

Stopping China's Mercantilism: A Doctrine of Constructive, Alliance-Backed Confrontation

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China's systematic mercantilism is a threat to the U.S. economy and the very soul of the global trading system. America cannot respond with either flaccid appeasement or economic nationalism; it must assemble an international coalition that pressures China to stop rigging markets and start competing on fair terms.

There is a growing understanding that China is an outlier when it comes to global norms and rules governing trade, investment, and economic policy, and that the unremitting and even accelerating "innovation-mercantilist" behavior on the part of the Chinese government represents a threat not only to the U.S. economy, particularly its advanced industries, but indeed to the entire global economic and trade system. The previous three U.S. administrations sought engagement and dialogue with China's leaders, in the belief and hope that this would lead the Chinese government to retreat from its mercantilist path. It should by now be clear that this approach has failed. For, rather than reform, China has doubled down on its innovation-mercantilist strategies, seeking global dominance across a wide array of advanced industries that are key to U.S. economic and national security interests. And despite the claims of some apologists for Chinese behavior, it's clear what the end game is: Chinese-owned companies across a range of advanced industries gaining significant global market share at the expense of American, European, Japanese, and Korean competitors. A far more proactive, whole-of-government response, in tight partnership with our allies, is needed to ensure that Chinese innovation mercantilism is contained and then rolled back and a genuine market- and rules-based global trading system restored.

Unless U.S. policymakers want to blithely accept Chinese innovation mercantilism and the damage

it inflicts on the U.S. economy and its advanced industries as beyond their control, it's time for a new approach that moves beyond the naïve push for further dialogue and instead makes it clear to Chinese leaders that such unfair, harmful policies cannot be practiced with impunity. But this fight cannot be about individual tactics, for the Chinese government has shown itself to be quite adept at abandoning certain tactics when they become discredited due to global pressure, only to adopt new and more effective ones in service of its overall mercantilist strategy. The focus needs to be not just on tactical wins, but on more broadly enlisting the global community to help roll back the entire Chinese innovation-mercantilist enterprise and getting China to finally become a responsible player in the global trading system. As such, the Trump administration has a unique opportunity to work with our allies to press Chinese leaders for a fundamental economic policy reset that will move the world economy back toward the rule of law and market-based policies.

However, to succeed, a new approach to U.S.-China economic and trade policy from the U.S. government will need to be pursued with great care and sophistication. The Chinese government is not without weapons, and it has demonstrated a strong willingness to use them to fight back against legitimate efforts to try to get it to stop manipulating the global trade system. And because of the lack of rule of law in China, the Chinese government could very well use its powers to capriciously punish U.S. firms producing or selling there. But doing nothing due to the fear of retaliation should not be an option.

As such, the Trump administration needs to make crystal clear that any such strategy is based not on punishing China nor seeking to hold it down. Indeed, it is in America's interest to have China rapidly increase its citizens' per-capita incomes. The administration also needs to make clear that the strategy is not based on making America great again or putting America first, but rather that it is based on saving the global trading system by restoring it to a rules-based one. In essence, the Trump administration should make clear that it is acting more "in sorrow, than in anger," and that any punitive actions are temporary, only in place until the Chinese government makes needed reforms.

Further, the time when unilateral U.S. action alone would suffice has gone. The last time that was perhaps possible was in the first few years of the Obama administration when the United States possessed enough leverage to press China on its own. But after at least two decades of unrelenting mercantilism, China is no longer as dependent on the United States economically, and thus our leverage acting alone is more limited. As such, any action toward China needs to be articulated through a strong and unified coalition, particularly with nations such as Australia, Canada, Germany, Japan, South Korea, the United Kingdom, and the European Union. All of these economies have been harmed by Chinese mercantilism and are even more likely to be hurt going forward as China ramps up its strategy of innovation mercantilism to obtain global technology leadership. And that means the focus of Trump administration trade policy complaints should be focused first and foremost on China, not on other nations such as Mexico, Germany, and others which may run trade surpluses with America, but are generally playing by the rules and should be our natural allies in this confrontation with China, not antagonists.

