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Decoupling from China

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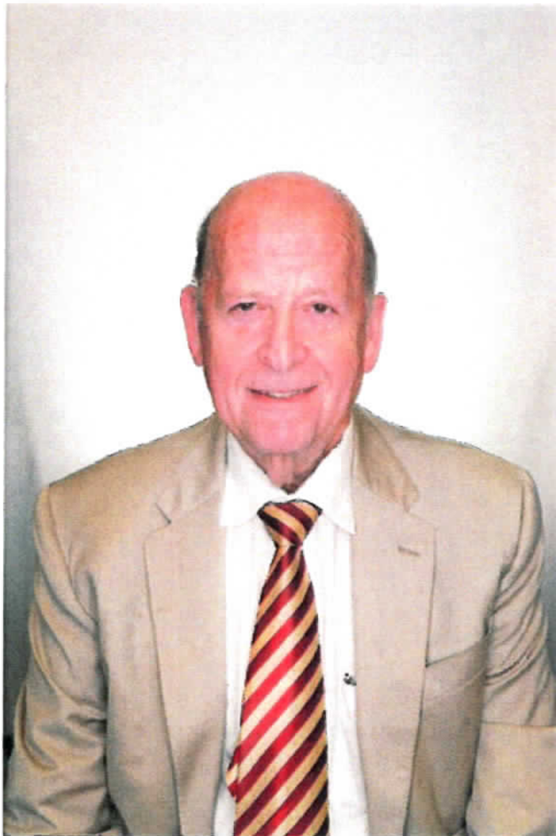

(NewsUSA) -We do not know what will come out of the meeting between President Trump and Xi Jinping at the G-20 on June 28, but the signs are ominous. The state-promoted anti-American propaganda blasting U.S. "bullying" on trade and the resurgence in Chinese nationalism stoked by Xi Jinping augur poorly for successful trade negotiations with China. And any deal made by Trump is likely to be attacked by Democrats as too weak, so Trump at this point has little incentive to make a deal with China before the 2020 presidential election.

My prediction is that China will not drop its equity caps and intellectual property theft, and will not stop subsidizing all of its state-owned enterprises. As a result; we will see acceleration of the decoupling of China from the United States, in other words, a reversal of the economic integration and interpenetration that has taken place between these two economies over the past 20 years. So let us examine the implications of the decoupling of China from the United States.

The first area to consider is trade. The IMF has estimated that if the United States were to impose 25 percent tariffs on all Chinese imports, and China were to retaliate, the trade volume between China and the United States would drop by 70 percent. So there would clearly be an initial "trade shock."

The question here is whether the U.S. can find other low-cost suppliers. The answer is yes. We have seen that suppliers such as Vietnam have stepped up their exports to the United States, and other Asian countries and Mexico will also try to fill the role of low-cost supplier to the U.S. market.

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Vietnam has gained an estimated 7.9 percent of its gross domestic product from new business created by the U.S.-China trade war.

The next largest gainer is Taiwan, with 2.1 percent of its GDP added as a result of the U.S.-China trade war needed from other countries supplied by China.

In summary, if the Trump tariffs were to remain in place, there would undoubtedly be an initial "trade shock," and some dislocations. Over time, however, the United States would gradually shift its import sources to lower- cost suppliers, and would substitute rare earth minerals from other countries. So, with regard to trade, China is replaceable.

The second area is investment. Chinese direct investment in the United States dropped 84 percent from 2017 to 2018, from $29.4 billion to $4.8 billion. The U.S. government, will further limit Chinese investors through national security reviews. Meanwhile, U.S. direct investment in China has stagnated at $26.9 billion, with the annual growth rate dropping from 11 percent to 1.5 percent in 2018. U.S. investment will increasingly take place in other low-wage Asian countries such as Vietnam and Taiwan, and Mexico. Moreover, the lowering of U.S. corporate tax rates on January 1, 2018, from 35 percent to 21 percent will discourage direct foreign investment by U.S. enterprises, and make the United States a more promising place to invest than China. Therefore, if the Trump tariffs remain in place, China can be largely replaced over time by other countries as an investment target.

Last month, the Trump Administration restricted sales by U.S. companies to Huawei, the Chinese telecommunications champion. This measure will force Huawei to develop its own versions of chips and operating systems to replace those that it now obtains from the West. And last week the Commerce Department imposed new export controls that will effectively bar five major Chinese supercomputer developers of next-generation, high-performance computing from obtaining U.S. technology. The Commerce ban on exports to the major Chinese supercomputer companies, along with the Huawei ban, will promote the decoupling of the two countries' tech supply chains. Therefore, it is likely that separate operating systems will be set up for telecommunications, supercomputers, and the Internet.

