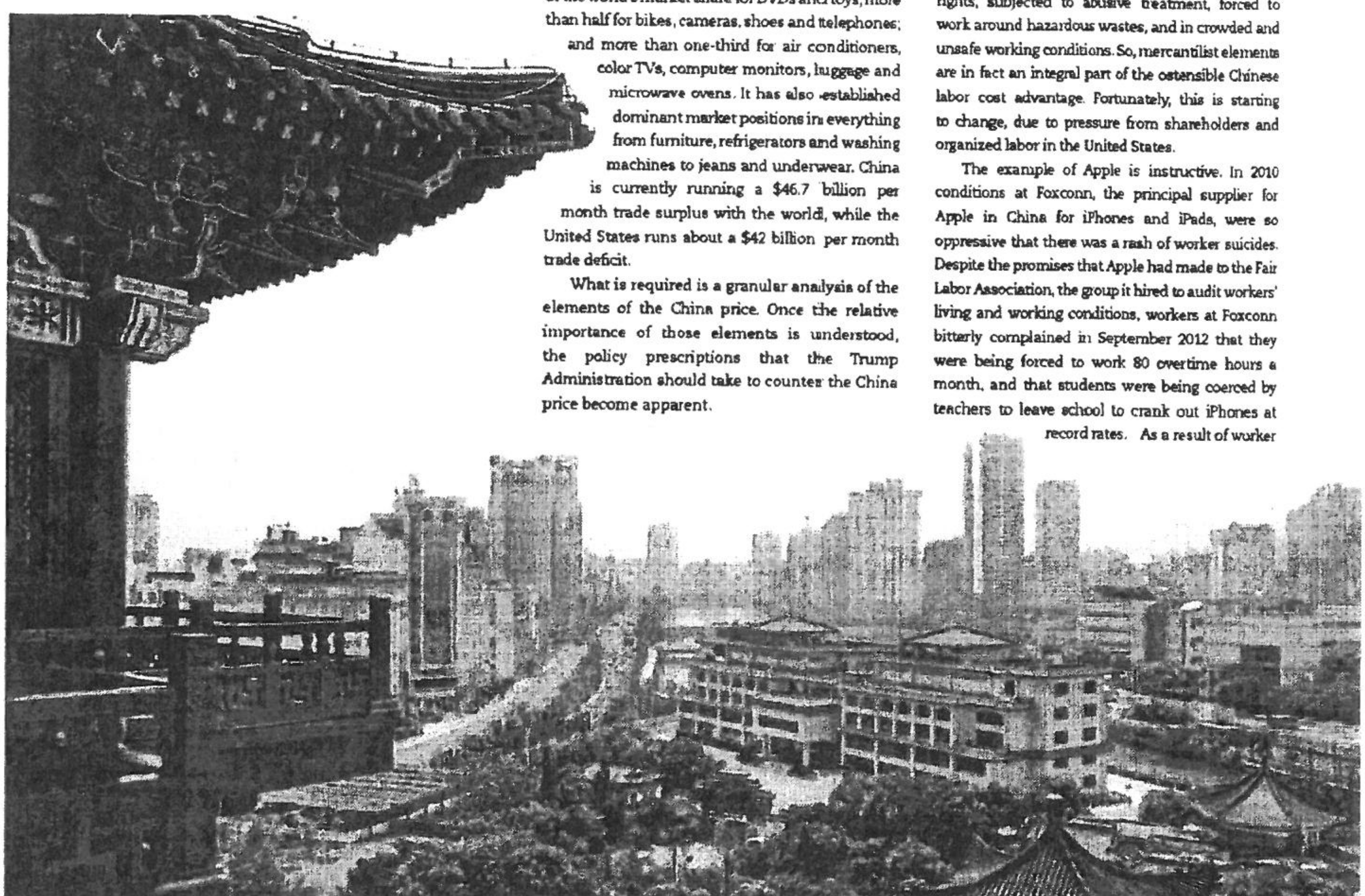
Bart S. Fisher

Kowtowing to China

President Trump, by his own admission, has "been soft" on China's trade practices, in the hope that its leaders will pressure North Korea to abandon its nuclear weapons program. This position represents an astonishing reversal from his campaign rhetoric in which he railed against allegedly unfair Chinese trade practice, and made his vow to strike back at China a central tenet of his campaign. For example, in a May 2016 campaign rally, Trump stated that "We can't continue to allow China to rape our country. It's the greatest theft in the history of the world." One suspects that the realization that China owns a large part of the U.S. debt, and that Trump has developed a strong personal relationship with Chinese President Xi Jinping have also contributed to this profound shift in his view of U.S.-China relations. In early November 2017, Trump stated that he has "great chemistry" with Xi, and said: "I don't blame China. After all, who can blame a country for taking advantage of another country for the benefit of its citizens?"

But is this conversion from China hawk to China dove justified by the real threat posed to the U.S. economy by the China price, which has typically been 30 percent to 50 percent below the U.S. price? The inability of U.S. companies to compete with this price has resulted in the destruction of many U.S. manufacturing industries. The China price is the reason that China has captured over 70 percent of the world's market share for DVDs and toys, more than half for bikes, cameras, shoes and telephones; and more than one-third for air conditioners, color TVs, computer monitors, luggage and microwave ovens. It has also established dominant market positions in everything from furniture, refrigerators and washing machines to jeans and underwear. China is currently running a $46.7 billion per month trade surplus with the world, while the United States runs about a $42 billion per month trade deficit.

What is required is a granular analysis of the elements of the China price. Once the relative importance of those elements is understood, the policy prescriptions that the Trump Administration should take to counter the China price become apparent.



A. Elements of the China price

1. Labor costs

The largest single element in the China price is its lower labor costs. According to the research done by Peter Navarro, lower labor costs account for 39 percent of the China Price advantage and clearly represent the dominant element of the China Price advantage over U.S. manufacturers. At first glance, one could say this is just an aspect of the Law of Comparative Advantage, with China possessing a comparative advantage in labor resources.

