USA launched a raft of cases against China. The first, on automotive parts, struck at China's automotive industrial policy, which dates back to 2006. The latter includes provisions to encourage domestic production of auto parts. One measure stipulated that if the number or value of imported parts in an assembled vehicle exceeded specified thresholds, tariffs charged on imported parts should be equal to the tariff on completed automobiles (typically 25 per cent) rather than the tariff applicable to auto parts (typically 10 per cent). The complainants, the USA, EU and Canada, argued that this violated National Treatment and constituted a prohibited local-content measure. Significantly, China chose not to settle the matter in consultations but to allow it to proceed to a formal adjudicatory panel (USTR, 2008). The latter ruled against China, a decision confirmed by the WTO's Appellate Body in late 2008. China repealed the measure in 2009.

The USA followed up with more cases. One case concerned Chinese subsidy programmes, e.g. income-tax exemptions and refunds, benefiting a wide range of locally manufactured goods. The USA argued that these measures discriminated against imports and imposed export-performance requirements, thus violating the WTO's Subsidies and Countervailing Measures and TRIMS agreements. The USA and China reached agreement on removing alleged prohibited subsidies during consultations.

In 2007 and 2008, the USA filed a case relating to copyright infringement in China; another, also IPR-related, on trading-rights restrictions on copyright-intensive publications and audiovisual products such as films, DVDs, music, books and journals (for which trading rights were restricted to Chinese state-trading enterprises); and one (filed jointly with the EU) on restrictions on financial-information services providers from dealing directly with Chinese clients (rather having to deal exclusively with Xinhua, the state news agency). The USA won the two IPR-related cases, while the last case was

⁷ The issue in the first case was China's attempt to promote the domestic semiconductor industry through VAT rebates for locally-manufactured integrated circuits (ICs). Imported ICs, however, faced the full VAT rate. The USA argued that this constituted a local-content measure in violation of the TRIMS agreement. China withdrew the measure after consultations. In the second case, the EU contested Chinese controls on coke exports, which limited the supply and raised the price of coke imports to the EU. China largely repealed the measure after consultations. In the last case, the USA argued that Chinese imposition of anti-dumping (AD) duties on kraft linerboards did not follow procedures in conformity with WTO AD rules. China repealed the duties after consultations.

settled in consultations in late 2008. In all three cases China agreed to repeal the offending measures.

In 2009, the USA, EU and Mexico took China to dispute settlement over export restrictions on several raw materials used as inputs for downstream production in the USA and EU, especially in steel, aluminium and chemicals. They argued that these measures artificially raised export prices while lowering prices in China, thereby favouring domestic downstream production and exports. The panel is due to rule in 2010.

These recent cases illustrate that China and its major trading partners have become more forceful in their use of dispute settlement. The USA has initiated cases that go to the heart of Chinese industrial policies and related domestic regulation. And China has become less wary of letting cases proceed to legal contest. On balance, this is healthy. China should be challenged in situations when it might well be in breach of its WTO obligations. At the same time, China should test the legal mechanics of WTO dispute settlement – to develop its trade-related legal capacity, defend its rights, and indeed to initiate cases when faced with infractions from its trading partners.

2.3: Negotiations and participation in the Doha Round

In stark contrast to its activism in implementing WTO obligations and in dispute settlement, China has been passive and a marginal player in the Doha Round – conspicuously so for the world's leading developing country and second-largest trading nation. It seems to have made a decision to sit out this Round. Many motives have been ascribed to China's quietism. The official rhetoric is that it needs time to digest new WTO obligations and generally acclimatise itself to WTO membership – but this is disingenuous after almost a decade in the club. More to the point, non-activism means that it has not stepped on developed and developing-country toes, and avoided extra pressure to further open its own markets through even stronger WTO commitments. But this has come at the cost of not forcefully pursuing its “offensive” interests, particularly to open other markets for its manufactured exports, and secure stronger disciplines on AD duties and other “trade remedies”. To cynics who believe the Doha Round has always been a lost cause, Chinese wisdom and foresight might seem particularly acute.

In terms of style, for much of the Round China differed markedly from most other developing countries, including the two other developing-country Big Beasts, India and Brazil. Unlike them, and indeed unlike the USA and EU, it eschewed polarising rhetoric and confrontational posturing. It was

especially careful not to antagonise the USA, but it was also sensitive to other developing countries' fear of the Chinese export juggernaut.

China's overall negotiating position, in common with other Recently Acceded Members (RAMs), is that it is willing to contribute little or nothing beyond its WTO-accession commitments.⁸ There is a large gap between the RAMs' strong WTO commitments and the weak commitments of most other developing countries. That is why the Doha mandate and subsequent negotiating texts have accorded special flexibility to the RAMs.

China's negotiating positions on specific issues have been mixed: offensive here, defensive there, and in-between here-and-there. That reflects a big, complicated country with a large spectrum of interests and preferences internally.

In the *non-agricultural market access* (NAMA) negotiations, China's interests are manifestly offensive: it wants greater access for its manufactured exports in both developed and developing countries. China has mixed positions on *agriculture*. Domestic sensitivities make it loath to commit to extra liberalisation. On the offensive side, it needs lower developed and developing-country barriers to its growing labour-intensive agricultural exports. It has an interest in banning developed countries' export subsidies and significantly reducing their trade-distorting domestic subsidies. Hence it joined the G20, led by India and Brazil. Its G20 participation, however, has been low key and non-belligerent. China is defensive in *services*. It has few export interests; and domestic sensitivities make it reluctant to concede stronger GATS commitments. However, as in goods, China is exceptional: in some cases its GATS commitments even exceed those of developed countries.

One of China's biggest priorities concerns *anti-dumping* and other trade remedies. It has been active in the AD component of the rules negotiations and tabled proposals, mainly with a view to removing, or at least diluting, its "non-market-economy" status with some WTO members, notably the USA and EU. China had been flexible on *Special and Differential Treatment* (S&D) for developing countries, and on the *Singapore issues* (investment, competition, transparency in government procurement, and trade facilitation).

