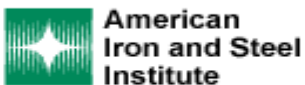




REBALANCING THE U.S.-CHINA ECONOMIC RELATIONSHIP: A STEEL INDUSTRY PERSPECTIVE

Alan H. Price
D. Scott Nance



JULY 2009

REBALANCING THE U.S.-CHINA ECONOMIC RELATIONSHIP: A STEEL INDUSTRY PERSPECTIVE

Alan H. Price and D. Scott Nance¹

Executive Summary

The international economic crisis has a number of causes. Among them is China's pursuit of economic policies that are fundamentally at odds with the chief underlying principle of the international economy itself – that trade should be based on comparative advantage. Rather, China has followed a policy of maintaining domestic employment by encouraging exports at all costs, without any regard to the impact on other countries, or on the world economy as a whole. It can do this because the Chinese government continues to play the dominant role in the Chinese economy.

China uses a variety of means to give its exports an unfair advantage in international trade. Probably the most important is currency manipulation. China deliberately keeps the value of its currency, the RMB, up to 50% below its market value. This makes Chinese exports artificially cheap in world markets, and exports from the rest of the world to China artificially expensive. China also erects a number of other barriers to imports.

China also bestows enormous subsidies on its manufacturers in a variety of forms, including equity infusions, low-cost loans, debt relief, below-market prices for rent

¹ Alan H. Price is the head of the Trade Remedies practice at Wiley Rein LLP. He is the author of three noted studies on Chinese economic policies: *The China Syndrome* (2006), *Money for Metal* (2007), and *Raw Deal: How Governmental Trade Barriers and Subsidies Are Distorting Global Trade in Raw Materials* (2008). He frequently testifies before U.S. government agencies on issues regarding China. D. Scott Nance is an International Legal Consultant to Wiley Rein. He is a co-author of *The China Syndrome* and *Money for Metal*, as well as numerous other studies of U.S. trade laws and policies.

and energy, various tax benefits, and direct grants. In another form of subsidy, China places taxes and limits on the export of key raw materials, like coke. These restrictions drive down the cost of these raw materials for Chinese manufacturers, while making them more expensive for their competitors in other countries. At the same time, the state-owned banks and investment funds are helping Chinese industries buy mines and other sources of raw materials around the world. To top it off, China effectively exports the ruinous environmental effects of its policies by maintaining weak environmental laws that are poorly enforced, saving Chinese manufacturers billions in compliance costs compared to their competitors in the United States.

China's policies have had disastrous consequences for the United States. The U.S. trade deficit with China has reached a staggering \$300 billion per year, and has cost the United States over two million jobs. As China actively encourages the development of high technology industries, the United States is increasingly seeing strategic capabilities in manufacturing, especially in the form of know-how, disappear.

China's policies resemble nothing so much as 18th century mercantilism. Until China begins to act as a responsible member of the international economy, it will continue to be a source of instability. It is unlikely to take the necessary steps on its own, however. Until China does so, the United States must be prepared to enforce its trade laws and its rights under international agreements vigorously. The United States must also put its own house in order by adopting coherent manufacturing and energy policies. If the United States and China can agree on a series of concrete changes to China's policies, the economies of both countries, and of the whole world, will benefit.

TABLE OF CONTENTS

Introduction	1
The Objectives of Chinese Economic Policy	1
The Impact of Chinese Policies	3
China's Economic Policies	4
State Ownership	5
Currency Manipulation	6
Subsidies	9
Directed preferential credit	9
Equity infusions, debt-to-equity swaps, and mergers	10
Provision of land, inputs, and energy at below-market prices	11
Tax policies	13
Access to Raw Materials	14
Restrictions on exports of raw materials from China	14
Acquisition of sources of raw materials in foreign countries	17
Weak and Inadequately Enforced Environmental Laws	20
Barriers to Imports	22
The Impact of China's Economic Policies on the United States	22
The Trade Deficit and Its Consequences	22
Chinese Policies and the Loss of Strategic Capabilities in the United States	25
Chinese Policies and the Revival of the Global Economy	27
China and the New Mercantilism	27
Steps China Must Take	29
Convincing China to Act	29
Conclusion	32

Introduction

The world economy is in a crisis. The crisis had many causes, most prominently problems within the financial systems of the United States and the United Kingdom. What many have ignored, however, is the role that China's economic policies have played in the crisis. The policies, which resemble nothing so much as 18th century mercantilism, are fundamentally at odds with a international economy based on free (if regulated) competition based on the principle of comparative advantage. They are inconsistent with China's position as the largest manufacturer in the world.

Until China modifies its policies, it is unlikely that the global economy can stabilize itself on a sustainable basis. China will not simply alter its policies on its own, however. Rather, the United States and other major trading nations must be prepared to take concrete measures that will impose real costs on China until it conforms its actions to the principles on which the international economic system is based.

Of course, taking these actions will also have costs for the United States and other countries. Major actors in the U.S. economy, including the U.S. government, have become dependent upon Chinese capital and Chinese imports. Moving the U.S. – China economic relationship to a more sustainable form will be painful for these sectors, and cannot be achieved overnight. Nonetheless, the rewards of such a transformation for both the United States and China will be great.

The Objectives of Chinese Economic Policy

“China's development strategy has been simple and focused: export at any and all costs.”² To accomplish this goal, the Chinese government has pursued a compre-

² A. Subramanian, “Is China Having It Both Ways?”, *Wall Street Journal* (March 25, 2009), available at <http://www.iie.com/publications/opeds/print.cfm?doc=pub&ResearchID=1163>.

hensive strategy of supporting the manufacture and export of goods from China to the rest of the world. It does so through a variety of measures, including manipulating its currency to give Chinese exports an advantage in other markets; providing select industries with massive subsidies in the form of cheap credit, energy, and land; driving down the costs of raw materials for Chinese manufacturers by placing restrictions on exports of raw materials; assisting Chinese manufacturers to buy up sources of raw materials abroad; applying weak and weakly enforced environmental laws.

To a major extent, the need to maintain high levels of employment as a political, social, and economic imperative drives Chinese policy. By transforming itself into the world's factory, China has created jobs for millions of workers who have left China's vast rural areas for better lives in the cities. China's huge population, though, means that to keep pace with population growth, the Chinese government and the Chinese economy has had to create a stunning 15 million jobs annually³ (compared to about 1.8 million needed in the United States). To avoid rising unemployment, the Chinese government must continue to support and expand export-oriented industries by whatever means are necessary.

This policy has been remarkably successful. China is now the world's third-largest economy. In less than a decade, China has established itself as the world's factory, and acquired foreign exchange reserves worth more than \$2 *trillion*, or 45 percent of its gross domestic product (GDP) in the process. The policy of encouraging exports

³ R. Jackson, *Population Aging in China: An Assessment of the Political, Social and Economic Risks* 3 (2005).

and restraining imports was also successful; by 2007, China's current account surplus reached a stunning 14 percent of gross domestic product.⁴

The Impact of Chinese Policies

China's mercantilist policies could not have succeeded without the active acquiescence of the United States. China offered a low-priced source of supply for American retailers in particular. Between 2000 and 2008, U.S. imports of Chinese goods grew from \$15.2 billion to \$337.8 billion, as American consumers showed an apparently insatiable appetite for cheap Chinese goods. Over the same period, China recycled these earnings by buying, among other assets, over \$1.3 trillion in U.S. government and government agency bonds.