The problem with that analysis is that workers in China frequently are paid less than the official minimum wage, forced to work excessive overtime, denied overtime pay, denied collective bargaining rights, subjected to abusive treatment, forced to work around hazardous wastes, and in crowded and unsafe working conditions. So, mercantilist elements are in fact an integral part of the ostensible Chinese labor cost advantage. Fortunately, this is starting to change, due to pressure from shareholders and organized labor in the United States.

The example of Apple is instructive. In 2010 conditions at Foxconn, the principal supplier for Apple in China for iPhones and iPads, were so oppressive that there was a rash of worker suicides. Despite the promises that Apple had made to the Fair Labor Association, the group it hired to audit workers' living and working conditions, workers at Foxconn bitterly complained in September 2012 that they were being forced to work 80 overtime hours a month, and that students were being coerced by teachers to leave school to crank out iPhones at record rates. As a result of worker riots and external pressures, Apple has pressed its Chinese supplier Foxconn to increase its wages and improve workers' living conditions. Apple is not alone. The same labor issues persist at the factories of Samsung, Nokia and other brands in China.

A more recent, and politically controversial, example of the long hours and low pay endured by many Chinese workers is the case recently brought to light about Ivanka Trump's clothing-maker in China. The factory that manufactures the Ivanka Trump fashion line in China requires its workers to work nearly 60 hours a week to earn wages of little more than $62 per week, according to a factory audit issued on April 25, 2017.

The data indicate that, even adjusted for productivity, China's hourly compensation costs are about one-fifth of U.S. labor costs. China's wages are four times lower that Brazil and seven times lower than Mexico.

In most cases, one would expect this type of wage advantage to shrink over time as labor markets tighten in tandem with economic growth. The problem with China, however, is that the Chinese government is seeking to move 400 million people from the countryside and into China's cities over the next several decades. To put these numbers in perspective the current work forces of the United States and Europe combined number less than 400 million.

Thus, despite much higher growth levels than the United States, and external pressures such as the Apple case mentioned above, wage pressures will remain a significant driver of the China price for decades to come.

