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China's Export Success

Due to Unfair Practices or Fair Competition?*

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Summary

Compared with previous ratings, China's trade policy today is more positively acknowledged. Yet, China can still be criticised in particular because of its non-transparent subsidy policy, the privileged role of state-owned enterprises, the heavy hand of the state in general, the sluggish enforcement of intellectual property rights, and the prevalence of non-tariff barriers. Yet, it cannot be ignored that Chinese entrepreneurship mentality is highly developed outside state interference in world markets. Especially, in the digital economy, high motivation and a large pool of human skills act as drivers of innovations, so far mainly process innovations. The trade war with the US hurts China and is responded by China with asymmetrical retaliation. The more Chinese exports to the US in total are affected, the more costs will have to be borne by US consumers as options to shift to alternative suppliers become weaker. What President Trump would see as a "good" deal for the US is unclear. It can be thus presumed that the trade war will continue into 2020 and that it is in fact a tech war. The EU is affected as EU companies produce in China for the US market and in the US for the Chinese market. While it might gain from trade diversion effects in the short run, the negative effects on investment due to uncertainty weigh more heavily. The EU is tempted to negotiate a free trade agreement with China but rightly refuses to start negotiations before China is prepared to conclude an agreement on investment. The EU should not see China and the US on equidistance. Workable relations with the US are much more important. To conclude, China's trade policy has improved relative to Western standards but still warrants further steps towards much less state influence. Yet, its global competiveness especially in the state-of-the-art digital economy is high and is owed to a strong entrepreneurial mentality.

1. China' trade policy receives better ratings than in the past

Since years, China has been the world's largest exporter of goods in absolute terms and by mid- 2019 it still keeps this position. At the same time, domestic value added as a share of gross exports has been steadily rising since 2011 (Goldberg, 2019). Thus, seemingly, further fragmentation of production and the growing share of intermediate trade in total trade has come to an end in China.

This observation coincides with those made in the 2018 WTO Trade Policy Review on China (WTO TPR, 2018), the seventh since China' s WTO entry. The report concludes that:

- Consumption in China during the observation period (2016-2018) were responsible for two thirds of Chinese GDP growth.
- The share of services in GDP rose above 50 per cent.
- The exchange rate regime became more flexible and thus were in line with the IMF 2015 assessment of the RMB being no longer undervalued and broadly in line with fundamentals (US Congressional Research Service, 2019).
- The MFN average applied import tariff rate amounted to 9.3 percent in December 2017, following a slowly declining trend over the last decade (9.7 percent in 2007) below the level of some important emerging markets like India or Brazil.
- During the 2016-2018 period, China was a respondent in five cases in the Dispute Settlement Mechanism, less than the US during the same period (21 cases as a respondent).
- China liberalized its policies towards inward FDI by shortening the "negative list" of industries where FDI is restricted or prohibited and by announcing

to relax restrictive joint venture requirements in the manufacturing sector and to lift them totally by 2022 in the automotive industry (Langhammer, Liu, 2018).

The TPR gives rise to one past and one forward looking observation. As concerns the former, after 2008 China launched the largest fiscal expansion program among all major trading partners in the world to overcome the crisis and thus helped to bring the world economy fast to the pre-crisis growth track. The price to be paid by acting as a demand engine for many countries, were setting up large excess capacities in many industries. As concerns the latter, the IMF expects that China moves into a current account deficit from 2022 onwards and becomes a net capital importer.

All these developments may suggest China to be a normal emerging economy with few reasons to be concerned about unfairness in its policies towards partner countries. This conclusion, however, would be premature. Unfair practices have not vanished.

Blind spots in China' s trade policy

The TPR reveals that China still has at least four blind spots which significantly act as barriers against fair and undistorted trade. First, there is no evidence about the volume and the direction of subsidies, especially at the sub-central level (para 3.104-05 in the TPR and on subsidies for intelligent manufacturing and advanced technologies (para 3.113). While direct export subsidies are per se illegal, domestic subsidies (either direct payments or tax privileges) can be indirectly trade distorting if they release companies from expenditures which can be spent on supporting the marketing of their products beyond their borders. China's industrial policy ("Made in China 2025") has earmarked ten industrial sectors for domestic support again without disclosing the amount of support. This is why partner countries insist that in anti-dumping investigations (AD cases) individual Chinese companies disclose their support from the government according to criteria set up by the partner countries. Second, state-owned enterprises (SOEs) receive privileged treatment. They are protected against insolvency through loans granted by state banks and will not be sued because of violations of intellectual property rights (IPRs). As state involvement remains considerable, the question of whether China is a market economy is valid. China argues that it has merited such treatment automatically after fifteen years of WTO membership in December 2016. Instead, the US and the EU apply their own impact assessment guidelines in order to find out whether Chinese state interference distorts domestic prices significantly. Third, the WTO TPR states that the enforcement of IPRs still remains a large challenge (para.3.259). This is partly due to the separation between administrative and judicial enforcement and the responsibility of different governmental levels. Evidence from the business sector suggests that lack of enforcement exists in particular when patents are affected. The rising number of disputes on patents violation exceeds that on disputes on copyright violation by factor of ten. Fourthly, trading partners complain about the violation of equal treatment of foreign suppliers against domestic competitors (national treatment). Such violation is often observed at the sub-central level especially in service sectors where tariffs do not exist and where domestic regulations decide on the conditions of market accessibility. In the special field of construction services, the Road and Belt Initiative being primarily funded from Chinese public sources has been criticized as a case of tied aid benefiting Chinese contractors. Contrary to China, Western donors submit their aid commitments to OECD Development Assistance Committee (DAC) standards. Under these standards, aid of Western donors has been rated to be largely untied (88 percent in 2016).

