China Without *a* Private Sector

By Greg Mastel

With the exception of North Korea and Iran, there is simply no worse place for U.S. trade and investment dollars to go than China.

For more than a year now, Washington and Beijing have been locked in an escalating trade conflict. Media coverage typically dismisses the conflict as a "trade war" similar to dozens of others with Japan, Europe, and many countries, and urges policymakers to "make nice" and move on for the sake of the stock market. Both the stakes and the scale of this trade war, however, are fundamentally different than the trade squabbles that have come before. The current clash is nothing less than a battle of economic systems. The United States with its market-oriented trading system is attempting to establish some sort of trade parity with China's largely state-controlled system. The stakes for the United States, China, and the rest of the world could hardly be higher, and a "political solution" that puts off real change is simply not acceptable.

Numbers tell a great deal of the story. China is and is likely to remain—barring a massive unforeseen change—the United States' largest trading partner. It is far and away the largest source of U.S. imports, but only third on the list of markets for U.S. exports. And that is a large part of the problem. The United States steadily imports from China three and one-half times what it exports to China. The U.S. bilateral trade deficit with China is by far the largest in U.S. history and in human history. China has also grown, largely based on foreign trade and investment, into the second-largest economy in the world and may pass the United States within a decade for the top spot.

Greg Mastel was Chief Economist and Chief International Trade Adviser with the Senate Finance Committee from 2000 to 2003. He is currently a Senior Adviser with Kelley Drye & Warren LLP in Washington, D.C.

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www.international-economy.com
editor@international-economy.com

Flooding the Steel Zone

The Chinese steel industry is now a collection of mostly state-owned enterprises that employ an estimated 3.6 million Chinese workers. For comparison, U.S. employment in the steel industry is about 140,000 and Japan employs about 170,000. Surprisingly, China's steel behemoth is a relatively recent development. In 2001 when China joined the World Trade Organization, China did not have a commanding steel industry and was responsible for about only 15 percent of global production. By 2018, more than half of the steel produced in the world was produced in China. China added far more steel capacity over that time than the rest of the world combined.

Converter, hot rolling department, main plant of HBIS Tangsteel, Tangshan, Hebei, China.

Lost in those statistics are several smaller economic realities. Notably, China does not have any comparative advantage in steel production. The average Chinese steel worker produces a little more than a third of what the average American, Japanese, or European steel worker produces. More surprisingly, all during China's rise in steel production, the global steel industry—as was documented in great detail by the OECD—has struggled with low prices and an epidemic of excess production capacity, which should halt or at least limit new investment in steel production. The market certainly has not been signaling China to produce more steel, unfortunately the Chinese government has.

Literally were it not for China's unwavering industrial policy, the rise of the Chinese steel industry over the last two decades could not have happened. And that policy has resulted in the export of unemployment in the steel industry to the rest of the world.

—G. Mastel

THE MACROECONOMIC PERSPECTIVE

The conventional wisdom has been that the trade deficit with China should be dismissed as merely the result of market forces penalizing the United States for spendthrift behavior. And there is an undeniable economic relationship between consumption, including government fiscal deficits, and imports. But why would an imbalance driven by bad fundamental economics be so pronounced with China and so much lower with market-oriented trading partners with which the United States also has a major trading relationship?

A prominent Chinese think tank, which inevitably reflects the views of at least a major part of the Chinese government, recently even advocated eliminating the private sector.

First, this trade deficit could be driven as much or more by Chinese efforts to restrict consumption in order to build up its industries, rather than by U.S. fiscal deficits. In other words, it might just as easily be said that China does not consume and import enough as that the United States consumes and imports too much. Particularly for an economy at its stage of development with so many of its citizens still in poverty, China should consume and import more. The accounting identity that links imbalances in the U.S. capital account with an offsetting imbalance in the current account (or dissaving and imports) is just an equation—it does not assign blame or indicate appropriate policy.

Further, a primary mechanism by which trade flows are supposed to balance over the long term is through the adjustment of currency exchange rates. A trade surplus should lead to a country's currency, which is used to purchase imports from the country, becoming more valuable (stronger) relative to other currencies. The stronger currency should increase the price of that country's exports and decrease the price of its imports, which pushes down the trade surplus. In theory, this currency adjustment should limit China's trade surplus with the United States.