2. Subsidies by China

he second largest element in the China price is export subsidies provided by its governmental units. This accounts for about 17 percent of the China price advantage. As a condition of its entry into the World Trade Organization (WTO) in 2002, which I argued for publicly, China agreed to eliminate or scale back its complex web of subsidies and tax preferences that benefit its export manufacturers. Unfortunately, this has not happened rapidly enough. Apart from significant domestic subsidies such as heavily subsidized energy and water, China continues to use its state-owned banks to provide non-performing loans (NPLs) to the state-owned enterprises (SOEs) centered in heavy industries such as steel and petroleum. These non-performing loans allow otherwise inefficient SOEs, known in China as the dinosaurs, to export when by all rights they should be allowed to go bankrupt, as would happen in a true market economy.

China's exports are further aided by its extensive value-added tax rebate system. The Chinese VAT is imposed over multiple stages of production, in the range of 13 percent to 17 percent. By exempting this tax on its goods destined for export, China gains a huge competitive advantage over its counterparts in the Americas.

Otherdirect subsidies to Chinese manufacturers include its Export Development Fund for the larger firms, the Fund for Small and Medium Enterprises, and the Chinese Export-Import Bank. Clusters of subsidies around specially designated regions.

3. Chinese currency manipulation

No Chinese trade-related practice has received more publicity than its currency manipulation. Here we are dealing with a moving target. In 2006 Navarro estimated that currency manipulation contributed 11 percent to the China price advantage. But the yuan at that time was trading at about an 8 to 1 ratio to the U.S. dollar. At that point estimates by others of the undervalued yuan ranged from 40 percent by Ernest Preeg to 25 percent by the Institute for International Economics. However, the yuan now (rate prevailing on Dec. 29, 2017) trades at a ratio of 6.507 to the dollar, so China has gradually appreciated its currency over time. The Obama Administration declined to name China a currency manipulator, noting that it had let the yuan rise nearly 10 percent in value against the dollar since June 2010. The Trump Administration has followed suit, also declining to name China as a currency manipulator, despite the promise of President Trump that he would name China as a currency manipulator on the first day of his presidency. Trump defended his U-turn on China's currency manipulation by stating, "Why would I call China a currency manipulator when they are working with us on the North Korean problem?"

A major problem in the currency manipulation debate is that the alleged practice lies largely in the eyes of the beholder. China has alleged that the United States, through the quantitative easing policies of its Federal Reserve System, has effectively devalued the U.S. dollar, thus manipulating its currency. And, in fact, other countries, such as Singapore, Korea, Taiwan and Japan, also manipulate their currencies.

Mexico has also complained about China's currency manipulation, as the Mexican peso appreciated 21 percent against the dollar from the mid-1980s through 2006 by 21 percent, while the Chinese currency depreciated. And the Brazilian Government has called for a revaluation of the yuan, contending that the cheap Chinese yuan is flooding into Brazil and hurting local manufacturers. So, this is an issue for all of the Americas, not just the United States.

4. Network clustering

Perhaps the most unexpected competitive advantage China possesses is network clustering. This currently amounts to a 16 percent competitive advantage for China. Network clustering refers to the practice of locating all or most of the key enterprises in an industry's supply chain in close physical proximity to one another. China has raised network clustering to an art form, with whole cities dedicated to the production of particular products. For example, Yanbun is the underwear capital of China; Foshan and Shunde are the major hubs for appliances like washing machines, microwave ovens and refrigerators; Huizou in the Pearl River Delta area of China is the world's largest producer of laser diodes and a leading DVD producer. Leilu focuses on bicycles, Wenzhou on commercial kitchen equipment, Chencun on flowers, and so on.

The importance of network clustering is that it reduces transportation costs by locating the factors of production closer to one another. It reduces inventory costs by speeding up throughput times. And it reduces downtime in the supply chain by smoothly moving all links in the supply chain in a coordinated fashion.

In other words, China has specialized in turning logistics and supply chains into profit centers.