⁸ See "Proposal on flexible provisions for recently acceded members", WT/MIN(03)W/8, September 4 2003, www.wto.org

That said, China's overall position seems to have hardened in the last few years. It has been impervious to US and EU demands to be more flexible with its defensive positions. Finally, during the WTO mini-ministerial in Geneva in July 2008, China emerged from the shadows. Led by its trade minister, Chen Denming, it formed part of the core group of six countries that tried to unblock deals in agriculture and industrial goods. Never before in the Round had it played such a role. But, within this core, it joined forces with India to defend a very generous “special safeguard mechanism” to protect against agricultural imports, and resisted US pressure to lower its cotton tariffs (Beattie and Williams, 2008).

China belatedly played an up-front role in WTO negotiations, but it proved to be defensive rather than pragmatic and middle-of-the-road. That dovetails with a slowdown of liberalisation at home and other defensive measures in China's trade policy, especially in the last three years. That is the subject of the next section.

3. China's trade-related reforms: unilateral measures and PTAs

China's mixed record in the WTO should be seen, above all, in the context of market reforms at home post-WTO accession. The overriding advantage of WTO accession is that it has locked in the sweeping unilateral reforms of the 1990s and earlier, made China's trade-and-investment regulations more transparent and predictable, and given China a long-term stake in multilateral rules. But faraway Geneva cannot drive reforms in Beijing. The national reform engine has stalled, and industrial-policy interventions have correspondingly increased. China's response to the global economic crisis has reinforced this trend. At the same time, China has been very active with PTAs, especially in its east-Asian neighbourhood. Now I turn to these two aspects of China's trade policy in more detail.

3.1. Unilateral measures

There has been paltry unilateral liberalisation going beyond China's WTO commitments. One example is the marginal opening of the highly protected securities sector, as a result of US pressure in the US-China Strategic Economic Dialogue (SED). More foreign fund managers have been allowed in as Qualified Financial Institutional Investors (QFIIs). Foreign-equity limits in joint ventures with Chinese securities firms have been increased, and these firms have been allowed to operate in a wider range of products. The government has also done a U-turn and welcomed foreign private-equity firms to participate in the local market. And it has allowed foreign participation in issuing RMB-denominated

bonds and equities as part of its plan to internationalise the use of the Renminbi. But these are baby steps, restricted by severe and entrenched controls on capital flows, the exchange rate and domestic interest rates.

These measures are small beer compared with huge external opening through the 1990s and up to 2006. But, to a large extent, liberalisation slowdown is predictable. The Beijing leadership is more concerned with social stability in the wake of the massive social convulsions that have accompanied market reforms. Decision making is much more collegiate, cautious and incremental. This characterises the leadership of Hu Jintao and Wen Jiabao – strikingly different from the bold, decisive strokes of Jiang Zemin and Zhu Rongji, and of Deng Xiaoping before them. On trade policy, national reforms and WTO-accession negotiations were highly centralised in MOFTEC (later MOFCOM), reporting directly to the State Council. After WTO accession, other regulatory agencies have got more involved. The government faces more lobbying – and resistance to further liberalisation – from national regulatory agencies, SOEs and other “national champions” in the private sector (or with hybrid forms of ownership), state-sponsored trade associations, as well as provincial and municipal governments. Economic nationalism in government and the Communist Party is more influential than it was in the 1990s, though it has not quite supplanted pragmatic pro-market reformers. Finally, as China's global economic clout has grown so quickly, so has the temptation to resort to more assertive mercantilism. That translates into unwillingness to open markets unilaterally, haggling hard over reciprocal concessions (especially with the USA), and stepping up industrial-policy interventions to promote favoured domestic sectors.

Trade economists from Robert Torrens and John Stuart Mill to Harry Johnson would not be surprised. When China joined the WTO, it regarded itself as a “price-taker” in the world trading system; it acted rather like a small or medium-sized open economy that could only adapt to the international terms of trade. Unilateral liberalisation, reinforced by strong WTO commitments, was the policy prescription. Now, Chinese policy-makers think of China as a member of a club of three: like the USA and EU, it can influence international terms of trade and world prices – or so they believe. Like the USA and EU, that shifts the policy inference away from unilateral liberalisation to reciprocity.

None of the above is cause for wild alarm and panic: China is, to some degree, acquiring the “normal” economic features and political pressures of a very large, complex market economy. And its already deep integration into the world economy – much deeper than that of Japan, South Korea and Taiwan at

an equivalent stage of development -- constrains protectionist pressures and their distortive effects on international trade and investment. Still, these pressures need to be contained, *especially* with a turbulent global economic environment and more protectionist pressures as a result of the recent crisis.

To list some major signs of industrial-policy intervention, as well as “unfinished business” in external liberalisation and related structural reforms:⁹

First, China's already complex export regime has become considerably more restrictive. Export taxes, reduced VAT rebates on exports, export bans, licensing and quotas are used to restrict exports of a growing number of goods – mainly raw materials and agricultural commodities. The objectives are various: defusing tensions with trade partners (e.g. over garments exports), reducing energy consumption, combating food inflation, and promoting downstream industries through cheaper inputs. But these measures distort international competition by lowering domestic prices and raising world prices (in products in which China is a major supplier and can shift international terms of trade). China's recent decision to cut export quotas on rare-earth metals by 40 per cent is a classic example – over two-thirds of world production is in China.¹⁰

Second, tax incentives, subsidies and price controls, as well as administrative “guidance” on investment decisions, are used to favour domestic sectors over imports, especially where SOEs and assorted “national champions” operate. This characterises iron and steel, petrochemicals, automobiles and auto parts, forestry and paper, non-ferrous metals, telecommunications equipment, semiconductors and other science-and-technology sectors.

Third, China has promoted unique national technical standards – some would say as a regulatory-protectionist device to compensate for falling border barriers. China-specific standards, at variance with international standards, can create high compliance costs for foreign enterprises. Notable examples are encryption for Wireless Local Area Networks (WLANs) and 3G mobile-phone standards. Foreign enterprises complain of lack of transparency in Chinese standard-setting bodies due to restricted membership, voting rights and information dissemination. This is exacerbated by standards set by different agencies at national and provincial levels. Foreign enterprises have similar complaints about

9 The following draws on WTO (2010), USTR (2010), European Chamber of Commerce in China (2010), Paulson (2008), Scissors (2009).