Unfortunately, this mechanism relies on currencies that adjust in response to market conditions. The Chinese currency—the RMB or yuan—is pegged to the dollar by the Chinese government. It only adjusts in response to decisions made by the Chinese government, not the market. The Chinese RMB has been persistently undervalued for decades as part of a Chinese export promotion strategy and has been identified as such by the U.S. Treasury without meaningful remedy. In recent months, the RMB has deteriorated markedly, losing more than 10 percent of its value relative to the dollar. As a result, the U.S. trade deficit with China could actually rise in response to RMB depreciation.

THE MICROECONOMIC PERSPECTIVE

At the level of individual industries, China also does not play by free market rules. China's grand plan to dominate ten high-value manufacturing industries, including semiconductors, robotics, and aerospace, known as "China 2025," has drawn considerable criticism in recent years. Criticism has been sharp enough that Chinese leaders now rarely use the term "China 2025." But Chinese industrial policy remains essentially unchanged and is an integral part of the Chinese system that has been operating to boost China's position in key industries for decades.

The Chinese steel industry is a telling case in point. Steel production has been a focus of Chinese industrial policy since the early days of Chairman Mao. The Chinese steel industry is now a collection of mostly state-owned enterprises that employs an estimated 3.6 million Chinese workers. For comparison, U.S. employment in the steel industry is about 140,000 and Japan employs about 170,000. Surprisingly, China's steel behemoth is a relatively recent development. In 2001 when China joined the World Trade Organization, China did not have a commanding steel industry and was responsible for about only 15 percent of global production. By 2018, more than half of the steel produced in the world was produced in China. China added far more steel capacity over that time than the rest of the world combined.

The only way to protect global free trade is to bypass the World Trade Organization.

Why would an imbalance driven by bad fundamental economics be so pronounced with China and so much lower with market-oriented trading partners with which the United States also has a major trading relationship?

Lost in those statistics are several smaller economic realities. Notably, China does not have any comparative advantage in steel production. The average Chinese steel worker produces a little more than a third of what the average American, Japanese, or European steel worker produces. More surprisingly, all during China's rise in steel production, the global steel industry—as was documented in great detail by the OECD—has struggled with low prices and an epidemic of excess production capacity, which should halt or at least limit new investment in steel production. The market certainly has not been signaling China to produce more steel, unfortunately the Chinese government has.

Literally were it not for China's unwavering industrial policy, the rise of the Chinese steel industry over the last two decades could not have happened. And that policy has resulted in the export of unemployment in the steel industry to the rest of the world right along with every ton of subsidized steel. In this light, it is understandable why the United States chose to place a tariff on imported steel to preserve its strategically and economically vital steel industry. And as "China 2025" demonstrates, Chinese industrial ambitions reach far beyond steel. Can the world afford in economic or technological terms to simply allow a repeat of China's steel performance in semiconductors, robotics, or aerospace?

A PARASITIC ECONOMY

The macroeconomic and microeconomic drivers for the U.S. trade deficit with China are not just the normal interplay of economic forces. The real driver is the policy of the Chinese government to build industrial and economic strength at the expense of its trading partners, most notably the United States.

China is certainly a non-market economy in the sense that economic decisions are often made by the government rather than the market. But it has become something far beyond the relatively benign international economic model envisioned by Karl Marx. China has actually developed into a "mercantilistic non-market economy" or perhaps more simply put, a "parasitic non-market economy." China's ability to draw in trade and investment dollars from the West has unquestionably been the central driver of the PRC's economic emergence in the last three decades. The long-term costs of allowing Beijing to operate by drawing dollars and technology from the United States and other western countries are difficult to even calculate.

SOCIALISM WITH CHINESE CHARACTERISTICS

A central premise of U.S. economic engagement with Beijing since President Richard Nixon's outreach during the Cold War has been that China would ultimately adopt a model like that of the United States and other Western powers. Premier Deng Xiaoping's efforts to open the Chinese economy to the West supported that story line. The collapse of the Soviet Union in 1989 led observers in the West to assume it was only a matter of time until the PRC fell in line.

Unfortunately, those assumptions are wrong. As China's President Xi Jinping said on Beijing's future in 2018: "We must resolutely reform what should and can be changed, we must resolutely not reform what shouldn't and can't be changed." President Xi also firmly repeated that China's system is "socialism with Chinese characteristics," something far different from a western market economy.

The Chinese RMB has been persistently undervalued for decades as part of a Chinese export promotion strategy.

Xi on Change

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Deng Xiaoping: *Rolling over in his grave?*

There have certainly been some changes in China, and statements like those of President Xi might perhaps be written off as political rhetoric. But there are three fundamental aspects of "socialism with Chinese characteristics" that suggest Xi's comments are more than just rhetoric.