Perhaps the single most important strategic factor to guide the Trump administration's policy

toward China should be to differentiate between protectionism and prosecution. In other words, enforcement should be used to contest Chinese protectionism that is affecting the global trade system, not simply as a tool to make the United States more competitive or to provide shelter to certain parties from the rigors and turmoil of global competition. This may sound like a semantic difference, and indeed, most in the Washington trade establishment refuse to accept the difference—seeing both as “protectionism”—but there is in fact a difference, and it’s a critical one. In this sense, it’s hard to see how the relatively modest Mexican trade surplus is the result of mercantilist Mexican policies and easy to conclude that the threat of tariffs on Mexican imports represents nothing more than U.S. protectionism. In contrast, the large trade deficit with China results from its mercantilist policies that regularly violate the spirit, and in many cases the letter, of World Trade Organization (WTO) rules. Since 2002, the United States has accumulated a goods trade deficit with China of over \$3.5 trillion, and trade with China alone accounted for about 50 percent of the U.S. trade deficit in goods in 2016. As such, tough action in return, even so-called “protectionist” policies, are justified. But again, the goal here is not permanent “protectionist” policies against China but rather an array of policies used as tools to pressure China into significantly reducing, and ultimately eliminating entirely, its use of mercantilist policies. Should China do that, the U.S. economy should remain open to China’s enterprises and to robust trade and investment between the two nations. Indeed, the United States should pursue a “selective” prosecution: China should be rewarded when it plays by the rules and progress is visible, but be met with resolute action where it does not play by the rules. Blanket, punitive trade taxes against China will not prove productive; U.S. strategy in response to China’s mercantilism will have to be more nuanced.

A U.S.-China economic and trade relationship that evolves according to equitable, rules- and market-based trade, with both nations competing by implementing constructive innovation- and productivity-enhancing policies, will produce win-win-win results for the United States, China, and the rest of the world. To be sure, it’s in the world’s interest for China’s economy to grow and for Chinese citizens to enjoy a significantly higher standard of living, but China should achieve this outcome within the boundaries of the rules set for international economic competition by the WTO and by pursuing an across-the-board productivity growth strategy (e.g., where it seeks to grow productivity in all industries, not just export-based ones), not an innovation-mercantilist growth strategy. But if China continues to compete substantially through the use of innovation-mercantilist policies, this will inflict significant damage on the U.S. and the global economy, forestalling global innovation progress in the process.

As such we advocate that the Trump administration, supported by Congress, acknowledge the following:

- Recognize that while the United States has trade disputes with many nations, the vast majority of critical issues concern one and only one nation: China. China is so large and its innovation-mercantilist practices so egregious and all-encompassing that it should be the principal focus of U.S. trade enforcement policy. Moreover, prevailing upon China to reduce its use of innovation-mercantilist practices will relieve pressure on other nations, such as

Indonesia, Malaysia, Vietnam, and even India, whose policymakers believe they have no choice but to keep up with China and to emulate its unfair trade practices. It will be of central importance not to get distracted by disputes with other nations of significantly less strategic importance.

- Embrace a realistic, clear-eyed understanding of China’s economic strategy. As it stands, that strategy is a fundamentally mercantilist one, which seeks to autarkically serve domestic markets through local production—including increasingly by developing China’s own high-tech, innovation-based industries even as it excludes foreign competition in such sectors—all the while still maintaining unfettered access to global markets for exports of Chinese products.
- Recognize that—as articulated initially in China’s “National Medium- and Long-Term Program for Science and Technology Development (2006-2020),” and more recently in the “Made in China 2025 Strategy” and the “13th Five-Year Plan for Science and Technology”—China seeks leadership in over 400 advanced technologies, from semiconductors, high-performance computers, and cloud computing to aerospace and biotechnology. When China pursues innovation-mercantilist policies—such as the acquisition of foreign technology enterprises leveraged by nonmarket, government-backed funds; forced transfer of technology or intellectual property (IP); IP theft; abuse of antitrust/antimonopoly policy; denial or restrictions of foreign firms’ access to Chinese markets; development of China-only standards; massive subsidies for Chinese firms; refusing to allow access to key resources (e.g., rare earth elements) unless companies locate in China; or any number of other unfair trade practices—such policies directly threaten the health and very viability of American (and other foreign) enterprises and thus need to be contested in the most vigorous manner possible by U.S. government agencies with enforcement power, whether under U.S. law or pursuant to international agreements.
- Steadfastly hold China to the commitments it made when it joined the community of trading nations in the World Trade Organization. This means not only adhering to the technical rules of the WTO, but in all instances abiding by the fundamental free-market tenets on which the WTO is based: those of national treatment, nondiscrimination, reciprocity, and transparency.
- Adopt a policy of “constructive, alliance-backed confrontation” with China that moves from legalistic or “meeting-by-meeting” engagements with China to a results-oriented one. This should entail holding China to specific goals, such as significantly reducing its global current account surplus and reducing its forced technology transfer and IP theft, as well as procedural goals, such as securing results demonstrating a shift from predominantly export-led growth to growth generated chiefly by raising productivity in the country’s non-traded (e.g., non-export) sectors. An approach that systematically addresses the fundamental problems is needed instead of contesting individual measures, because Chinese innovation mercantilism has proven hydra-headed: For every one policy effectively countermanded, two more appear.