¹⁰ “Rare earths leverage”, *Wall Street Journal*, 19 October 2010.

Chinese conformity-assessment bodies. They also complain about requirements to share commercially-sensitive information and intellectual property when submitting samples and information for mandatory testing.

Fourth, services barriers have come down more slowly than goods barriers, and perhaps more slowly than expected after WTO accession. High and discriminatory capital requirements discourage entry for foreign services providers in, for example, telecommunications, insurance and construction (though capital thresholds have been reduced in banking). Licensing procedures have become more transparent and regular, but problems remain, especially in financial services, telecommunications and express-delivery services. Equity and operating restrictions are prevalent in insurance, securities and telecoms, though not (at least formally) in banking. Basic telecommunication services is dominated by four SOEs, all with close links to the Ministry of Information Industries and Technology (MIIT), and foreign entry is restricted to joint ventures. But no joint venture involving a foreign-invested enterprise has been licensed since WTO accession. MIIT is reluctant to allow new competition to incumbents in value-added telecom services such as modems, mobile WIFI and Voice-over-Internet Protocol. It has only issued 3G licenses to local incumbents.

Equity and severe operating restrictions apply to foreign Internet Services Providers (ISPs). They are hemmed in by the world's most comprehensive internet filtering regime, the Chinese "Great Firewall", which affects much internet commerce. This has provided cover for more aggressive "online protectionism", benefiting local ISPs (such as the search engine Baidu) over foreign competitors (such as Google). In 2009, a measure to force PC-makers to install a locally-produced internet filter, ostensibly to block pornography, was "delayed" after a barrage of opposition, mainly from US technology companies. Several measures targeting Google led to its unilateral withdrawal from China in 2010.¹¹

Fifth, foreign-investment restrictions have been tightened. In November 2006, the National Development and Reform Commission (NDRC) announced a five-year plan for foreign investment. It stressed a shift from "quantity" to "quality", tighter tax supervision and restricted foreign acquisition of "dragon-head" enterprises. This was soon followed by a government "guiding opinion" identifying an enlarged list of "pillar" and "backbone" sectors in which further foreign investment in SOEs was to be

¹¹ On Chinese online protectionism, see Hindley and Lee-Makiyama (2009).

prevented. New provisions on mergers and acquisitions also contained vague language on “national economic security” and “critical industries”, probably intended to block foreign acquisitions. The government is drawing up rules to vet foreign acquisitions on national-security grounds. Foreign enterprises also fear that the new Antimonopoly Law, effective from August 2008, will be used to block mergers and acquisitions involving foreign-invested enterprises, and protect SOEs and other national champions. It contains vague language on the “public interest”, “national economic security” and “unreasonable prices”, and no definition of market dominance. It has sweeping exemptions for SOEs. It may have stalled several deals involving MNEs; and it was used to block Coca Cola’s acquisition of Huiyuan Juice (what would have been the biggest foreign takeover of a Chinese company).

The *Foreign Investment Catalogue*, issued in 2007, suggests a more selective approach to foreign investment, targeting higher value-added sectors rather than basic manufacturing. It includes new restricted sectors such as biofuel production and soy crushing, and blanket prohibitions on foreign investment in movie production, news websites, audiovisual and Internet services. Another government “opinion” calls for expanded domestic market share in industrial-machinery manufacturing sectors, which could presage difficulties for foreign investors seeking control of leading domestic firms. Finally, the government promotes domestic services sectors through foreign-investment restrictions, notably in financial services and telecommunications.

Sixth, government procurement explicitly discriminates in favour of domestic enterprises. China has applied to join the WTO's Government Procurement Agreement (GPA), in line with its WTO-accession commitments, but negotiations have been predictably glacial. It submitted a revised offer in 2010, much diluted by exempting local governments and SOEs. Overall, discriminatory government-procurement practises have become more pronounced. “Buy China” measures, operating at national, provincial and municipal levels, were introduced as part of the fiscal-stimulus package in 2009.

More importantly, an “indigenous innovation” policy, announced initially in 2006, is geared to promoting domestic technology companies at the expense of foreign competitors. In 2009, a government Circular on “national indigenous innovation product accreditation work” stipulated that, to qualify for accreditation for procurement preferences, intellectual property must be “originally registered” in China, with “Chinese intellectual property and proprietary brands”, and that intellectual property must be “totally independent of overseas organisations or industries”. The government then created a catalogue of 240 “indigenous-innovation” products. In 2010, the authorities softened these

rules following complaints from over 30 foreign-industry groups.

Other compulsory certification schemes restrict foreign access to government procurement. This applies to cars, car parts, IT and telecom equipment, healthcare equipment, and electro-technical and power-transmission equipment. Encryption-rich products such as firewalls, secure routers and smartcards must undergo compulsory certification according to Chinese standards if they are to qualify for government procurement. This can require handing over software source codes and other confidential information. Again, the government has agreed to delay implementation in response to complaints from foreign technology companies. Also, there is a new proposed security classification scheme for technology products. It contains vague language on “critical infrastructure” and “public security” that could bar FIEs from commercial projects in transport, telecoms, water, healthcare, energy and banking.¹²

The high-speed rail sector is a headline example of how government procurement has been used to build up national champions. Foreign suppliers have been restricted to joint ventures and forced to transfer sensitive technology in order to get contracts. In quick time, domestic firms, using foreign technology and with low-cost finance from state-owned banks, have got to the stage of competing with American, European and Japanese MNEs for contracts abroad.¹³

Seventh, energy sectors are largely insulated from global markets. Price controls apply to oil, natural gas, coal and electricity. Three giant SOEs dominate oil and gas, and the private sector is barred from production in oil, gas and coal. Export restrictions and imports controlled by state-trading enterprises protect SOEs in these sectors from international competition. That applies to nuclear and renewable energy as well. Foreign makers of electric cars and wind turbines and solar panels, for example, complain of being shut out of domestic projects. They are restricted to joint ventures and are subject to onerous local-content and technology-transfer requirements.