The United States has allowed China to continue down its mercantilist path despite clear evidence that China's policies have been harmful to the United States. The U.S. trade deficit with China has risen to astronomical proportions. This deficit has cost the United States hundreds of billions of dollars worth of economic production. It has resulted in the loss of hundreds of thousands of jobs and the disappearance of entire industries. This has resulted in the loss to the United States of strategic capabilities, not just to manufacture products in these industries, but to innovate in these industries as well.

The consequences for the international trading system have been damaging. So long as China continues to pursue these policies, it will continue to distort trade and investment worldwide. A full recovery from the current crisis will be possible only when China commits to following the same rules as the rest of the world.

⁴ Organization for Economic Cooperation and Development, *China: Defining the Boundary Between the Market and the State* 47 (2009) (preliminary version).

China's Economic Policies

Until 1979, the Chinese economy was centrally planned and strictly controlled by the government. Although reforms instituted since then have introduced many of the features of a market economy to China, the Chinese government continues to dominate the economy. According to the U.S. State Department, "China retains much of the apparatus of a planned economy."⁵ There are still Five Year Plans for the entire Chinese economy, as well as development plans for individual industries, such as steel. The Chinese government continues to own, directly or indirectly, substantial portions of the Chinese economy.⁶ Significantly, the Chinese government itself describes the Chinese economy as embodying "socialism with Chinese characteristics."⁷

Besides direct ownership, the Chinese government intervenes in the Chinese economy in a number of other ways to support Chinese exports and reduce imports. The most obvious and far-reaching method is its manipulation of China's currency, the renminbi or RMB. By keeping the value of the RMB artificially low, the Chinese government makes Chinese exports cheaper in the United States and other countries than they would otherwise be, while making U.S. exports to China more expensive. The Chinese government provides selected industries with enormous subsidies. It provides manufacturers with additional advantages by restricting the export of key raw materials, and by assisting them in purchasing sources of raw materials in other countries. China's environmental laws are generally much less stringent than those of the United

⁵ U.S. Commercial Service, *Doing Business in China: 2009 Country Commercial Guide for U.S. Companies* 3 (2009).

⁶ See, e.g., *China: Defining the Boundary Between the Market and the State* at 66.

⁷ See, e.g., The 17th National Congress of the Communist Party of China, *Socialism With Chinese Characteristics*, available at <http://english.people.com.cn/90002/92169/92211/6275043.html>.

States, and in any case are ineffectively enforced. Taken together, these policies give Chinese manufacturing an enormous competitive advantage in global markets.

State Ownership

The chief economic lever of the Chinese government remains state ownership of major companies. It is difficult to estimate exactly how much of the Chinese economy the government “owns,” but estimates range between 35 and 80 percent. The Chinese government continues to occupy the “commanding heights” of the Chinese economy, owning a controlling interest in the four largest banks, as well as the largest insurance company. It also owns companies in major industries, including telecommunications and steel. The state exercises ownership both directly and indirectly, through state-owned banks and investment groups that frequently hold substantial stakes in Chinese companies.

As a recent OECD study explains,

Although much smaller than a decade ago, China’s SOE sector is still greater in scope than seems warranted on the basis of strict economic criteria. China is virtually unique in its state dominance of all major segments of the financial sector. Chinese SOEs {state-owned enterprises} still dominate in the automobile, steel, and other metals industries ...⁸

Through this ownership, the Chinese government can direct resources, including investment and credit, to favored enterprises. It can also ensure that these enterprises behave in a manner consistent with the government’s overall policy objectives.

The dominant role of the Chinese government is especially obvious in the steel industry. China implemented a formal Steel and Iron Industry Development Policy in

⁸ *China: Defining the Boundary Between the Market and the State* at 66.

2005. A recent report by the office of the U.S. Trade Representative explains that China's steel policy

is troubling because it attempts to dictate industry outcomes and involves the government in making decisions that should be made by the marketplace. It prescribes the number and size of steel producers in China, where they will be located, the types of products that will and will not be produced, and the technology that will be used. This high degree of government direction and decision-making regarding the allocation of resources into and out of China's steel industry raises concerns not only because of the commitment that China made in its Protocol of Accession to the WTO that the government would not influence, directly or indirectly, commercial decisions on the part of state-owned or state invested enterprises, but also more generally because it represents another significant example of China reverting to a reliance on government management of market outcomes instead of moving toward a reliance on market mechanisms.⁹

Currency Manipulation

Since 1997, the government of the People's Republic of China has systematically intervened in foreign exchange markets to keep the value of the Chinese currency, the RMB (also known as the "yuan"), steady in relation to the U.S. dollar.¹⁰ Because of this intervention, economists and policymakers worldwide agree that the value of the RMB has remained well below what it would be if the RMB were allowed to float. For many years, China pegged the value of the RMB to the U.S. dollar. Beginning in July 2005, the People's Bank of China let the RMB trade within a broader (though still tightly controlled) range). As a consequence, between 2005 and 2008 the RMB appreciated against the dollar by around 20 percent. Since the middle of 2008, however, the RMB

⁹ Office of the U.S. Trade Representative, *2008 National Trade Estimate Report on Foreign Trade Barriers* 81 (2008).

¹⁰ For a general overview of China's currency policies, see U.S. Department of the Treasury, *Report to Congress on International Economic and Exchange Rate Policies: June 2007* 30 (2007).

has held very steady against the dollar, leading an economist at one Chinese think tank to admit that “{w}e have now moved back to a virtual US dollar peg.”¹¹

According to one widely accepted measure, *The Economist’s* “Big Mac Index,” the RMB’s current value is approximately 48 percent below its actual market value.¹² The International Monetary Fund recently calculated that, based on purchasing power parity, the value of the RMB should be 3.793/\$1.¹³ In fact, the exchange rate on May 1, 2009, was 6.818/\$1.¹⁴

The U.S. Treasury Department has stated that “{o}fficially, China operates a ‘managed floating exchange rate regime based on market supply and demand with reference to a basket of currencies.’”¹⁵ To keep the RMB purposefully weak vis-à-vis the dollar, the People’s Bank of China (“PBOC”), China’s central bank, buys dollars from Chinese exporters at the pegged rate.¹⁶ By offering holders of foreign exchange an artificially high rate in RMB for dollars, the PBOC provides them with a strong incentive to sell their dollars to the PBOC, rather than using them to purchase goods and services from the United States and other countries. This allows China to maintain domestic employment in manu-

¹¹ R. McGregor, China’s forex reserves pass \$2,000 bn, *Financial Times* (July 15, 2009).

¹² “Burgernomics,” *The Economist* (May 8, 2009), available at http://www.economist.com/markets/rankings/displaystory.cfm?story_id=13635995.

