



# ANALYSIS

Volume 8, Number 4

## PROMOTING U.S. INTERESTS IN CHINA: ALTERNATIVES TO THE ANNUAL MFN REVIEW

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For further information about NBR, call or write:

THE NATIONAL BUREAU OF ASIAN RESEARCH

4518 University Way NE, Suite 300  
Seattle, WA 98105  
Tel: (206) 632-7370  
Fax: (206) 632-7487  
Email: [nbr@nbr.org](mailto:nbr@nbr.org)  
<http://www.nbr.org>

## ACKNOWLEDGMENTS

From its inception, The National Bureau of Asian Research (NBR) has addressed as a major part of its research agenda the issues underlying the development of an effective American policy toward China. In the context of this year's annual exercise of granting most-favored-nation trading status to China, NBR organized a panel of the nation's leading experts on China, foreign affairs, and trade policy. Their activities included a conference at the National Press Club, a luncheon with Members of Congress, a briefing for congressional staff, publication of op-eds in national newspapers, and testimony before congressional committees. The views of five experts from that remarkable panel are presented in this volume.

This year, several factors intensified the debate over renewal of MFN status to China. Concerns over the treatment of Hong Kong following its transfer to P.R.C. sovereignty, the growing bilateral trade deficit with China, the alleged Chinese involvement in illegal contributions to U.S. political campaigns, and the modernization of the Chinese military have led to one of the most contentious discussions of China policy since 1989. The authors of these essays, as well as the other participants in NBR's program on MFN and U.S.-China relations, addressed the foreign policy challenges presented by these concerns.

The countless expressions of support and compliments that NBR has received on this spring's project, which included a nationally-televised C-SPAN broadcast of our May 21 press briefing, are a reflection on the talented and generous people who made the project possible. First and foremost, thanks go to the participants: Harry Harding, Mike Lampton, Nick Lardy, Ken Lieberthal, Mike Oksenberg, Doug Paal, Richard Perle, Laura Tyson, and Bob Zoellick. NBR is also extremely grateful to Senator William Roth, Chairman of the Senate Finance Committee, who opened the press briefing by announcing his support for granting permanent MFN status to China in conjunction with China's acceptance of a commercially viable WTO accession agreement.

NBR is deeply appreciative of the invaluable contributions of the members of NBR's Congressional Advisory Board who made possible the luncheon and briefing on Capitol Hill. Senators Slade Gorton, Joseph Lieberman, and Patty Murray cosigned a letter of invitation to their Senate colleagues, and Congressmen Doug Bereuter and Norm Dicks cosigned a similar letter to House members. Special thanks are in order for the congressional staff who have helped NBR on this and many other projects: George Behan, Daniel Bob, Dan Martz, Ben McMakin, and Susan Wunderly.

At NBR, Research Director Mark Frazier did an outstanding job of organizing the project and attending to the details of the events in Washington, D.C. The staff at NBR provided their able assistance at every stage of the project, including helping with preparations for the May 21 meetings and professionally editing this volume. Special thanks are due to Managing Editor Bruce Acker, Office Manager Jen Linder, and interns Suanne Buggy and Bryan Krekel. Funding from the Henry M. Jackson Foundation made possible the reproduction of the C-SPAN broadcast and publication of this special edition of the *NBR Analysis*.

Richard J. Ellings  
Executive Director  
The National Bureau of Asian Research

## INTRODUCTION

Before granting conditional most-favored-nation (MFN) trading status to a communist country, the President is required by the Jackson-Vanik amendment to the 1974 Trade Act to show either that the country's emigration policies are undergoing reforms that would give its citizens the right to emigrate, or that waiving this requirement will ultimately promote open emigration. The Jackson-Vanik Amendment also specifies that a joint resolution of the House and Senate is required to overturn the President's decision.

For some time, many policymakers in both the White House and Congress, as well as many nongovernmental specialists, have contended that the annual review of China's trading status does more to undercut than to support the full spectrum of American interests in the People's Republic of China (P.R.C.). The MFN debate this year has been complicated by new factors, including concerns about China's treatment of Hong Kong after the territory's reversion to Chinese sovereignty and allegations of Chinese contributions to U.S. political campaigns. In addition to these relatively recent problems, there are long-standing concerns about human rights abuses, the U.S. trade deficit with the P.R.C., the growing strength of the Chinese military, and China's role in nuclear and chemical weapons proliferation.

Because of these developments, The National Bureau of Asian Research convened a group of leading experts on foreign policy and Chinese affairs to assess the MFN issue in the complex context of U.S.-China relations. On May 21, at the National Press Club and in private briefings on Capitol Hill, specialists addressed the annual review process and discussed other key issues in U.S. policy toward China.

Participants in the NBR-sponsored events included: **Harry Harding**, dean of the Elliott School of International Affairs and professor of political science and international affairs at George Washington University; **David M. Lampton**, president of the National Committee on U.S.-China Relations in New York; **Nicholas Lardy**, senior fellow in the Foreign Policy Studies Program at The Brookings Institution and former director of the Henry M. Jackson School of International Studies at the University of Washington; **Kenneth Lieberthal**, professor of political science and business administration at the University of Michigan; **Michel Oksenberg**, senior fellow at the Asia/Pacific Research Center at Stanford University and President Carter's senior staff member on the National Security Council with responsibility for China and Indochina; **Douglas Paal**, president of the Asia Pacific Policy Center in Washington, D.C., former special assistant to Presidents Bush and Reagan for National Security Affairs and senior director for Asian Affairs on the National Security Council; **Richard Perle**, resident fellow at the American Enterprise Institute for Public Policy Research, former assistant secretary of defense for international security policy (1981-1987), and a senior staff member for Senator Henry M. "Scoop" Jackson in the 1970s; **Senator William Roth**,

**Jr.**, chairman of the Senate Finance Committee; **Laura D'Andrea Tyson**, professor of economics and business administration at the University of California-Berkeley and former national economic adviser and chair of the White House Council of Economic Advisers during President Clinton's first term; and **Robert Zoellick**, executive vice president and general counsel at FannieMae and former undersecretary of state and deputy chief of staff during the Bush Administration.

Senator Roth opened the National Press Club briefing by announcing plans to introduce legislation that would grant permanent MFN to China. The Senator pointed out that "most-favored-nation" is really a misnomer, since MFN confers no special favors on China, only normal trade relations that the U.S. offers to almost every other nation. Senator Roth argued that maintaining normal terms of trade with China is in America's economic and strategic interest. Renewing MFN will help to integrate China into the global economy and give P.R.C. leaders an incentive to act in ways compatible with American interests. If MFN were to be revoked, the Senator pointed out, American exports to China would come to a standstill, up to 200,000 American jobs would be threatened, and China's reforming leaders would be forced into a bitter trade war that would jeopardize the course of domestic reform.

Richard Perle, who drafted the Jackson-Vanik Amendment as an aide to Senator Jackson, offered a critical perspective on the context and intent of the legislation. The amendment was designed to pressure the Soviet Union to ease restrictions on emigration in exchange for normal tariffs on Soviet imports to the United States. During the press briefing, Mr. Perle noted that the original legislation is now being used to punish China for a wide range of practices unrelated to emigration. He stressed that China's human rights record, bilateral trade surplus, acquisition of dual-use technologies, weapons sales, and other practices raised by opponents of MFN renewal should be handled under more appropriate legal authority.

The essays that follow present a wide array of policy options for the United States. Nicholas Lardy and Laura Tyson argue, in support of Senator Roth's position, that revoking MFN would have a negative effect on the U.S. economy and would not promote U.S. economic, political, and security interests in the P.R.C. Most of the authors urge the Clinton Administration to make it a priority to reach agreement with China on accession to the World Trade Organization (WTO). Kenneth Lieberthal and David M. Lampton contend that the United States should grant permanent MFN status to China to encourage leaders in Beijing to negotiate an agreement on China's accession to the WTO. Dr. Lampton argues that greater consultation between the White House and Congress is needed to avoid contentious and counterproductive debate over China policy. Douglas Paal contends that executive branch inattention to Asia policy has shifted the initiative to the legislative branch. He recommends that Congress appoint a special envoy for China, Hong Kong, and Taiwan, and expand the parameters of Section 301 of the Trade Act to make it easier for the president to take action against trading partners that employ non-tariff barriers to U.S. trade and to impose sanctions on countries like China that are accused of violating non-proliferation agreements.

While their policy recommendations vary widely, participants in the MFN project agree that the complex challenges presented by China are poorly met through the annual review process. These challenges will require focused attention and concerted action by U.S. policymakers into the twenty-first century.

## ENDING THE MFN BATTLE

*David M. Lampton*

The annual debate over normal (most-favored-nation, or MFN) tariff treatment for China has become the principal, fruitless vehicle by which Congress and the President engage in dialogue about China policy. This process has produced virtually no discernible change in Beijing's policies and has weakened the elite and popular base of those in China most inclined toward genuine reform; it has locked successive administrations and Congress in unproductive debate annually for eight years; it has encouraged presidents to make commitments they cannot keep (such as Bill Clinton's 1993 pledge to link MFN to human rights in China); and all this has made U.S. administrations look impotent to Beijing and dangerously unpredictable to allies and friends in the region and throughout the world. In short, the MFN debate has been the poorest imaginable way to make coherent policy or to be credible to Beijing.

An entirely new process is required that will involve Congress more intimately and constructively in China policy and that will be more effective with the Chinese. If properly managed, granting permanent MFN status in the context of China's accession to the World Trade Organization (WTO) can have results relevant to human rights and American economic interests, get the MFN debate monkey off our backs, and end the pointless argument about whether Americans care more about trade or human rights. They care about both, and under the right circumstances these objectives can be mutually reinforcing.

### Background

Since the passage of the Jackson-Vanik Amendment to the Trade Act of 1974, the extension of MFN tariff treatment to "non-market" (communist) economies has required the president to issue a waiver that is subject to congressional review and debate. In this waiver, the president must certify that the country in question permits free emigration and/or that such a waiver promotes the Amendment's objectives. By majority vote in both houses, Congress may refuse to agree to an extension. This refusal can be vetoed by the president, in which case a two-thirds majority of both houses is required to override the president's veto. In the final analysis, the president can extend MFN to China (or any other non-market economy) if he is able to round up 34 votes in the U.S. Senate or 146 votes in the House of Representatives and if he has the stomach to play the game until its brutal end. There is every reason to believe that President Clinton is committed to this course in 1997, barring a debacle in Hong Kong's reversion to the sovereignty of the People's Republic of China (P.R.C.), discovery of a smoking gun in the "Donorgate" scandal as it relates to alleged Chinese campaign contributions, or renewed conflict in the Taiwan Strait.

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David M. Lampton is president of the National Committee on U.S.-China Relations, a private, non-profit, educational organization in New York City. In December 1997, Dr. Lampton will become George and Sadie Hyman Professor of Chinese Politics and director of the Chinese Studies Program at the Johns Hopkins School of Advanced International Studies in Washington, D.C. A shorter version of this paper appeared as an op-ed in the *Christian Science Monitor*, May 23, 1997, p. 19. The views expressed here are his own.

## The MFN Process: Defects and Multiple Agendas

From many points on the political compass there is agreement that the annual MFN debate is no way to make China policy. Indeed, many participants from interest groups, civic organizations, the business community, the executive branch, Congress, and U.S. allies abroad, are exhausted by the process and appalled by its unintended consequences and ineffectiveness. Why has it been so ineffective?

The MFN review process is, in essence, a threat to withhold normal tariff treatment from China. Effective threats need three elements: (1) they need be specific; (2) they need to hold out the prospect of inflicting unacceptable damage on the recipient; and (3) the person or nation delivering the threat must be credible. The last eight years' experience of using the MFN threat to change Beijing's behavior has proven only one thing conclusively—it fails along each of these dimensions.

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*. . . broader human rights concerns, trade conflicts, the bilateral trade deficit with China . . . and weapons-proliferation objectives have all been shoehorned into the MFN debate in a way that is beyond the intent of the governing legislation.*

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### *Specificity*

Although the Jackson-Vanik Amendment holds that free emigration from non-market economies is the governing consideration for normal tariff treatment, the goals sought by those who wish to deny MFN to China have expanded greatly and unpredictably since the Tiananmen tragedy of 1989. Now, broader human rights concerns, trade conflicts, the bilateral trade deficit with China (\$39.52 billion in 1996, according to Washington, and \$2.7 billion in January 1997 alone<sup>1</sup>), and weapons-proliferation objectives have all been shoehorned into the MFN debate in a way that is beyond the intent of the governing legislation.

Diverse participants in the debate now know that the annual review promotes none of the objectives of those who would like to continue threatening MFN denial. Nevertheless, many worthy groups use the debate to advance their causes, often more in consideration of domestic goals than either the realities or effects in China. Labor leaders employ the debate to show the rank-and-file that they are concerned about the movement of manufacturing jobs abroad; right-to-life groups use the debate to show their supporters that they are ever vigilant concerning abortion; some religious groups use the debate to express concern for persecuted believers in China; those concerned about Chinese weapons sales use the debate to draw attention to the genuine dangers of the proliferation of weapons of mass destruction; and the party out of the White House tends to use the MFN debate to show that it is tougher and more devoted to American values than the incumbent at 1600 Pennsylvania Avenue. Some Democrats tarred President Bush with the brush of being soft on China; now that the GOP is out of the White House, some Republicans in and out of Congress are seeking to wield the same weapon against President Clinton. All this makes American policy highly unpredictable—an ever changing kaleidoscope of demands and electoral strategies. As the Capitol Hill newspaper *Roll Call* put it, “China bashing offers candidates a multitude of opportunities, but the attacks must be fine-tuned for each particular audience.”<sup>2</sup>

<sup>1</sup> “China Defends U.S. Trade Gap,” *International Herald Tribune*, March 22–23, 1997, pp. 1 and 4. As noted later in this essay, these figures overstate the U.S. trade deficit with China by as much as one-third.

<sup>2</sup> Charles E. Cook, “The China Syndrome: Issue Looming Large Over Presidential Race,” *Roll Call*, April 17, 1997, p. 6.

For a threat to be effective, the recipient of the threat must know, with a high degree of certainty, what must be done to have the threat withdrawn. Beijing's leaders, like those anywhere else, have limited political capital with which to meet internal and external demands. By proliferating the objectives, and then failing to establish priorities among them, the MFN debate becomes ineffective in three ways: (1) It gives Beijing no guidance as to what, specifically, it needs to do first to improve relations with the United States. Since Beijing cannot meet all demands, and it is unclear that meeting any single demand will do much good, paralysis results; (2) The mere fact that Washington simultaneously makes so many demands inadvertently conveys that the U.S. government cannot muster sufficient political support to articulate powerfully and consistently any single objective—it really is not committed to anything; and (3) It causes Beijing's leaders to think (perhaps correctly) that no matter how they may respond to Washington's demands, there only will be more demands rather than improved relations. They see no reason to put themselves on a treadmill that gets them nowhere and drains away their own domestic political capital and popular standing in the process. All this occurs against the backdrop of political dynamics in China that do not reward leaders for being weak in the face of foreign threats.