Eighth, China’s “investment nationalism” extends to its Go Out policy. SOEs benefit from cheap finance from state-owned banks. They enjoy strong political support to build infrastructure in and secure long-term energy supplies from resource-rich countries. Such capital-intensive outward investment contrasts with predominantly labour-intensive inward investment.

¹² “Foreign groups fear loss of contracts”, *Financial Times*, 9 November 2010.

¹³ “A future on track”, *Financial Times*, 24 September 2010.

Ninth, China has become a prominent user of trade remedies. It had 102 AD measures in place by January 2010. It also launched three countervailing duty investigations in 2009.

And tenth, foreign business associations – especially from the USA and EU – continue to complain of opaque and unpredictable laws and regulations. This encompasses too short or no prior consultation before the release of laws and regulations (as was the case with the Circular on indigenous innovation); and discretionary enforcement that leads to big differences in regulatory implementation in different parts of the country.¹⁴

3.2: Unilateral measures and the global economic crisis¹⁵

China's main response to the recent economic crisis was a supercharged fiscal and monetary stimulus amounting to almost a half of GDP in 2009. That comprised a direct fiscal-stimulus package of USD 585 billion, and, far more important, state-directed bank lending of almost RMB 10 trillion (USD 1.5 trillion) in new loans. That ensured growth of about 9 per cent in 2009 – over 90 per cent of which was due to the stimulus. The latter went mostly into fixed-asset investment in physical infrastructure, though some of it inevitably seeped into financial and property markets. The stimulus's engine was ramped-up lending by state-owned banks to industrial SOEs.

Trade and FDI-restricting measures have increased during the crisis. Some are directly crisis-related; others would probably have materialised with or without the crisis. VAT rebates on labour-intensive exports were increased – but this follows past practice, compensates for rebate reductions in 2006/7 and is not exactly clear-cut protectionism. There were “Buy Chinese” government-procurement provisions – but China has long-standing discriminatory government procurement and is not yet a member of the WTO's GPA. Tighter standards were used to ban a few European agricultural products. Subsidies and lower sales taxes have favoured the domestic car industry. A new Postal Law bans foreign companies from providing certain domestic express-delivery services. There was stepped-up technology-related protectionism, e.g. indigenous-innovation measures and online-services restrictions. And more trade remedies were initiated. On the other hand, China reduced or eliminated some export duties, and

¹⁴ The European Chamber of Commerce in China (2010) highlights these obstacles to foreign business above other barriers in its annual position paper.

¹⁵ This section draws on Sally (2009a) and Erixon and Sally (2010).

opened up the domestic market to foreign travel agencies. It is also the most frequent target of other countries' crisis-related protectionism (Table 4). It has been on the receiving end of tariffs, import licensing, AD duties, and tighter standards on its exports of iron, steel, aluminium, footwear and toys.

Chinese protectionism has increased since the crisis broke, but not dramatically or to the extent of reversing a thirty-year liberalising trend. Indeed, China does not figure in *Global Trade Alert's* list of top ten offenders on crisis-related trade-restrictive measures; the EU-27, India, Russia and Brazil do figure in this list (Table 5). Overall, the Beijing leadership has not rocked the boat during or after the crisis: it has not resorted to aggressive mercantilism. Recent trade conflicts with the USA and EU over the measures mentioned above, as well as exchange-rate tensions, should not be exaggerated: they do not amount to a trade war. Protectionist responses have been heavily constrained by China's already deep integration into the world economy, particularly through processing trade and global manufacturing supply chains, and by its strong WTO commitments.

3.3: PTAs

China is the driving force for PTAs in Asia. By 2009, it had 11 PTAs on the books, with 11 others under negotiation or proposed (Table 6). However, China's trade with its FTA partners is still a relatively small share of its overall trade, accounting for about a quarter of imports and less than a third of exports.

The China-ASEAN PTA, more than any other, is the one to watch in the region. It is the largest PTA ever negotiated, covering 11 diverse economies with a population of 1.7 billion. It came into force in January 2010.¹⁶ There has been progress in eliminating tariffs on trade in goods. However, little progress has been made on non-tariff barriers in goods, services and investment (both relatively weak agreements), and other issues. China has stronger "WTO-plus" PTAs with Hong Kong and Macau (both admittedly special cases); a comprehensive PTA on goods with Chile; newly concluded PTAs with New Zealand, Singapore and Peru; and is negotiating PTAs with Australia, Iceland, the Gulf Cooperation Council and Norway. It has a partial-scope tariff agreement with Pakistan. Most recently, it signed an Economic Cooperation and Framework Agreement (ECFA) with Taiwan. This followed a series of bilateral agreements to liberalise highly restricted trade across the Taiwan Straits. But much

¹⁶ The four new, less-developed ASEAN countries have until 2015 to implement their commitments.

remains to be done: ECFA is a “framework agreement” with initially limited liberalisation. China is also negotiating or thinking of negotiating rather weak PTAs elsewhere in the developing world, e.g. with Mercosur and the South African Customs Union (SACU). These are shallow –mostly preferential tariff reductions on a limited range of products.

China gives unilateral tariff preferences to 41 least-developed countries (LDCs). It has pledged to give duty-free access to 95 per cent of imports from LDCs, though by an unspecified date.

China's approach to PTAs is pragmatic and eclectic (Antkiewicz and Whalley, 2005). But it is mostly “trade light”. Even the China-ASEAN PTA is unlikely to create much extra trade and investment if it does not go substantially beyond tariff elimination in goods. China's PTAs are driven more by “high politics” (competition with Japan to establish leadership credentials in east Asia; securing privileged influence in other regions) than by economic strategy. Foreign-policy “soft power”, ie. diplomacy and relationship-building, is paramount.

This reflects the emerging PTA pattern in Asia, and the established PTA pattern in other developing-country regions (Sally, 2006). Politically sensitive sectors in goods and services are carved out, as are crucial areas where progress in the WTO is elusive (especially disciplines on AD duties and agricultural subsidies). Little progress is usually made in tackling domestic regulatory barriers (e.g. relating to investment, competition, government procurement, trade facilitation, cross-border labour movement, and food-safety and technical standards). PTAs hardly go beyond WTO commitments, deliver little, if any, net liberalisation and pro-competitive regulatory reform, and get tied up in knots of restrictive, overlapping rules of origin (ROOs).