How has China been able to do this? The reason is that it is a planned economy, with 5-year plans organized and approved by the State Council. The United States is simply not organized in such a fashion, but I would suggest that freedom for our enterprises to locate where they wish to locate is a trade-off worth making. However, this raises the broader issue of industrial policy, targeting, and what will work best in the 21st century: The Beijing Consensus or the Washington Consensus, which emphasizes free and open markets? Generally speaking, the countries in the Americas have opted for the Washington Consensus, through the fairly rapid liberalization of its trade and investment regimes, and the general decrease of the role of the state in economic affairs. Mexico, for example, shifted from its state-led industrialization strategy in 1988 to pursue a market-led strategy. At this point Latin America is one of the more open market regions in the world.

5. Foreign direct investment

The fifth driver of the China price has been direct foreign investment. As massive amounts of foreign capital flood into China its efficiencies improve dramatically. Foreign investment into China has grown at 17 percent annually for five years, and among developing nations, China has become the leading destination for Foreign Direct Investment (FDI). Since 1983, FDI into China has grown from less than $1 billion per year to over $60 billion. And 72 percent of China's FDI targets manufacturing. One can see the synergy here, as its undervalued currency, provides a huge incentive for FDI.

Ironically, so does the U.S. tax code. The U.S. multinational enterprises are actually encouraged to invest abroad as a result of the tax privilege of deferral. Under the U.S. tax code a U.S. multinational enterprise established as a subsidiary is not taxed in the United States on the foreign source income that it earns abroad unless such foreign income is repatriated in the form of dividends, except in very limited situations. This tax privilege of deferral is in essence a subsidy that encourages U.S. multinationals to operate abroad. Deferral amounts to an interest-free loan by the U.S. Government for income that is accumulated until dividends are repatriated to the parent. Deferral thus encourages overseas investment over new investment in the United States.

Since approximately 30 percent of the exports from China to the United States are from affiliates in China we can see the untenable situation that now exists. Inter-affiliate imports, so-called "captive imports," encouraged by the U.S. tax code, are made in China and re-exported to the Americas. Obviously the MNEs are going to China to reap the benefit of China's other competitive advantages as well, but the U.S. tax code gives them a running start.

And with the increased FDI comes increased technology transfer, as Chinese enterprises will form joint ventures that contractually obligate their foreign partner to share knowledge and technology with the local partner.

In an effort to escape this technology transfer trap, foreign investors are now increasingly establishing wholly-owned foreign enterprises (known as WOFEs). Today WOFEs account for 65 percent of new FDI in China and they dominate high-tech exports. WOFEs account for 62 percent of industrial machinery exports, 75 percent of exports of computers, components and peripherals, and 43 percent of exports of electronics and telecommunications exports.

Navarro estimates that catalytic foreign direct investment accounts for 3 percent of the China price advantage but this appears low, since 30 percent of China's exports to the United States are inter-affiliate exports, i.e., from an affiliate of a U.S. enterprise to its parent.

5. Counterfeiting and piracy

Counterfeiting and piracy account for about 9 percent of the China price advantage. Counterfeiting and piracy enables Chinese companies to save research and development and the marketing expenses required for brand building. Much of China's counterfeiting and piracy is state-sanctioned. In one case I worked on it was the Chinese Government's official printing press in Shanghai that was knocking off the chemical abstracts, costing the American Chemical Society, which was my client, $40 million per year. China had 9 subscriptions to cover its 1.3 million scientists, and dozens of universities, research institutes and think tanks that were using the publication. And the rate of software piracy in China is well over 80 percent, with the government often the worst offender.

On average 20 percent of all consumer products in the Chinese market are counterfeit. And, if a product sells, it is likely to be duplicated. Of small comfort is the fact that U.S. companies are not being picked on in this regard, as pirates and counterfeiters target both foreign and domestic companies.

6. Other aspects of the China price

The remaining areas where China secures a competitive advantage over other countries include minimal worker health and safety regulations and lax environmental regulations and enforcement. Cumulatively, according to Navarro, these factors amount to about 5 percent of the China price advantage.

