

## Testimony

### US Trade Policy: The China Question

#### Prepared Remarks before the Senate Finance Committee

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Let me begin by saying how honored I am to have been invited to appear before your Committee, Senator Baucus. I have long been familiar with the leadership you have provided on trade issues in the Senate over many years, enabling the United States to be the major player in the liberalization of world trade that has brought so many indisputable benefits to us and to many nations around the world.

You have asked me to address the question of China and what it implies for US trade policy. China, of course, has long been an important source of controversy for US trade policymakers. The debates over whether to grant it MFN status were followed by whether, and on what conditions, it should be admitted to the WTO (World Trade Organization). I recall how USTR Charlene Barshefsky arrived from Beijing with an agreement on the terms of Chinese entry into the WTO just in time in Seattle in November 1999 for the WTO meeting which blew up in the face of President Clinton and the rest of us, postponing by two years to 2001 the start of the Doha Round of multilateral trade negotiations.

Many were certain that the focus on China had detracted from the US preparations and preparedness over the Seattle meeting, illustrating tangentially how multilateral trade liberalization is often handicapped, not advanced, by distractions over bilateral and plurilateral (i.e. with members exceeding two but less than all nations) trade negotiations.

Today, the issue of China is even more prominently at the center of a major debate over US trade policy. But the stakes in this debate are higher as the China question now is part of a substantive debate, especially after the last election, over the question whether further freeing of trade or a retreat (however slow) into de facto protectionism makes sense for the United States. More precisely, the China question is one of two issues today that must be addressed regarding our trade policy. So, let me say a few words about the other issue, and then turn more bodily to the China question which you are addressing today, Senator Baucus.

I: Inclusion of Labor and (Domestic) Environmental Standards in Trade Treaties:

#### Case of “Export Protectionism”

The first relates to the fact that the New Democrats have been elected, with a Democratic majority, in the last Congressional election with promises to require labor and (domestic) environmental standards as central features of trade treaties. While there are groups that want to spread higher standards because of altruism and sympathy, the motivation that prompts the demands for inclusion of labour standards elsewhere as preconditions for trade liberalization by the United States—these demands come from AFL-CIO and the new Democrats are reflecting for political convenience these demands while some share the AFL-CIO viewpoints independently of voting considerations, for sure—is quite simply self-interest and fear.

The insistence that labor and environmental standards, for example, must be demanded from others with low standards because otherwise free trade would be “unfair” have long been exposed as unpersuasive. Let me state here just a few of the counter-arguments against such demands: systematic analysis of the different rationales

proposed for them is available in many other places and needs to be consulted for a fuller understanding of the protectionist dangers we currently face.<sup>[1]</sup>

First, if these demands take the common form that others must have similar “burdens” as our producers do, it is easy to see that standards, theirs and ours, are generally speaking different for perfectly legitimate reasons and that our objecting to others’ standards is as right or wrong as their objecting to ours. Would we then let others exclude our exports simply because our standards are lower than those of Europe, even Canada’s, in many areas? In case one doubts that US standards are lower, just think of the obvious examples. Almost alone in the world, we allow capital punishment, including the capital punishment of juveniles. Or take the several international reports on the state of our prisons, and our widespread use of prison labour to produce goods for sale by firms who are not required to pay minimum wage payments and offer labour protections. Then again, on the right to unionize, the Human Rights Watch (with whom I work on the Academic Advisory Committee on Asia) has produced a detailed analysis which concludes that this right is effectively denied to “millions” in the US, largely (but not exclusively) because the right to strike has been crippled by the Taft-Hartley provisions. Indeed, many abroad find it very hard to believe that, with little more than 10% of our labor force unionized, and with wide appreciation of the legislated difficulties faced by unions in organizing labor, we can claim that we have the higher moral ground in these matters. At a time when the Bush administration’s unilateralism has provoked serious anti-Americanism, the self-righteous tone of our labor and environmental lobbies and the dissonance between our postures and our own practice are also not likely to make the United States any more likeable to the world.