In addition to bilateral PTAs, China is at the heart of regional-economic-integration initiatives in east Asia (Kawai and Wignaraja, 2008). An “ASEAN Plus Three” PTA (the “three” being Japan, South Korea and China) has been touted, as has a three-way Northeast-Asian PTA (Japan, China and South Korea) and an “ASEAN Plus Six” PTA that might include India, Australia and New Zealand. Visions of an East Asian Economic Community and even an Asian Economic Community have appeared on the horizon.

So far this talk is loose and without much substance. To begin with, regional trade integration is partial and skewed. It is restricted to east Asia; south Asia is the most malintegrated region in the world and

has barely inserted itself into regional and global manufacturing supply chains. True, east-Asian intra-regional trade and FDI have increased considerably. But they are a direct product of *global* economic integration, particularly in manufacturing. Their core is a dense network of production-sharing and trade in manufacturing parts and components, which are in turn linked to final markets in Europe and North America (Athukorala, 2006; Baldwin, 2006). Beyond these manufacturing niches, mainly in ICT products, east Asia remains highly malintegrated, beset by border and non-border barriers to intra-regional commerce.

Since the crisis, a newly fashionable argument holds that regional trade patterns are changing fast, and will favour regional production for regional consumption, i.e. a more comprehensive type of regional integration less reliant on the West. China is the hub of this new regionalism. Its booming domestic consumer market and still huge infrastructure requirements will attract greater exports of capital equipment and final goods – not just parts and components for assembly and re-export – from other east-Asian countries. Indeed, there may have been an increase in this kind of east-Asian trade in 2009/10, riding the wave of high Chinese growth while Western demand has shrunk. But these prognostications are highly premature and speculative. China has enjoyed a short-term consumption boost through massive government stimulus. That will inevitably wane. But it is highly questionable that it has had a *structural* shift to a more consumption and less investment-oriented economy. And there is no serious empirical evidence to date that east-Asian trade has become noticeably less reliant on extra-regional markets (Athukorala and Kohpaiboon, 2010).

On the policy front, regional players are speeding ahead with bilateral PTAs. The emerging pattern is of a patchwork of “hub-and-spoke” PTAs, in a “noodle bowl” of trade-restricting ROOs. This does not seem to have done much harm so far; but, if unchecked, it could slow down and distort the advance of regional and global production networks. So could region-wide PTAs that discriminate against extra-regional trade and FDI. Will bilateral PTAs be folded into simpler, more comprehensive region-wide PTAs, especially in east Asia? Will a serious China-centred APT FTA emerge? That looks highly unlikely in the medium-term. Countries are at widely different stages of development with competing producer interests, significant barriers to trade with each other, and without a culture of deep cross-border cooperation. Moreover, bitter nationalist rivalries – especially between China, Japan and South Korea, and between China, India and Pakistan – will continue to stymie east-Asian and pan-Asian regional-integration efforts for a long time to come.

Perhaps the best that can be expected is gradually stronger “soft cooperation” in regional institutions such as APEC, ASEAN, APT and EAS. They can be chat forums, gradually improve mutual surveillance and transparency, promote trade facilitation and “best-practice” measures, and (at best) cement unilateral liberalisation and help prevent its reversal in difficult times. Inevitably, China will be the most important player in these institutions; no stronger cooperation, hard or soft, will work without its lead.¹⁷

4. China's trade policy: challenges ahead

China's domestic climate for further trade-and-investment liberalisation is clearly more inclement than it was before WTO accession; and there is greater industrial-policy interventionism. These tendencies are reinforced by a global climate of stalled liberalisation, with a new wave of government “crisis interventions” in the wake of the global economic crisis.

From a market-liberal perspective, China should restrain its industrial-policy activism and its protectionist spillover. And it should go further in two respects: plug gaps in its implementation of WTO commitments; and proceed with WTO-plus reforms. But this is easier said than done, and it does not appear realistic in the current climate. Industrial-policy activists abound in Beijing and in provincial and municipal governments. In particular, sub-national officials enjoy considerable *de facto* autonomy, which they often use to restrict competition and protect well-connected incumbents. And, for the time being, they have a fair wind in their sails.

On WTO implementation, China needs to improve its enforcement of the TRIPS, TRIMS, SPS, TBT and SCM agreements, and have better WTO notification of its subsidies. Better enforcement of WTO agreements requires stronger restrictions on regulatory discretion at national and sub-national levels, especially on official “encouragement” and “guidance” of measures that are clearly incompatible with WTO obligations. More transparency is also needed, eg. freely and promptly circulating draft laws and regulations to interested foreign enterprises, and allowing them sufficient time for comment. That said, limits to regulatory discretion will prove very difficult in a country that still has not completed its journey from Plan to Market, and which has large, complex bureaucracies at national and sub-national levels.

¹⁷ On prospects for regional economic cooperation and integration, see Sally (2010).

What about WTO-plus reforms? China could further reduce applied import tariffs, especially on industrial goods. It should reverse export controls on raw materials and agricultural commodities. But its more substantial – and politically very tricky – challenge is to tackle high trade-related domestic regulatory barriers in goods, services, investment and public procurement.

Ideally, China would reduce measures to promote capital-intensive, SOE-dominated sectors at the expense of imports; align national standards with international standards, alongside a more active role in international standards-setting bodies; restart services liberalisation (by easing capitalisation requirements, equity restrictions, and licensing and operating procedures); lower foreign-investment restrictions (by narrowing down lists of sectors in which foreign investment is banned or discouraged, and not applying antitrust provisions to block foreign transactions in favour of national champions); limit online and high-tech protectionism; and gradually liberalise markets in government procurement and energy.

There are several tracks on which to pursue China's trade-related reforms: the unilateral (domestic) track; in the WTO; in PTAs; and in key bilateral and regional relationships, especially with the USA, EU and its east-Asian neighbours. Consider each track in turn.