### **Damage**

Second, to be effective, a threat must hold out the promise of inflicting *unacceptable damage*. Beyond the fact that it is hard to know what is unacceptable to P.R.C. leaders (and Beijing thinks it has a higher threshold for economic and political pain than Washington), China tends to compute the damage of MFN withdrawal differently than some in the United States. In some congressional and interest group quarters, the following reasoning is used to assess the potential damage to China: In 1996, according to U.S. figures, the P.R.C. netted \$39.52 billion in its trade with the United States—35 percent of China's total exports went to the United States.<sup>3</sup> If normal (MFN) tariff treatment were removed from China, so this logic goes, U.S. tariff levels would rise to trade choking Smoot-Hawley levels sufficient to kill off trade in entire categories of Chinese exports to America (e.g. toys, sporting goods, shoes, apparel, etc.). The expected decline in export earnings plus the unemployment effects in China's labor-intensive industries would create for a marginally strong national leadership severe domestic pressure to come to terms.

Beijing does the economic and political computations differently, starting with its assertion that China's trade surplus with the United States is only \$10.53 billion.<sup>4</sup> About 40 percent of its exports in 1996<sup>5</sup> were produced by foreign-invested ventures, many with heavy American financial participation. If exports to America were to decline precipitously, these foreign-invested firms would be affected severely. American jobs would suffer—as would the export earnings of companies with clout in Washington, D.C. American jobs would suffer because foreign firms in China import components and capital equipment from the United States in great quantity. If facilities in China cannot export to the United States, they have no need for the high value added products they import from America. Simultaneously, P.R.C. leaders know that from 1990–1996 China was the fastest growing market for American exports and that they have the capacity to place those exports at risk. Moreover, as the Chinese compute, American purchases are a modest percentage of total national output.<sup>6</sup>

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<sup>3</sup> PRC Ministry of Foreign Trade and Economic Cooperation, General Administration of Customs.

<sup>4</sup> "China Defends U.S. Trade Gap," *International Herald Tribune*, March 22–23, 1997, p.4. This figure is far lower than the corresponding American figure for many reasons, including differing methods of calculating reexports through Hong Kong. In fact, both American and Chinese trade figures understate exports to one another. See, Nicholas R. Lardy, "China's No Renegade Mercantilist Trader," *The Wall Street Journal*, February 7, 1996, p. A14.

<sup>5</sup> Seth Faison, "Asia's Giant, After Detours, Takes Familiar Growth Path," *The New York Times*, March 4, 1997, p. A1.

<sup>6</sup> Nicholas R. Lardy, "U.S.-China Intellectual Property Rights Agreement and Related Trade Issues," Statement before Joint Subcommittee Meeting, House Committee on International Relations and Senate Committee on Foreign Relations, March 7, 1996.

Also, because a large proportion of Chinese exports from foreign-invested firms involve the assembly of components made elsewhere in Asia (especially in Taiwan, South Korea, and Hong Kong), the Chinese argue that their true net export revenue from assembly operations is closer to 15 percent of the export value. This means that China sees its real earnings in exports to the United States as much lower than the U.S. figures ascribe.<sup>7</sup> Irrespective of the precise figures, the point is that China sees a lot less at stake than U.S. calculations suggest, and therefore believes American threats are considerably less potent than we assume them to be.

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*Because much of the reported volume of “Chinese exports” actually represents South Korean, Taiwanese, Hong Kong, and ASEAN components and value added, when Washington threatens withdrawal of MFN, America inadvertently threatens its strongest allies and friends in the region.*

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Beijing’s next calculation flows from the above argument. Because much of the reported volume of “Chinese exports” actually represents South Korean, Taiwanese, Hong Kong, and ASEAN components and value added,<sup>8</sup> when Washington threatens withdrawal of MFN, America inadvertently threatens its strongest allies and friends in the region. These are the countries and areas about which Washington professes to care the most. Moreover, these neighboring economies not only have their exports at risk, they have invested heavily in China’s economy more generally. They have done so in order to use the P.R.C. as an export platform and in order to reach China’s growing domestic market. Hong Kong invested US\$20.1 billion in China in 1995 alone; Taiwan invested about \$3.2 billion in 1995, and started a \$3.2 billion coal-fired plant in Fujian Province more recently;<sup>9</sup> and South Korea invested \$1 billion on the mainland in 1995.

As the leader of Hong Kong’s Democratic Party, Martin Lee, said in an interview during his April 1997 trip to the United States, revoking MFN for China would be like saying, “If you [Beijing] still beat your wife and violently, I’ll shoot her [Hong Kong].”<sup>10</sup> Beijing simply finds no credibility in the proposition that Washington will impose a threat that hurts its friends more than its adversaries at precisely the time when Congress is concerned about the fate of Hong Kong and Taiwan and stability on the Korean Peninsula. The P.R.C. may be wrong that maintaining consistency will inhibit Congress, but it makes sense in Beijing.

Turning to politics, there are some (but by no means all) constituencies in China that would see gains to be made if Washington were to use the MFN sword. There are those members of the Chinese elite and public who argue that America is the ultimate strategic threat to China’s continued growth, prosperity, and national power. As in Washington, coalitions form in Beijing. American withdrawal of MFN would congeal a coalition of conservative military people (who desire more defense spending and a faster pace of armed forces modernization); weak political leaders who need a focal point to rally nationalist sentiment; and central bureaucrats and ministries that might prefer seeing the free-wheeling southern Chinese export-oriented economy get its comeuppance and be brought to Beijing’s heel. Finally, all of the natural economic and politi-

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<sup>7</sup> “Interview with Foreign Trade and Economic Cooperation Vice Minister Sun Zhenyu,” *Beijing Review*, April 14–20, 1997, pp. 19–20.

<sup>8</sup> Nicholas R. Lardy, “China and the WTO,” *Brookings Policy Brief*, November 1996 (No. 10), p. 3.

<sup>9</sup> Julian Baum, “Mainland Attraction,” *Far Eastern Economic Review*, April 17, 1997, p. 28.

<sup>10</sup> Steven Erlanger, “Clinton to Tweak China Over Hong Kong,” *The New York Times*, April 15, 1997, p. A3.

cal frustrations of the reform era could now be laid at America's doorstep. In short, implementation of American threats would represent a political windfall for those we least want to assist in the Chinese political system.<sup>11</sup>

To sum up, for Beijing, Washington overestimates the costs of MFN withdrawal to China, underestimates its own losses, and proposes to inflict the most pain on its friends in the region. Further, some in China see political advantages to heightened conflict with Washington, though this is not the dominant sentiment. In the end, the Chinese believe that the United States probably will not withdraw MFN because of America's own low threshold for economic pain, Americans' innate pragmatism, U.S. fear of losing market share to European and Japanese competitors, pressure from countries and areas that have invested heavily in China and about whom we profess to care, and the broader fear of nations in the Asia-Pacific basin that America will push Beijing into a more hostile posture. If it does, Beijing reasons, Washington could not long sustain the effort. If the United States imposes the sanction, and then is subsequently forced to rescind it, America will appear to friends and foes alike as a paper tiger, a nation in decline.

### ***Credibility***

The third requirement for making threats effective is the *credibility* of the threat and the threatener. In May 1994, when President Clinton broke the linkage between MFN and human rights that he had established just a year earlier, he convinced Beijing of what it had suspected—Washington was bluffing. Last year, Congress reinforced this image by its strong vote in the House of Representatives to sustain MFN for China (286–141), and this after Chinese missile exercises near Taiwan that justifiably aroused the legislative branch. And finally, America's complex laws and vacillation on the issue of non-proliferation have further convinced Beijing that Washington is most reluctant to harm its economic interests for other policy objectives. Beijing listens when officials like former Assistant Secretary of State Winston Lord, speaking of the Administration's reluctance to impose economic sanctions for suspected missile and nuclear technology exports to Pakistan, says: "I would say to sanction \$70,000 worth of [Chinese ring magnet] exports with huge sanctions which cut off our exports to China does not seem to be the most effective way to go about it...."<sup>12</sup> As Adm. Bill Center, who represented the Joint Chiefs of Staff in deliberations about technology sales to China in 1994, said: "For the Administration, this has been a difficult decision [whether to sell precision machinery to China], weighing jobs against counterproliferation."<sup>13</sup> In the end, the items in question were sold to the P.R.C. for allegedly civilian use; later it was discovered by American authorities that the machinery had been diverted to military production.

Taking the factors of specificity, unacceptable damage, and credibility into account, it is easy to explain the areas where American threats of economic sanctions have been effective in the past: intellectual property rights, specific negotiations over textiles, and similarly narrow economic issues. In each case, Americans have been united, the demands were limited and clear, we had usable tools (e.g., Section 301 of the Trade Act), and Beijing knew the Administration had the capability and will to inflict unacceptable damage. The MFN stick lacks every one of these essential features.

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<sup>11</sup> Based on two trips to China in the immediate wake of the death of Deng Xiaoping, I would also note that it appears President Jiang Zemin is seeking to move ahead with meaningful political restructuring, change that Deng resisted during his waning years. We should be asking ourselves whether or not it really makes sense to be making Jiang's life more difficult at this point.

<sup>12</sup> Winston Lord, "Testimony," in Barber B. Conable, Jr., et. al, *United States-China Relations: Current Tensions, Policy Choices*, National Committee on U.S.-China Relations and Council on Foreign Relations, July 1996, p. 26.

<sup>13</sup> Jeff Gerth, "Officials Say China Illegally Sent U.S. Equipment to Military Plant," *The New York Times*, April 23, 1997, pp. A1, A9.

## Currently Proposed Options for MFN

In the context of the 1997 MFN debate, several alternatives have been proposed. Of course, one alternative is to terminate MFN tariff treatment for China, which, as mentioned, is unlikely to happen in the current round of debate. It is good to recall why Congress has not adopted this course of action the last seven times the issue has been raised: (1) Using Department of Commerce methodology, more than 200,000 American export jobs could be lost and America would forego a future potential market of unknown, but sizable dimensions; (2) America's allies in Europe and Asia oppose such a course and would move into the commercial vacuum created by the American withdrawal from the Chinese market; (3) The collateral damage to Hong Kong, Taiwan, and China's own emerging middle class offends both American values and interests; and (4) Such a hike in tariffs would constitute a declaration of economic war on the P.R.C. and be taken by Chinese as a signal that Washington desires to retard China's emergence as a power. This would place America in strategic opposition to China with consequences that would be destabilizing in East Asia and lead to a regional arms buildup, if not a new cold war.

Another alternative that is being proposed is to extend MFN for an additional year, but place conditions on that extension. Future extensions could be contingent on Chinese performance vis-à-vis Hong Kong, human rights, weapons proliferation, the trade deficit, etc. This alternative has the same weaknesses as President Clinton's 1993-1994 conditionality attempt and would present America with the choice between self-inflicted economic damage and retreat once again if the Chinese failed to comply. Chinese non-compliance is more likely this time than last, given the President's prior retreat and rising nationalism in the P.R.C. This proposal has the further drawback that if Congress were to decide to make MFN conditional, it would still have to define the "conditions" to be specified, which would unleash political controversy and could lead to one of two outcomes: paralysis or a snowball effect of multiple conditions.

A third cluster of options is a combination of conditioning MFN and *increasing* the frequency with which the MFN issue is debated by the Congress. Proposed by Speaker Newt Gingrich, with a closely-related variation embodied in a bill by Senator Connie Mack, the idea is to extend MFN by three (Mack) to six (Gingrich) months to give time to assess the outcome of the transition in Hong Kong. In April 1997 Speaker Gingrich said, "I very much favor something like a six-month extension [of MFN]." <sup>14</sup> Later in the month he elaborated by saying he supports legislation to renew MFN for three to six months. <sup>15</sup>

Such an approach would magnify all of the problems of conditionality and would turn the current annual debate of three to four months duration each year into permanent warfare (at least for the next year). In so doing, this procedure would immobilize American companies and Chinese buyers of American products and services because they could *never* be sure of the tariffs and political environment under which they would be operating. This proposal has two additional disadvantages: First, two-to-five months of observation past the July 1, 1997, reversion date probably will be insufficient to gauge what is genuinely going on in Hong Kong. Second, I am unaware of anyone in Hong Kong who wishes to see MFN held hostage to their own treatment. The approach promises to victimize the victims.

A fourth proposal, advanced by many in the business community, is to unilaterally, permanently, and promptly extend MFN to China. Irrespective of the intrinsic merits of this proposal (and there is the problem that Washington would lose leverage in the WTO negotiations), there is very limited support for this idea now. A variant of this would be an executive branch deter-

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<sup>14</sup> "China Trade: Gingrich Asks Shorter Rein," *The New York Times*, April 14, 1997, p. A10.

<sup>15</sup> Steven Erlanger, "Clinton and Gingrich View Hong Kong as Test for China," *The New York Times*, May 1, 1997, p. A8.

mination that China is now a “market economy” and therefore no longer subject to Jackson-Vanik provisions. Such a determination, however, would be inconsistent with China’s current, mixed economic system and inconsistent with the G-7’s assertion in the WTO negotiations that China still behaves in many important non-market ways.

A final alternative is simply to extend MFN for an additional year, as per past practice. Unless Washington moves in an entirely new direction, as suggested below, this may well be what happens, though one can expect the toughest battle since 1990 to maintain a status quo that is satisfactory to few.

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*The situation in which Washington finds itself is unsatisfactory . . . China receives MFN renewal each year, it remains unbound by the trading rules of the WTO, the American government ties itself in knots, and Washington does not extract any meaningful leverage.*

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### **A Better Approach To China Policy**

The situation in which Washington finds itself is unsatisfactory from almost any vantage point. In the end, China receives MFN renewal each year, it remains unbound by the trading rules of the WTO, the American government ties itself in knots, and Washington does not extract any meaningful leverage. There is a better approach to conducting China policy.

Whether or not a better approach is adopted will depend on whether U.S. policymakers are looking for *solutions* or *issues*. The upcoming congressional and presidential campaigns already are weighing heavily in the calculations, as evident in Speaker Gingrich’s and Vice President Gore’s Spring 1997 visits to China. China policy already is emerging as a “wedge issue” in the permanent election campaigns that have come to characterize American politics. The right wing of the Republican Party is seeking to use China policy as a way to distinguish itself from the Democrats in an effort to regain the White House and increase its majority in Congress. “[T]he [Republican] party’s center of gravity has moved from Indiana to Georgia, and the power center has shifted from the US Chamber of Commerce to the National Federation of Independent Business.”<sup>16</sup> In other words, the center of gravity in the Republican Party has moved from “internationalism” to a more domestic focus and from Wall Street to “Main Street.” And, the left wing of the Democratic Party is seeking to use China policy to distinguish itself from Vice President Gore in the race for the 2000 presidential nomination and to force the Clinton Administration to be more sensitive to labor and human rights constituencies.<sup>17</sup> “Politically speaking, the issue of lost jobs (which Gephardt will play up) is more potent than the potential for new ones (Gore’s emphasis).”<sup>18</sup>

One better approach has several key elements:

- Annual MFN renewal as it occurs under the current, agonizing yearly review process has thus far permitted China’s products to enter the U.S. market under the low tariffs applied to goods from WTO members, but the P.R.C. does *not* have to adhere to WTO trade rules. Permanent MFN extension to the P.R.C. should be

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<sup>16</sup> Charles E. Cook, “The China Syndrome: Issue Looming Large Over Presidential Race,” *op. cit.*

<sup>17</sup> David M. Lampton, “Fueling Conflict with China,” *The Journal of Commerce*, April 3, 1997, p. A7; see also, Charles E. Cook, “The China Syndrome: Issue Looming Large Over Presidential Race,” *op. cit.*

<sup>18</sup> Charles E. Cook, “The China Syndrome: Issue Looming Large Over Presidential Race,” *op. cit.*

used solely as an inducement to Beijing to reach a commercially acceptable agreement on the terms of its accession to the WTO. Beijing views permanent MFN status as the big prize, indeed the only prize worth paying the internal readjustment costs necessary to gain WTO admittance.