Second, and equally important, our attempts at imposing such standards on the developing countries will not succeed with the larger and economically more important developing countries such as India and Brazil. These countries are fully democratic; they are neither more dictatorships nor violators of human rights than we are. In fact, India is a splendid democracy which has managed multi-religiosity, multi-ethnicity and diversity within a democratic framework. Its unions are also free; and its environmental movement is strong. As for Brazil,

President Lula has risen from the ranks of the trade union movement and has better credentials as a trade unionist than even John Sweeney! Yet, both India and Brazil strongly reject the inclusion of labor and environmental standards in trade treaties. In fact, India just recently told the EU that they could not have an FTA with it unless non-trade issues were mixed up with it, causing the EU to go back to the bargaining table; and the same can be confidently expected to be the case with the US. It is also noteworthy that no trade treaty purely among developing countries has these extraneous non-trade issues within it: it is a characteristic of bilateral trade treaties that hegemonic powers, with their lobbies, impose on lesser countries in one-on-one, unevenly-matched bargains. If the new Democrats want to go down this route, they face the prospect of confining their trade liberalization to weak, ineffectual nations which will roll over when faced with such demands. Some liberalization indeed!

Third, key political leaders in the US, until recently, were cognizant of the fact that it was more efficient to pursue labor agendas in the ILO and trade issues in the WTO and in other trade treaties and institutions. Senator Patrick Daniel Moynihan frequently wrote to me agreeing with this position, including sending me for my files a memo to this effect, based on an op ed of mine, signed by POTUS as “seen”! But I must also say that I was pleasantly startled when Senator Kerry, several months before he decided to run for the Presidency, said in a Panel on trade at Davos that he favored a “dual track” approach: labor issues at the ILO and trade issues at the WTO. I should add that I went up to him after the session and said that I was a Professor of Economics at Columbia, and had been a Professor at MIT and was a constituent of his since I still had a house in Lexington, Mass. And that I had been greatly impressed with his speech on the dual track approach. I thought he would throw his arms around me in a bear hug, like President Clinton, at receiving such a compliment from a constituent. Instead he looked past me and walked away. My thought was: how can he connect with voters outside the comfortable environment of Massachusetts when he has no political skills? Well, the Presidential election answered that question decisively, I am afraid!

It has become fashionable for some commentators such as the political science Professor Mac Destler and the journalist Mr. Bruce Stokes to say that the US has become less protectionist in recent years. This is seriously wrong. Yes, we probably have less sectoral, import protection. But the protectionism we now face is across-the-board, export protectionism. The attempts at raising labor and domestic environmental standards as preconditions for trade liberalization are transparent attempts by a terrified labor movement, and sympathetic media personalities like Lou Dobbs, to raise the cost of production of rivals in the poor countries so that the force of competition is moderated. Imagine a beast charging at you: you can either catch it by the horn (i.e. conventional import protectionism) or reach behind it, catch it by the tail and break the charge (i.e. export protectionism). The forced raising of standards in the poor countries desirous of trading with us is “export protectionism”: It is insidious because it is not transparent to the general public as such and partly because it can be successfully disguised as altruism and empathy for the people in the poor countries. It is also invidious because it is not confined to specific sectors but cuts across many sectors, indeed wherever the imposition of such standards by de facto exercise of political power manages to raise the cost of production of rival firms abroad.

It is a dangerous protectionist beast that the new Democrats, and several compliant Republicans who would rather advance business deals than stand for any principles, are therefore turning loose on the trade arena. But the other major threat comes from China today. Part of it is from China’s low standards on human, and hence labor, rights and so what I have argued above holds *pari passu* in regard to China. But it comes from other China-specific factors, to which I now turn below.

## II: China: Macroeconomic Red Herrings

I do not intend to pun; but the macroeconomic criticisms such as those advanced by Senators Charles Schumer and Lindsey Graham, threatening across-the-board tariffs against China if the Renminbi is not revalued sizably, are a red herring. Consider the following:

\* There is an exaggerated focus on the Chinese reserves which are currently at a trillion dollars. But the Japanese reserves are pretty close, at around 800 billion. The rest of Asia, including Taiwan and India, add up to a similar sum. So, for Asia as a whole, the reserves are about three times the Chinese levels: so why pick just on China?

\* Regardless, the accumulation of Chinese reserves has created a deep-seated concern that this is the cause of US payments deficit. But the US deficit is a reflection of US excess spending. In a multi-country world, if the Chinese currency were revalued, the US deficit with China would be reduced, the Chinese reserves would tend to fall, but the US deficit with third countries would increase. The only way to reduce the US deficit would be to reduce US aggregate excess spending. The fault lies within us.

\* Many fear that the Chinese surpluses will continue growing exponentially and, since they are currently invested in US Treasury bills, will give the Chinese great power to disrupt our markets and will also give them political clout over us, in consequence. But almost nothing keeps growing exponentially. In the case of China, as much as for India, the pressures are growing to spend a large fraction of the reserves on infrastructure needs and on expanding education and health expenditures on the poor. We can confidently expect therefore that Chinese reserves will level off in the near future.