¹³ International Monetary Fund, World Economic Outlook Database, available at <http://www.imf.org/external/pubs/ft/weo/2008/02/weodata/weorept.aspx?pr.x=94&pr.y=18&sy=2006&ey=2013&scsm=1&ssd=1&sort=country&ds=.&br=1&c=924&s=PPPEX&grp=0&a=#notes>.

¹⁴ Federal Reserve Bank of St. Louis, China / U.S. Foreign Exchange Rate, available at <http://research.stlouisfed.org/fred2/series/DEXCHUS/downloaddata?cid=94>.

¹⁵ U.S. Department of the Treasury, *Report to Congress on International Economic and Exchange Rate Policies: April 2009* (“2009 Exchange Rate Report”) 17 (2009)

¹⁶ For a brief review of the mechanism the PBOC uses to control the value of the RMB, see *2009 Exchange Rate Report* at 17, 19.

facturing goods that would otherwise be imported. At the same time, an undervalued RMB provides Chinese producers and export-oriented industries with undeniable advantages in international trade.

The Chinese government's deliberate undervaluation of the renminbi makes U.S. products more expensive to Chinese consumers who therefore purchase fewer of them. Conversely, China's undervalued currency also makes Chinese products cheaper in the United States, and therefore U.S. consumers purchase more of them. The combination is a major contributor to the record high and still growing U.S. trade deficit. The undervalued Chinese currency harms American competitiveness and is also a factor encouraging the relocation of U.S. manufacturing overseas while discouraging investments in U.S. exporting industries.¹⁷

In its recent report on the exchange rate policies of the United States' major trading partners, the Treasury Department admitted that "China returned to a policy maintaining a largely-stable renminbi-dollar exchange rate."¹⁸ The Department also stated that "China's continued large current account surplus and accumulation of foreign exchange reserves suggest the renminbi remains undervalued."¹⁹ Nonetheless, the Secretary of the Treasury declined to make a formal finding that China has manipulated its currency, on the grounds that China had shown increased flexibility regarding the RMB; that it had appreciated against the dollar (although it remained undervalued); and that the pace of accumulation of foreign exchange reserves had slowed.²⁰ The failure to designate China formally as a currency manipulator cannot disguise the fact that in fact

¹⁷ 2006 Report to Congress of the U.S.-China Economic and Security Review Commission, 109th Cong., 2d Sess. at 46 (2006).

¹⁸ 2009 Exchange Rate Report at 17.

¹⁹ 2009 Exchange Rate Report at 19.

²⁰ 2009 Exchange Rate Report at 3.

China does actively manage the value of the RMB to the benefit of its manufacturers and exporters.

Subsidies

China provides favored industries with various forms of subsidies, including directed credit; equity infusions and debt-to-equity swaps; and the provision of land, energy, and other inputs on preferential terms. These subsidies substantially reduce the recipients' costs, and give Chinese companies a decided advantage in international competition.

Directed preferential credit

The Chinese government owns the four largest commercial banks in China, while provincial and local governments have great influence over bank lending at the local level. The various levels of Chinese government commonly direct banks to lend funds to favored enterprises at interest rates well below market rates, even when the borrower may not be creditworthy.²¹ In many cases, government direction of credit is formal, and is contained in official plans and policy statements.²² The state-owned banks also provide cheap credit and even direct grants through such practices as the automatic roll-over of unpaid principal and interest and the forgiveness of non-performing loans.²³

²¹ See Eurofer, *The State-Steel Nexus in China's Steel Industry: Chinese Market Distortions in Domestic and International Perspective* 32 (2009).

²² For a recent example, see Issues and Decision Memorandum accompanying *Citric Acid and Certain Citrate Salts from the People's Republic of China*, 74 Fed. Reg. 16836 (Dep't Commerce April 13, 2009) (final countervailing duty determination) at 12.

²³ *The State-Steel Nexus in China's Steel Industry: Chinese Market Distortions in Domestic and International Perspective* at 79-80; A. Price, T. Brightbill, C. Weld, and S. Nance, *Money for Metal: A Detailed Examination of Chinese Government Subsidies To Its Steel Industry* 49 (2007) ("*Money for Metal*").

Cheap credit allows these enterprises to fund investment and operations for much less than would otherwise be possible. Directed credit is used in particular to allow Chinese companies, including steel producers, to upgrade their technology, making them more competitive internationally.²⁴ These funds have also been used by the Chinese steel producers to expand production of high value-added products.²⁵ A report sponsored by several associations of steel producers in the United States concluded that the preferential credit had provided the Chinese steel industry with subsidies worth \$17.3 billion.²⁶

Equity infusions, debt-to-equity swaps, and mergers

Because of political demands to keep employment up, the Chinese government often provides state-owned companies with financing when they would otherwise go bankrupt. This financing commonly takes two forms: new equity infusions in return for additional shares in the company, and the conversion of loans by state-owned banks and investment companies into equity. These investments are typically made without regard to whether the investment is a wise one. To the contrary, equity infusions and debt conversion are normally necessary because a company is out of funds and cannot raise them from truly private sources.²⁷ In this way, the Chinese government props up loss-making companies that, in a true market economy, would fall into bankruptcy.

²⁴ *The State-Steel Nexus in China's Steel Industry* at 109.

²⁵ *The State-Steel Nexus in China's Steel Industry* at 105.

²⁶ *Money for Metal* at iii.

²⁷ For a general description of equity infusions, and especially debt-to-equity swaps, into the Chinese steel industry, see *The State-Steel Nexus in China's Steel Industry* at 83; *Money for Metal* at 31-33.

In addition to investing in companies directly, the Chinese government, through state-owned companies, has also purchased shares in Chinese steel companies through public offerings. As well as increasing the government's share of ownership, these actions provide concrete encouragement to private investors to invest in these companies as well. In at least one case, the Chinese government took the extraordinary step of stating that it would not allow the share price of Shanghai Baosteel, China's largest steel producer, to fall below a stated level.²⁸

Another way the Chinese government subsidizes favored companies is through mergers or acquisitions where the acquiring company pays little or nothing for the assets it receives. Because so many manufacturing companies are owned or controlled by the government, the government can essentially order companies to "merge," without any consideration for the underlying economics. In 2005 and 2007, for example, two of China's largest steel producers acquired substantial stakes in smaller producers at no cost. These government-mandated "mergers" provided production assets worth RMB 9.4 billion to Chinese steel producers who compete directly with American and other steel producers on world markets.²⁹

Provision of land, inputs, and energy at below-market prices

The Chinese government controls all land in China. As a consequence, "{m}any Chinese steel mills never had to pay any real prices for the land they are operating their facilities on."³⁰ The U.S. Commerce Department has repeatedly found that the Chinese

²⁸ See *The State-Steel Nexus in China's Steel Industry* at 110.

²⁹ *Money for Metal* at 44-47.

³⁰ *The State-Steel Nexus in China's Steel Industry* at 85.

government provides favored companies with land at rates well below market values.³¹ In addition, the Chinese government controls most or all of the water and electricity suppliers. Through these suppliers, it sells water and electricity gas to some manufacturers at artificially low prices.³² The same is true for natural gas as well.³³ Low prices for land and energy give Chinese manufacturers a distinct advantage in international competition.