- Although WTO entry is primarily a trade issue, entry into the world body under appropriate commercial terms also has wide-ranging and positive implications for the long-term development of humane, open, pluralistic governance in China. Were China to agree to enter the WTO under commercially appropriate terms, it would have to agree to a much more open, transparent, and rule-based system. Such a system would support the development of a middle class, law, and civil society. Each of these, in turn, promote more humane and responsive governance, albeit over a fairly long period of time and with distinctive Chinese features. In short, instead of using MFN withdrawal as an incredible, shrinking threat, the United States should use MFN as a positive inducement to entry into the global trading system in a way that is maximally supportive of America's economic and human rights goals.
- Another element of the approach would stem from the recognition that the MFN debate has had such durability because Congress demands a regular, meaningful role in the development of China policy and the subsequent monitoring of its implementation. The executive branch should agree with the relevant oversight committees of Congress (Foreign Affairs, International Relations, National Security, Armed Services, Ways and Means, Finance, and Budget) to submit a yearly report on the Administration's comprehensive China policy objectives and the means by which those objectives are to be promoted. Such a document also should assess progress in achieving American goals. This would institutionalize executive-legislative branch dialogue, properly emphasize the multiplicity of American objectives, force divergent government agencies to coordinate more adequately, and focus on feasible means to achieve feasible objectives. Such institutionalized dialogue, through both public and executive session hearings, could serve to involve Congress and educate the public. Further, the President ought to meet with congressional leaders on a regular basis concerning China policy, whether there is a crisis of the moment or not. Presidents regularly met with the bi-partisan congressional leadership during the Cold War when building support for policy vis-à-vis the Soviet Union was essential. The relationship with China requires similar, sustained attention by leaders on both ends of Pennsylvania Avenue.
- The final dimension of the recommended approach is to institutionalize consultation with our allies in Europe and Asia on China policy. The fact is that this and past administrations have developed China policy with only marginal attention paid to what our allies thought or were willing to support. We should place more emphasis on multilateral approaches, reserving unilateral sanctions for circumstances where American leverage over Beijing is overwhelming and the capacity of allies to undermine us is nil. Moreover, the leadership of the relevant congressional oversight committees should be involved in these multilateral consultations at regular intervals. Executive branch leadership alone is inadequate. We also need congressional leaders with the experience, knowledge, and personal involvement that enables them to be effective partners with the Administration.

This multi-pronged approach will certainly not halt all conflict between Congress and the Administration over China policy, nor will it eliminate the many points of disagreement between Beijing and Washington. But it may extricate us from the endless and self-defeating MFN battle along the Potomac and across the Pacific.

# NORMALIZING ECONOMIC RELATIONS WITH CHINA

*Nicholas R. Lardy*

American companies have substantial interest in our economic relations with China. U.S. firms sold \$17.5 billion worth of goods to China last year, either directly or through Hong Kong, making it our eighth largest export market. U.S. exports to China have been growing at an average annual compound rate of 20 percent since 1990, tripling in value over the period. That makes China the most rapidly growing export market among our top twenty export destinations.

In addition, U.S. firms have invested significant amounts in joint ventures, wholly foreign-owned companies, and natural resource development projects in China. Through the end of 1996, cumulative U.S. investment in China was \$13.5 billion, making the United States the third largest source of direct investment in China, following Hong Kong and Taiwan.

## The U.S. Trade Deficit

Although U.S. firms have had considerable success selling to China, the United States nonetheless has experienced a growing deficit in its trade with China. According to the Department of Commerce this deficit quadrupled from about \$10 billion in 1990 to almost \$40 billion last year. In several of the past 12 months the U.S. trade deficit with China exceeded that with Japan. This has led some to conclude that China's economy is relatively closed and that China will replace Japan in the future as our most troublesome trading partner.

However, it should be noted that the Commerce Department figures for our bilateral trade with China are quite misleading. They understate the sales of U.S. firms in China and overstate the sales of Chinese firms in our market. In 1996 American companies earned \$5.5 billion from the sale of goods to Hong Kong that were then immediately reexported to China.<sup>1</sup> None of these sales are reflected in Commerce Department data on exports to China.<sup>2</sup> Commerce Department data on the value of imports from China in 1996, also includes more than \$7 billion in profits earned by Hong Kong firms that reexported goods of Chinese origin to the United States. The

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Nicholas R. Lardy is a senior fellow in the Foreign Policy Studies Program at The Brookings Institution. Prior to that, Dr. Lardy served as director of the Henry M. Jackson School of International Studies at the University of Washington. He has written widely on the Chinese economy and U.S.-China economic relations, including *China in the World Economy* (1994) and *Foreign Trade and Economic Reform in China* (1990).

<sup>1</sup> Reexports to China of U.S. goods in 1996 totaled \$5.87 billion. *Hong Kong External Trade*, (Hong Kong: Hong Kong Government Census and Statistics Department, December 1996). According to a survey of the Hong Kong Government Census and Statistics Department, Hong Kong companies earned an average mark-up of 5.6 percent on goods reexported to China. Thus I estimate that U.S. firms earned \$5.5 billion (\$5.87 billion x (1-0.056)).

<sup>2</sup> U.S. export data are recorded on the basis of the declared country of destination when the goods leave the United States, not the ultimate destination. Since one-third of what U.S. firms sell to China goes via Hong Kong, this procedure introduces a significant undercount of U.S. exports to China.

overstatement occurs because the Commerce Department attributes the entire landed value of these products to China, whereas about 25 percent of the value has been added in Hong Kong by companies that are responsible for the design, marketing, and financing of these goods.<sup>3</sup>

Interestingly, the valued added in Hong Kong for goods of Chinese origin has increased by half over the past 8 years. The reason is simple. More and more of the products that Hong Kong firms reexport are produced in their own factories in China. Most of the high value-added functions remain in Hong Kong; only the inexpensive labor-intensive processing is carried out in China. By contrast, a decade ago the role of Hong Kong firms was far more limited. They were simply middlemen between production in China and demand in the outside world.

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*... since the share of exports sold to China via Hong Kong companies has grown over time, the growth of real U.S. exports to China since 1990 is much more rapid than official data show.*

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Table 1 shows the bilateral trade data for the years 1990 through 1996, as reported by the Department of Commerce and as adjusted to take into account U.S. exports that moved through Hong Kong and value-added in Hong Kong for Chinese exports. The official data substantially understate the level of U.S. exports to China in recent years. More importantly, since the share of exports sold to China via Hong Kong companies has grown over time, the growth of real U.S. exports to China since 1990 is much more rapid than official data show. The table shows that the Commerce Department consistently overstates the magnitude of our trade deficit with China by half.

**Table 1**

	U.S. Exports			U.S. Imports			U.S. Deficit	
	Commerce Data	Plus Sales through Hong Kong	Real U.S. Exports	Commerce Data	Less Hong Kong value added	Real U.S. Imports	Commerce Data	Real
1990	4.8	1.2	6.0	15.2	1.8	13.4	10.4	7.4
1991	6.3	1.6	7.8	19.0	2.7	16.2	12.7	8.4
1992	7.5	2.1	9.6	25.7	4.1	21.5	18.2	11.9
1993	8.8	2.9	11.7	31.5	5.7	25.9	22.8	14.2
1994	9.3	3.5	12.8	38.8	6.3	32.5	29.5	19.7
1995	11.7	4.7	16.5	45.6	6.8	38.7	33.8	22.3
1996*	12.0	5.5	17.5	51.5	7.2	44.3	39.5	26.8

Sources: U.S. Commerce Department and Hong Kong Census and Statistics Department.

\* Annualized based on January–November 1996.

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<sup>3</sup> The Commerce Department records imported goods based on the country of origin and does not adjust the landed value of the products in the United States to account for value-added in intermediate locations.

In addition it is worth noting that the United States has a modest surplus in trade in services with China. This surplus roughly doubled between 1992 and 1995, reaching \$937 million in the latter year.<sup>4</sup>

### Explaining the U.S. Trade Deficit

The United States global merchandise trade deficit reached an all-time high of \$188 billion in 1996, almost 75 percent higher than in 1990. The underlying cause of this growing trade deficit is the low savings rate in the United States. As long as we are able to finance only a small portion of our domestic investment with our own savings, the United States must borrow funds from world capital markets. Our global trade deficit is the inevitable consequence of this ongoing borrowing. Until the U.S. savings rate rises substantially relative to the rest of the world, we will continue to have a global deficit.

The question then becomes: What is the geographic distribution of this large global trade deficit? In recent years our deficit with China has grown dramatically in absolute terms but relatively more modestly as a portion of our total global trade deficit. Based on Commerce Department data our deficit with China rose from about one-tenth of our total deficit in 1990 to one-fifth in 1996.

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*China's openness to foreign investment is unprecedented in East Asia and has led to a substantial geographic realignment of labor-intensive production. . . .*

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The chief reasons that our deficit with China has grown in recent years are the relocation to China of production facilities that previously were in Hong Kong, Taiwan, and elsewhere in East Asia, and the large and growing demand in the United States for inexpensive consumer electronics, apparel, footwear, toys, and leather goods. China's openness to foreign investment is unprecedented in East Asia and has led to a substantial geographic realignment of labor-intensive production of these products. As a result, China's market share of world exports of clothing, toys, sporting goods, and footwear rose from 14 percent in 1984 to 39 percent in 1994.<sup>5</sup>

Interestingly, although our deficit with China has grown in recent years, this growth largely represents the transfer to China of what otherwise would have been rapidly growing bilateral trade deficits with other countries in Asia. For the products given above, the combined share of world exports from Hong Kong, South Korea, Singapore, and Taiwan actually fell by more than China's share rose. The resulting fall in the combined U.S. trade deficit with China plus these four Asian tigers indicates that China is not even replacing the export shares previously produced in these countries. Thus the argument that our growing deficit with China has caused a large loss of manufacturing jobs in the United States seems misguided. Other countries in Asia have moved up the technology ladder, increasingly leaving China to concentrate its production on the most labor-intensive goods. The major adjustment of employment that this process entails has been within Asia. Very little labor displacement has occurred in the United States.

The importance of foreign direct investment to China's overall trade growth is also underlined by the growing share of its total exports produced by foreign-invested firms. Their share

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<sup>4</sup> "U.S. International Sales and Purchases of Private Services," *Survey of Current Business*, Vol. 76, No. 11 (November 1996), pp. 70-112.

<sup>5</sup> World Bank, *World Development Report 1996: From Plan to Market*, Oxford and New York: Oxford University Press, 1996, p. 134.

of exports exceeded 1 percent for the first time in 1985. Since that time, exports of foreign-invested firms as a share of China's total exports have grown steadily to 20 percent in 1992 and 31 percent by 1995. In 1996 their share jumped to an astounding 44 percent.

In addition, foreign firms are also central to the development of exports processed by Chinese firms. The foreign firm provides parts and components and pays a Chinese enterprise to assemble or process these inputs. Since the foreign firms are providing the inputs for production, marketing, and financing, their role in both the manufacture and the international sale of the final product is substantial. However, since there is no foreign ownership of the facilities in which the processing occurs, these firms are not classified as joint ventures. Together, exports of foreign-funded firms and export processing on behalf of foreign companies by Chinese firms now account for between two-thirds and three-quarters of China's total exports.

In sum, most of the growth of China's exports can be explained by its relative openness to foreign direct investment and rising real wages elsewhere in Asia. This has made China the natural location for the production of an increasing share of the world's labor-intensive commodities. The United States, as the largest world market for these goods, has emerged as China's largest export market.<sup>6</sup>

### **China's Global Trade Position**

The increase in our deficit with China to a level second only to that with Japan has led many in the United States to assume that China, like Japan, must be running an ever growing global trade surplus. Many go further and assume that China is a relatively closed economy which in its international trade does not play by the rules of market economies. Yet this reasoning obscures a fundamental difference between the two countries. China does not have a systemic global current account surplus.<sup>7</sup> Rather it has experienced a pattern of trade in which its global current account balance swings back and forth between deficit and surplus. Its biggest recent deficit was \$12 billion in 1993. Since that time it has run very small surpluses. In 1995 China's current account surplus was \$1.62 billion, under one-quarter of one percent of its gross domestic product. In 1996 the number is estimated to have been \$1.08 billion, about one-tenth of one percent of gross domestic product.<sup>8</sup> In short, unlike Japan, China has not adopted macroeconomic and exchange rate policies that have resulted in growing global current account surpluses. Cumulatively, since the reform period began in 1978 China has no global current account surplus at all.

### **China's State-Owned Sector**

While China has been experiencing an export boom since 1985, the growth of exports from China's state-owned firms has been relatively modest. Exports produced in indigenous factories actually fell sharply last year. This poor export performance reflects the deeply troubled condition of China's state-owned industries. This troubled status is revealed in several different ways, in addition to their weak export performance.

Perhaps most significantly, state-owned enterprises have experienced a dramatic decline in their return on assets from 15 percent in 1987 to 5 percent in 1994. Second, the share of state-owned firms running in the red quadrupled from just under 10 percent in 1985 to more than 35 percent in 1996. Third, the asset to liability ratio of state-owned enterprises has plunged over

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<sup>6</sup> Based on direct Chinese sales to the United States plus the reexports of Chinese goods from Hong Kong to the United States. Official Chinese data show the United States to be China's third largest export market, after Hong Kong and Japan.

<sup>7</sup> The current account balance is the sum of the trade balance and the balance on services. Services include, among other things, shipping, insurance, tourism, and net receipts of foreign investment income.

<sup>8</sup> Resident Mission in China, *Economic Note*, Beijing: The World Bank, February 1997, p. 12.

the past decade. By 1994 more than one-quarter of China's state-owned enterprises had liabilities exceeding assets and another fifth had liabilities approximately equal to assets. Thus, almost half of all state-owned firms were at or beyond the brink of insolvency. And these calculations understate the financial problems of state-owned firms since they do not include unfunded pension liabilities, which have ballooned enormously during the reform period.

Because the contribution to output of state-owned enterprises has declined so much during the reform era, some have suggested that restructuring state-owned firms through bankruptcies and mergers is now a much easier task than would have been the case a decade ago. This view seems mistaken for two reasons. First, state firms continue to employ two-thirds of all workers in urban areas, a share that has barely budged over the past decade. The specter of rising open urban unemployment is one that haunts Chinese leaders as they consider the reform options before them.

Second, the declining performance of state-owned firms has had devastating consequences for China's banks, all of which are effectively state-owned. More than four-fifths of the financial liabilities of state enterprises are loans borrowed from state banks. In turn, more than four-fifths of all outstanding bank loans are to state-owned firms. China's largest state banks now have non-performing loans that are several times the value of their own capital, meaning that these institutions are insolvent. The cost of writing off nonperforming loans and rescuing households, which are the source of about 80 percent of the banks' funds, from massive losses on their deposits will be many times larger (relative to GDP) than was the cost of resolving the savings-and-loan crisis in the United States.

### **Implications for U.S. Policy**

The United States should take as one of its principle objectives in its relations with China the normalization of bilateral economic relations. This should include three fundamental steps.