China holds an estimated $1.1 trillion of U.S. government bonds. Some have warned that if China decided to dump U.S. dollars, U.S. interest rates would soar and the U.S. economy would implode. China's holdings, however, are not a particularly large proportion of the roughly $22 trillion total of U.S. government debt. Furthermore, China has already sold $221 billion in long-term Treasuries since early 2015, with no harm done to the U.S. capital market.

We are entering a new phase of increased Chinese assertiveness. China is now challenging the United States for global supremacy, while the U.S. Government distrusts Chinese intentions and sees China as a predatory competitor and an adversary. The global consensus based on liberalization is likely to be replaced by rival trading blocs. This may not be a desirable development from the standpoint of the United States and the global economy, but it is the most important geopolitical event of our era. Decoupling from China, while painful for both countries, would be preferable to a real war with China, the likely alternative.

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Bart S. Fisher

Containing China

The Chinese character for China depicts a place between heaven and earth, at the center of the universe, and, for 5,000 years, China has viewed itself as the leading power on earth in terms of the quality of its civilization. The United States and other countries must keep this worldview in mind as they seek to contain China's quest for global domination.

China continues to run a non-market-oriented economy. It provides heavy subsidies to its state-owned enterprises, dumps its exports unfairly, manipulates its currency, appropriates U.S. intellectual property, including patents, copyrights, and trademarks, and, most devastatingly, uses the Internet to seize an almost insurmountable advantage in the world of electronic commerce.

Most of the press coverage in the United States of U.S.-China trade issues has been about tariffs the United States has applied against China pursuant to Section 301 of the Trade Act of 1974, which allows the president to take all appropriate actions to counter the unfair acts, practices or policies of a foreign government. The containment of China, however, must be multi-dimensional, focused not only on tariffs, and played out by both Congress and the Executive Branch. Section 301 is but one tool in the U.S. arsenal of possible responses to China's quest for global influence as a rising power. The problem with the Trump Administration's Section 301 complaint against China is that, while its objective is correct - reducing our one-sided trade relationship with China - there is no well-defined overall policy of containment. Several steps have been taken thus far, but much more needs to be done. The purpose of this article is to outline an ongoing strategy of containment that the United States should use to counter China's behavior in the marketplace.

II. Promotion of U.S. foreign investment: The BUILD Act

China's Belt and Road Initiative has as its goal the creation of a new silk road for Chinese trade and investment throughout the developing world. Containing China requires a commitment to counter this initiative by supporting U.S. investment in infrastructure in emerging markets. A major step was taken in this direction on Oct. 5, 2018, when President Trump signed into law the Better Utilization of Investments Leading to Development (BUILD) Act of 2018, which creates a new foreign aid agency: the United States International Development Finance Corporation (IDFC). This largely overlooked legislation consolidates the Development Credit Agency (DCA) of the U.S. Agency for International Development with the Overseas Private Investment Corporation (OPIC) and triples the financing authority of OPIC from $22 billion annually to $60 billion. The IFDC has the authority to provide loans, loan guarantees and insurance to companies willing to do business in developing nations.

The drafters of the BUILD Act have made clear that its intent is to counter China's drive towards global dominance by providing an alternative to "state-directed investments by authoritarian governments," an obvious reference to China and its growing overseas aid. As Senator Bob Corker, the chairman of the Senate Foreign Relations Committee, stated, "We're seeing what China is doing throughout Africa and South America ..., and people are waking up and realizing we have to have involvement with the countries, not just for a return on investment, but to move them toward a market-based approach."

The BUILD Act provides the resources for the United States to launch an ambitious program of infrastructure and low-carbon technology across the emerging world, which will be an effective counter to China's Belt and Road Initiative.

III. Restrictions on inward foreign investment: CFIUS reforms

The second element of containment is to sharply limit, through U.S. government intervention, Chinese investment in the United States that is a threat to U.S. national security. It is appropriate to be skeptical of China's investments in the United States in light of its predatory, mercantilist behavior, and recently documented Chinese-government-directed hacking of U.S. government agencies and private industry. The challenge here is to maintain the balance between the desire for commercial engagement with China and the need to check China's quest for technological supremacy. As Assistant Attorney General John Demers has stated, "China wants the fruits of America's brainpower to harvest the seeds of its planned economic dominance."