First, the primary thrust of trade-related reform must be unilateral, i.e. outside trade negotiations, and hitched firmly to domestic reforms to improve the business climate. Put another way, trade policy should be embedded in domestic economic policy and its institutional framework rather than being driven by external negotiations and international institutions. Trade-related regulatory reforms are bundled up with domestic politics and economics; initiating and implementing them is overwhelmingly a domestic affair; and the scope for productive international negotiations and agreements is restricted.

Chinese unilateral liberalisation also has a vital external dimension. It is the biggest the world has ever seen, with the biggest spillover effect in Asia. China's opening not only spurred southeast-Asian liberalisation pre-Asian crisis; it probably helped prevent liberalisation reversal post-Asian crisis. It has also encouraged east-Asian countries to further liberalise at the margin post-Asian crisis – for fear of losing trade and FDI to China. Not least, China has probably spurred Indian liberalisation of import tariffs and FDI restrictions in some services sectors. Hence much depends on this Chinese engine for future trade and FDI reforms, elsewhere in Asia and beyond. It is important that it revs up again.

Second, China-induced unilateral liberalisation is not a panacea. It does not lock in liberalisation against future backtracking. Nor does it provide fair, stable and predictable rules for international commerce. That leaves room for reciprocal negotiations and international agreements, particularly in the WTO.

The failure of the Doha Round (as of the time of writing) probably shows that future multilateral liberalisation will be elusive and modest at best. Arguably, the best the WTO can hope for post-Doha is to lock in pre-existing unilateral liberalisation through binding commitments, and gradually improve the functioning of multilateral rules. There should indeed be much stronger focus on safeguarding, updating and improving trade rules – in which China has such a substantial stake. This is more important for most WTO members than extra multilateral liberalisation. China should be active in plurilateral “coalitions of the willing” to make key market-access and rule-making decisions, and correspondingly take on stronger commitments than poorer, weaker and more recalcitrant developing countries. China, India and Brazil – the three developing-country Big Beasts in the WTO – should exercise co-leadership alongside the USA, EU and perhaps Japan (if the latter can get its act together). China's helping hand will be indispensable – arguably more important than those of India and Brazil. Given its trading weight, China is one of the Big Three in the WTO, alongside the USA and EU. Without China's more active participation, it is doubtful that the Doha Round can be concluded. Post-Doha, it is vital that China move to the WTO foreground and play an active co-leadership role.

Third, PTAs are generally trade-light; their noodle-bowl discriminatory patchwork causes complications for business and multilateral rules; and they are unlikely to spur regional and global integration. There should be much more caution with PTAs; and serious attempts made to minimise the damage from their discriminatory provisions. Again, China's lead will be important. It needs to signal its intention to avoid gimmicky initiatives, clean up existing weak and dirty PTAs, and make them more compatible with multilateral rules.

Fourth, China's key bilateral relationships, especially with the USA, matter as much as what it does in the WTO and PTAs. These are, of course, two-way streets. The Beijing leadership is likely to arrest protectionist backsliding, and go farther with liberalisation and structural reforms, if it enjoys friendly, give-and-take relations with major trading powers. That also applies to its relations with its east-Asian neighbours. This is probably necessary to overcome domestic opposition to change. Tub-thumping

protectionism and belligerence by the USA about issues such as the Chinese exchange rate and current-account surplus, and imports of garments and other labour-intensive exports, as well as on security-related issues, invite a Chinese backlash and make its leadership more defensive. That is a recipe for reform stoppage and reversal.

Thus it behoves the USA and other trading partners to strengthen “constructive engagement” with China across a broad range of economic and foreign-policy issues, while containing foreign-policy belligerents and protectionist forces at home. This will, in turn, encourage Beijing to strengthen its key bilateral relationships and its participation in international institutions, contain aggressive nationalistic tendencies (especially directed at Taiwan and Japan), and, not least, step up economic reforms at home.¹⁸

Realism tells us that most of this wishlist is not on today’s Beijing agenda. It is not minded to curtail industrial policy, proceed with WTO-plus reforms, be proactive in WTO negotiations or restrain PTA permissiveness. But that same wishlist is worth promoting so that it can be achieved, however partially and patchily, when political conditions are ripe.

Fifth, talk of constructive engagement in key bilateral relationships – especially with the USA – leads inevitably to consideration of global macroeconomic tensions. US complaints about an allegedly grossly undervalued RMB and persistent Chinese current-account surpluses have become shriller. China stands accused of protectionism via “currency manipulation”, which, it is said, constitutes an export subsidy. Via its current-account surplus, China is charged with adding to global imbalances at a time when US demand is depressed, and when the USA is attempting a shift from consumption to savings. Other countries succumb to the temptation of devaluing their currencies; a round of competitive devaluation ensues. This is the prelude to “currency wars”, which in turn threaten a new round of trade protectionism.

The US House of Representatives has passed a bill to slap trade sanctions on China as retaliation for its currency manipulation. Fred Bergsten, Paul Krugman, Martin Wolf and other luminaries have called for trade or capital-market sanctions if China does not fall in line. Ahead of the G20 summit in Seoul, the

¹⁸ This is the coda to Robert Zoellick's much-publicised speech on US-China relations (Zoellick, 2005). It is also the underlying logic of the US-China Strategic Economic Dialogue, now renamed the Strategic and Economic Dialogue.

US proposed “numerical targets” (of +/- 4 per cent of GDP) to limit current-account imbalances.¹⁹

Large and persistent currency undervaluation and current-account surpluses, especially for a country as large and as important as China, can perhaps be a source of global instability, and indeed exacerbate protectionist pressures. One is reminded of the currency wars of the 1930s (some countries stayed on the gold standard while others left it), which triggered more trade protectionism than the Smoot-Hawley tariff.²⁰ But today the spectre of currency wars has not triggered a new round of protectionism – so far. And the negative consequences of currency undervaluation and current-account imbalances are probably exaggerated.