#### ***Lifting of Tiananmen Sanctions***

First, the remaining economic sanctions that were enacted following the Tiananmen Square repression should be lifted. Although sanctions were imposed by industrialized countries in a coordinated fashion, every other country has long since lifted them.<sup>9</sup> But the United States continues: (1) to suspend Overseas Private Investment Corporation (OPIC) programs of insurance, reinsurance, financing, and guarantees in China; (2) to prohibit the activities of the Trade and Development Agency in China; and (3) effectively to block U.S. firms from supplying nuclear power generation equipment to China. In addition, although not a part of the post-Tiananmen sanctions, the United States Export-Import Bank has refused to consider the financing of U.S. equipment for the Three Gorges project on the Yangtze River.

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*. . . economic sanctions provide the United States with virtually no leverage since there are alternative sources of supply for all major products American companies sell or might sell to China.*

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These sanctions substantially disadvantage U.S. firms vis-à-vis their European and Japanese competitors without imposing any significant penalty on China. In short, economic sanctions

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<sup>9</sup> The exception is the sanction on the sales of military equipment, which is still observed by the G-7 nations. There are indications, however, that the French plan to resume military sales.

provide the United States with virtually no leverage since there are alternative sources of supply for all major products American companies sell or might sell to China. For example, it is estimated that over the past five years U.S. firms have lost six billion dollars in sales of nuclear power generation equipment to European firms.<sup>10</sup> U.S. policy should seek to provide a level playing field vis-à-vis our economic competitors. Thus the economic sanctions currently imposed on China should be lifted.

### ***China's Membership in the World Trade Organization***

Second, the U.S. negotiating posture with respect to China's entry into the World Trade Organization should be based on a more realistic assessment of the costs and benefits of China's participation. The Clinton Administration tends to emphasize the long-term benefits China will gain as a result of opening its economy more fully to international competition, and tends to overlook the structural adjustment costs that must be borne in the short-run. Yet because the financially weak state-owned firms remain the dominant employers in urban areas, it seems likely that these short-term adjustment costs will be quite substantial.

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*A protocol governing China's participation [in the WTO] would lock China into a time-specific path of future economic reform.*

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While underestimating the short-run costs to China, the U.S. negotiating position appears to recognize insufficiently the gains to the United States from China's participation in the WTO. A protocol governing China's participation would lock China into a time-specific path of future economic reform. For example, the protocol and its annexes will specify precisely when China will have to dismantle import quotas and licensing requirements that the Chinese government currently imposes on 384 product categories. Should negotiations break down and China not become a member of the WTO, U.S. businesses would face enormous uncertainty about China's timetable for phasing out these quota and licensing arrangements. From a commercial perspective, there is a significant advantage to knowing precisely when such barriers will be phased out.

China's entry also would lead to significantly increased U.S. exports of capital goods and agricultural products, providing additional employment in industries with above average wages in the United States. Increased imports from China are likely to be concentrated in apparel. Imports of these products by industrialized nations currently is governed by the Multifibre Agreement. But under the terms of the Uruguay Round Treaty industrialized nations have agreed to phase out quotas in apparel and textiles over a ten-year period, beginning in 1996. Since China is a low-cost producer of many of these products, phasing out the restrictions will allow it to displace other producers whose market position is currently maintained artificially by quotas. One simulation of the effects of China's entry into the WTO suggests that because most of the increase in U.S. imports of labor intensive goods from China will displace workers in Taiwan, Hong Kong, and South Korea, the dislocation of unskilled labor in the U.S. textile industry between now and the year 2010 will be less than 5,000 jobs a year on average.<sup>11</sup> This is an extraordinarily small number in an economy that has been generating an annual net increase of 1.4 million jobs since 1990.<sup>12</sup>

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<sup>10</sup> *China Market Intelligence*, April 1997, p. 4.

<sup>11</sup> Zhi Wang, "Impact of China's WTO Accession on Labor Intensive Exports and Implications for U.S. Agricultural Trade—A Recursive Dynamic CGE Analysis," paper prepared for the 1997 annual meetings of the American Agricultural Economics Association. See also the same author's study, *The Impact of China and Taiwan Joining the World Trade Organization on U.S. and World Agricultural Trade: A Computable General Equilibrium Analysis*, Washington, D.C.: Economic Research Service, U.S. Department of Agriculture, 1997.

<sup>12</sup> Bureau of Labor Statistics, *Labor Force Statistics from the Current Population Survey*, BLS Home Page, cpsinfo@bls.gov.

Another gain for the United States would be that China, once a member of the WTO, would be subject to the dispute settlement procedures of the international body, providing a more effective way of addressing bilateral trade friction.

### ***Permanent Most-Favored-Nation Status***

Third, as part of China's entry into the WTO, the United States should provide permanent most-favored-nation trading status to China. Since China already has been granted permanent MFN status by all of its other trading partners, permanent MFN status in the U.S. market is perhaps the most important benefit China could receive from becoming a member of the WTO. However, this will require specific action on the part of the U.S. Congress to revise the Jackson-Vanik amendment with respect to China.

The present atmosphere, in which even the annual renewal of China's MFN status is judged by some to be in doubt, erodes any incentive the Chinese have to make further concessions in the talks on WTO membership. Why should the Chinese in the Geneva talks propose more far reaching proposals to further reduce tariffs and dismantle other trade barriers when the ability of the administration to deliver a congressional vote that would provide permanent MFN trading status for China is in doubt? Absent strong White House leadership on this issue, the prospect of a conclusion of a satisfactory WTO protocol is jeopardized.

# WTO, MFN, AND U.S.-CHINA RELATIONS

*Kenneth Lieberthal*

## Introduction

As of late 1996, the Clinton Administration anticipated important progress in U.S.-China relations during 1997. The benchmarks would be a visit by Vice President Al Gore to Beijing in the spring, the potential granting of permanent most-favored-nation (MFN)<sup>1</sup> trade status to China during the summer, the relatively smooth reversion of Hong Kong to Chinese rule in July, and a head-of-state summit in the fall that would highlight agreement on China's application to join the World Trade Organization (WTO), the major global organization to set the rules for international trade.

While the administration secured annual renewal of MFN for China in 1997, as a result of political developments during the winter of 1996-97, permanent MFN has been dropped from the agenda. The focus in this essay is on the other major economic issue in U.S.-China economic relations during 1997, China's accession to the World Trade Organization.

The following analysis supports a rather stark conclusion. There is evidence that the Chinese leadership is serious about making the compromises necessary to enter the WTO and that Chinese President Jiang Zemin may have built this into his strategy for solidifying his leadership position during the coming months. A Sino-U.S. agreement on the terms of China's WTO accession consequently could be feasible in time for a fall 1997 summit. But there is mounting evidence that any such agreement would not prove sustainable in Washington, D.C., given the political cross currents swirling around China policy, and that the Chinese are worried about these developments. The worst possible outcome for Sino-U.S. relations would be the good faith negotiation of an agreement that the Clinton Administration then could not sustain because of obstacles in Washington. That outcome would leave the Chinese leadership embittered and distrustful and would further sharpen the edges of the debate over U.S.-China policy. The Administration should, therefore, calibrate its approach to the WTO negotiations to an assessment of its ability to protect the resulting agreement from domestic challenges.

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Kenneth Lieberthal is the Arthur Thurnau Professor of Political Science and the William Davidson Professor of Business Administration at the University of Michigan. He is the author of *Governing China: From Revolution Through Reform* (1995).

<sup>1</sup> MFN itself is a misnomer, as it actually refers simply to normal tariff status, as reflected in the fact that the United States currently grants MFN to more than 190 countries.

## **WTO Accession**

The WTO is not an organization to which a country belongs based on acceptance or rejection of a single fixed document. While all countries must accept a core “single package” of treaty text, there is room for an applicant country to bargain on the schedule by which it will comply fully with these agreements.<sup>2</sup> In addition, a few agreements, such as those on government procurement and civil aviation, are optional. The final combination of commitments is spelled out in a protocol<sup>3</sup> (and its annexes), an application document, and a Working Group report. The very complexity of the process and of the substance allows for some leeway for negotiations.

China itself is a very unusual case. In many ways the People’s Republic of China (P.R.C.) is an anomaly: a developing country that has developed a powerful export capability and that has a significant impact on the international economy. For China, perhaps more than for any other country, there is no clear agreement among WTO members as to the precise template of an acceptable accession agreement.

The United States serves on the Working Group that will make a recommendation to the WTO about China’s application to join. Because the United States has sought more rigorous conditions for China’s WTO accession than have other participants, the Working Group is very likely to accept terms for entry that meet America’s requirements, but this is not automatic. If the Working Group recommends China’s accession to the WTO, it still must be approved by the WTO membership by a two-thirds vote. Even then a WTO member can opt out of the treaty relationship for its own bilateral dealings with the P.R.C.

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*While the United States cannot alone grant China entry to the WTO, the bilateral negotiations between Washington and Beijing over this issue are crucial to China’s chances of success.*

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Washington has argued that China should enter the WTO on “commercially viable terms.” There is no specific set of guidelines that define this phrasing but in general it means accession on terms that bring China into full WTO compliance as quickly as possible. While the United States cannot alone grant China entry to the WTO, the bilateral negotiations between Washington and Beijing over this issue are crucial to China’s chances of success.

## **WTO Negotiations: The State of Play**

This essay is necessarily speculative, since WTO negotiations between the United States and the P.R.C. and the state of succession politics in China are not very transparent and in a state of flux. But because 1997 is an unusually important year for U.S.-China relations, the Administration must develop a strategy to deal with these key matters.

Both Washington and Beijing are notably inconsistent concerning the negotiations over China’s entry into the WTO. Direct participants in the negotiations talk to each other in a fashion that signals determination to see the matter through, and they have made very significant progress

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<sup>2</sup> These include the General Agreement on Tariffs and Trade (GATT), the General Agreement on Trade in Services (GATS), the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS), related documents, and Tokyo Round agreements.

<sup>3</sup> The text of a confidential draft of that protocol is available in *Inside U.S. Trade*, Washington, D.C., March 14, 1997, pp.23-29.

on major issues since the start of the year.<sup>4</sup> The Chinese side has been indicating by its concrete proposals, its rhetorical packaging, and the direct involvement of key individuals such as Minister of Foreign Trade and Economic Cooperation Wu Yi<sup>5</sup> that it is serious about obtaining agreement with the U.S. on a WTO entry protocol during 1997. China has announced a standstill on new rules and practices inconsistent with the WTO, has promised foreign trading rights to both domestic and foreign-invested categories within the years of WTO accession and has agreed to immediate full enforcement of intellectual property rights (IPR) requirements upon accession (Hong Kong, by contrast, has a five-year IPR transition). Reflecting this situation, key negotiators on the American side exhibit optimism and a sense that success is a realistic possibility.

Yet, in both capitals the public stance is one of greater caution. Frequent visitors to Beijing who are not directly involved in the negotiations are often told by their Chinese counterparts that China does not expect an agreement on WTO entry this year, that the P.R.C. recognizes how high the costs of entry will be and is not convinced the benefits warrant paying this price, and that the unfolding succession in China during 1997 makes this a particularly unlikely period to make necessary concessions that hurt key domestic interests. U.S. Trade Representative Charlene Barshefsky has also struck a cautious note in her public pronouncements. She has not committed to a goal of reaching an agreement in 1997 and has not exuded confidence that such an agreement is within reach. Her public tone is one of uncertainty, especially in regard to China's readiness to make the important decisions necessary to obtain WTO entry.

The discontinuity between the more optimistic, determined private assessments and more cautious public postures that downplay the chances of a 1997 agreement may reflect bargaining tactics on each side. In China, the more cautious rhetoric may be intended to produce uncertainty in the United States, to make Americans feel a deal is going to be very difficult to sell domestically in the P.R.C., and therefore to soften the American position. In Washington, the subdued public posture may be intended to avoid creating pressure to negotiate an agreement (which would require concessions) by a fixed deadline and to head off any perception by an already-skeptical Congress that the White House is too eager to obtain a WTO accession accord for China.

Despite the above uncertainties about ultimate Chinese intentions, the substantive positions taken by the Chinese side in the actual negotiations to date provide sufficient evidence of seriousness of purpose. It is therefore prudent to analyze the role of WTO negotiations in U.S.-China relations with the assumption that the Chinese really want to reach an agreement. If this assumption is accurate, it has substantial implications for our understanding of the dynamics of accession politics in China and the strategy that Jiang Zemin is pursuing to secure his position.

### ***China: Domestic Politics and the WTO***

With Deng Xiaoping's death in February 1997 and the 15th Congress of the Chinese Communist Party scheduled for early this fall, the coming few months are critical for Jiang Zemin in his effort to consolidate his leadership of the P.R.C. through reconfirmation of his current positions and the appointment of key supporters to major posts. The 15th Congress will formally select a new Central Committee, Politburo, and leadership of the Military Commission of the Communist Party. Yet the Congress will do far more than that. Decisions will have to be made by the opening of the Congress on the changes that will be implemented next spring in the leadership of the government (the State Council) and the legislature (the National People's Congress).

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<sup>4</sup> Given the complexities of the various agreements and negotiations concerning WTO accession, it is quite possible for various participants and observers to hold significantly different views as to how well the negotiations are going and the likelihood of producing agreement in the near term. For a negative assessment, see: Thomas J. Duesterberg, "China's Not WTO Material—Yet," *The Wall Street Journal*, April 23, 1997, p. A18.

<sup>5</sup> Minister Wu Yi had absented herself from WTO accession negotiations for a considerable period of time before the latest round.

The coming months are, therefore, the Chinese equivalent of American presidential and congressional elections wrapped into one. A very wide array of leadership posts is at stake. Almost certainly, for example, at least eighteen ministers in the State Council will step down in the spring of 1998, and Premier Li Peng cannot constitutionally serve as head of the government beyond next March. Replacement of the top two military officers is widely expected, as the current incumbents are, it appears, too old to serve again. The resulting bargaining over positions is intense.

The 15th Congress will also make programmatic pronouncements about political and economic issues confronting the country. Of these, perhaps none is more pressing than the inter-related problems of reforming the state-owned enterprises (SOEs) and firming up the country's tottering banking system.

China's remarkable economic growth under the reforms has taken place primarily outside of the formerly dominant state-owned sector. New rules adopted in the 1980s freed local governments and entrepreneurs to set up their own enterprises and run them in a relatively competitive environment. The results of these new efforts have been astonishing, with more than double digit growth almost every year that has powered the overall economy into real growth rates of nearly ten percent per annum.<sup>6</sup>

But this strategy of creating room for local entrepreneurship has not included overall privatization of the state-owned sector. Rather, for a variety of reasons—muddled ownership and management rights, huge welfare burdens, unclear incentives, and so forth—this sector has generally fared poorly. Indeed, in 1996 for the first time overall losses exceeded profits in SOEs. Better than half the SOEs would be considered bankrupt by Western accounting standards (their liabilities exceed their assets and projected income-earning capacity). They are kept afloat primarily by bank loans, which continue to flow even when there is little prospect of loan repayment. China's banks are obligated to provide about 70 percent of their loans to the state-owned sector in order to prop up this part of the economy.