How relevant are the blind spots? Three aspects warrant attention

First, unlike border measures (tariffs, FDI market access) which can be quantified for deciding pro or against Chinese trade and investment liberalization, behind-the border-measures such as violation of national treatment by denying foreigners equal access to public funding widely escape quantification. This because there is a critical lack of disclosure of data on such support received by companies. Second, there is a gap between fixing liberalization by law and law enforcement. One source of such gap is the imbalance between behaviour of central and sub-central authorities the latter being often a stumbling block against liberalization. Third, while old barriers have been identified and sometimes fixed, new tools of intervention of public and party authorities at the company level are perceived by foreign suppliers as costly barriers. Yet, according to the World Bank's Index "Ease of Doing Business", in 2018 China kept rank 46 compared to ranks between 80-76 over 2014-17. Thus, relative to other countries, business in China seems to have been facilitated though the jury whether this holds for foreign business to the same extent as for local entrepreneurs is still out. Some reports on foreign business sentiment speak against equal treatment.

2. Chinese entrepreneurs enjoy a strong competition-oriented motivation

Both commitment and entrepreneurial spirit are assets which Chinese companies have witnessed even under difficult conditions. Where, for example, European investors failed to set up companies in manufacturing in Sub-Saharan Africa which can compete on world markets, Chinese investors managed to do so. Furthermore, China can count on a large experienced community of overseas Chinese (estimated at about 60 million) which are familiar with domestic and local markets and have never cut the ties to their home country. Openness to inward FDI is a further support for gaining competitiveness as China is known to be a "finishing touch" producer in the downstream segment of global supply chains. Though this advantage in labour-intensive assembling has been reduced due to the rise of real labour costs during the last decade, China was able to compensate for this rise by strong automatization. Such success has been possible because China has emerged as a leading source of digitalization technologies. It owes this success to four advantages over competitors: abundant data as Chinese are keen to use these technologies everywhere in their daily life, the lack of data regulation to protect privacy, massive capital support from the government and in particular strong human skills as reflected in many patents owned by Chinese. So far, these advantages have found their impact in close links to hardware manufacturers (McKinsey 2017).They have made making existing production more efficient through process innovations. Restrictions against free flow of information via the internet have so far prevented Chinese suppliers to be as innovative in product innovations as their Western competitors so that these innovations in the information business and other services have been still a strength of Western companies. Furthermore, Chinese suppliers of information hardware as well as software (such as operating systems for mobile phones) are still dependent on supply from US producers and thus vulnerable to restrictive policies from the US government.

3. The trade war with the US: shooting at a moving target

By fall 2019, it is open how the trade war between China and the US develops and when it comes to an end. Uncertainty is thus the key word which hinges upon both economies and given the dominant global role of both countries upon the entire global economy. This uncertainty matters much more than the direct costs of tariff increases loaded upon US and Chinese consumers and companies from both countries. It is particularly caused by lack of information about what President Trump would see as a "good" deal and how far current negotiations are still from such a deal. What can be derived from modelling the impact of the trade war is that it will cost China more than the US if the retaliation spiral continues (Felbermayr, Steininger 2019). As long as trade measures remain mild, the US wins and China loses. With further and more aggressive retaliation, the US will always lose less than China. This has to do with the greater vulnerability of China given their large trade surplus. The models exclude retaliation beyond merchandise trade, for instance in the financial sphere. In all steps so far (from July 2018 starting with 34 billion US$ Chinese exports affected by tariffs to announced measures for December 2019 when effectively all Chinese goods exported to the US will be subject to additional tariffs), China's retaliatory response has been far lower and thus asymmetrical. The models conclude that Europe would win in real income due to trade diversion though this gain would be very modest. The scope of trade diversion depends very much on the possibility of US consumers to shift their demand away from China to substitutes from Europe or other suppliers. This was possible in the beginning when US authorities imposed tariffs on goods where substitutes were available: non-consumer goods and intermediates. China thus had to lower their prices in order to defend their market share. This terms of trade loss led China bear the costs. At the end of the tariff war, the US will target consumer goods in which China as part of the global supply chain faces fewer competitors. Costs could shift more to US consumers facing a regressive income tax as these goods are primarily demanded by low-income people. Given the uncertainty about the contents of a "good" deal for the US, it is not unlikely that President Trump will stretch the conflict close to the end of his presidency in 2020. The probability of conflict stretching, however, would shrink if the US economy would weaken. Then, a deal would relieve markets. Stretching the conflict beyond tariffs on merchandise trade could imply a game changer, with possibly very serious consequences for the global economy." Beyond trade" measures could, for instance, include the denial of Chinese companies' access to US financial markets by invoking the International Economic Emergency Power Act (IEEPA). Such game changer could be responded by China in letting the RMB fall or stopping the purchase of US assets. Negative effects on growth cannot be assessed under a "financial" war scenario but they would be substantial.