B. Countering the China price

How should the United States counter the China price? The answers to this question lie in the realm of U.S. tax policy and U.S. trade policy.

1. International tax provisions in the new U.S. tax legislation

Interestingly, the first significant steps to counter the China price have not occurred in the area of trade policy but with the passage of the new U.S. federal tax legislation passed in Dec. 2017, and entered into force on Jan. 1, 2018. The international tax provisions of this legislation will have a dramatic impact on the decisions of U.S. multinational enterprises to invest in the United States or overseas. Reductions in overseas investments will result in reduced imports from foreign affiliates, which amount to 30 percent of the U.S. imports from China. The new tax legislation reduces the U.S. corporate rate of taxation from 35 percent to 21 percent, which will encourage investment in the United States over foreign locations. Moreover, the new legislation has a deemed repatriation rate of 15.5 percent on the undistributed earnings of overseas affiliates that consist of cash or cash equivalent, and a rate of 8 percent on undistributed earnings that do not consist of cash or cash equivalents. The U.S. shareholder will be allowed to pay the newly assessed U.S. tax over an 8-year period. The latter provision represents a significant erosion of the current policy of deferral of taxation on foreign affiliates. Coupled with the newly granted 100 percent U.S. tax exemption for dividends received from a foreign corporation, the new U.S. international tax policy will discourage direct foreign investment by U.S. enterprises, and encourage the repatriation of dividends, steps that should significantly increase investment in the United States, and decrease foreign imports.

2. Trade policy steps taken by the Trump administration

a. The antidumping laws of the United States

The most significant trade-related step taken thus far by the Trump Administration regarding China has been the decision it announced on Nov. 30, 2017, to reject China's bid for market economy status, and to continue its classification of China as a non-market economy. This will increase the effectiveness of the U.S. antidumping law. This designation permits the U.S. Commerce Department to refer to the economy of a third country at a comparable stage of economic development to calculate the home market "fair value" price, and the economy usually chosen for that analysis is India. This exercise is generally referred to as calculating the "constructed value" of the home market price. China has argued, citing its WTO 2001 accession protocol, that it is a market-oriented economy. If it were to be so classified, it would be virtually impossible to assess antidumping duties against China because its home market prices are so low. China has launched a complaint against the United States regarding this decision with the World Trade Organization. The Trump Administration's determination that China is a nonmarket economy is, however, correct. For example, China's foreign exchange regime is still controlled by its State Administration for Foreign Exchange (SAFE), and its many state-owned enterprises still dominate the economy.

Individual unfair trade practice petitions have also been filed at a record rate in 2017, apparently reflecting the view that the Trump Administration will more vigorously enforce the U.S. unfair trade practice statutes: 23 new trade petitions have been filed in 2017, making 2017 the busiest year for trade cases since 2001. These cases involve fights over Chinese products such as aluminum foil. An aggressive technique employed by the U.S. Department of Commerce has been to self-initiate antidumping and countervailing duty petitions against China on common aluminum sheet. This marks the first time since 1985 that the Commerce Department has self-initiated an antidumping case. The investigations launched on Nov. 28, 2017, cover more than $600 million worth of imports, and may signal stricter enforcement of the U.S. antidumping laws.

b. The countervailing duty laws of the United States

The countervailing duty law of the United States permits the United States to assess duties equal to foreign subsidies, bounties, or grants for foreign goods entering the U.S. market. It appears that this statute will be more vigorously enforced. For example, there is an action now pending against Chinese subsidies for its aluminum exports to the United States. China's aluminum exporters now benefit from government reductions on their energy bills and tens of millions of dollars in cash infusions. Subsidies such as these have propelled the surge in China's aluminum production in recent years, which has increased from 24 percent 10 years ago to 55 percent of global production in 2015. China has also been circumventing prior countervailing and antidumping duties amounting to 374.15 percent by importing products such as aluminum pallets from China, which is just aluminum being reshaped to avoid the punitive U.S. duties. China started to use these new methods to sell aluminum in the United States after the tariffs were imposed, indicating that they were designed to avoid trade barriers.

c. Intellectual property

A major tool in the tool kit to improve the U.S. trade posture is Section 337 of the Tariff Act of 1930, which permits the United States to issue exclusion orders and cease and desist orders against imports that compete unfairly, and covers patents, copyrights, trademarks and potential antitrust violations. The majority of Section 337 actions are against China, and the majority of those cases involve patent-based violations. Section 337 enforcement needs to be expanded. It is the "catch all" statute designed to limit imports that are competing unfairly in the U.S. market.