The state-owned sector is thus in deep trouble and seriously requires adjustment, but such adjustment will come at a dear cost. There is no way to make many of these enterprises competitive without a wave of major, potentially destabilizing, downsizing. The banking system has bad debt amounting to roughly 25 percent of annual GDP, an astonishingly high figure. But it makes little sense to reform and recapitalize the banks (through, say, government bond issuance) as long as the banks are forced to loan large amounts to essentially bankrupt SOEs. Bank health thus depends on SOE reform, which is economically complex and politically risky.<sup>7</sup> Currently, SOEs employ roughly 70 percent of the urban working population, excluding the "floating" population that has flooded into the cities in search of temporary jobs but has no right of permanent residence there. SOEs provide not only jobs but also housing, health care, and other social services for their employees, and China lacks a social safety net to take up the slack in the event of large cutbacks in SOE employment. By all accounts, workers in state-owned enterprises, especially middle-aged employees, feel a strong sense of entitlement to jobs.

The SOE and banking problems are not new, but they have been worsening yearly. During the Chinese equivalent of an election year, one might expect the leaders to duck such tough issues for fear of alienating key constituencies (not ordinary citizens, but the officials who oversee the state-owned sector). Time and again in recent years, Chinese leaders have signaled determination to tackle the SOE and banking problems, only to temporize at crucial junctures.

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<sup>6</sup> There is a vast literature on these developments. See, for example, Lili Liu, "A Gradual Approach," *The China Business Review* (May–June 1996), pp. 19–24; Barry Naughton, "China's Macroeconomy in Transition," *The China Quarterly*, vol. 144 (December 1995), pp. 1083–1104; and Barry Naughton, *Growing Out of the Plan*, Cambridge: Cambridge University Press, 1995.

<sup>7</sup> Akira Fujimoto, "Debt Crisis in China's State-Owned Enterprises—State-Owned Enterprise Reform Comes to a Deadlock," *China Newsletter*, July–August 1996, pp. 19–24.

The WTO is directly pertinent to this core set of issues. WTO rules will require that China open up its economy to a far greater extent, increase overall transparency, and reduce dramatically the subsidies it funnels into state-owned enterprises. The SOEs, in short, will become subject to international competition to a far greater extent than is currently the case.<sup>8</sup> Without serious restructuring, many will not survive. Therefore, agreement to enter the WTO on reasonably rigorous terms (i.e., with relatively short phase-in of full WTO requirements in various sectors) is necessarily linked to serious SOE reform, with all of its political perils.

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*. . . the progress in WTO negotiations . . . suggests the possibility that Jiang Zemin is promoting a bold economic reform strategy as part of his effort to secure the preeminent leadership position.*

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Given the necessary link between SOE reform and WTO accession, the progress in WTO negotiations during the winter and spring of 1997 suggests the possibility that Jiang Zemin is promoting a bold economic reform strategy as part of his effort to secure the preeminent leadership position. This would not be very surprising. Almost every succession in a communist country since the late 1940's has been accompanied by substantial new initiatives designed to highlight the energy and capabilities of the new leadership. The succession process itself demands a new political platform of promised reforms that break through some of the bottlenecks that developed under previous leaders. Based on conversations with knowledgeable Chinese and other indicators, Jiang's platform concerning the urban economy probably includes most or all of the following:

- *Bold SOE reform.* Small and medium SOEs will transfer to a share-holding system, with institutions owning most shares and substantial cross investment allowed. Boards of directors will decide on the hiring and firing of top management.<sup>9</sup> The government will retain ownership of only about 1,000 SOEs in sensitive sectors such as energy and utilities.
- *Abolition of most government offices that manage SOEs.* If such offices are not abolished, the state-owned enterprises are likely to function along administrative, rather than economic, lines.
- *Major job retraining and placement programs.* People let go from SOEs will be given job training and new employment opportunities. A version of this program currently being tested in Shanghai stipulates that if someone refuses two such opportunities, they will not receive further state help.
- *Banking system reform.* Three "policy" banks will make loans for low-profit projects that are important for the overall economy, such as infrastructure projects. The other banks will operate on commercial principles, without a requirement that they use most of their loan capital to shore up declining SOEs. China has already reorganized its banking system into commercial and policy banks, but to date has not allowed the commercial banks to make loans on strictly economic criteria. This banking reform will require massive state support to write off bad loans to make the commercial banks economically viable.

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<sup>8</sup> WTO entry will also open other sectors to greater international competition, with potentially serious consequences for the P.R.C.'s economy.

<sup>9</sup> Currently, the Chinese Communist Party appoints and removes leading SOE managers.

The above moves will produce considerable economic hardship. They adversely affect the immediate interests of millions of urban workers, of powerful bureaucracies such as the State Planning Commission, and of many managers and officials. Pursuing such changes during this critical succession period is, therefore, bold and risky—Jiang needs to mobilize substantial support and to protect himself from internal critics who will raise the specters of instability, slower growth (while the banking system is being recapitalized), and other problems. There are reports that Jiang hopes to place Zhu Rongji, the vice premier who is primarily responsible for bringing about the soft landing in the economy between 1995 and 1997, in the position of premier so that Zhu can take charge of implementing these changes between now and the end of the century. Zhu is known as a very capable individual who understands the urban economy and who does not suffer either fools or resistance lightly. The appointment of Zhu Rongji as premier would be a strong indication that the above outline of Jiang's strategy is basically accurate.

Although painful, the above reforms are essential if China wants to develop globally competitive urban enterprises. To date, more than 60 percent of China's exports comes either from firms that are foreign invested or from enterprises producing solely on contract to a foreign purchaser (such as Nike). Put differently, China's economic development to date has not produced a large number of indigenous firms that are competitive on the international market, despite the fact that China has sustained a remarkable record of export growth since 1978. The P.R.C.'s long-term goals require that reform go far deeper into the urban economic system.<sup>10</sup>

In this context, Jiang may be using entry into the WTO as an additional lever to justify politically the painful reforms he is supporting domestically. The WTO can provide him with the excuse that the pace of change he is promoting is necessary to meet the requirements imposed by this global trading organization. If this assessment of the Chinese succession situation is accurate, the WTO is a critical building-block in Jiang's strategy, and it is linked to major components of his emerging political platform. He is taking substantial risks domestically in order to make WTO accession feasible. He will be rewarded if an announcement of U.S.-China agreement on terms of accession is ready in time for the planned Jiang-Clinton summit following the 15th Party Congress this fall. And he will be wounded politically if he forces through agreement on WTO entry in China but then fails to secure American support. As of late spring 1997 China has begun an urgent effort to assess the likelihood of such an outcome.<sup>11</sup>

### **America: Domestic Politics and the WTO**

The Clinton Administration may find it difficult to do what is necessary to negotiate a good WTO accession agreement with China that will be acceptable in Washington, D.C. No single problem makes agreement impossible, but a very wide range of forces will create difficulties on this issue during the remainder of 1997. Obstacles arise from so many sources and angles that it will take very concerted leadership by the White House to steer WTO accession for China through the turbulent Washington political waters, and any agreement may become so buffeted by the crosscurrents that it eventually sinks.

A key negotiating tactic adopted by the Administration to date may make it very difficult to obtain a "commercially viable" agreement. As explained above, Jiang Zemin and his political allies may be strongly motivated to seek agreement on WTO entry as a part of their domestic political strategy. Their position on this would be strengthened substantially if Washington were

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<sup>10</sup> See, inter alia, Susan Shirk, *How China Opened Its Door*, Washington, D.C.: Brookings Institution, 1994; and Nicholas Lardy, "The Role of Foreign Trade and Investment in China's Economic Transformation," *The China Quarterly* (December 1995), pp. 1065-1082.

<sup>11</sup> David Sanger, "China is Seeking Guarantees from Congress Before Opening up Its Markets," *The New York Times*, April 30, 1997; p. A5.

to make a commitment to link China's WTO entry to granting permanent most-favored-nation trade status to the P.R.C. Such a commitment would alleviate concerns that Washington might opt out of WTO-mandated treatment of China in the U.S.-P.R.C. bilateral economic relationship, as allowed by WTO rules.

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Currently, the United States is China's only major trading partner that has not granted the P.R.C. permanent MFN status. China, moreover, grants MFN to the United States. But the Jackson-Vanik Amendment to the 1974 Trade Act, originally crafted in order to encourage Jewish emigration from the Soviet Union, requires that China's MFN status be renewed each year, and this has provided the political opening to pressure the P.R.C. on a wide range of issues. During the 1990s, human rights and other groups have tried to use the threat of withdrawing China's normal tariff status as a lever to influence Chinese behavior on non-economic issues. Given China's large volume of exports to the U.S. market, permanent MFN would be a significant inducement to Beijing to reach a WTO entry agreement on commercially viable terms.

But the Clinton Administration has refused to date to link permanent MFN with admission to the WTO for China. Legally, it is possible to separate the two, but doing so takes away a major bargaining chip that might otherwise be used effectively. Some argue that China already receives the major benefit WTO membership offers—permanent MFN—from all of its other trading partners, even without having to make the domestic economic changes that WTO membership requires. The United States, because of its use of the Jackson-Vanik Amendment in the past, therefore has unique leverage in negotiating a WTO entry package with China because it can tie permanent MFN to the deal.

Given the politics in Washington, as of mid-1997 it would not be credible for the Administration to guarantee permanent MFN upon China's acceptance of a WTO entry agreement.<sup>12</sup> But the White House could potentially strengthen its bargaining position in WTO negotiations considerably were it to pledge a good faith all-out effort to amend Jackson-Vanik in order to provide permanent MFN for China if a WTO accession accord is reached. This kind of initiative could strengthen Jiang Zemin's hand in Beijing in favor of an accord while not giving up anything that is not already under consideration. The present tactical approach—holding back on permanent MFN until the end of negotiations—may not be optimal.

The more fundamental challenge to successful WTO negotiations this year, though, stems from developments in the political situation in Washington. This is a multifaceted issue in which many disparate challenges may have a devastating cumulative impact. The core issue is whether, in the final analysis, the White House will have the political will to follow through on a commercially viable WTO accession accord with Beijing. The political atmosphere in Washington is making this increasingly doubtful. The White House is under pressure on China policy from segments of both the Republican and Democratic parties. Neither party is united on the issue, but those who seek to bend China policy to their domestic political agendas are strong enough in both parties to be a significant factor.<sup>13</sup>

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<sup>12</sup> David Sanger, "Boeing and Other Concerns Lobby Congress for China," *The New York Times*, April 29, 1997, p. A6.

<sup>13</sup> Steven Erlanger, "China Policy: Politics Rules," *The New York Times*, April 29, 1997, pp. A1 and A6.

Republican-led campaign finance investigations in both the House and the Senate include a China component. The Republicans have accused the White House of a long list of improprieties in soliciting and accepting funds for the 1996 presidential campaign. The Administration used a part of this money to support a very expensive television advertising effort during 1995 that is widely credited with helping Mr. Clinton bounce back from the devastating Republican election victories of 1994. That success left a bitter taste in the mouths of many Republicans, and there is a partisan element to at least some of the investigations now under way.

Initial stories suggested the possibility that the White House had raised money improperly from Taiwan. Vice President Gore attended a function at a Taiwanese Buddhist sect's monastery in California that turned out to be a fund raiser, thus possibly violating laws against soliciting campaign funds from foreign sources. Allegations surfaced of a solicitation of a large contribution from Taiwan by Mark Middleton, a Clinton friend who had headed America's unofficial representative office in Taiwan, the American Institute in Taiwan. Additionally, three Taiwanese Americans—John Huang, Johnny Chung, and Charlie Trie—were linked to questionable campaign efforts.

But then the focus of this story suddenly changed. Bob Woodward published an article in *The Washington Post* that revealed that the FBI had intercepted discussions at the Chinese Embassy in Washington of a Chinese effort to funnel money into various election campaigns in order to sway policy toward China.<sup>14</sup> Some form of these allegations was provided to the National Security Council staff, but was not communicated to higher levels. Also, John Huang and the others were tied into a wider web of campaign activities that involved alleged contacts with the P.R.C. (and complex relationships with others, such as the Riaddy family in Indonesia, whose Lippo Group in turn has business dealings in Hong Kong and China).

The welter of alleged associations quickly produced accusations that Beijing had funneled money to both the White House and Congress in an effort to subvert the American political process and to change U.S. policy toward China. Although no specific allegations (as of the time of this writing) have been made about money actually changing hands, the Republicans quickly seized on the potential Beijing tie to argue that China had effectively bribed the White House into sustaining a policy favorable toward Beijing.

Based on the resulting political momentum, some Republicans have called for the White House to submit any proposed WTO entry agreement to Congress for review. There is no statutory requirement for such Congressional oversight. The political argument being made is that the White House, having allegedly accepted Chinese money, is now so subject to Beijing's manipulation that it cannot be trusted to protect American national interests in a trade deal, and thus the Congress must ride herd on any accession agreement. Regardless of the merits of such a position, the political momentum has strongly associated campaign excesses with the U.S.-China relationship in a fashion that may be reducing the Administration's energy and initiative in its dealings with Beijing.

The problems for the White House on this issue are not limited to Republican partisanship. The trade union base in the Democratic party is strongly against trade agreements with China until Beijing permits the development of free trade unions inside the P.R.C. The basic argument, which the AFL-CIO makes with particular vigor, is that Chinese workers would be far less capable of stealing American jobs if they were able to engage in real collective bargaining to achieve decent wages.

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<sup>14</sup> Woodward's latest update of this story is, "Top Chinese Linked to Plan to Buy Favor," *The Washington Post*, April 25, 1997, p. A1.

This issue is also caught up in Democratic Party politics. Representative Richard Gephardt, the Democratic leader in the House, has long had strong ties to organized labor and has represented its views on international trade issues. Mr. Gephardt is widely considered a likely candidate against Vice President Gore for the Democratic presidential nomination in the year 2000, and thus it is arguably strongly in Mr. Gephardt's political interests to oppose the White House and Mr. Gore personally on improving trade ties with China. Mr. Gephardt has issued his own call for any China WTO agreement to be submitted to Capitol Hill for critical scrutiny before it is accepted. The White House therefore is unlikely to be able to characterize the Congressional pressures on WTO agreement as strictly a partisan effort.

There are also single issue groups that have utilized China as a symbol to promote their particular agendas. The television coverage of the repression during and immediately after the Tiananmen massacre of June 4, 1989, was so startling that it made China a vivid symbol of repressive government, alien to American values. Since then, many groups—including human rights, political Christian movements, non-proliferation, and others—have used China as a foil for their political activities. By linking their agendas to China, such organizations could provide their respective platforms with additional appeal and emotional impact.<sup>15</sup>

These groups have tended to focus their efforts on the annual MFN renewal process on Capitol Hill, presumably in part because of the added emotional energy that comes from the timing of that effort every year.<sup>16</sup> Having established a strong link between their concerns over Chinese behavior and America's trade policy toward China, many of these groups may take a strong stand against a WTO accession agreement once a draft is negotiated between Beijing and Washington. Such pressure can be brought to bear most effectively on Capitol Hill, but anticipation of the pressure may influence White House strategies during the negotiating process itself.

In early 1997 a new concern about China strategy quickly mushroomed on the political horizon. Highlighted by the wide attention given to a newly-published polemical volume by Richard Bernstein and Ross Munro, *The Coming Conflict With China*, a rash of articles and editorials warned of an allegedly inevitable Chinese threat to American interests after the turn of the century and called for the United States to begin immediately to take appropriate actions to contain and counter this looming danger. The argumentation behind this new challenge has remained remarkably unfocused and speculative. The very impressive press coverage and political reaction this argument immediately generated, though, highlights the political minefield that the Administration's policy of engagement with China must traverse.