Reviews of foreign investment in the United States are undertaken by the Committee on Foreign Investments in the United States (CFIUS), a federal inter-agency committee chaired by the Secretary of the Treasury. CFIUS national security reviews are usually conducted before foreign investment is undertaken, at the request of the foreign investor. However, the U.S. Government can undertake a CFIUS review after the foreign investment is made and unravel the transaction.

On Aug. 13, 2018, President Trump signed the Foreign U.S. Investment Risk Review Modernization Act (FIRRMA) to expand the U.S. government's power to review investments from foreign countries. This legislation is a direct response to China's efforts to obtain U.S. technology through mergers, acquisitions and takeovers.

There are three principal reforms under FIRRMA. First, the CFIUS inter-agency committee will now review proposed purchases of minority shareholding interests of U.S. companies. This is a significant shift in policy, which had permitted CFIUS reviews only of majority, or control, purchases. Second, the Committee's jurisdiction now specifically includes real estate transactions located in an area adjacent to ports or near military installations or other sensitive U.S. government facilities. This was implicit in prior CFIUS legislation but has now been made explicit. Third, the bill expands CFIUS's jurisdiction to include any investment by a foreign person in a U.S. business that (1) owns, operates, manufactures, supplies or services critical infrastructure; (2) produces, designs, tests, manufactures, fabricates or develops critical technologies; or (3) maintains or collects the sensitive personal data of U.S. citizens that may be exploited in a manner that threatens national security. Covered investments subject to CFIUS review include investments that afford a foreign person (1) access to material nonpublic technical information; (2) membership or observer rights on the board of directors of a U.S. business; or (3) involvement in decision-making regarding the sensitive personal data of U.S. citizens, critical technologies or critical infrastructure.

Investments in U.S. businesses by a foreign person through an investment fund as a limited partner are permissible, assuming the fund is managed by a general partner who is not a foreign person and the foreign person does not have the ability to control the fund or its investment decisions.

The net effect of FIRRMA is that investors from China, or any other foreign country, will have to thread a very narrow needle in order to invest in a critical U.S. technology or infrastructure. FIRRMA would appear to permit such investment only if the foreign investor is a minority, non-control, passive investor in a fund managed by a U.S. entity as the general partner.

IV. Tax reform

The third element of containment is international tax reform. America's economic power is diminished

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[illegible] U.S. subsidiaries [illegible] in China instead of the United States. The trend of outsourcing with foreign subsidiaries in China has been encouraged, however, by the U.S. tax policy of deferral of foreign source income that is earned by foreign subsidiaries.

This issue was addressed with the passage of the Tax Cuts and Jobs Act of 2017, U.S. federal tax legislation that entered into force on Jan. 1, 2018. By reducing the corporate rate of taxation from 35 percent to 21 percent, the new U.S. international tax policy will discourage direct foreign investment by U.S. enterprises. This move should significantly increase investment in the United States, and reduce imports from China, as currently an estimated 30 percent of all imports from China are imports from Chinese affiliate companies to U.S. parent companies.

V. Tighter export controls

The fourth element of containment should be the use of America's export control program to limit the transfer of U.S. advanced technology to China.

High-end technology has emerged at the center of the U.S.-China trade war. The stated objective of China's Made in China 2025 program is to make China a major competitor in advanced manufacturing. That program involves government subsidies, heavy investments in research and innovation, and targets for local manufacturing industries. Through these means, China plans to dominate leading-edge industries like electric cars, robotics and artificial intelligence.

President Trump has pushed China to drop these plans and to limit transfers of advanced U.S. technology that would support the Made in China 2025 program. On Nov. 22, 2018, the U.S. Department of Commerce called for public comments on whether a list of new technologies that would have national security implications, from artificial intelligence (AI) to microprocessors and robotics, should be subject to more stringent export control rules. The AI technologies that will be considered for tighter controls include technologies such as neural networks, deep learning, computer vision, natural language processing, and audio and video manipulation, and therefore should be carefully controlled through stringent U.S. export controls. Tighter export controls, however, would affect U.S. manufacturers as well as purchasers in China, since AI is a key element of many computer products made by U.S. tech firms, including smartphones, connected speakers and self-driving cars. Moreover, many high-tech products are used for both military and civilian purposes.

Unfortunately, both U.S. export controls and possible Chinese retaliatory tariffs could increase the costs for U.S. exporters of components and reduce competitiveness of U.S. manufacturers across a range of high-tech sectors. Therefore, export controls need to be very carefully calibrated in order to preserve the competitive position of U.S. exporters in the world marketplace.