4. Europe in a "sandwich" position. What to do?

Europe is affected by the trade war as its companies are part of the global supply chains producing on both markets for the targeted market. Small trade diversion gain will probably be clouded by the negative effects on investment sentiment. Apart from the trade war, it is important to note that both the US and China have been active to test the strength of EU unanimity by playing divide and rule games. The US advocates a hard Brexit, accuses Germany of economic dominance and thriftiness, and urges for a common defence position against Huawei. China tries to decouple Southeast European countries from a common position of the EU towards the Road and Belt Initiative (17+1 strategy). Furthermore, China wants the EU to begin negotiations on a bilateral free trade agreement while the EU wants China to sign a bilateral investment agreement which is negotiated since 2013. Negotiations are difficult because the EU wants to use its mandate from the 2009 Lisbon Treaty to replace national bilateral investment agreements by a single one and because the existing agreements do not specify equal treatment in market access for foreign and domestic competitors (so-called pre-entry conditions)but only post-entry conditions (such as compensation in case of expropriation). To tie the hands of governments before investment is launched is particularly important in a state-dominated economy like China. For the EU Commission to expand its mandate from trade to investment is more important than a trade agreement. The recent initiative of the EU Commission (initiated by France and Germany) to introduce a "screening" catalogue for checking the compliance of foreign investment with security interests has burdened these negotiations since it is seen by China as targeted against its companies.

The EU is required to weigh the importance of its bilateral relations with the US and China. For many political and financial reasons, the former are more important than the latter. There is no equidistance between the two. This implies that the EU should seek to revitalize the TTIP negotiations, preferably in sectors where relatively high tariffs set during the Uruguay Round no longer reflect the current state of competitiveness. It would also be helpful if the EU and the US would seek to find common platforms for reforming the WTO, for instance by defining MFN-based rules for digital trade. Such a platform would be much more difficult to negotiate with China which insists on differential and special treatment (SDT) for itself as a developing economy. Since SDT and MFN are not compatible, there should be a better match between the reform proposals of the EU and the US than between the EU and China.

5. Concluding remarks

As seen from seven WTO TPR on China since 2001, the improvement stands out clearly. In three elements (trade policy in the narrow sense, exchange rate policy, and FDI treatment) progress towards less discrimination, more liberalization and more transparency has been made. In addition, the Chinese fiscal expansion program in the 2008 crisis has helped many countries to return sooner to the pre-crisis growth path than without the program. The program came at the price of excess capacities in many Chinese industries which today distort world markets. Yet, blind spots in the Chinese trade policy are still virulent, in particular in subsidies, state intervention and IPR protection. China is moving from an export-oriented investment-driven economy to a domestic-market innovation-driven economy. For many countries, in particular the US, this transition is too slow. The US-China trade war can seriously backfire upon the entire global economy for two reasons. First, there is total uncertainty about the contents of a deal which President Trump would sign. Second, to open the financial and the technological sphere as a new battlefield would be a serious game changer. It is out of question that China will sacrifice its economic system. The EU should not fall into the fallacy of equidistance between the two superpowers. In spite of President Trump's aggressive bargaining, the match between the US political and economic "fundamentals" and those of the EU is much better than with China. This suggests a clear sequence of politics: revitalizing the TTIP negotiations, finding common platforms with the US on WTO reform, and concluding a bilateral investment agreement with China. A free trade agreement with China is an issue of the far future.

To sum up, in the past China's export success was much more built on "unfair" practices than today. Today, China's competitiveness can be predominantly explained by skills, entrepreneurial spirit and strong engagement in places where fruits hang highly. Yet, its trade policy has still ways to go before it can be labelled truly fair.

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