The White House response to the above situation has been to declare its determination to continue to "engage" China in a constructive dialogue, with a view to encouraging China's entry into the international system on the basis of acceptance of the rules of the game as they currently exist. The White House has argued that such constructive engagement internationally will very likely promote changes toward a more tolerant government domestically in China. To further this agenda, the White House has pursued expansion of business ties with China, diplomatic engagement (including a March 1997 visit to Beijing by Vice President Gore and a proposed Clinton-Jiang summit in Washington in the fall), renewal of MFN, four power talks (China, North Korea, South Korea, and the United States) on the Korean issue, and so forth.

But behind this facade of consistency, there are signs that the political heat regarding China is taking a toll. Vice President Gore, for example, sought to avoid any formal toasts with Pre-

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<sup>15</sup> The comments here refer only to political tactics. They do not reflect a position on the inherent value or importance of the various agendas in their own right. Cf. Kenneth Lieberthal, "Domestic Forces and Sino-U.S. Relations," in *Living With China: U.S.-China Relations in the Twenty-First Century*, Ezra Vogel, ed., New York: W.W. Norton, 1997.

<sup>16</sup> By happenstance, the President must submit his MFN renewal recommendation to the Congress by June 3 each year, which links it closely with commemoration of the June 4 Tiananmen repression.

mier Li Peng, lest they prove politically damaging (Li sprang a toast on the vice president during a signing ceremony, in any case). The Gore trip was also notable for both its reluctance to give the press much information and the press' determination to dog the vice president with questions about how he had handled the issue of purported Chinese campaign contributions in his talks with the P.R.C.'s leaders.<sup>17</sup> A trip initially seen as an opportunity for the vice president to engage in high diplomacy, therefore, became something more akin to a damage control operation—all without the Chinese having actually done anything directly to diminish the luster of the vice president's visit.

There are other indications of the impact of the political crosscurrents in Washington. In late 1996 there had been discussion of seeking permanent MFN renewal for China in 1997. Such discussion has been dropped amid concerns that the fight simply to renew MFN status in mid-1997 will be especially rancorous.

Personnel appointments evidently also have been affected. Reportedly, appointment of a new Assistant Secretary of State for East Asian Affairs was held up while the White House made sure there were no unpleasant surprises in the candidate's record. As a consequence, this nomination was announced by the White House only on May 23, despite the fact that earlier in 1997 Secretary of State Albright and Vice President Gore had been to Beijing and Chinese Foreign Minister Qian Qichen had visited Washington. In addition, in the middle of May the two leading American negotiators on the WTO accession issue—Lee Sands and Deborah Lehr of the U.S. Trade Representative's office—left office to join the private sector.

As of June 1997, therefore, the Administration is preparing for potential WTO accession, the transfer of Hong Kong to P.R.C. sovereignty, and a likely presidential summit with China in the fall while being short handed in key posts directly pertinent to the management of these very issues. Discussions with some of the participants in Washington leave the very strong impression that in a diffuse sense the interplay of China policy with the political crosscurrents in the capital has been a factor in producing this disturbing situation.

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*... within Washington, policy toward China is being buffeted from various sides, potentially putting at risk the Administration's ultimate ability to follow through on a WTO accession agreement if it is reached.*

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### **Sino-U.S. Relations and the WTO**

The above analysis can be summed up in two crucial observations: within China, Jiang Zemin may be taking a politically risky approach to the succession, with accession to the WTO playing an integral part in this effort; and within Washington, policy toward China is being buffeted from various sides, potentially putting at risk the Administration's ultimate ability to follow through on a WTO accession agreement if it is reached. The hope in both Beijing and Washington is that announcement of a commercially viable accession agreement can be a highlight of the Clinton-Jiang summit in the fall. But there is a growing possibility that negotiation of such an agreement would unleash a political dynamic in Washington that would ultimately force the Administration to back away from supporting the accord. Should this latter development come to pass, it would likely do enormous damage to the fabric of Sino-U.S. relations.

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<sup>17</sup> Fully half the press questions at the vice president's news conference in Beijing focused on this single issue.

From an American perspective, it is important first to obtain agreement from China regarding the type of WTO accession agreement that will truly bring the P.R.C. into the WTO framework, with all its requirements, in a relatively short period of time. WTO entry itself actually requires a wide range of agreements concerning specific issues and sectors, and thus no single point in time can be specified as the “right” target for all the various components of an accession agreement. But short time frames must be the rule, given the size and impact of the Chinese economy.

Having negotiated a good agreement, it is critical for Washington to be able to follow through and fully support this agreement as a basis for China’s actual entry into the WTO. There is a strong suspicion in Beijing that the United States, despite protestations to the contrary, sees itself as a long term adversary of China and seeks to constrain China’s growth, isolate the P.R.C. internationally, and divide the country internally. American success in negotiating a good WTO accord with China followed by American failure to follow through on promoting China’s WTO entry would give powerful ammunition to those in China that harbor this suspicion about the underlying motives of U.S. policy.

The Clinton Administration’s efforts to develop constructive engagement with China ultimately require that both sides increase their trust in each other’s intentions and good faith. Short of this, the goals of constructive engagement will remain largely illusory. Failure to follow through on a commercially viable WTO entry accord for China would greatly damage Beijing’s trust in the United States, especially as the WTO issue may be directly linked to Jiang Zemin’s personal political strategy for the succession. The stakes are high.

The 1997 political calendar is already fraught with opportunities for Sino-American distrust to fester. Hong Kong’s reversion may well produce media treatment that highlights political uncertainty and fear, with resulting reverberations in Washington. Beijing, already very anxious about reversion and seriously desiring that things go well, could easily perceive that problems are being fomented by Washington and Britain in order to frustrate China’s hopes. It is not hard to envision political tensions in the Sino-U.S. relationship that might result from the dynamics of the change in Hong Kong’s status this summer.<sup>18</sup>

The debate over MFN renewal in the Congress this summer might also have produced rhetoric that sharpens Beijing’s sense of threat from Washington. Conservatives such as columnist George Will, for example, have publicly argued that, “Whatever the tactics, the strategic aim of U.S. policy is, and must be, the subversion of the Chinese regime. It is China’s turn.”<sup>19</sup> Munro and Bernstein in *The Coming Conflict With China* cite remarks they have heard and read in the P.R.C. to make the case that China eventually will view the U.S. as an enemy whose influence in Asia must be curtailed. Just as this book has stirred the pot mightily in the United States (Will, for example, refers explicitly to this volume as a source of his thinking), writings such as these inevitably produce a parallel reaction in Beijing. There is the obvious possibility of a self-fulfilling prophecy on both sides, to the detriment of each, in this dynamic. Because much of the MFN debate in 1997 will take place during the month following Hong Kong reversion, the rhetoric—and implied threats—is likely to be especially sharp.

In sum, whereas six months ago both MFN and the WTO were viewed in Washington as potential building blocks in a more effective Sino-U.S. relationship, political currents in Washington have begun to move the momentum in the other direction. Ironically, this has occurred while Beijing has shown signs of increasing its enthusiasm for these accords and of being willing to work more effectively to bring them about.

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<sup>18</sup> Kenneth Lieberthal, “The Hong Kong Factor in Sino-U.S. Relations,” in *Hong Kong’s Transition: Context and Implications From Both Sides of the Pacific*, New York: The Asia Society, April 1997.

<sup>19</sup> George Will, “China’s Turn,” *The Washington Post*, April 17, 1997, p. A23.

## Prescriptions for U.S. Policy

Both strategic and tactical prescriptions for U.S. policy grow out of the above analysis. As this overview suggests, the Administration's policy toward China as of mid-1997 remains basically reactive and is easily buffeted by domestic crosscurrents. This reflects the continuing American perception of the P.R.C. in symbolic terms that resonate with the Tiananmen massacre in 1989, with the only major addition being the new notion that a growing China will inevitably become an enemy of the United States in Asia. As long as this framework governs discussion of China policy, that policy will fall far short of the Administration's goals.

The Clinton Administration should recognize, therefore, that it cannot handle China on strictly a tactical level. A tactical approach will remain too vulnerable to the political obstacles noted above. The Administration must instead seize the initiative and define the framework within which America's policy toward China is debated. Any such effort, given the current political situation, requires presidential leadership and consistency.

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*. . . the Administration must lay out for the American Congress and public the major trends that it sees in Asia, the United States' long-term interests in the region, and the requirements of those long-term interests as they affect our relations with China.*

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Essentially, the Administration must lay out for the American Congress and public the major trends that it sees in Asia, the United States' long-term interests in the region, and the requirements of those long-term interests as they affect our relations with China. A major presidential address on these issues could focus sufficient attention to begin to set the stage for a new debate on China policy. Top administration officials must follow up in a consistent fashion by substantiating the president's analysis in various issue areas. The Administration's policy is often portrayed sarcastically as, essentially, one of trading off the well being of individual political dissidents for additional dollars in Sino-American trade. This characterization is unfair, inadequate, and inaccurate. But the Administration's failure to date to make a forceful case for the array of American interests tied to building constructive cooperation with China leaves the White House vulnerable to such an attack.

America has long term interests in securing active participation, on fair terms, in a stable and prosperous Asia. Barring some unforeseen cataclysm, Asia will inevitably make some accommodations to a stronger China. American security, economic, diplomatic, and cultural interests require, therefore, that we assess how best to produce the Asian situation we seek given the unavoidable reality of a major Chinese role. Any sensible approach to this complex issue requires, at a minimum, realistic assessments of developments in China and of the views and trends in the rest of the region. A policy that is shaped by contention over domestic issues in which the key players opportunistically use symbolic caricatures of China as part of their political arsenals is a policy that will almost certainly fall far short of meeting America's vital needs.

Complex domestic political forces in China and legitimate uncertainties about the P.R.C.'s future make it difficult, at best, to produce agreement on the best approach for America to take to the region. The Administration must lead the way in a discussion of issues based on a balanced assessment of realities in Asia if America is to fare well in that region over the coming decade.

If the White House is willing to pursue something akin to the above approach, it should then focus on achieving and implementing a commercially viable WTO agreement and permanent MFN renewal as important parts of the strategy. These initiatives would help to increase Beijing's trust in Washington's long-term good will and facilitate economic changes in China that would knit the country more fully into the international system over the long run. While neither of these results would guarantee that China would play an increasingly responsible role in the international system of the future, both should at least move the odds in a favorable direction. Neither is against American interests.

With specific reference to WTO and permanent MFN, this approach would require that the White House, having made a strong public case for reaching good agreements with China:

- give priority to this set of issues;
- have the courage to move forward even in a difficult domestic political atmosphere;
- undertake a major effort to make its case to various domestic constituencies;
- do considerable forward planning;
- improve its ability to coordinate policy on these issues within the executive branch;
- force the various executive branch agencies to focus on the issues and facilitate the negotiations being led by the U.S. Trade Representative's office;
- move quickly to staff its China- and Asia-related posts;
- and communicate to China that permanent MFN will almost certainly accompany a WTO accession agreement.

Should the White House be unwilling to seize the initiative to change the framework of the debate on China and to follow up appropriately with the above initiatives regarding WTO accession and permanent MFN, there is a significant possibility that the President's goals regarding China policy will not prove politically sustainable. If the result is that promises to Beijing cannot be met, the consequences may prove worse for U.S. interests than if no such commitments had been made in the first place. The White House must, in short, reach a sober assessment of what it can do regarding policy toward China and Asia and then tailor its rhetoric and initiatives accordingly. While the WTO and MFN issues are not necessarily the most important elements in this mix, the Administration's approach to these issues in 1997 can highlight whether the United States is capable of following a long-term strategy toward China during the second Clinton term.

## ARE ECONOMIC SANCTIONS AN EFFECTIVE TOOL FOR REALIZING U.S. INTERESTS IN CHINA?

Laura D'Andrea Tyson

Disappointment over China's human rights record, concerns about the U.S. trade deficit, and speculation about the possible involvement of the Chinese government in campaign financing have intensified the debate over U.S.-China policy. An increasing number of critics from both the left and the right are clamoring for a tougher stance toward China, one that relies more on threats and sticks and less on constructive engagement and carrots. So far, economic threats, not military ones, have garnered the most favor with China critics, although the sensationalist title of a new book, *The Coming Conflict with China*, seems to suggest that a call for military threats might not be far behind.<sup>1</sup>

On the economic front, two kinds of actions have been proposed. The first is the threat of imposing sharply higher tariffs on imports from China by revoking its most-favored-nation (MFN) trading status. This year, advocates of MFN revocation from the human rights community have been joined by those who would like to see higher tariffs on China as a means to cut the U.S. trade deficit and those who would like to condition renewal of MFN for China on its behavior toward Hong Kong. A second economic action favored by China critics is the threat of impeding China's accession to the World Trade Organization (WTO) by imposing conditions or approval procedures for China that are tougher than those applied to other WTO members. In this instance, diehard opponents of the WTO have been joined by those who would like to postpone or block China's membership altogether.

Frustration with China's behavior on a number of fronts is understandable. And actions that threaten to cut off China's access to the U.S. market are intuitively appealing because the United States is one of China's largest overseas markets. The United States buys about 17 percent of China's global exports according to Chinese statistics and about 30 percent according to U.S. statistics.<sup>2</sup> So, the logic goes, the threat of lost sales will encourage China to improve its human rights record, abolish its trade barriers, and safeguard the rights of Hong Kong's citizens.

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Laura D'Andrea Tyson is currently a professor of economics and business administration at the University of California at Berkeley, where she holds the endowed Class of 1939 Chair. She served as the President's National Economic Adviser and chaired the White House Council of Economic Advisers during President Clinton's first term in office. Dr. Tyson has published widely on industrial competitiveness and trade, including the highly acclaimed book *Who's Bashing Whom? Trade Conflict in High Technology Industries* (1992). A shorter version of this paper appeared as an op-ed in *The Wall Street Journal* May 23, 1997.

<sup>1</sup> Richard Bernstein and Ross H. Munro, *The Coming Conflict with China*, New York: Alfred A. Knopf, 1997.

<sup>2</sup> There are substantial differences between the measurement of trade flows between the U.S. and China depending on whether U.S. or Chinese sources are used. The U.S. figures are misleading because they include in the value of China's exports to the U.S. the value of all Chinese products that are reexported from Hong Kong, including the value added by Hong Kong companies. Nicholas Lardy estimates that official U.S. statistics overstated China's exports to the U.S. by \$7 billion and the U.S. trade deficit with China by about one-third in 1996. Nicholas Lardy, "China and the WTO," *Brookings Policy Brief*, no. 10, November 1996, Washington, D.C., The Brookings Institution.

Despite the growing popularity of economic sanctions with China's critics, it is important to ask whether economic sanctions will serve U.S. interests in China. And that requires that a more fundamental question be addressed first. What are these interests and the tradeoffs among them?

The United States has many and varied interests in its dealings with China. We share common security interests with China on the Korean Peninsula. As two of the world's largest sources of carbon emissions, we also have common environmental interests and responsibilities. In addition, the United States is deeply concerned that China adhere to its commitments in nuclear nonproliferation and deeply disturbed about China's alleged support of Pakistan's nuclear ambitions. U.S. policy toward China is also shaped in part by our interest in promoting democracy and human rights around the world, not just because we value them for their own sake but because we believe that they promote global peace and stability. And finally, we have substantial commercial interests in China, which is the most rapidly growing market in the world and the single largest recipient of foreign direct investment.