- Take a “whole-of-government” approach to confronting Chinese innovation mercantilism. This means that the United States Trade Representative (USTR) plays a key strategic and convening role, but that agencies across the federal government, including the Department of Commerce, the State Department, the U.S. Patent and Trademark Office (PTO), and others are empowered and enrolled with their distinctive strengths and capabilities to play a greater role in countering the threat.
- Recognize that Chinese economic policy has tremendous implications for U.S. national security beyond U.S. economic competitiveness through the vitality of the U.S. industrial base, the security of components which pass through defense industrial supply chains, and the ability of U.S. economic strength to finance a robust national security and defense apparatus.
- Recognize that the United States must continue to take the leading role in shaping the rules guiding a liberalized international trade system and that this means completing even higher-standard trade, investment, and other multilateral international agreements. If the Trans-Pacific Partnership Agreement (TPP), the Trade in Services Agreement (TiSA), and the Transatlantic Trade and Investment Partnership Agreement (T-TIP) can be improved upon and completed, this would serve U.S. interests. In contrast, a failure to complete and to implement next-generation trade agreements that establish higher-standard rules, principles, and norms for market-based global trade will only cede the terms and structure of global trade to Chinese leadership. It’s imperative the United States seek alliances and build next-generation trade deals with countries that are committed to the rule of law and principles of rules- and market-based trade.
- Ensure much better access to China’s market on fair terms, so that U.S. enterprises and industries (along with those of other foreign countries) have every opportunity to be competitive global players in the sectors in which they compete.
- Seek ultimately a win-win economic and trade relationship with China grounded in the framework of rules-based, market-determined, enterprise-led trade activity. This needs to be achieved with the assistance of like-minded allies to make this outcome a reality.

To realize this broad vision, however, the United States needs a new approach supported by improved strategic positioning, organizational improvements within the federal government, stronger processes, new policies, and new administrative and legislative actions. This should include the following:

Improve Strategic Positioning

- The Trump administration needs to adopt a new strategic direction for trade. It should:
- Lead a reinvigorated and reformed market- and rules-based global trading system, working in close collaboration with like-minded countries. This should include not only administration-to-

administration cooperation, but also legislative-to-legislative cooperation.

- Work with our allies to create and maintain a comprehensive “bill of particulars” on Chinese innovation-mercantilist policies and practices, and decide which elements can be brought to the WTO for action and which need new rules.
- Develop new and improved rules that fully address Chinese innovation mercantilism, and agree to pursue implementation of them with like-minded countries. Reevaluate the effectiveness of existing trade institutions in confronting Chinese innovation mercantilism, building new trade agreements and institutions as needed.
- Make sure any agreements with China include these new rules, and complete agreements with China, such as a Bilateral Investment Treaty (BIT), only after China complies with its existing trade commitments and is prepared to bind itself to new rules that prohibit its mercantilist proclivities.

Improve Organizational Arrangements Within the Federal Government

Any new strategy will not be fully effective without organizational reforms within the U.S. federal government. To achieve this, the Trump administration or Congress should:

- Establish an Industrial Intelligence Unit within the National Intelligence Council.
- Create a sub-directorate within the National Security Council responsible for raising to the highest levels of U.S. government the need to develop and coordinate a whole-of-government response to combatting foreign innovation mercantilism.
- Create an Office of Competitiveness within the United States Trade Representative’s Office, whose job it would be to identify, in collaboration with the interagency trade task force, foreign government policies and practices that do not necessarily violate the WTO but that hurt U.S. commerce. Staff and resource this new office with economists with sectoral industry expertise, lawyers, and other professionals who understand the legal implications of China’s mercantilist practices, and make it a key task for a deputy trade representative to closely supervise this work.
- Staff and resource USTR and other federal agencies playing an important role in confronting Chinese innovation mercantilism to reflect the scale and importance of their duties. Ensure adequate funding and staffing for the Interagency Center on Trade Implementation, Monitoring, and Enforcement (ITEC) and those working under the Assistant U.S. Trade Representative (AUSTR) for Monitoring and Enforcement.
- Expand America’s network of intellectual property and digital trade attachés around the world.
- Inculcate a more tech- and IP-focused foreign commercial service and Patent and Trademark Office, in particular with staff that can help U.S. enterprises identify opportunities to license greater amounts of IP or technology on legitimate, market-based terms, in China.