\* The Chinese reluctance to allow the Renminbi to crawl up faster than the slow upward climb after the small revaluation in July 2005, and thus to abandon the peg to the US dollar which she adopted in 1994, has to be understood in light of the fact that some of today’s most profound international macro-economists such as the Nobel Laureate Robert Mundell of Columbia University and Ronald McKinnon of Stanford University have argued against China’s abandoning the peg, even though economists such as Nouriel Roubini of New York University have argued for exactly the opposite. [2] Since such diametrically opposed recommendations are not uncommon in macroeconomics, and even the proponents of Chinese Renminbi revaluation divide into many

camps on the extent of the desirable revaluation, it is important to remember that the confidence with which Senators Schumer and Graham, and many in their camp, regard China as perfidious in not accepting their recommendation to revalue the Renminbi significantly, suggests that even good politicians are bad economists and that hubris in macroeconomics is a deadly fault.

\* Besides, these economists frame their analysis in terms of which exchange rate regime, pegged or flexible, is good for China itself, rather than for the rest of the world, including the United States. But the concern in the US must be over the implications for the US, not for China, unless we are going to be altruistic. How does one then assess the efforts of Treasury Secretary Paulson to ask for financial sector reforms in China? Frankly, while such reforms are likely to be good for China itself, I do not see our pressures for them as anything other than using our confrontations with China to open the Chinese market more rapidly and deeply to our financial firms on Wall Street: this is good for Wall Street but it is not clear how it will benefit the US in any other Chinese-macroeconomics-related benefit spillovers.

### III: Trade Policy Issues Raised by China: Unnecessary Alarm

So much then for macroeconomic issues and the confusions that characterize those who seek aggressive postures towards China in regard thereto. But there are also direct trade policy questions where aggressive actions are demanded today, principally because there is much fear of China's impact on our economic prosperity and on our workers' real wages. But let me say that these fears are, at best, seriously exaggerated, and at worst, unjustified. But first, let me make three general points.

First, as is now widely appreciated, China has played a helpful, not a disruptive, role at the WTO, fully justifying the arguments of those such as myself who predicted this outcome. [3] Those who feared that China, to mix metaphors, would be a bull in the WTO shop, have proven wrong.

Second, the complaint by some observers that China has not played a sufficient role in the ongoing Doha Round negotiations ignores the fact that China was subjected to several WTO+ concessions barely before the Doha negotiations began: she has therefore, in the unfortunate language of negotiations, put down major down payments already.

Third, there is, as with Japan in the 1980s, continuous dissatisfaction with the Chinese implementation of their WTO obligations, especially in relation to intellectual property protection. But, as with the Japanese government, it makes no sense to keep pressuring China bilaterally. Few big powers give in to such pressures to the extent that would satisfy the complaining nations. Besides, while China is authoritarian, it is well established that domestic lobbies in shape of different ministries and regional authorities play a similar role and it is necessary for the central authorities to countervail their objections. This can be done more effectively when there are impartial decisions requiring corrective action, than if simply bilateral pressures, often triggering nationalist responses, are cited as a reason to take remedial action. Such impartial decisions are available from the WTO Dispute Settlement Mechanism. So, as we did with Japan in the end, it is best to ignore China's promises and sensitivities: let us use the DSM with increased frequency. More WTO cases by us will lead to less friction with China, and more satisfaction for the American private sector interests, than bilateral pressures.

But, even if China is behaving responsibly and differences in US and Chinese views of China's implementation of its contractual obligations can be resolved amicably and efficaciously through the Dispute Settlement Mechanism without raising temperatures in bilateral confrontations, the big question that dominates thinking about China and US Trade Policy relates instead to the fear of China's impact on our economic prosperity and on our worker's wages. Let me turn to these questions now.

First, in regard to the impact on our worker's wages, the pressure on them in the last two decades, if not a little longer, has been manifest. But the question is whether it has anything to do with China. This is, in fact, part of the broader question: has Globalization turned the heat on our worker's wages? This is certainly what many

fear. But, as I pointed out in an op-ed in *The Financial Times* (January 4<sup>th</sup>, 2007), the evidence for such a link is pretty thin. [4] The fact is that many empirical studies of the effects of trade with the developing countries—and that certainly includes China and India—on our workers' wages have shown a rather small adverse effect; and my own empirical work even suggests a favorable effect that has moderated the fall in wages which would have occurred because of labor-saving technical change. [I also argued that Globalization has been feared to have adversely affected our worker's wages through the substantial influx of unskilled illegal immigrants, an issue that does not concern China and us, of course. But here too, the adverse effect is now estimated to be negligible and recent studies again suggest that the effect may even be favorable.]