The Chinese government also provides subsidies to manufacturers through low-cost inputs. The suppliers of many basic materials in the Chinese economy, such as steel, are government owned. These companies frequently sell their products to other Chinese manufacturers at prices well below world market values. The Commerce Department has determined that, because the Chinese government ultimately directs the operations of these companies, this provision of inputs at below-market prices constitutes a subsidy as well.³⁴

³¹ See, e.g., Issues and Decision Memorandum accompanying *Laminated Woven Sacks from the People's Republic of China*, 73 Fed. Reg. 35646 (Dep't Commerce June 24, 2008) (final countervailing duty determination) at 14-18.

³² *The State-Steel Nexus in China's Steel Industry* at 86-88.

³³ See, e.g., Issues and Decision Memorandum accompanying *Lightweight Thermal Paper from the People's Republic of China*, 73 Fed. Reg. 57323 (Dep't Commerce October 2, 2008) (final countervailing duty determination) at 22-24.

³⁴ See, e.g., Issues and Decision Memorandum accompanying *Certain Welded Austenitic Stainless Pressure Pipe from the People's Republic of China*, 74 Fed. Reg. 4936 (Dep't Commerce January 28, 2009) (final countervailing duty determination).

Tax policies

The Chinese government uses various tax breaks and rebates to encourage production and exports by favored industries.³⁵ Indeed, one recent study notes that “the idea to direct industrial development by means of tax-based incentives has been widely accepted by China’s policy makers.”³⁶ These benefits are often provided by local and regional, rather than national, authorities.³⁷ The tax advantages Chinese steel producers have received, for example, include

- Preferential income tax rates
- Discounts on corporate income tax;
- Tax privileges for operations in central and western China;
- Tax benefits for technology development;
- Tax benefits for using “waste resources”; and
- Tax exemptions.

China’s also manipulates rebates of the value added tax (“VAT”) on exports to encourage or discourage the export of specific products. It is common for countries to rebate VATs on all exports. China, however, rebates the VAT only on selected products.³⁸ Moreover, the amount of the rebate also varies, encouraging exports of products

³⁵ For an extensive discussion of the various ways China uses its tax laws to subsidize manufacturing, see *The State-Steel Nexus in China’s Steel Industry* at 111-136.

³⁶ *The State-Steel Nexus in China’s Steel Industry* at 111.

³⁷ *The State-Steel Nexus in China’s Steel Industry* at 111.

See *The State-Steel Nexus in China’s Steel Industry* at 113-128.

³⁸ See, e.g., Notice of the Ministry of Finance and Four Other Ministries/Administrations Concerning the Adjust of Export Tax Rebates for Some Commodities and the Enlargement of the Catalogue of Banned Commodities in Processing Trade, CaiShui {2006}, No. 139 (September 14, 2006), available at <http://www.apparel and footwear.org/reports/circular139-2006.pdf>.

with higher VAT rebate rates.³⁹ Indeed, it appears that, for some products at least, the amount of the rebate is greater than the amount of the VAT actually paid -- if in fact the VAT has been paid at all.⁴⁰ Manipulation of VAT rebates allows the Chinese government to target individual industries and products for export. In general, China pays higher VAT rebates on higher value-added goods, encouraging the production and export of those goods as compared to upstream products.

Access to Raw Materials

China is rich in some raw materials for industry, such as coal and rare earths, and quite poor in others, including petroleum and iron ore. The Chinese government has followed a deliberate policy of restricting exports of Chinese raw materials to ensure a steady, low-cost source of supply to its domestic manufacturers. At the same time, the Chinese government has assisted Chinese companies in acquiring sources of raw materials in other countries.

Restrictions on exports of raw materials from China

By limiting foreign access to Chinese raw materials, China provides its manufacturing sector with another form of subsidy. China maintains restrictions on exports of a wide range of industrial materials, including “antimony, bauxite, coke, fluorspar, indium, magnesium carbonate, molybdenum, rare earths, silicon, talc, tin, tungsten, and zinc, all of which are of key interest to U.S. downstream producers.”⁴¹

³⁹ See U.S. Trade Representative, *2009 National Trade Estimate Report on Foreign Trade Barriers* 98 (2009).

⁴⁰ U.S. Trade Representative, *2007 National Trade Estimate Report on Foreign Trade Barriers* 92 (2007).

⁴¹ *2008 National Trade Estimate Report on Foreign Trade Barriers* at 103.

The most extreme form of these restrictions are quotas, which limit the amount of the material that may be exported from China. Although China is the world's largest producer of coke, for example, it has limited exports of coke to less than six percent of Chinese production.⁴³ Additionally, China imposes taxes on exports of key raw materials such as steel scrap. These export taxes range from 5 percent all the way up to 40 percent.⁴⁴ While export taxes do not prevent producers from exporting the covered materials, the taxes give them a huge incentive to sell domestically instead.⁴⁵

These export restrictions have two effects, both of which provide additional aid to Chinese industry. First, by restricting worldwide supply of these materials, the Chinese restrictions make them more expensive for China's competitors in other countries, including the United States. Second, by artificially inflating domestic supply, they make these materials cheaper for Chinese industries.⁴⁶ In 2008, the combination of export quotas and export taxes resulted in an export price for coke from China that was \$200/ton, or 50 percent, higher than the domestic price.⁴⁷ As Eurofer, the European steel producers' association, has pointed out, the restrictions on exports of coke by China have caused "a drying out of Chinese exports to the global markets that drives prices up and leaves non-Chinese steel producers competing for an increasingly scarce

⁴³ See A. Price et al., *Raw Deal: How Governmental Trade Barriers and Subsidies Are Distorting Global Trade in Raw Materials* 6 (2008) ("Raw Deal").

