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International trade: China must be pushed to play by the rules

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Scott Morrison is right: no one would gain were the trade conflict between the US and China to escalate. But he is also right that difficult issues must be addressed if an open trading system is to survive.

At their heart is China's ongoing refusal to play by the rules.

To say that is not to suggest that China is alone in that respect. However, China's sheer size and the tightness of its integration into the international economy mean that its behaviour now has a disproportionate impact not only on world markets but also on public opinion.

Moreover, the fact that China presents both a far-reaching economic challenge to the advanced democracies and an even more far-reaching geopolitical threat compounds that impact, while creating the risk of a vicious spiral in which a trade policy breakdown fuels the geopolitical conflict, pushing the situation to the brink.

The problems arise, at least in part, from the decision to allow China to join the World Trade Organisation in 2001 even though it was still far from completing the transition to a market economy.

The decision was entirely political: China's accession to the WTO, it was assumed, would give the transition added impetus, while also promoting democratisation. As the best way "to integrate China further into the family of nations", US president Bill Clinton declared, accession would have "a profound impact on human rights and liberty", while George W. Bush, then running for president, claimed it would infuse "habits of liberty" and arouse "expectations of democracy".

That those expectations were unrealistic — not merely politically but also on the trade front — soon became apparent.

The initial flashpoint centred on China's exchange rate. The Chinese authorities' decision in the mid-1990s to peg the yuan to the US dollar was relatively uncontentious; however, it became the source of serious imbalances once the dollar began to depreciate in 2002. The yuan's value should have increased sharply as productivity levels in China rose. Instead, the Chinese authorities ensured it sank with the US dollar.

The resulting undervaluation of the yuan made Chinese exports extraordinarily competitive, allowing them to more than treble between 2003 and 2008 alone. By 2016, when the undervaluation was finally corrected, Chinese firms had not just become substantial players in a broad range of industries but had severely weakened their foreign rivals, entrenching the market shares that the yuan's misalignment had helped them acquire.

However, far from bringing market-distorting interventions to an end, the currency appreciation merely led to a change in their form.

In particular, as the rising value of the yuan placed pressure on domestic producers, government subsidies skyrocketed, notably to industrial businesses that were publicly owned. Up to 2012, those businesses were more or less able to cover their costs; after that, however, their profitability collapsed, so that by 2016 more than 40 per cent were loss-making.

But large losses didn't force them to retrench, as should have happened. Instead, generous public support made it possible for them to engage in breakneck expansion, with the assets of state non-financial firms quadrupling between 2008 and 2016 to a level more than twice China's GDP.

Significantly, the handouts didn't stay in those firms' pockets: rather, some of them went to -finance overpayments to favoured private providers of inputs and undercharges to favoured private purchasers of their outputs.

There was consequently a sizeable, but inherently opaque, subsidy to the best-connected, and often most corrupt, firms in the private sector, bolstering their export competitiveness.

Nor did the distortions end there. For example, China is two to four times more restrictive than the advanced economies in terms of permitting foreign companies to compete in areas such as banking, insurance, telecommunications and transport and logistics.

The result has been to shelter domestic suppliers of those services from competition — which, in turn, has allowed them to indirectly subsidise major suppliers. Whether firms such as Huawei and the China Railway Rolling Stock Corporation would otherwise have risen, in barely a decade, from insignificance to dominating the world market is questionable.

That those firms have also benefited from preferential public procurement, both within China and in the Belt and Road Initiative, has only made the distortions to world trade all the more severe.

Unfortunately, there is no reason to believe any of those market-distorting interventions are being wound back.

Rather, as President Xi Jinping put it in his speech to the 19th party congress in 2017, the Chinese Communist Party has every intention of maintaining its unwavering "support (for) state capital in becoming stronger, doing better and growing bigger". With Xi repeatedly stressing the nexus between the party's supremacy and the commanding role of the state sector, a more hands-off approach is not on the cards.

And even in the areas where the Chinese admit reforms are urgently needed — such as intellectual property protection and the judicial enforcement of contracts — progress has been glacial.

That obviously imposes economic costs. But every bit as harmful is its effect in undermining the legitimacy of the international trading system, especially, but not solely, in the US.

Support for that system was fragile even before China emerged on the scene: while congressional Democrats were as willing to vote for trade liberalisation as their Republican rivals throughout the period from 1950 to 1992, they veered towards protectionism in the wake of the North American Free Trade Agreement, leaving the GOP increasingly exposed to the charge that it was exporting American jobs.

But it was the shortfall between what was expected of China and what China actually delivered that ultimately made a continued commitment to the multilateral trading system politically unviable.

Barack Obama largely ignored the gathering storm, refusing to invest any political capital either in salvaging the Doha Round of multilateral trade negotiations or in securing congressional approval of the Trans-Pacific Partnership.

In contrast, the Trump administration, despite its bluster and missteps, has tackled the underlying issues head-on, not merely in its bilateral relation with China but also by making credible proposals for reform of the WTO.

However, with next year's elections looming, Donald Trump may well prefer a short-term deal — in which China promises to make "huge" purchases of American exports — to persevering with attempts at a durable solution.

Australia's interests are clear: they lie in securing a future for a multilateral, rules-based trading system. That means facing the blunt reality: a liberal world order cannot survive if it is constantly undermined by a deeply illiberal global power, as China now is.

If the US is willing to bear the costs required to get China on to a course consistent with its international responsibilities, Australia should be its staunchest ally.