VI. Tariffs and the current trade war with China

The fifth step that needs to be undertaken is an effort to defuse the escalating trade hostilities between the United States and China. More than half of Chinese imports now face punitive import tariffs. The tariff rate on $200 billion of Chinese imports was set to climb from 10 percent to 25 percent on Jan. 1, 2019, and President Trump threatened on Sept. 17, 2018, to "immediately" place tariffs on another $267 billion worth of imports "if China takes retaliatory action against our farmers or other industries." Tariffs are a tax on U.S. consumers and it is not at all clear that additional U.S. duties will work to disrupt China's industrial development through its Made in China 2025 program.

Fortunately, a major thaw in the tariff war with China occurred at the G20 meeting in Buenos Aires on Dec. 1, 2018, when President Trump decided not to raise tariffs on $200 billion of Chinese imports from 10 percent to 25 percent on Jan. 1, 2019, as had earlier been threatened. In return, President Xi Jinping of China agreed to "immediately" begin discussions on China's industrial policies, including its coercive licensing of U.S. technology, trade secret theft and nontariff barriers to trade. The agreement has a 90-day deadline for review, which will occur on March 1, 2019. It remains to be seen whether China will live up to its undertakings, and whether the United States will be

VII. Conclusion

The objective of U.S. trade policy should be the containment of China, which must be undertaken through patient, persistent pressure on a variety of fronts. President Trump has said that trade wars are easy to win, and he believes he can wreck the Chinese economy, as Reagan outspent the USSR on defense. He is wrong. While the pace of Chinese economic growth has fallen by half since 2007, China is not the Soviet Union Reagan faced down in the 1980s, any more than it is Japan in 1941, desperate for the oil that President Roosevelt embargoed. It is large enough to supply itself with most of what it needs to survive. Furthermore, the Korean War demonstrates that when China feels its vital interests are being threatened it can and will lash out at the West with devastating consequences.

China's name for the United States is Meiguo, the beautiful country. The history of China's relationship with the United States is one of hope followed by disappointment, but at the end of the day the Chinese people still view America as the beautiful country.

The result has been interdependence, and an entangling embrace that neither can quit. As John Pomfret has pointed out, the relationship between the United States and China "is powered by love and hate, contempt and respect, fear and awe, generosity and greed."

The only constant in international relations is change, and it is the job of statesmen to manage change for the better. The relationship between the United States and China has permanently changed. China is no longer a developing country, entitled to undertake one-sided policies counter to the interests of the United States. It is a rising power that needs to be contained within the norms of a rules-based system. Critics have noted that thus far President Trump has not demonstrated that he has either the foresight or the discipline required to carry out the patient, persistent policy of containment outlined in this article. But Trump will not be president forever. While he remains in office, the elements of containment described herein must remain the order of the day.

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Bart S. Fisher

The original sin

The trade war with China has its roots in that country's manipulation of its currency, its original trade-related sin. On Dec. 11, 2001, China formally acceded to the World Trade Organization, and in the next year, 2002, the United States' trade deficit with China was "only" $103 billion. By 2017, however, that deficit had more than tripled to $375 billion. What was the problem that created the dreaded "China Price," typically 30 percent below the U.S. price for the comparable good, allowing China to undersell its American competitors? By 2002, it was clear to all that the primary engine of China's export explosion was its undervalued currency, the yuan. China was clearly manipulating its currency to obtain an unfair competitive advantage against the United States and other countries.

Currency manipulation was being accomplished through a state monopoly over foreign currency run by its State Administration of Foreign Exchange (SAFE). China required that foreign exchange proceeds be handled by SAFE, which resulted in the state's purchasing the foreign exchange earnings of firms at the established rate of 8.28 yuan to the dollar. SAFE continued to intervene in the forward exchange market by buying dollars with the yuan in order to bid up the price of the dollar and suppress the value of the yuan.

> ***"Today, the established yuan/dollar exchange rate is about 6.64 yuan to the dollar, an arguably fair exchange rate."***