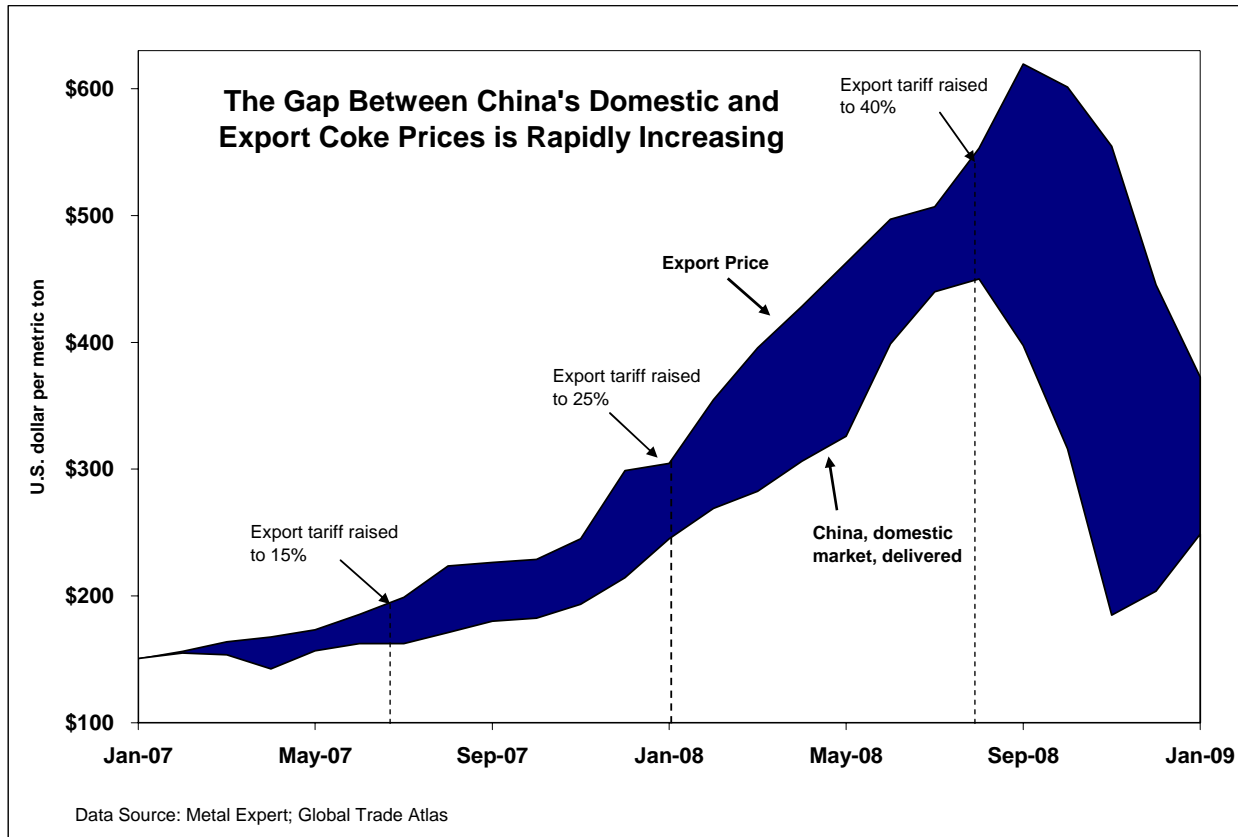
⁴⁴ *Raw Deal* at 11.

⁴⁵ See *The State-Steel Nexus in China's Steel Industry* at 32.

⁴⁶ *The State-Steel Nexus in China's Steel Industry* at 145.

⁴⁷ *Raw Deal* at 7.

resource.”⁴⁸ The following chart shows how China’s export tariffs on coke have increased the spread between domestic and export coke prices, to the benefit of Chinese coke consumers.



Some have claimed that China’s export taxes on coke and other raw materials represent a form of environmental legislation that discourages the production of these raw materials.⁴⁹ In fact, these taxes do nothing to limit the *production* of these materials, but only their *exportation*. Given that the U.S. steel industry in particular emits much lower levels of greenhouse gases per ton of steel produced than does the Chi-

⁴⁸ *The State-Steel Nexus in China's Steel Industry* at 32.

⁴⁹ See, e.g., T. Howard et al., *Leveling the Carbon Playing Field* 63-64 (2008).

nese industry,⁵⁰ the Chinese export taxes actually encourage production in the less efficient producer (China) than in the more efficient (the United States).

As discussed below, to assure access to key raw materials, China has been systematically investing in raw materials suppliers around the world. China prevents other countries from following a similar strategy with respect to China, though. China simply prohibits any foreign investment in production of certain key raw materials, including antimony, molybdenum, tungsten, and tin.⁵¹ Beyond this, Chinese policies make it difficult if not impossible for foreign enterprises to invest in production of other raw materials.⁵²

Acquisition of sources of raw materials in foreign countries

China is heavily dependent upon imports of key raw materials such as petroleum and iron ore. China is also following a classic mercantilist strategy by helping its industries to purchase sources of raw materials around the world. In some cases, Chinese state-owned companies buy stakes in foreign commodities producers. For example, the state-owned metals producer Aluminum Corporation of China (Chinalco) recently attempted to purchase a stake in Rio Tinto worth \$19.5 billion.⁵³ Besides partial ownership of Rio Tinto, the purchase would have given Chinalco direct stakes in some of Rio Tinto's mining assets. The deal ultimately collapsed, in part because of political opposi-

⁵⁰ *Leveling the Carbon Playing Field* at 47.

⁵¹ *Raw Deal* at 13.

⁵² *Raw Deal* at 13-14.

⁵³ A. Cha, "China Gains Key Assets in Spate of Purchases," *Washington Post* A1 (March 17, 2009).

tion within Australia to “giving China direct access to a huge trove of natural resources.”⁵⁴

In other cases, state-owned banks and investment groups make the investment.⁵⁵ The two often work in concert; Chinalco’s bid for the stake in Rio Tinto was funded in large part by the state-owned China Development Bank.⁵⁶ Overall, before Chinalco’s bid for Rio Tinto was rebuffed, state-owned Chinese companies had announced plans to buy stakes in the Australian mining industry worth \$22 billion.⁵⁷

A recent article in the *Washington Post* described the objectives and effects of this policy:

Chinese companies have been on a shopping spree in the past month, snapping up tens of billions of dollars’ worth of key assets in Iran, Brazil, Russia, Venezuela, Australia and France in a global fire sale set off by the financial crisis. The deals have allowed China to lock up supplies of oil, minerals, metals and other strategic natural resources it needs to continue to fuel its growth. The sheer scope of the agreements marks a shift in global finance, roiling energy markets and feeding worries about the future availability and prices of those commodities in other countries that compete for them, including the United States.⁵⁸

⁵⁴ D. Cimulluca, Rio Tinto Scuttles Its Deal With Chinalco, *The Wall Street Journal* (June 5, 2009).

⁵⁵ See *Raw Deal* at 17-19.

⁵⁶ *China Development Bank funds Chinalco’s Rio stake buy*, Reuters, Feb. 1, 2008, available at <http://www.reuters.com/article/CompanyNews/1dUSHKG18531920080201>.

⁵⁷ M. Wines, “Australia, Nourishing China’s Economic Engine, Questions Ties,” *The New York Times* (June 3, 2009). The saga of Chinalco’s attempted purchase of a stake in Rio Tinto appears to be far from over, as China is now accusing Rio Tinto of bribing practically every major steel producer in China to obtain confidential information. See, e.g., D. Barbazo, Rio Tinto Gave Bribes to Many, China Says, *New York Times* (July 15, 2009), available at http://www.nytimes.com/2009/07/16/world/asia/16riotinto.html?_r=1&scp=5&sq=Rio%20Tinto%20China&st=cse.

⁵⁸ “China Gains Key Assets in Spate of Purchases.