I considered other possible links (such as the outflow of multinational investments and the weakening of labor power in wage negotiations due to Globalization) and found that they too yielded nothing significant, leading me to consider that the fear of Globalization, and hence of China, on our wages was unjustified and that the principal culprit was rapid and deep unskilled-labor-saving technical change. [This is a judgment that has recently been made also by Federal Reserve Chairman Ben Bernanke. But, of course, he is not an expert on international trade any more than his predecessor Alan Greenspan was. So while his views on the subject attract media attention, they carry for the knowledgeable scholars less weight than his views on macroeconomics, even though it is good to see that he holds the right views on the issue!]

Next, and finally, let me turn to the somewhat different question: can we compete with China (and India) or are we doomed to a gloomy prospect, with diminishing (aggregate) prosperity? Let me make a few important points, instead of offering an exhaustive analysis.

\* China's size and also her rapid growth over two decades make many worried. But that is wrong. We are bigger in both GNP, and even more so in per capita GNP. China's huge geographical size, and its vast population, creates unjustified fears.

And the assumption that the high growth rates will continue into the future ignores the fact that China has many economic problems that plague it, especially inefficient State Operating Enterprises, still much poverty, and a terribly weak financial sector. Its demographic structure, thanks to the draconian and effective one-child policy, also is lopsided, closer to that of Europe than of India. These problems cast a shadow over China's ability to sustain its high growth rate.

But the prospects of China registering "miracle" growth rates for much longer are also cast in doubt by her communist politics. China lacks currently the four elements of a functioning democracy: NGOs, a free press, opposition parties and an independent judiciary. The result is growing social disruptions as commissars and their cronies grab land, for example. No one can predict whether China's rulers will react to these disruptions by introducing democratic reforms or by repression. But the transition to either situation is not going to be easy. Then again, without NGOs, opposition parties and a free press to countervail gross abuse of the environment, China has been devastated by massive environmental neglect: this has not merely meant that China's effective growth rate, adjusted for the environmental damage, is probably 3 percentage points lower than estimated, but also increasingly handicaps future growth rates by saddling the authorities with gigantic clean-up costs, for example.

\* Tom Friedman has also propagated unwittingly the myth that China and India will come down a "flat road" and, like Russell Crowe's Roman legions, assault us. He is dead wrong. He forgets that there are many potholes in this flat road and comparative advantage is not dead. Take, for instance, the fact that communist China, with its fear of samizdat, cannot promote software: this yields us and India a huge competitive advantage in the IT sector, on which much of modern technical change depends! Or recall the fears in the 1980s that Japan would take over everything, starting with our autos and semiconductors. Yes, they have remained fierce competitors in manufactures. But, for cultural reasons, they have been klutzes in the financial sector which requires rapid responses rather than the tender loving care and craftsmanship that have made Japanese a powerhouse in manufactures.

\* Professor Paul Samuelson, some years ago, also created a stir essentially by noting that the accumulation of skills and capital by India and China would imply that they would be becoming more like us. By producing increasingly therefore the skills-intensive products which we had specialized in, they would drive down their prices and thus reduce our gains from trade. True enough, this can happen. But when the critics of Globalization like the famous journalist Robert Kuttner interpreted this as saying that we must then use protection as a response, they were dead wrong. If Florida gets a hurricane that devastates Miami, Governor Jeb Bush would only add to that devastation by cutting off trade with the rest of the United States!

But Professor Samuelson was likely too pessimistic in thinking that the gains from trade would diminish as countries got similar in endowments. As countries get similar, trade in similar products, or what is sometimes called trade in variety, breaks out. Recent empirical studies by the economists Robert Feenstra and David Weinstein show that the gains from trade in variety are immense. If you doubt this, just walk down Madison Avenue in New York and you will see how men's and women's designers compete and flourish in the same "industry", none seeking protection and each (and their customers) enjoying the fruits of trade in variety. I wonder how many people really think that the United States, in putting Europe and Japan back on their feet, and thus making them again more similar to us in endowments, hurt the US. Equally, we need not fear that the rise of China and India will do us harm, instead of good.