First, there is no rule of law in China as the term is understood in the West. Chinese courts are explicitly under the control of the Chinese Communist Party. Western-educated reformers have clearly had a role in shaping China's court system, but no matter how many trappings of western courts that Chinese courts adopt, they are fundamentally subservient to the Chinese Communist Party. A Chinese court overruling the central government in any meaningful way is simply not possible, and the

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Communist Party is clearly not planning to abandon its hold on power.

Second, China is an authoritarian state. Most remember China's brutal repression of a modest student-led call for reform at Tiananmen Square in 1989. Things are not appreciably better today. Religion and political protest are still tightly controlled. Beijing's dismantling of democracy in Hong Kong over the last twenty years leaves no doubt as to the regime's intended political direction.

China also does not play by free market rules.

Finally, Chinese government control of its economy remains sweeping and is increasing rather than fading away. An economic plan outlined by President Xi reserves the "…Communist Party of China leadership over all forms of work in China." By some measures, China's state-owned enterprises have decreased in relative strength over the last forty years. But that trend appears to have reversed in the last decade or so; the assets controlled by the hundred largest centrally administered Chinese state-owned enterprises have risen sharply to $10.4 trillion—a more than ten-fold increase since 2003. The total value of China's 51,000 state-owned enterprises is about $29.2 trillion, according to the OECD. For comparison, the annual GDP of the United States in 2017 was about $19.4 trillion.

In many sectors such as steel as described above, finance, energy, and defense, state-owned enterprises dominate and their role seems to be increasing as state investment and lending pushes out the private sector. In remarks late last year, President Xi suggested increasing "guidance" of the private sector. There has been growing discussion in Beijing of nationalizing private sector enterprises, and a prominent Chinese think tank, which inevitably reflects the views of at least a major part of the Chinese government, recently even advocated eliminating the private sector. Given these developments, even the use of the term "private sector" in the context of China should be followed by a question mark.

CAN WE CHANGE CHINA?

It is simply not realistic for western analysts to talk about any deep market reform in China in the short term. That is not the direction that China is moving. It is naïve to think the Chinese Communist Party plans to phase itself out of the economy or the political system. For the foreseeable future, the United States and other western countries will be dealing with a non-market economy that is hostile to U.S. and western interests on many fronts—economic, diplomatic, and—as recent developments in the South China Sea demonstrate—military.

America Is Funding Its Greatest Military Threat

Much of the discussion of the Trump tariffs also misses another "big picture." China has a systematic pattern of engaging in mercantilist trade practices. It has also become a serious diplomatic and military rival for the United States. The U.S. trade deficit with China bolsters the Chinese economy and in so doing bolsters the Chinese state and supports China's military ambitions. With the exception of North Korea and Iran, there is simply no worse place in the world for U.S. trade and investment dollars to flow than China. From a global diplomatic and security perspective, it would be much better if those dollars instead flowed to democracies in North and South America, Asia, Africa, and elsewhere.

That would be true even if in the end the U.S. global trade balance would be unchanged, with U.S. imports from China being replaced by U.S. imports from the dozens of other countries that do not pose a security threat, are far more democratic than Beijing, and more or less play by the rules of free trade. That would, in and of itself, be a great positive development. It simply does not make sense for the United States to contribute more than $400 billion (the size of the U.S. trade deficit with China) annually to the economic and military rise of a potentially dangerous global rival when better options are obviously available.

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—G. Mastel

The Trump administration deserves credit for pushing China hard for reductions in the trade deficit and trade reform. Efforts to make real progress on deep-seated issues such as respect for intellectual property and reform of state enterprises are likely only possible, if at all, over a long-lasting period of consistent pressure. Even on an issue where China would seem to have real self interest in progress—protecting intellectual property—efforts to force change are likely to take years and face fierce push-back from Chinese bureaucrats and courts. Recent efforts by China's national champion, Huawei, to engage in open piracy, patent abuse, and using Chinese courts as a shield for its intellectual property violations are evidence that the struggle will be at least long.

A Chinese court overruling the central government in any meaningful way is simply not possible.

The Trump teams' efforts to force China to increase purchases of American products have real short-term potential. It is worth remembering that every $1 billion reduction in the U.S. trade deficit creates approximately 10,000 jobs. If the current efforts to reduce the trade deficit were able to generate a $50 billion decrease in the U.S. trade deficit with China, it would create something on the order of 500,000 U.S. jobs. Steps like this have real value while pursuing long-term efforts aimed at reform.