Establish Stronger Processes to Contest Chinese Innovation Mercantilism

Organizational reforms will need to be accompanied by new approaches and processes responding to China's innovation-mercantilist policies. To do that, the Trump administration or Congress should:

- Ensure that free trade agreements (FTAs), BITs, and other agreements have new and improved rules that address Chinese innovation mercantilism. These would include looking at stronger performance requirements for goods, services, and investment; rules on competition/unfair government practices (e.g., against governments involved in setting licensing fees for standards); more vigorous transparency requirements (for China covering their “normative documents”); stronger national treatment requirement for IP; etc.
- Elevate trade enforcement in the interagency process.
- Permit USTR to hire outside counsel for WTO disputes, as many countries (such as China) do, particularly for more technically complex matters.
- Strengthen the rules of engagement in negotiations with Chinese trade negotiators.
- Bring more trade disputes before the WTO.
- Task USTR with considering development of a non-violation nullification and impairment case, given that many Chinese policies undercut the benefits and rights the United States thought it was getting when it allowed China to join the WTO.
- Improve monitoring and transparency regarding China's WTO-contravening industrial policies (such as subsidies), making up for Chinese failure to provide timely notification to the WTO of such policies.
- Revise and use discretionary powers under the U.S. Trade Act to address unfair trade practices.
- Enhance application of Section 337 of the U.S. Tariff Act and develop a strategy to counter possible Chinese retaliation from increased use of this instrument.
- Permit the U.S. International Trade Commission (ITC) to issue Trade Enforcement Advisory Opinions.
- Encourage the ITC to examine and make findings regarding the impact/threat of unfair mercantilist practices on U.S. commerce, and exclude foreign products, services, and technologies that benefit from such policies.

Rethink Key Policies Toward Contesting Chinese Innovation Mercantilism

A number of key policy areas, such as antitrust and foreign investment review, need to be rethought as they apply to China. As such, the Trump administration or Congress should:

- Push back against China's use of antitrust policies as a tool of industrial policy and take into

account competitiveness impacts in antitrust policy.

- Pass legislation that allows firms to ask the Department of Justice (DOJ) for an exemption to coordinate actions regarding technology transfer and investment to nations like China.
- Ensure reciprocity in intellectual property and technology licensing.
- Insist on reciprocally equivalent access and treatment regarding foreign direct investment.
- Reform the Committee on Foreign Investment (CFIUS) to reflect the realities of modern state-led capitalism and if necessary require separate investment reviews for investment from state-directed economies.
- Protect and retain U.S. comparative advantage in advanced-technology industries by passing legislation requiring notification to the U.S. government on a confidential basis of technology licenses to China and of transactions in China in which the Chinese government or Chinese government-affiliated entities are involved.
- Address Chinese currency manipulation.

Take Additional Administrative and Legislative Actions

Finally, there are a number of specific changes and actions the administration should push for. As such, the Trump administration and Congress should:

- Increase number of fact-finding investigations initiated by the U.S. International Trade Commission to include investigations related to issues such as licensing, antitrust, and indigenous innovation.
- Task the Department of Commerce with issuing more reports on strategic economic and trade issues.
- Deny use of the U.S. banking system to companies benefitting from stolen IP.
- More closely coordinate domestic IP actions with foreign actions, such as by targeting companies or regions in China that engage in widespread IP theft for criminal enforcement actions and significantly increasing inspections of Chinese imports by U.S. customs.
- Provide enhanced small-claims mechanisms for small- and medium-sized enterprises to bring IP actions against importers and overseas manufacturers stealing their IP, including under the Defend Trade Secrets Act.
- Provide technical assistance and support for companies retaliated against in China for bringing trade complaints.
- Continue not to recognize China as a market economy and amend U.S. trade law to reflect that nonmarket economy status includes state planning and control over intellectual property and technology.
- Adjust, curtail, or cut off scientific and other cooperation in the absence of progress on Chinese mercantilism and insist on reciprocity in treatment of technology transferred so that

the U.S. government can own improvements in any joint technology agreement.