Naturally, tradeoffs have to be made among these diverse and sometimes competing interests. Representatives of human rights organizations often argue that we are according too much importance to our commercial interests relative to our values. Others argue that we should sacrifice some of our commercial interests in an attempt to slow China's military buildup or deter its arms sales. And there are those who maintain that we should compromise on our human rights agenda to safeguard the access of American companies to China's growing market.

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*Whether we like it or not, China is emerging as a great economic, military, and political power. The United States cannot stop this process. Instead, with the limited means at our disposal, we can try to shape the kind of great power China will become and the path it will travel to get there.*

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A single goal—China's peaceful and stable transition to a more democratic, market-oriented, open society that respects the rule of law at home and abroad—links and sometimes overrides our otherwise conflicting interests. Whether we like it or not, China is emerging as a great economic, military, and political power. The United States cannot stop this process. Instead, with the limited means at our disposal, we can try to shape the kind of great power China will become and the path it will travel to get there. As then-Senator Sam Nunn noted in a 1996 speech on U.S.-China policy, history is littered with the uninformed and ineffective responses of an established power towards a rising power.<sup>3</sup> We need to take appropriate actions now if we are to avoid the mistakes of history.

And since the actions currently embraced by the critics of U.S.-China policy are the economic threats identified here, we must ask whether they are appropriate actions to realize our long-term goal. As the following analysis indicates, the economic and historical evidence suggests that the answer to this question is a resounding no.

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<sup>3</sup> Address of Senator Sam Nunn, The Committee of 100 Fifth Annual Conference, "U.S.-China Relations into the Next Century," April 26, 1996.

## The Costs for China of Restricted Access to the U.S. Market

China is already an economic powerhouse in the world economy and its economy will continue to grow well into the next century. With 20 percent of the world's consumers, it is already the third largest market in the world and one of the largest trading nations. From 1990 to 1996, according to Department of Commerce statistics, U.S. exports to China rose by 90 percent, making China our fastest growing export market. During this period, imports from China grew even faster, and the U.S. trade deficit with China increased dramatically, making it second in magnitude only to the trade deficit with Japan.

Taken together, these trends have led many observers to three conclusions. First, that China, like Japan, is a mercantilist power whose barriers to imports and investment produce a permanent balance-of-payments surplus over time. Second, that restricting its access to the U.S. market would impose a substantial commercial cost on China. Third, that the cost of such actions for the U.S. economy would be inconsequential—indeed, some observers even maintain that reducing China's access to the U.S. market would be beneficial, because it would curb the trade deficit with China and move jobs from China back to the United States. All three of these conclusions are erroneous.

Although China's evolving economic system clearly contains structural barriers to imports and foreign competition, as Japan's system does, China does not enjoy a large and persistent current account surplus, the most characteristic feature of a mercantilist system.<sup>4</sup> Rather China's current account balance exhibits cyclical swings alternating between several years of deficit and several years of surplus.<sup>5</sup> Whether positive or negative, such imbalances are small relative to China's size. On average, the current account has been close to balance over the cycle, indicating that China has not adopted macroeconomic and exchange-rate policies in pursuit of mercantilist ends.

Despite its structural barriers to trade, China has registered a deficit in its trade account in most years since reform began in 1978, and over the reform period as a whole, it has run a large cumulative deficit. Like its current account, China's trade account has also exhibited a cyclical pattern, with imports and exports responding to changes in macroeconomic fundamentals and changes in real currency values.<sup>6</sup> These trade patterns imply that as China continues to break down its structural barriers to trade and investment, both exports and imports will increase—that is, China's trade will increase without a significant change in its overall trade deficit and current account position.

In contrast to Japan, China has adopted a development strategy in which foreign direct investment plays a pivotal role. In 1996, China's inflow of foreign direct investment was about \$40 billion. About 40 percent of all foreign direct investment in the newly industrializing economies currently flows to China.

Foreign investment has allowed companies headquartered outside of China, including major American companies, to establish strong positions in a number of consumer product lines, including soft drinks, fast food, and cosmetics. Such investment has also been a major force behind China's export boom. According to Nicholas Lardy, 60 percent of the growth in China's exports between 1985 and 1994 is attributable to foreign-funded enterprises.<sup>7</sup> According to a recent *Wall*

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<sup>4</sup> The current account balance is the sum of the trade balance and the balance on services. Services include, among other things, shipping, insurance, tourism, and net receipts of foreign investment income.

<sup>5</sup> Nicholas Lardy, "American Economic and Security Interests in China," speech for a study group of the Economic Strategy Institution *American Interests in Asia*, Washington, D.C., January 16, 1997.

<sup>6</sup> These characteristics of China's trade performance are documented in Nicholas Lardy, *China in the World Economy*, Washington, D.C., Institute for International Economics, 1994.

<sup>7</sup> Nicholas Lardy, "The Role of Foreign Trade and Investment in China's Economic Transformation," *China Quarterly*, no. 144, (December 1995).

*Street Journal* estimate, in 1996 such enterprises accounted for somewhere between 40 and 50 percent of China's overall exports.<sup>8</sup> In that year, exports by China's state-owned companies were actually lower than the year before. The bulk of the exports originating from foreign-funded firms are from processing and assembly plants that have high import content. Thus foreign investment in China, as in other developing economies, has contributed to growth on the export and import sides of the trade ledger. In contrast, Japan's relative closure to foreign direct investment has been a key factor behind low import penetration of its domestic market.<sup>9</sup>

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*Much of China's foreign direct investment involves the transfer of assembly and processing facilities from Singapore, Hong Kong, Korea, Taiwan, and other Asian locations that have become comparatively high-cost bases of operation.*

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Much of China's foreign direct investment involves the transfer of assembly and processing facilities from Singapore, Hong Kong, Korea, Taiwan, and other Asian locations that have become comparatively high-cost bases of operation. Between 1987 and 1993, for example, 82 percent of the increase in the U.S. trade deficit with China was offset by a decrease in the U.S. trade deficit with Hong Kong and Taiwan. Since 1994, the increase in America's trade deficit with China has been more than offset by a decrease in the trade deficit with Japan and the four Asian tigers. Such displacement has been particularly pronounced in labor-intensive product lines, such as consumer electronics, apparel, footwear, and toys, in which labor costs are a major determinant of foreign direct investment decisions. As a result of shifts in production from other Asian locations, China's global market share of such products has increased, while the share produced by the four Asian tigers has fallen precipitously.<sup>10</sup>

Withholding MFN status from China would substantially increase U.S. tariffs on Chinese imports, raising the average duty rate on all imports from 5.5 percent to 44.8 percent. This would certainly make Chinese exports relatively less attractive in the United States, but the resulting drop in such exports would have a limited impact on China for two reasons. First, China is a very large economy, and exports to the United States represent only a small percentage of its GDP—in the range of 2–3 percent. Second, China's exports to the United States are primarily assembly goods that have a high content of imports. Nicholas Lardy has shown that between 70 and 80 percent of the value of China's exports to the United States represents the value of products imported into China from the United States and other countries and processed in China for export.<sup>11</sup> Therefore, restricting the value of China's exports to these markets would correspondingly reduce the value of China's imports, almost to an offsetting extent, so that the short-term impact on China's trade imbalance, and hence on its aggregate production and employment levels, would be small.

Of course, this macroeconomic calculation overlooks the fact that even in the short run a steep decline in China's exports to the United States could have pronounced regional and industrial effects, and fall disproportionately not on China's state-owned enterprises but on China's

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<sup>8</sup> Joseph Kahn, "Foreigners Help Build China's Trade Surplus," *Wall Street Journal*, April 28, 1997.

<sup>9</sup> Laura D'Andrea Tyson, *Who's Bashing Whom? Trade Conflict in High-Technology Industries*, Washington, D.C., Institute for International Economics, 1992.

<sup>10</sup> Nicholas Lardy, "American Economic and Security Interests in China," *op. cit.*

<sup>11</sup> Nicholas Lardy, "US-China Intellectual Property Rights Agreement and Related Trade Issues," Statement before Joint Subcommittee Meeting, House Committee on International Relations and Senate Committee on Foreign Relations, March 7, 1996.

foreign-funded enterprises and on the foreign investors and firms that supply them with inputs for processing. The adverse consequences would be especially pronounced in Hong Kong, Taiwan, and Singapore, which are major investors and suppliers to China. This is the primary reason these three countries, as well as all of our other Asian trading partners, strongly oppose revocation of China's MFN status.

Over the long run, restricting China's access to the U.S. market would have a more pronounced impact on its development prospects by reducing flows of foreign direct investment that otherwise might have been directed to China to produce goods and services for export to the United States. A reduction in such flows would also impede the flow of technical and managerial know-how that accompanies them. Although it would be unwise to overlook these potential long-run costs, it would be equally unwise to assume that Washington could effectively impose a large up-front cost on China by withholding MFN.

### **The Costs for the United States of Restricting China's Imports**

Any action like MFN revocation that would reduce substantially China's exports to the United States would result in higher prices in American stores and even temporary shortages in some product lines, such as particular toys and silk garments, in which China is America's dominant supplier. Since China is a major supplier of low-end products in such important consumer items as apparel and footwear, discount and other retail outlets that serve low-income consumers would be especially hard-hit.

Over time, these adverse price effects would be mitigated to some extent by the development of alternative sources of supply, but production facilities and employment would not migrate from China back to the United States. Instead, other less developed countries with an abundance of cheap labor, such as Indonesia, India, and Mexico, would become more attractive targets for foreign investment and production aimed at U.S. consumer markets. Relatively high labor costs in the United States make it an unattractive location for the kinds of labor-intensive products it currently purchases from China. The steady erosion of American production and employment levels in such products will persist regardless of whether China's access to the U.S. market is restricted and regardless of what happens to the trade deficit with China over time.

Although proponents of MFN revocation focus on China's exports to the United States, U.S. exports to China would also be affected in several ways. First, there would be a direct impact on exports to China of goods used in China's substantial assembly and export operations. Second, China has already demonstrated its willingness and ability to retaliate against U.S. exports in response to pressure from Washington. Largest among these exports are aircraft, power generation equipment, grain, computers, telecommunications, and electrical equipment. Most of these products are purchased directly by state bureaucracies or by state-owned enterprises in China, so retaliation could be prompt and deliberately targeted to inflict the greatest economic pain. Furthermore, all of these products have alternative foreign suppliers who would benefit from the opportunity to win sales from their displaced U.S. competitors.

Third, the Chinese could also retaliate by blocking the participation of American firms in China's substantial infrastructure investment projects. According to the World Bank, China's infrastructure requirements over the next decade will total \$750 billion, much of which will entail purchases of aircraft, power generation equipment, telecommunications, computers, construction, engineering services, and other high-skill, high-wage technologies that must be supplied from either American suppliers or their competitors headquartered in Europe or Japan. A loss of U.S. market share in China in these products would mean a loss of high-wage job opportunities at home.

Finally, revocation of China's MFN status would dampen U.S. exports by reinforcing the growing perception that American suppliers cannot be relied upon because of the penchant of the U.S. government for unilateral economic sanctions. In critical technologies, such as aerospace, telecommunications, and power generation, the loss of export markets could be long-term and substantial because the initial choice of supplier determines later choices in services, parts, and follow-on sales.

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*. . . lurking just below the superficial appeal of MFN revocation is the reality that its commercial costs to the United States . . . would be substantial.*

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In short, lurking just below the superficial appeal of MFN revocation is the reality that its commercial costs to the United States in the form of higher import prices, temporary shortages of popular consumer goods, adverse effects on low-income consumers, and reduced export, investment, and high-wage job opportunities would be substantial. And while MFN revocation would certainly reduce overall trade between the United States and China, it would have no discernible effect on the U.S. trade deficit nor would it bring jobs back to America from low-cost production locations in Asia.

Some will argue that any costs to the United States from MFN revocation, even though substantial, should be tolerated in pursuit of other U.S. goals in China. The United States is a rich and principled nation. Why shouldn't it sacrifice commercial interest to some extent to achieve its long-run goal of moving China towards a more democratic and rules-based society?

The answer is simple—because such sacrifices, while real, are antithetical to realizing this goal. MFN revocation would disproportionately harm the reforming and private elements of the Chinese economy, which rely heavily on foreign investment and technology for their development. It would impede the flow of information about Western culture, ideas, business practices and perspectives that accompanies such investment. And it would weaken the voices of reformers in the government.

China's experience in a wide variety of sectors, including finance, civil aviation, and energy, confirm that foreign trade, investment, and competition strengthen internal reforms and promote development and adherence to the rule of law.<sup>12</sup> A similar conclusion emerges in the intellectual property area. As a result of its intellectual property rights agreement with the United States, China has recently taken several significant actions to strengthen the rule of law. According to the Office of the United States Trade Representative, since June 1996 tough new controls have been instituted at China's borders to prevent compact disk production machinery from entering the country. China's police have arrested scores of pirates and closed 28 underground production facilities accounting for the production of more than 200 million illegal CDs. Even more important in the long-run rule of law, China is in the process of enacting domestic laws for intellectual property protection; it has established intellectual property rights tribunals within its court system, and it has sought the help of international agencies and foreign governments to train officials and judges in the enforcement of such laws.<sup>13</sup>

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<sup>12</sup> Michael Oksenberg and Elizabeth Economy, *Shaping US-China Relations: A Long-term Strategy*, Council on Foreign Relations Study Group Report, New York, Council on Foreign Relations, 1997.

<sup>13</sup> *Ibid.*

Finally, there is nothing in China's history—or in the general history of economic sanctions—to suggest that MFN revocation will lead China to change its behavior in human rights, nonproliferation, or other non-economic areas. Although China has shown a willingness to adjust its commercial behavior in response to a threat of well-targeted and limited commercial sanctions—most recently in its intellectual property dispute with the United States—it has resisted efforts to link its commercial interests to its behavior in other areas. Nor are the general conditions that are most auspicious for the effectiveness of economic sanctions present in this case.<sup>14</sup> Not a single one of America's trading partners has indicated any willingness to support multilateral sanctions, so our action against China would perforce be unilateral. The immediate aggregate impact on China from such a unilateral action would be quite small, with the greatest hit falling on China's foreign-funded firms and their Asian and American investors and suppliers. Nor is China so small or so dependent on U.S. trade and investment that it could not find alternative sources of supply relatively quickly, thereby easing the blow of unilateral U.S. action over time.

The history of China's burgeoning commercial relations with the rest of the world contains another lesson for how the United States can best foster China's transition to a rules-based society. China has compiled a strong record of honoring its commitments and the rules of the game in those international economic organizations it has joined, including the International Monetary Fund and the World Bank. This record suggests that if China reaches an agreement with the United States and its other trading partners to become a member of the World Trade Organization on commercially acceptable conditions, these conditions will be honored.

### **The Significance of WTO Accession**

During the last several years, the debate over China's WTO membership has revolved around China's contention that it deserves developing-country treatment in the WTO. Such treatment would grant China the longest allowable time for coming into compliance with WTO standards and would exempt it from some standards altogether. The Clinton Administration maintains that even though China is a developing country, it does not warrant developing-country status because it is already a major power in global trade. Consequently, the United States has insisted that China's WTO membership be based on normal commercial conditions, although it has been willing to negotiate China's timetable for meeting these conditions. To date, the U.S. position has been supported by the other nations participating in the negotiations.