While Australia has in the past been receptive to such purchases, the fact that the Chinese government is the dominant shareholder in the major Chinese resources companies is causing Australia to reconsider its policies.⁵⁹ The implications of these purchases are the same as those of the large-scale holding by China of U.S. government debt:

There is also the question of whether China's stake in strategic industries – like its investment in United States Treasury bonds – could one day morph from a business deal to an instrument of diplomatic influence.⁶⁰

Lately some have expressed concerns that China's acquisition of sources of raw materials may allow it to control access to certain key materials worldwide. China already produces 90 percent of the world's rare earths, including europium, dysprosium, and yttrium, which have both important commercial and military uses. The state-owned China Nonferrous Metal Mining Co. recently acquired a majority stake in an Australian company that is developing the world's richest undeveloped deposit of rare earths. Another Chinese company, East China Exploration & Development Bureau, similarly bought a 25 percent share of another Australian rare earths producer. As a major Australian newspaper explained:

And both deals come against a background of China, which produces more than 90 per cent of the world's rare earths, working to ensure that it maintains its stranglehold on those elements. Use foreign sources, and save our own, is Beijing's policy. In February it again reduced the export quotas for its domestically produced rare earths ...

Apart from the military issue that has Washington concerned, The Times reported recently that China being what is called the "ultimate monopolist" in rare

⁵⁹ "Australia Feels Chill as China's Shadow Grows."

⁶⁰ "Australia Feels Chill as China's Shadow Grows."

earth metals would allow that country control over the future of consumer electronics and green technology.⁶¹

Recent announcements make clear the extent to which the Chinese government is prepared to support these efforts. Because of its currency manipulation and other practices, China has accumulated enormous foreign exchange reserves. At the end of June 2009, China held foreign exchange worth more than \$2 trillion – the largest reserve in the world.⁶² China has publicly stated that it will use these reserves to support overseas acquisitions and expansion by Chinese companies, especially by large state-owned industrial groups like Chinalco. The focus is likely to be on the acquisition of assets in resource-rich developing economies.⁶³ As Qu Hongbin, the chief China economist at HSBC explained, “{t}his is the first time we have heard an official articulation of this policy ... to directly support corporations to buy offshore assets.”⁶⁴ Such an attempt by the Chinese government to gain control over vital raw materials is the essence of mercantilism, and contrary to the fundamental principles on which the international trading system is based.

Weak and Inadequately Enforced Environmental Laws

In the United States, environmental compliance is a major cost of doing business for manufacturers, especially in industries like steel. While China has a range of environmental laws, these laws are generally much less strict than those of the United States and other developed countries. China allows particulate matter emissions at

⁶¹ R. Bromby, “China tightens grip on rare earths,” *The Australian* (May 1, 2009).

⁶² China’s forex reserves pass \$2,000 bn

⁶³ J. Anderlini, China to deploy foreign reserves, *Financial Times* (July 21, 2009).

⁶⁴ China to deploy foreign reserves.

levels during the ironmaking process six times those permitted in the United States, for example.⁶⁵ Chinese environmental laws also allow the Chinese steel industry to emit substantially higher levels of other pollutants, such as sulfur dioxide and nitrogen oxides, than is possible in the United States.⁶⁶

In any case, environmental enforcement in China is spotty at best. The central government lacks any real enforcement capability.⁶⁷ Ensuring compliance with environmental laws is left to local authorities, who often place keeping factories open and workers employed over protecting the environment.⁶⁸ Even when penalties are imposed, they are too small to act as a meaningful deterrent to polluting.⁶⁹

China's weak and poorly enforced environmental laws give Chinese manufacturers a decided advantage in international competition. One source has estimated that American steel producers spend twice as much per ton of steel on environmental protection as their Chinese counterparts do. If China's environmental laws were as strict, and as well enforced, as those in the United States, the Chinese steel industry alone would have been required to spend an additional \$1.7 billion per year.⁷⁰ When this figure is multiplied for other industries, it becomes clear that China's lax protection of the environment is a major source of competitive advantage for Chinese exporters.

⁶⁵ Alliance for American Manufacturing, *An Assessment of Environmental Regulation of the Steel Industry in China* 45 (2009).

⁶⁶ *An Assessment of Environmental Regulation of the Steel Industry in China* at 49-50.

⁶⁷ *An Assessment of Environmental Regulation of the Steel Industry in China* at 82-84.

⁶⁸ See *An Assessment of Environmental Regulation of the Steel Industry in China* at 83.

⁶⁹ *An Assessment of Environmental Regulation of the Steel Industry in China* at 85-88.

⁷⁰ *An Assessment of Environmental Regulation of the Steel Industry in China* at ix.

Barriers to Imports

In addition to providing domestic manufacturers with a range of advantages, China also erects barriers to imports of manufactured goods. With respect to steel, for example, the Chinese government encourages Chinese steel producers to use domestically-produced rather than imported equipment.⁷¹ China also imposes penalties on automotive manufacturers who use imported rather than Chinese-produced components.⁷² China discriminates against imports from other industries, including semiconductors and fertilizers, as well.⁷³ China also maintains high tariffs on imports that compete with sensitive domestic industries such as motorcycles and video and audio recorders.⁷⁴

The Impact of China's Economic Policies on the United States

China's economic and trade policies have had three obvious impacts on the United States. The first is the creation of an enormous trade deficit. The flow of funds from the United States to China has enabled China to amass massive holdings of U.S. securities, especially U.S. government debt. It has also caused the loss of manufacturing capability in the United States, and with it valuable strategic capabilities in research and development and in intellectual capital.

The Trade Deficit and Its Consequences

In 1999, the total U.S. deficit on current account with China was \$72.7 billion. By 2008, this deficit is estimated to have climbed to \$306.4 billion. This deficit reflects

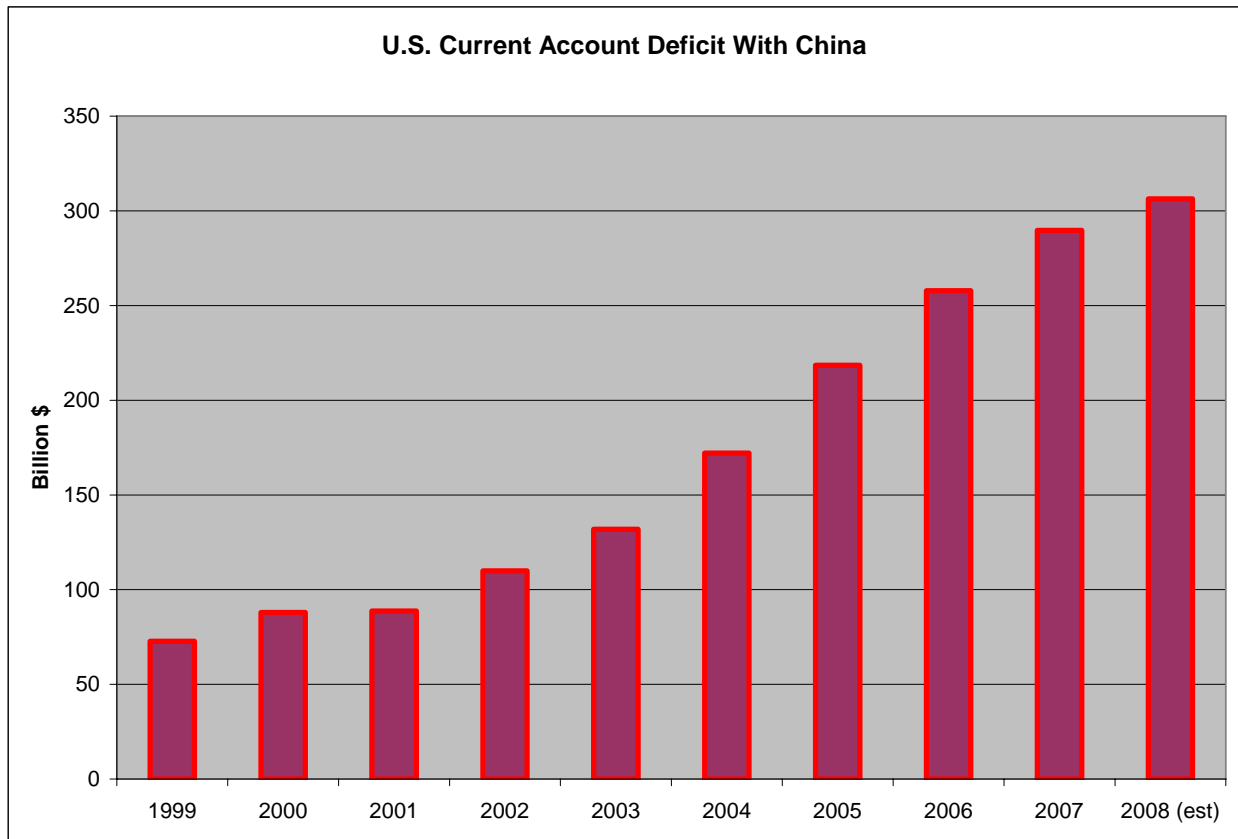
⁷¹ 2008 National Trade Estimate Report on Foreign Trade Barriers at 80.