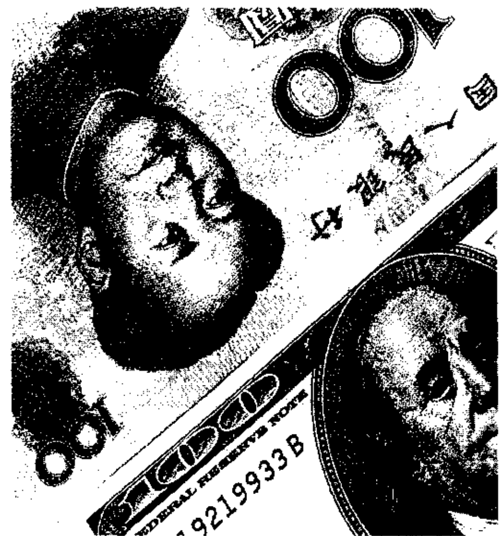
The question was not whether China was manipulating its currency but by how much. At the low end of the scale was the Goldman Sachs calculation, which estimated the undervaluation at 15 percent. The estimate by the Manufacturer's Alliance and Ernest Preeg was 40 percent. And the purchasing power parity scale represented by The Economist's Big Mac index (indicating what a Big Mac served by McDonald's would cost around the world) was 56 percent, about the same level as the World Bank estimate. According to *The Economist*, the yuan was the most undervalued currency in the world.

The loss of 2.2 million U.S. manufacturing jobs over the 32 months before 2003 was clear evidence of the burden this unfair trade practice was placing on U.S. commerce.

On Sept. 4, 2004, a group of associations and companies known as the China Currency Coalition filed a complaint against China's currency manipulation with the Office of the United States Trade Representative pursuant to Section 301 of the Trade Act of 1974. The purpose of a Section 301 complaint is to allow the U.S. government to unilaterally enforce its rights under trade agreements, and to counter the unfair acts, practices, or policies of foreign governments that burden U.S. commerce. The definition of unfair practices under Section 301 includes acts, practices, or policies of foreign governments that are unreasonable or discriminatory. So the legal issue in the 2004 Section 301 currency manipulation case was whether it was "unreasonable" for China to have a dramatically undervalued currency vis-a-vis the United States and to therefore be able to put pressure on one U.S. industry after another, including textiles, wood furniture, paper products, and metal parts.

Section 301 is not the only provision applicable to currency manipulation. Article IV, Section 1(ii), of the Articles of the International Monetary Fund prohibits members from manipulating their currencies in order to gain an unfair competitive advantage in international commerce, and Article XV(4) of the General Agreement on Tariffs and Trade prohibits its signatories from manipulating currency in order to gain a competitive advantage in international trade.

Despite the compelling legal and economic case presented by the China Currency Coalition, the Office of the United States Trade Representative,



at the direction of President George W. Bush, summarily rejected this Section 301 petition within 45 minutes of its filing. This failure of the United States to counter the currency manipulation of China was the functional equivalent of waving the white flag of surrender on trade to China. It has led to the hollowing out of many of America's Rust Belt industries, and indirectly to the election of Donald Trump as president of the United States.

In the years following the rejection of the 2004 Section 301 complaint, China rode the back of an undervalued currency to the largest peacetime transfer of wealth in human history, from the United States to China. Since then, however, China's currency has appreciated. Today, the established yuan/dollar exchange rate is about 6.64 yuan to the dollar, an arguably fair exchange rate. The Section 301 train therefore has left the station with regard to the currency manipulation issue, and it would not be appropriate to retaliate against China now based on the grounds of currency manipulation. Section 301 remains in the U.S. toolbox, however, as an implement that can be used to counter other unfair trade practices by the government of China.

On June 20, 2018, President Trump's Office of the U.S. Trade Representative filed its own Section 301 action aimed at a bevy of Chinese practices related to technology transfer, intellectual property, and innovation. A trade value of $34 billion is covered by this proposed action, which calls for the imposition of an additional ad valorem duty of 25 percent on certain imported products from China. The stakes were raised exponentially on July 10, 2018, when President Trump announced tariffs of 10 percent on an additional $200 billion in Chinese exports to the United States.

The correct approach at this point is a two-track strategy, one relying on unilateral action through a Section 301 complaint based on the valid complaint against forced technology transfers and the theft of U.S. intellectual property, and a second track that would rely on engagement with China through the resurrection of the Trans-Pacific Partnership (TPP).

President Trump withdrew the United States from the TPP negotiations on Jan. 23, 2017. He correctly noted that the TPP was fatally flawed and should not have been approved in its current form. For starters, the agreement does not proscribe currency manipulation, which, as noted above, has been used by China to undermine the United States. In addition, it allows for self-certification of exporters. Thus, Vietnam, for example, could export products duty-free to the United States with 90 percent of the product being produced in China, which is not a TPP member. The TPP, as currently drafted, would actually expand the export possibilities for China into the U.S. market, in effect giving China duty-free treatment with no corresponding concessions on its side.

Fortunately, President Trump has instructed his trade advisors to consider conditions under which the United States can join the TPP.

The suggested two-track strategy, based on pressure and engagement with other nations, is the way to protect American interests and avoid future China trade wars.

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