Conventional American reasoning on this set of issues has deep flaws, with dangerous policy inferences. The RMB may be undervalued, but no one knows what the “right” market exchange rate is or should be, and estimates of undervaluation range from 0-50 per cent. An obsession with nominal exchange rates is also misleading. The assumption of a straightforward, mechanical translation from an undervalued currency to a current-account surplus is highly questionable, *especially* in China’s case. Processing trade, in which China is deeply embedded, blunts the effects of currency swings. A large and sudden RMB revaluation could be very destabilising for the Chinese export economy, without making a corresponding dent into the US current-account deficit. American consumers and firms who use Chinese inputs would suffer through higher prices. Underlying economic policies relating to savings, investment and consumption probably have a greater effect on external imbalances than exchange rate valuations. Finally, is an obsession with national current-account imbalances warranted in a world of 21st-century globalisation characterised by processing trade and vertically-integrated global supply chains?²¹

A Chinese move to *gradually* revalue the RMB alongside domestic structural reforms would probably ease global imbalances and protectionist pressures. But the American obsession with the RMB and the Chinese current-account surplus is both misguided and dangerous. Its analysis belongs to a world that predates modern globalisation, and its headline prescriptions (trade and/or capital-market sanctions) are

¹⁹ Martin Wolf, “How to fight the currency wars with a stubborn China”, *Financial Times*, (need date); Martin Wolf, “Current-account targets are a way back to the future”, *Financial Times*, (need date); Clive Crook, “Time to get tough with China”, *Financial Times*, 11 October 2010; Fred Bergsten, “Obama has to tell Beijing some hard truths”, *Financial Times*, 28 November 2010.

²⁰ Douglas Irwin, “Goodbye free trade?” *Wall Street Journal*, 15-17 October 2010.

²¹ Ikenson (2010); Yiping Huang, “What to do about China’s currency?” *East Asia Forum* (need details); Yiping Huang, “Improving China’s art in dealing with external pressures”, *East Asia Forum*, 16 September 2010 (need weblink); Yiping Huang, “Rebalancing China’s economic structure”, *East Asia Forum*, September 3rd 2010 (need weblink).

crudely mercantilist.

An allied prescription – G20 coordination of exchange rates and global imbalances in a “Plaza II accord” – is equally wrong. It presupposes knowledge of the “right” exchange rates and external balances – which nobody has. Such a grand global design smacks of command-economy thinking and massive social engineering. It wilfully ignores what Hayek called a “knowledge problem”, inherent in complex market economies, and its policy nostrums are what Hayek also called a “fatal conceit”. Also, deep-seated differences among G20 members on underlying economic policies have prevented and will prevent “hard coordination” of *anything* – trade, macroeconomic policy, financial regulation, structural reform or anything else for that matter. In that sense the G20 is no different from the G8. Very “soft” cooperation is the best that can be achieved; hard coordination is a will-o-the-wisp.

5. The broader context: China’s hybrid political economy and geopolitics

China’s trade policies must be seen in the context of the domestic economy and its political arrangements, and also in the context of China’s rising geopolitical power.

The uneasy coexistence of external openness and domestic industrial policy is but a reflection of hybrid conditions at home. Despite over three decades of market reforms, China’s economy remains “unbalanced”. Symptoms include over a third of the world’s current-account surplus, foreign-exchange reserves amounting to half of domestic GDP, and household disposable income that is barely over a third of GDP. The private sector makes up about two-thirds of GDP, but the public sector retains some “commanding heights”. The government and SOEs dominate banking, insurance, the bond market, telecoms, aviation, shipping, railroads, oil, coal, steel, natural gas, petrochemicals, power generation and distribution, and other sectors besides. Growth continues to rely on high rates of domestic saving and investment, but at the expense of repressed consumption. *Dirigiste* policies favour polluting, capital-intensive industrial and resource-based SOEs, state banks in a backward financial system and capital markets, and monopolistic services providers in other sectors. Externally, surplus savings plus an undervalued exchange rate contribute to global economic imbalances and generate extra trade tensions.

“Rebalancing growth” – making it more consumption and less investment-driven – requires deep competition-enhancing reforms. Here the wishlist is long: revaluation of the Renminbi to something

approaching market-determined levels; restructuring and privatisation of SOEs and state-owned banks; financial-sector liberalisation to liberate credit allocation, deepen equity and bond markets, and turn savings into more productive investments; secure private property rights, including legal title to rural land; deregulation of internal trade to create a more integrated domestic market; liberalisation of the household registration (*hukou*) system so that workers and their families can move more readily from the countryside to urban areas; market pricing for a range of inputs (land, water and other natural resources); and better provision of public services (health, education, pensions and social security).

Such reforms would lower transaction costs and improve the business climate, as would WTO-plus reforms on trade and FDI. They would also help reduce global macroeconomic imbalances and lower trade tensions. But these are “second-generation” reforms “behind the border”. They concern factor markets (land, labour, capital and energy) as much as product markets. They lie at the heart of domestic economics and politics. They are much more difficult politically than “first-generation” reforms, such as the earlier phase of trade and FDI liberalisation “at the border”. In China, needed reforms go to the core of the Communist Party-government-public sector nexus and its grip on power (Pei, 2006; Huang, 2008). It is unlikely to happen soon. Indeed, China’s crisis response – essentially an investment binge – bolsters the public sector and state power at the expense of the far-less-subsidised private sector. It has succeeded in arresting growth slowdown in 2009, but it exacerbates China’s structural fault-line of over-investment and under-consumption. Its command-and-control mechanisms take market reform backwards. And there is the real risk of surplus manufacturing capacity flooding into anaemic export markets in Europe and North America, thereby inviting protectionist retaliation against China.