\* I should also add in this context that the recent fears fueled by economists who write about how China's production of engineers, for example, already exceeds that of the United States, ignore two important problems with that argument. First, the quality of the Chinese engineers is not near that of ours. Second, a large number of engineers is required in China to repair roads, bridges etc. and to be engaged in internal non-traded sectors like construction, and will have no direct impact on the numbers available for the traded sectors. Besides, the Cultural Revolution destroyed the stock of engineers and intellectuals in a very big way; and these decimated stocks will have to be depleted.

The "fallacy of numbers" is also evident in discussions of India. Thus, while many fear that outsourcing will take over most jobs in the US, the facts are that even call-answer personnel cannot be so readily multiplied. Thus, of the age cohort that can go to College, only less than 8 % does. Of this, a further small fraction studies in English. Of that, a further small fraction can speak English. And of that, a tiny fraction can speak English that you and I can understand! Yet, India's huge population is cited uncritically as implying a major threat to our service jobs!

#### China: A Gulliver in a Lilliputian World Economy

While therefore the fears of China, and the demands for us to reshape our trade policy in a protectionist direction vis-à-vis China, are mistaken, is there need for some response? I believe that the China phenomenon underlines dramatically the need to strengthen our adjustment assistance policies, something that we need to do in order to cope in any event with the volatility of comparative advantage in today's global economy and enhanced competition.

To see this clearly, remember that the recent China-bashing reflects only the third time that we have had to contend with the fears of the "yellow peril". The first was when Japan was exporting labour-intensive products, including the celebrated "one dollar blouses" worldwide in the early 1930s. The second occurred when Japan was crowding autos, TV sets, semiconductors etc. in the 1980s. The third is with China in the 1990s and now. [There has also been a "brown peril" flirtation, aimed against India. Sadly, Senator Schumer has succumbed to Japan-bashing in the 1980s, to India-bashing in the 1990s, and now to China-bashing. I grew up on cricket; but I know enough about baseball to know that three strikes and you are out. Does that apply to politics?]

In each case, the problem has been an unusually rapidly growing economy, with substantial outward orientation on exports. The result has been an inability for others to absorb the resulting tsunami in trade: I call this the problem of Gulliver in a Lilliputian world economy. Mind you, when such nations export, they take away

markets from others. But when they import, they create markets for others. The problem is that the markets created are not the markets lost. So, for those who lose markets to the exports from these Gullivers, the effect is dramatic.

Overall, the numbers on trade are still manageable. But for specific sectors, they react as if they are facing a tsunami.

What China's exceptional growth and trade do in an exceptional degree, therefore, is to accentuate greatly for some sectors the problem of adjustment. This only reinforces the need to revamp and expand our adjustment assistance programs, building in new ideas like wage insurance as well. Since these are needed in any event to cope with the volatility introduced by modern Globalization, perhaps China is doing us a good turn by enhancing the need to adapt ourselves institutionally for the new Age of Globalization.

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[1] I, among many others, have written extensively on why the attempts to include labor and domestic environmental standards in trade treaties are misguided. Especially, exactly ten years ago, I and the late Professor Robert Hudec produced two substantial volumes on the subject; see Bhagwati and Hudec (eds), *Fair Trade and Harmonization: Prerequisites for Free Trade?*, MIT Press: Cambridge, Mass., 1996. I have also written extensively on the subject in the *American Journal of International Law*, in my Testimony to this Committee on the FTA with Jordan, and in many op ed articles in *The Financial Times* etc. I have not seen any persuasive response to my criticisms. My sense is that the AFL-CIO is no longer interested in arguments (where they cannot win) and have decided to go exclusively to the political route. Given their substantial resources, evidently, it is a smart strategy for them to substitute financial for human capital!

[2] Cf. Ronald McKinnon, "Why China Should Keep Its Dollar Peg", Stanford University, January 2007; and Nouriel Roubini, "Why China Should Abandon Its Dollar Peg", Stern School of Business, New York University, 2007.

[3] This is the unanimous view of many Sinologists who have written on the subject. For an excellent overview and synthesis, see the forthcoming book by Claude Barfield Jr., *The Eagle and the Dragon*, American Enterprise Institute, Washington D.C., 2007.

[4] I had dealt with the issue, with other empirical and analytical arguments, in Chapter 10 of my 2004 book, *In Defense of Globalization* (Oxford University Press), and I have also expanded on the themes of my *Financial Times* article in the Afterword in the new edition of this book, to be issued in June 2007.