On Aug. 18, 2017, President Trump launched an investigation under Section 301 of the Trade Act of 1974 to determine whether acts, policies and practices of the government of China related to technology transfer, intellectual property and innovation are unreasonable or discriminatory and burden or restrict U.S. commerce.

Section 301 of the Trade Act of 1974, as amended, gives the U.S. Trade Representative broad authority to respond to a foreign country's unfair trade practices. If the USTR makes an affirmative determination of actionable conduct, it has the authority to take all appropriate and feasible action to obtain the elimination of the act, policy, or practice, subject to the direction of the president, if any.

The statute includes authorization to take any actions that are within the president's power with respect to trade in goods or services, or any other area of pertinent relations with the foreign country.

This decision will be closely watched, and the only criticism of the investigation thus far has come from Democrats, who say the investigation does not go far enough.

d. Fairly priced imports

A consensus exists that imports that are unfairly competing the U.S. market need to be limited. The controversy exists with regard to goods that are fairly priced that are still entering the U.S. market in numbers large enough to seriously injure U.S. industries.

During the presidential campaign, Trump called for a tariff of 45 percent to be imposed on China's imports. There are two statutes that would now permit the president to carry out the threat of higher U.S. tariffs. The first statute is Section 232 of the Trade Expansion Act of 1962. Under this statute the president can declare that for national security reasons he can limit imports coming into the United States. The problem with the use of this statute is that with current U.S. unemployment levels at 4.1 percent, which most economists would term nearly full employment, it is difficult to make the "national security" case under Section 232.

Nevertheless, President Trump has launched an investigation under Section 232 with regard to the U.S. steel and aluminum industries. With the United States down to one aluminum smelter it is possible that an affirmative decision may be made on aluminum, but it is highly unlikely that an affirmative decision would be made with regard to steel, where the United States still possesses a major, if declining, productive capacity. Hearings have been held on both steel and aluminum, and the steel industry is divided on the issue. Manufacturers that use steel and aluminum as inputs into their final products oppose import restraints, while certain domestic producers favor import restraints. There is also a statute, known as the "safeguard" provision, that allows the president to limit imports if they are seriously injuring a U.S. industry. U.S. solar panel manufacturers are currently seeking relief under the "safeguard" law against China. They argue that over the past few years, a flood of less expensive Chinese solar panels has undermined the ability of the industry to compete. The ITC ruled in favor of the two manufacturers, SolarWorld and Suniva, in October 2017, but the companies have said that the duties recommended by the ITC are too small.

C. When will the China swoon end?

Predictions are always a dangerous game with President Trump, but it is likely that the China swoon will end in 2018. The key reason is that China has simply not delivered on Trump's unrealistic expectation that it would rein in North Korea. Kim Jong Un has proven to be a tougher, more resilient leader than was generally expected, and China has been ineffective in stopping North Korea's nuclear development. Nor has China taken any significant steps to reduce its aggressive steps in the South China sea. But most important are the domestic U.S. political factors. With the 2018 elections for Congress already underway, and with it being a distinct possibility that the Democrats could win back both the Senate and the House, it is likely that the warmth in U.S.-China relations will diminish, and that Trump's protectionist rhetoric will return. Early markers will be the decisions of the Trump Administration in its probes against the Chinese intellectual property practices and Chinese steel and aluminum industries under the national security trade statute. The jury is still out, but it is likely that 2017 will prove to be the calm before the coming China trade wars.

Bart S. Fisher is an attorney in Washington, DC and co-author of "International Trade and Investment: Regulating International Business."