Almost amusingly, some critics in the United States have condemned the efforts to win concrete increases in purchases of U.S. exports. Their argument goes that these increased purchases will rely upon Chinese agencies and state-owned enterprises that the United States should be seeking to phase out. The assumption underlying the argument is that China is just on the brink of phasing out the government control of the economy, were these enterprises not revived to import from the United States. Unfortunately, Chinese state control of the economy is deep-seated, strong, and not in need of a boost from U.S. efforts to increase imports in order to survive.

The real issue is whether the tools of Chinese state control can be put to use to increase U.S. exports and increase U.S. employment, or will instead continue—as they have for decades—to limit U.S. exports and reduce U.S. employment. China cannot "slip" back into being a non-market economy. It is and has for seventy years been a Communist country. Realistically, there is almost nowhere for Beijing to "slip" to. The PRC is not about to become a Jeffersonian democracy committed to open markets. Decades of good intentions, kind words, and generous trade policy have made little progress toward that goal.

ECONOMICALLY CONTAINING CHINA

President Trump's efforts to impose tariffs on imports from China and, to a lesser extent, limit Chinese investments using the Committee on Foreign Investment in the United States have drawn criticism. But the assumptions underpinning those criticisms cry out for examination. In the main, they are simply a tired repetition of the "free trade" is good, "protectionism" is bad mantra. These critics are either unaware or fail to acknowledge the real long-term advantages of free trade—efficiency gains (comparative advantage, competition)—and assume that the other party is also following the rules of free trade. If the other party is, as is the case with today's China, an increasingly state-run economy pursuing aggressive mercantilist policy to boost its industries and undermine those of its trading partners, the benefits of free trade will never emerge.

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Critics would likely respond that forcing such a reshuffling of U.S. trade patterns might simply result in China shifting its exports to other markets. Undoubtedly, China would attempt to minimize impacts by making such a shift. The rest of the world, however, is not nearly as committed to a doctrine of free trade as the United States. In practical terms, other countries are simply not likely to allow China to run massive trade surpluses with them. Those that have any doubt should simply compare the efforts of Japan and the European Union to limit China's trade surpluses with those of the United States over the last three decades. In any event, such a shift in trade patterns would put U.S. trade dollars to work reinforcing U.S. trade, diplomatic, and security interests rather than undermining them. Again, a gain in and of itself.

Some would argue that such a policy shift away from China would violate the terms of the World Trade Organization. It is difficult to imagine that the farsighted leaders who created the global trading system after World War II would ever have imagined that a primary focus of that system in 2019 would become to protect most mercantilist country in the world from pressure to reform. For its part, China has largely delayed or ignored the promises it made to join the World Trade Organization in 2001. And the World Trade Organization has proven utterly incapable of controlling China's protectionism in the last two decades.

Under these conditions, the only way to protect global free trade is to bypass the World Trade Organization and bring China to heel with unilateral measures. One thing the Trump administration's trade tussles with China have demonstrated beyond doubt is that the World Trade Organization with its glacial and ineffective dispute process is utterly unable to police the current trade disputes with China. And, on a more positive note, it is unable to materially hinder the United States in its efforts to set a new policy with China. The World Trade Organization should and quite likely will remain on the sidelines while the United States rights its trade and economic policy toward China.

China is far and away the largest source of U.S. imports, but only third on the list of markets for U.S. exports.

If the United States is engaged in a real military conflict with China or even an extended cold war in the coming years, it is difficult to imagine historians will not view these enormous economic transfers to Beijing as national insanity. A policy to dramatically reduce imports from China though tariffs or other means or at least demand China reduce the deficit by increasing purchases from the United States as a necessary *quid pro quo* is long overdue. It is not realistic or necessary to stop all trade with China, but trend lines can be reversed by using available policy tools and political messaging.

Similarly, investment flows both into the United States from China and into China from the United States should be scrutinized carefully to prevent loss of key technology and China's control of key industries. The recent changes to CFIUS in the United States and the careful scrutiny of the involvement of Chinese companies, like Huawei, in the development of new 5G telecommunications networks are good signs that this policy shift may already be underway.

The recent disputes with China have demonstrated how out-of-date and ill-conceived U.S. economic and trade policy has been toward China for at least two decades. It is time to finally see China as it is, not how we wish it to be. The lessons we have recently learned from some tariffs on Chinese products point the way to a real shift that could finally create real balance in the relationship between Washington and Beijing. ◆