⁷² 2008 National Trade Estimate Report on Foreign Trade Barriers at 80.

⁷³ 2008 National Trade Estimate Report on Foreign Trade Barriers at 80-81.

⁷⁴ 2008 National Trade Estimate Report on Foreign Trade Barriers at 82.

trade in goods and services, as well as other payments, such as the interest China receives from the \$1.2 trillion in U.S. government bonds it owns. The following chart shows the explosion of the U.S. deficit on current account with China over the past ten years. The trade deficit with China dwarfs the deficits with all other countries. In 2008, China accounted for fully 33 percent of the total U.S. deficit for trade in goods.



“The growth of U.S. trade with China since China entered the World Trade Organization in 2001 has had a devastating effect on U.S. workers and the domestic economy.”⁷⁵ One study estimates that, between 2001 and 2007, the U.S. trade deficit

⁷⁵ Robert Scott, *The China Trade Toll 1* (2008).

with China cost the United States 2.3 million jobs.⁷⁶ Approximately two-thirds of these jobs – over 1.5 million -- were in manufacturing.⁷⁷

The trade deficit with China has an obvious effect on U.S. gross domestic product (GDP). Prof. Peter Morici of the University of Maryland – College Park estimates that every dollar of the trade deficit reduces U.S. GDP by \$1.80 dollars. Had the U.S. trade in goods deficit with China in 2008 been zero, for example, total U.S. GDP would have increased by around \$480 billion, or more than three percent of total GDP. The increase in GDP made possible by a lower trade deficit with China would have more than offset the *decline* in GDP of three percent the United States experienced from the second quarter of 2008 to the first quarter of 2009. In contrast, China's GDP grew by nearly eight percent over the same period.

Higher GDP translates into more jobs. A commonly-accepted measure is that each additional \$100,000 in GDP creates one new job. An addition to GDP of \$480 billion would create 4.8 million new jobs in the U.S. economy. There can be no doubt that American workers are desperate for new jobs, especially now. As noted above, the United States needs to generate 1.8 million new jobs a year simply to keep pace with population growth. Yet in the first two quarters of 2009, the U.S. economy lost nearly one million jobs. The official unemployment rate stands at 9.5 percent; when discouraged workers and those involuntarily working part time are included, the total unem-

⁷⁶ *The China Trade Toll* at 1.

⁷⁷ *The China Trade Toll* at 13.

ployment rate is 16.8 percent.⁷⁸ Even reducing the trade deficit with China modestly would raise employment in the United States significantly.

Chinese Policies and the Loss of Strategic Capabilities in the United States

In a recent report to Congress, the U.S.-China Economic and Security Review Commission described the following dynamic:

Beginning with cost advantages attributable to a host of factors (its low wage base, the absence of many social programs and supports available to U.S. workers, refusal to recognize workers' rights, failure to establish and adhere to environmental standards, etc.), manufacturers in China have been able to wrest sales from firms in the United States. This has resulted in the creation of a cycle in which many U.S. companies wanting to remain profitable have concluded they either must move their own manufacturing operations to China or halt their manufacturing operations and purchase parts and components, and sometimes assembled products, made in China by other firms.⁷⁹

As well as costing the United States hundreds of thousands of jobs, this process has resulted in the loss of valuable manufacturing capacity in the United States. In some industries, reliance on China as a source of components has become very high or even complete.⁸⁰ Although the Department of Defense has regulations in place intended to ensure that the United States does not rely on imports for key defense goods, there is a real concern within the defense community that the United States has come to rely on China for key components, without even necessarily realizing it.⁸¹ Perhaps even more worrisome, though, has been the loss of know-how in strategic fields:

⁷⁸ Bureau of Labor Statistics, Table A-12: Alternative measures of labor underutilization, available at <http://www.bls.gov/news.release/empsit.t12.htm>.

⁷⁹ U.S.-China Economic and Security Review Commission, *2007 Report to Congress* 51 (2007).

⁸⁰ *2007 Report to Congress* at 52.

⁸¹ See *2007 Report to Congress* at 52.

The workforce loss is of particular concern with respect to workers with unique skills in such fields as tooling, shipbuilding, and aircraft and submarine production. These skills are highly specialized, requiring unique training and industry know-how. Some of the skills involved are so specialized and precise that it takes workers not months but a number of years to acquire them through both concentrated training programs and on-the-job apprenticeship. Manufacturing downsizing attributable to offshoring has resulted in fewer Americans being trained in these fields, leaving a skills gap as the aging defense manufacturing workforce moves toward retirement.⁸²

China has adopted a policy of encouraging the development of high tech industries and exports of high tech products and services. Among the products targeted are computers, telecommunications equipment, and aerospace components.⁸³ China has used subsidies as a deliberate means of attracting high tech companies to produce in China.⁸⁴

The success of China's policy of targeting high tech industries for development, and the concomitant loss of strategic capabilities in the United States, has manifested itself in a growing "high tech" trade deficit with China. The Commission estimated that in 2008, the U.S. trade deficit with China in computers and electrical machinery alone would reach \$124 billion. Moreover, the United States, once a net exporter of high technology products, is now experiencing a global trade deficit in trade in these products.⁸⁵ This development, which has worrisome implications for both long-term economic competitiveness and national security, is a direct outcome of China's economic policies.

⁸² 2007 Report to Congress at 53.

⁸³ U.S.-China Economic and Security Review Commission, 2008 Report to Congress 69 (2008).

⁸⁴ 2008 Report to Congress at 70.