As part of a commercially acceptable WTO protocol, China must make clear commitments in three key areas: adherence to the fundamental GATT and WTO principles of nondiscrimination, national treatment, and transparency; a credible and tangible market-opening package for American goods, services, and investment; and appropriate safeguards, that would be triggered in the event of unanticipated import surges or other dramatic and unexpected trade developments. China still has a considerable way to go toward providing such commitments. And since market access difficulties for American and other foreign firms are rooted in China's state-enterprise structure, WTO membership must require a schedule of commitments for phasing out subsidies to state-owned enterprises. This entails substantial political and economic risks in the short run, because such enterprises still employ about two-thirds of China's urban labor force.

In recent months, the Chinese have signaled that they are interested in moving the WTO negotiations to a successful resolution this year. They have announced a standstill on new rules and practices that are inconsistent with WTO regulations, and they have promised foreign trad-

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<sup>14</sup> For a discussion of the limited conditions under which economic sanctions are most likely to be effective, see Gary Clyde Hufbauer, Jeffrey J. Schott, and Kimberly Ann Elliott, *Economic Sanctions Reconsidered*, second edition, revised, Washington, D.C., Institute for International Economics, 1990.

ing rights to both domestic and foreign-funded enterprises within three years of WTO accession and full enforcement of multilateral rules for intellectual property protection immediately upon accession.<sup>15</sup> In addition, they have made substantial commitments on customs valuation procedures and statutory import inspections.

Unfortunately, just as China has evinced some willingness to take meaningful steps toward WTO membership, and just as its other trading partners, especially Japan, are beginning to signal their desire to expedite the process, a growing number of China critics in the United States are proposing to slow China's accession to the WTO, either by attaching new membership conditions relating to China's behavior in non-economic areas such as human rights or by requiring Congressional ratification.

Such proposals are misguided. Instead of threatening to impede China's bid for WTO membership, we should indicate up front and credibly that we will facilitate it, provided that China meets the necessary and normal commercial conditions. Both U.S. commercial interests and the basic goal of fostering the emergence of a rules-based system in China would be well-served by China's membership in the WTO under these conditions. Once China joins the WTO, it would be subject to a comprehensive system of multilateral rules and legal precedents and enforcement procedures. Moreover, WTO accession on commercial terms would promote continued economic reforms by committing the Chinese government to concrete market-opening measures on a specific timetable.

The conclusion that emerges from the foregoing analysis is a straightforward one. Our commercial relations with China are not just good for China, they are good for us. They are not just good for the interests of our large multinational corporations, but also for a large and diverse set of American producers and consumers. And they are not just good for these commercial interests, but they are also our most effective means to realize our long-term goal of China's stable transition to a more open society. Revoking China's MFN status or impeding its membership in the WTO may seem attractive as ways of expressing our dissatisfaction with China's behavior. But ultimately both actions would prove to be self-defeating gestures that would neither improve the lives of the Chinese population nor serve our long-term objectives.

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<sup>15</sup> These rules were codified in the Trade-Related Aspects of Intellectual Property Rights (TRIPS) agreement of the Uruguay Round.

# ALTERNATIVES TO REVOKING MFN FROM CHINA

*Douglas H. Paal*

No weed in any garden emerges with greater persistence or more frustrating consequences than our annual national debate over whether to extend normal trading relations with China (known as MFN, or most-favored-nation trade status). Every spring the President is required to affirm the weed's existence, to note that the denial of MFN would harm relations with China to an unacceptable extent, and to offer measures to show critics of the trading relationship that normal trade relations can be turned to good advantage in relations with China.

To use a gardening metaphor for the annual MFN debate is not to trivialize the issues, but to point to the need to get around the frustrating terms in which the debate is framed. It is unfortunate that members of Congress find themselves, year after year, offered only a clumsy, all-or-nothing vote on whether to continue normal terms of trade with China, or to deny MFN and thereby express disapproval of Chinese behavior, mistrust of Chinese intentions, or discontent with the incumbent Administration's management of Chinese affairs.

It is true that U.S.-China relations are deeply troubled, and that they are likely to remain so for the next quarter century, if not beyond. There are so many lists of these troubles that it would be redundant to repeat them here. Just examine any of the major American journals, emanating from left, right, and center, and the issues are amply detailed. Moreover, the U.S. Administration regularly repeats its laundry list of concerns, lest anyone actually begin to form a more upbeat picture of the historical trends than the current snapshot of relations may offer.

The contention of this essay is that although many real problems bedevil our relations with the Peoples Republic of China (P.R.C.), there is more cause for optimism than pessimism. Nevertheless, we cannot rely on long-term mood swings anymore than we should rely on short-term ones. The United States should draw lessons from both the positive and negative experiences of past and contemporary dealings with China, and move to pragmatic steps that will increase the chances of a positive-sum relationship with the P.R.C.

## **The Ledger: Positives and Negatives**

Space does not allow a complete cataloging of the constructive improvements produced by China's internal reforms and opening to the outside world. The China that greeted President Nixon during his historic visit twenty-five years ago was without freedom for virtually all of its citizens. Even the few leaders at the apex of society that may have enjoyed some degree of willfulness could hardly have been called free.

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Douglas H. Paal is President of the Asia Pacific Policy Center in Washington, D.C. He was Special Assistant to Presidents Bush and Reagan for National Security Affairs and was Senior Director for Asian Affairs on the National Security Council.

Two decades of reform at home and increasing interdependency abroad have brought a remarkable, though far from complete, degree of freedom. In terms of freedom from scarcity and the opportunity to make individual choices about education, career, spouse, and associates, China is much freer than it was. Foreign journalists can report critically and even erroneously without significant retribution, though they are not completely free to move about without caution. Military officers can joke in private about their leaders and still be promoted. To some degree, these measured, limited, but significant improvements are due to the willingness of the United States to keep the door open for trade and educational and cultural exchange. To close the door by discarding normal trading status for China would retard these tendencies to a degree that would probably not be acceptable to the American people over time.

Perhaps the best indicator of China's potential for an improved future, however, is the inevitable, if gradual, generational change that awaits. Behind every tedious bureaucrat can be found a younger, more open successor who knows that China's future best lies in interdependency and cooperation, not confrontation or retreat into a false autonomy. Raised in a culture that reveres elders, suspects upstarts, and experienced a tragic clash at Tiananmen Square, these successors are generally more patient than their counterparts in the United States, but they are there.

While a greater degree of freedom is allowed for ordinary Chinese seeking ordinary lives, many restrictions remain for those who seek higher levels of political and organizational freedoms. Since 1989, and even more intensely recently, the Chinese regime has worked to root out all forms of autonomy for groups that potentially could challenge the weakened authority of the Communist Party.

The tremendous economic vitality and cultural reawakening of China have sparked impulses in society to create interest groups, based on everything from technologies to trade unions to religion, that need not be dependent on the state. This trend towards a plurality of institutions is the forerunner of possible, though not inevitable, progress in China from pretensions to totalitarianism, to less-stifling authoritarianism, to increasingly pluralist stages of social and political development.

Officially, Beijing shows every intention of preventing the growth of autonomy and the devolution of authority. In an ever more obvious display of its political weakness and lack of legitimacy, the Communist Party has ruthlessly imprisoned and suppressed anyone or anything that smacks of a potential to organize an opposition.

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*Beijing needs to come to realize that we have the determination to pursue our goals of greater freedom for the Chinese people, peaceful integration of China into the global community, and protection of our interests in the region and the world.*

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### **A Pragmatic Agenda**

So how might the United States replace this annual MFN debate in order to help the Chinese themselves increase civil and personal freedoms, as well as to deal with acknowledged problems in the arenas of trade, human rights, and regional and global security? What can the Administration and Congress do to amplify the impulses in China toward constructive change?

First, we need to remind ourselves that China is a huge country of 1.2 billion people with enormous internal differences in development, deep divisions over its role in the region and the

world, justified and mythologized grievances toward the outside world, and a strong culture that can adapt, but often with great difficulty. Thus, any policy toward China should be pursued in a long-term context. As we look back and see progress over the past twenty-five years, so we will want to measure the results of policy against the next twenty-five years. Shorter time horizons will only lead to frustration and failure.

Nevertheless, long-term policies are the accumulation of many short-term actions. Successive U.S. administrations need to remind the American and Chinese people of our long-term goals repeatedly and explicitly, both to sustain a domestic consensus through ups and downs in relations and to create a context in which China will find American behavior for the most part predictable. Beijing needs to come to realize that we have the determination to pursue our goals of greater freedom for the Chinese people, peaceful integration of China into the global community, and protection of our interests in the region and the world.

In this regard, the second requirement for the Clinton Administration is to come out of the shell into which it seems to have retreated since allegations surfaced of questionable Chinese and Asian donations to the Democratic National Committee. A line needs to be drawn between unethical or illegal behavior, which should be dealt with in Congress and the courts, and national policy, which should stand on its own merits.

The Administration should not simply repeat its mantra of hopes and concerns about China, as Secretary Albright did at Annapolis in May, but begin to argue for a tough-minded policy toward China, as House Speaker Gingrich forthrightly did on his helpful visit to China, Hong Kong, and Taiwan this spring. The situation requires a forceful presidential speech on China policy. The policy it outlines should be neither as confrontational as the first two years of the Clinton Administration nor as supine as the second two years. The United States needs to walk on two legs with respect to China: one of genuine cooperation, the other of caution and military preparedness.

An important indicator that the Administration is working to develop sound policy is the nomination of key officials responsible for the Asia Pacific region. Even with capable and available talent waiting for the nod, the White House delayed nominating an assistant secretary of state for East Asia and the Pacific for four months, suggesting to the leaders of the region a lack of seriousness about the challenges that China and the region pose.

A third pragmatic proposition offers an alternative to the Administration getting its act together. Both Democrats and Republicans can agree in private despair over this Administration's lack of self-confidence in foreign affairs, especially regarding China and Asia, where none of its top officials has had significant day-to-day experience.

As an alternative to voting against MFN for China, which hurts U.S. interests as much as Chinese, the Congress can vote to establish a special envoy for China, Hong Kong, and Taiwan affairs, on the model of Richard Holbrooke's role in the Bosnian settlement or Dennis Ross's position in the Middle East. The Administration appears unprepared to appoint such an envoy, so Congress can step in with its own legislative action. By doing so, Republicans in the Congress could express their mistrust of an Administration "tainted" by allegations of questionable donations. Democrats could ensure that the Administration would be more responsive to their concerns than the current situation allows. Both parties could create a position that by legislative design would be more responsive to Congressional concerns, recognizing the reality that the initiative regarding China has already shifted by inattention from the executive branch to the legislative.

This concept may trouble constitutional experts, but the precedents exist. Indeed, many policymakers in the Administration have indicated privately that they would prefer this sort of

special envoy arrangement to continued drift and inattention. Candidates are few, but names such as retired Senator Sam Nunn or Ambassador to Indonesia Stapleton Roy likely would receive enthusiastic endorsement.

These days, eyes are focused more on Hong Kong than other issues in the China relationship. A special envoy is needed to present America's interests in the outcome of the Hong Kong transition to China's leaders, to explain those interests to the American people, and to chart a long term course of policy.

In two or three years, when Hong Kong has passed through its transition, there is every reason to expect a return of tensions to the Taiwan Strait, similar to those experienced in 1995 and 1996. A second presidential election there may well produce a leader from the Democratic Progressive Party, which has openly endorsed Taiwan's independence, against China's fiery opposition. The relationship between the P.R.C. and Taiwan has been periodically tense and is capable of leading to limited conflict and possibly even regional war. As in the Middle East, it is now becoming clear that a "peace process" of some sort is needed to keep China and Taiwan talking and not fighting. A special envoy would be in a position to start a process that promotes greater dialogue under U.S. auspices.

Fourth, the growing U.S. trade deficit with China, despite many statistical faults, points to a disturbing trend. China's exports to the United States continue to rise, and U.S. exports to China remained essentially flat in 1996 and early 1997. Beijing says this is due to statistical accounting differences, U.S. restrictions on high technology transfers, and structural differences in the two economies.

The Chinese may be right that some U.S. technologies cannot be exported, such as nuclear power equipment, until China more fully complies with international standards in the area of nuclear proliferation.<sup>1</sup> It is true there are statistical quirks that overestimate the Chinese surplus. And structural differences do lend China an opportunity to export low level manufactures to the United States. But it is also true that commercial opportunities ranging from sales of civilian jetliners to licenses to sell insurance are being held hostage to Chinese government efforts to pressure Washington into more accommodating positions on issues such as human rights. It is clear that in order to obtain orders for thirty French jetliners, France in 1997 sold out the European Union's position on human rights in the P.R.C. by not supporting the annually proposed UN resolution condemning human rights abuses.

Even though occasional international tawdriness in the interest of a better deal can be overlooked, there are underlying areas of concern. Members of Congress have been frustrated, for example, that entities controlled by the Chinese military have been able to market their products in the United States, thus strengthening a potential adversary.

Unfortunately, the United States has precious little leverage to change the current situation in China without resorting to the drastic route of totally denying MFN trade status. It is therefore extremely important that an overarching deal be negotiated between China and the international trading community that would bring China into conformity with the rules of the World Trade Organization (WTO).

Finally, Congress has the opportunity to create a National Security Super 301 Section Amendment to the Trade Act to remedy the United States' lack of leverage against China and other trading states. As Congress moves this year to approve, as it should, continued normal trade

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<sup>1</sup> Although China has made greater incremental progress toward compliance than is generally acknowledged, its cooperation in the nuclear field with Pakistan and Iran remains a matter of concern.

status for China, it can at the same time create a new authority for the President to take action against trading partners such as China when they employ nontariff, policy-based barriers to U.S. trade. This would add to other congressionally mandated authorities on the books to sanction Chinese behavior in the areas of chemical weapons and missile sales. If, for example, Beijing continues to hold aircraft sales hostage to a warm reception for China's leaders in Washington (where the welcome is not likely to be very friendly) the President, with the support of or pressure from Congress, could identify Chinese corporations or entities with whom trade can be found to be not in the national interest of the United States, and thus liable to higher tariffs.

This authority would be consistent with America's interest in establishing a level playing field with China and other abusers of the international trading system. At the same time, it provides added incentive for China to come to terms with U.S. negotiators in the run-up to admission to the WTO, which is a stated goal of U.S. policy. That goal had been undermined by the Uruguay Round negotiations that inadvertently gave China preferential tariffs despite the fact that China had not yet entered the WTO. China now enjoys the same, lower tariff levels on its exports that WTO members enjoy, despite not yet having agreed to enter the WTO. On a case by case basis, the President and Congress could raise tariffs back to pre-1995 levels to give incentive to China's exporters to meet the WTO's terms.

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In sum, the intellectual framework for U.S.-China relations must be long term in nature. It requires measurement of progress against decades rather than months. It also requires presidential leadership with capable assistants. Failing that, success demands the appointment of a congressionally responsive special envoy within the executive branch. With or without an envoy, the President would profit from new authority to sanction trading partners who introduce non-trade factors into commercial relationships, as President Clinton clumsily did in 1993 when he linked trade and human rights in China. Step-by-step, better relations with China are possible on a pragmatic, long-term basis. Maintaining China's MFN status is the only basis upon which more constructive policy will be possible.