In essence, China’s development trajectory follows that of other east-Asian countries in massively over-investing and misallocating capital, but its embedded political economy keeps it on the same treadmill. However, investment-driven growth is subject to diminishing returns (note the slowdown in total-factor-productivity growth since the late 1990s), and Chinese exports face a turbulent post-crisis external environment of depressed global demand and greater trade friction. Hence the need for structural reforms to deliver more sustainable, better quality growth.²²

European and American business leaders also complain that they face a much more frustrating environment. Gone are the days when Western MNE executives were given the red-carpet treatment,

²² Yu Yongding, “China needs slower, better growth”, *Financial Times*, 6 August 2010.

showered with investment incentives, juicy contracts and ready access to senior officials. Now they face more regulatory obstacles, access to policy-makers is more restricted, and they are lectured to by party and government officials. To many it seems like Beijing intends to preserve, even enhance, its arbitrary power over foreign and domestic business, and to display its mercantilism more aggressively. US Chamber of Commerce and European Chamber of Commerce surveys of their members in China reveal a rising tide of discontent. Their treatment in China also makes them less keen to lobby on Beijing's behalf in Washington and in European capitals whenever China-bashing protectionist pressures arise.²³

Such corporate sentiments are symptomatic of stalled reforms and even reform reversal – up to a point. It is easy to exaggerate and paint a black-and-white picture. The picture is much more mixed; it has many patches of light and shade. Contrary to sensationalist claims,²⁴ China is not about to disengage from the West, and especially the USA. It is not about to make a sudden switch from exports to reliance on domestic consumption. “State capitalism” is not about to take over the economy. And China is not about to “rule the world” – to become an aggressive leader in Asia and the wider world. For there are powerful countervailing forces. China's economic globalisation, its embeddedness in multilateral rules and institutions (especially the WTO), its regional and bilateral trade relationships, all hem in aggressive mercantilist tendencies. This has remained true during and after the recent crisis. Fundamental market reforms, including external liberalisation, have not been reversed. FDI continues to increase. MNEs are still committed to staying in China and are making healthy profits there. Some of their discomfiture is inevitable since they are beginning to penetrate domestic markets, where regulatory protectionism is more entrenched and difficult to dislodge compared with less-regulated, more internationally exposed export-platform operations.

At bottom, the Beijing leadership remains pragmatic and internationally engaged. It does not want to “rock the boat” too much. But stalled trade and FDI liberalisation, the absence of domestic structural reforms and creeping protectionism threaten future trade tensions. They also diminish China's ability to look outward and exercise leadership in the regional and world economies.

²³ Alan Beattie, “Trading blows”, *Financial Times* July 6 2010; “China's frustrated ‘old friends’”, *Wall Street Journal*, July 9-11 2010; Joerg Wuttke, “China is beginning to frustrate foreign business”, *Financial Times* xxxx 2010.

²⁴ See Jacques (2009) and Bremmer (2010).

On a final geopolitical note, it is clear that China has become more assertive in foreign policy since the global economic crisis. Pragmatism, conciliation, charm offensives and other manifestations of “soft power” seemed to characterise China’s self-proclaimed “peaceful rise” pre-crisis. Since then, China’s growing self-confidence has shown a different face. China has said “no” more often to the USA, e.g. on RMB appreciation and numerical targets for current-account imbalances ahead of the G20 summit in Seoul. It said “no” to the USA and EU on the climate-change agenda at the Copenhagen summit in late 2009. It has been more assertive in south Asia (cementing relations with India’s neighbours and laying stronger claim to Arunachal Pradesh) and elsewhere in the developing world. It has also been more assertive in the east-Asian neighbourhood, e.g. in the South China Sea and in a recent spat with Japan in the Senkaku islands. Harsher rhetoric and occasional hectoring are more on display. To Robert Kaplan, these are manifestations of the expanding geography of a would-be hegemon of the Eastern Hemisphere. China is a rising “über-realist” power, reaching across land and sea to secure energy supplies to fuel its economic growth – and rubbing up against the USA and other emerging powers such as India and Russia (Kaplan, 2010). To Joseph Nye, China is dangerously miscalculating, displaying a combination of overconfidence in foreign policy and underconfidence in domestic affairs (Nye, 2010).

China may be rising economically and geopolitically, but there remain binding constraints on its ability to lead externally, whether in its east-Asian neighbourhood or on the global stage. It is still far behind the USA in terms of market size, living standards and military resources. Other countries, not least in east Asia, do not want to live under Chinese hegemony. Crucially, China lacks a tradition of external leadership, and its recent opening to the world economy is simply too new for it to exercise leadership assuredly. Rather the Chinese governing elite is too preoccupied with domestic political and economic issues to be willing and able to exercise external power strongly and responsibly. Its main concern is to keep its external environment safe for China’s economic development, not to act as a regional or global policeman.

6. Conclusion

This paper has covered broad Chinese trade-policy trends post WTO accession: implementation of WTO obligations; dispute settlement; participation in the Doha round; PTAs; and unilateral measures. In sum: China has a mixed record on WTO implementation; a flurry of litigation has followed several years of diplomatic reconciliation in dispute settlement; and China has been passive in the Doha round.

In contrast, it has been very active with PTAs, setting off a “domino effect” in east Asia. But its PTAs are “trade light”, driven more by foreign policy than commercial considerations. Finally, unilateral liberalisation – the driving force of external opening in the 1990s – has stalled. There has been very little “WTO-plus” liberalisation, while measures of selective protection, especially related to foreign investment and industrial-policy targeting, have increased. China’s response to the global economic crisis has reinforced these trends, but it does not represent a dramatic increase in protection or fundamentally reverse China’s opening to the world economy.

China’s short-term challenge is to contain protection at home. That will send positive signals to contain protectionism worldwide. Beyond that, China’s challenge is to stimulate further unilateral liberalisation related to domestic structural reforms. That means tackling non-border, but still trade-related, regulatory barriers, especially in investment and services. Cleaning up PTAs and strengthening participation in the WTO are important auxiliary objectives. This should be seen in the context of further liberalising the Chinese economy and “rebalancing growth”. But this does not appear to be Beijing’s agenda today. Not least, such “second-generation” reforms strike much closer to vested interests at the heart of the Party State in China. Nevertheless, pro-market reformers should work to make it tomorrow’s, or the day-after-tomorrow’s, agenda. Finally, two-way “constructive engagement” in China’s key bilateral and regional trade relationships is vital to contain protectionism and smooth China’s further integration into the global economy. The US obsession with RMB undervaluation and China’s current-account surplus is not an exercise in constructive engagement – indeed quite the opposite.

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