⁸⁵ 2008 Report to Congress at 71.

Chinese Policies and the Revival of the Global Economy

China's economic policies are profoundly at odds with the fundamental principles on which the international trading system is based. Given this, it was perhaps inevitable that China's emergence as a major manufacturing power would destabilize that system. Unless China changes these basic policies, it will be difficult if not impossible to restore stability to the international financial and trading systems.

China and the New Mercantilism

Before Adam Smith revolutionized the science of economics with the publication of *The Wealth of Nations* in 1776, most countries in the world followed a strategy of mercantilism. Mercantilism essentially treated international trade as a zero-sum game, with imports being bad and exports good. The chief objective of mercantilist policy was to maximize a country's bullion reserves, large reserves being equated with national wealth. To do this, countries aggressively encouraged exports and discouraged imports. Ultimately, mercantilism is a beggar-thy-neighbor approach to trade.

Adam Smith and then David Ricardo showed that international trade is not a zero-sum game. To the contrary, trade on the basis of comparative advantage increases both world and national wealth. Ricardo himself, however, noted that the operation of comparative advantage is distorted when governments intervene in the operation of the market, and especially where they provide artificial advantages to their exports.⁸⁶ Subsidies to exports and barriers to imports distort the operation of the market and ultimately decrease wealth, not just in the world, but in the country. The world economy, as reflected in the various agreements that form the foundation of the World

⁸⁶ See D. Ricardo, *On the Principles of Political Economy and Taxation* 217 (3d. ed. 1821).

Trade Organization, is based on this principle of free (if regulated) trade based on comparative advantage.

China's economic policies are directly contrary to these principles. Instead, by pursuing a strategy of exporting at all costs, China has implemented old-fashioned mercantilism. The objective now is to maximize foreign exchange reserves rather than bullion reserves (although China has recently begun to make large-scale purchases of gold) but the results are the same.⁸⁷ Otherwise, China follows the traditional mercantilist imperatives of encouraging exports at all costs while limiting imports.

China's policies reflect at least in part the Chinese government's continued image of China as a developing country that needs special measures to compete in the world economy. In fact, while China's per capita income remains well below levels in the OECD countries, China is by most measures a developed country. It has the third highest gross domestic product in the world.⁸⁸ It has foreign exchange reserves of \$2 trillion. China's annual expenditure of \$44 billion on research and development places it among the world's leaders in this category.⁸⁹ In steel, one of the most widely traded international goods, China has five of the world's largest eleven companies.⁹⁰ These companies, and their equivalents in industries ranging from automobiles to electronics to aerospace, have access to the same sources of capital and technology as their for-

⁸⁷ P. Waldmeir, "Beijing bets on bullion," *Financial Times* (May 6, 2009), available at <http://www.ft.com/cms/s/0/2df309d8-3a74-11de-8a2d-00144feabdc0.html>.

⁸⁸ International Monetary Fund, *World Economic Outlook Database*, April 2009, available at <http://www.imf.org/external/pubs/ft/weo/2009/01/weodata/index.aspx>.

⁸⁹ *2008 Report to Congress* at 72.

⁹⁰ Worldsteel, *World Steel in Figures 2008 7* (2009).

eign competitors. That China is a “developing country” can no longer justify its anti-competitive, mercantilist policies.

Steps China Must Take

For the global economy to achieve lasting stability, China must abandon its mercantilist approach to trade. To do so, it must undertake the following changes:

- Ending large-scale government direction of individual industries;
- Privatization of the larger companies in China, including the four major commercial banks (and not simply the sale of shares to state-owned investment funds);
- Allowing the market to set the value of the RMB;
- Ending subsidies to major industries;
- Effective enforcement of environmental laws, treating industries producing for domestic consumption and for export equally; and
- Ending restrictions on exports of raw materials.

If China alters its policies to conform with the rules on which the rest of the world operates, it will lay solid foundation for a stable global economic system that can bring prosperity to everyone, including China.

Convincing China to Act

Unfortunately, China is extremely unlikely to take these steps on its own. To the contrary, the present state of affairs works very much to China’s advantage. From the Chinese perspective, its policies have been extremely successful in developing the Chinese economy and maintaining employment. Until it is shown that its policies have real costs for it, there is no reason for China to alter its policies.

The experience of the past few years confirms this conclusion. For example, the United States has been engaged in a “dialogue” with China over its currency policies for

the past five years. China has repeatedly promised to let the market set the value of the RMB, and then done nothing. If the United States and the rest of the international economic community are serious about convincing China to alter its policies, they must be prepared to take concrete measures that will leave China with the choice of following the rules that the rest of the community obeys, or losing its unfettered access to the U.S. and other world markets.

The United States must also put its own affairs into order. Among the measures the United States should take are:

- The establishment of an effective policy to encourage manufacturing;
- Vigorous enforcement of the rights of the United States under international agreements;
- Full enforcement of American international trade laws; and
- Commitment by the United States to further action if China does not alter its currency policies in particular.

The enormous increase in Chinese exports of manufactured goods to the United States over the last decade mirrors the decline of American manufacturing, which shed more than three million jobs over the same period. The starting point for any effort to decrease the trade deficit with China must begin with the creation and implementation of policies that will enable American manufacturers to compete on an equal basis with Chinese exporters.

Many of China's policies violate the rights of the United States under various international agreements. China's restrictions on raw material exports in particular are contrary to China's obligations under the General Agreement on Tariffs and Trade. There are also strong arguments that China's currency and subsidy policies violate its

GATT and WTO obligations as well. The United States should actively vindicate its rights under these agreements by requesting consultations with China, as provided for by various WTO agreements. If these consultations do not give rise to concrete commitments by China to bring its policies into conformance with its obligations, the United States should seek dispute settlement through the World Trade Organization.

China's currency policies also violate the rights of the United States under the Articles of Agreement of the International Monetary Fund. Thus far, while the IMF has expressed concern over China's currency regime, it has declined to take any action. Should China continue to intervene actively to control the value of the RMB, the United States should request that the IMF take formal action.

The U.S. Department of Commerce has found in multiple investigations that the Chinese government has provided its exporters with a range of countervailable subsidies. However, the Department has so far declined to countervail subsidies provided before China joined the WTO in 2001, even though the relevant WTO agreements permit it to do so. A decision to countervail these subsidies would demonstrate to China that the United States will respond to its mercantilist policies.

While China has repeatedly promised to move towards a fully floating RMB, it has failed to follow through on these promises. The United States should make it clear that, if China does not allow the RMB to float within a specified period, the United States will take concrete measures, such as the treatment of the difference between the market and the controlled rate of the RMB as a countervailable subsidy.

Conclusion

China's economic policies are causing real harm to the United States and to the entire global economy. China is unlikely to change those policies on its own. Ultimately, the world economy will recover and achieve stability only if and when China begins to act in a manner consistent with the principles that underlie the international trading system. At some point, China and the United States must undertake a series of difficult negotiations that may require all parties involved to make concessions. Until China shows that it is ready to discuss its next steps, the United States must be prepared to take unilateral and potentially painful measures to bring the U.S.-China economic relationship back into balance.