[After Trump Series 2] Prospects for U.S.-South Korea Cooperation in an Era of U.S.-China Strategic Competition

U.S.-South Korea Cooperation in Confronting the China Challenge

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The problem

The U.S. and South Korea share a set of concerns with China's trade and investment practices, which in many instances are outside the norms of advanced economies. China likes to think of itself as a developing country, based on its per capita GDP, but it is the second largest economy in the world and the largest trading nation so that the U.S. and its partners like South Korea would like to see it move quickly to advanced country standards. The specific policies in question include extensive non-tariff barriers such as arbitrary and changeable standards; restrictions on foreign investment in some sectors, particularly in services; poor protection of intellectual property rights; forced technology transfer through various coercive means; extensive role in the economy of state-owned enterprises that have favorable access to land and credit; and subsidies to develop specific technologies.[1] The impact of these policies is to distort trade flows from what they would be in a more fully open environment. Bringing China up to advanced country norms would open new trading opportunities and raise American and South Korean incomes.

Aside from these practices that directly affect the U.S. and other advanced economies, China is also out of step on global norms for lending to poor countries, which will have important indirect effects on the global economy. China's belt and road initiative has been lending about $50 billion per year to developing countries, primarily to construct transport and power infrastructure. The initiative

[1] Wu, Mark. 2016. "The 'China, Inc.' Challenge to Global Trade Governance." *Harvard International Law Journal* 57 (2): 261-324.

has the potential to be beneficial as developing countries need this infrastructure. However, the Chinese loans lack transparency so it is hard to know which projects are financed and on what terms, and whether the overall amount for a particular country is leading to unsustainable debt. What is clear from available information is that the loans are mostly commercial.[2] With the COVID-19 pandemic and recession, many countries especially in Africa are falling into debt distress. China did join the G20 in calling for a debt service suspension this year for the poorest countries, but it is not a member of the Paris Club of official creditors so that providing further debt relief is going to be complicated and perhaps insufficient. While China is the largest official creditor to the developing world, private lending from international banks and bond holders has been even greater, complicating further the challenge of debt relief for poor countries.[3]

In the U.S. economic dialogue with China, macroeconomic issues have also been prominent. In the mid-2000s China was also out of step globally in that it had an undervalued exchange rate and a large overall trade surplus, the broadest measure of which is the current account. But this problem has been corrected; China's currency appreciated 35% since 2007, on a trade-weighted basis, and its current account surplus fell from above 10% of GDP to less than 1%. This macroeconomic success takes one issue off the table and demonstrates that it is possible through dialogue and incentives to bring China up to global norms.[4]

Within the category of IPR protection and forced tech transfer, a special concern for the U.S. and its allies is theft of technologies that have military applications. Any IPR theft from American firms makes us poorer; but theft of military technologies also undermines our security. Hence, special policies are needed to protect national security.

The Trump administration has attempted to address these issues but its China economic policy has completely lacked realism. The examples are endless: The administration imposed a 25% tariff on most imports from China, a tax paid by American consumers and firms, in order to get China to negotiate. This succeeded in bringing China to the table, but the U.S. side over-estimated how much leverage it had. U.S. trade is simply not that important to China anymore (it has more trade with ASEAN than with the U.S.). So, China was not willing to make sweeping structural reforms. It did agree to purchase more from the U.S., but the specific targets in the phase 1 deal proved also to be

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[2] Dollar, David. 2018. "Is China's Development Finance a Challenge to the International Order?" *Asian Economic Policy Review* 13(2): 283–298.

[3] World Bank. COVID-19: Debt Service Suspension Initiative, https://www.worldbank.org/en/topic/debt/brief/covid-19-debt-service-suspension-initiative

[4] Dollar, David. 2020. "China's Evolving Role in the International Economic Institutions," in Dollar, D., Y. Huang, and Y. Yao, eds, *China 2049: Economic Challenges of a Rising Global Power.*

unrealistic. As of mid-2020, China is only buying about one-half of what would be required to meet the targets.[5] This is partly because of the COVID-19 pandemic, but the experience shows the failure of managed trade with China.

The U.S. policy also showed a lack of understanding of how global value chains work. China has increasingly moved into the middle of value chains, producing medium-technology components and some machinery. Faced with the U.S. tariffs, some final assembly shifted to countries like Indonesia and Vietnam. But China's exports of machinery and components to those countries increased, so its overall exports did not go down. China's share of world exports in fact has gone up during 2020. The U.S. in turn has imported more from Southeast Asia, and there has been no decline in the overall American trade deficit. So, American consumers paid more but trade patterns did not change in any fundamental way. Trump's tariffs also did not succeed in bringing manufacturing jobs back to the U.S. His trade policy in fact led to a net loss of 175,000 manufacturing jobs.[6] The new Biden administration has an opportunity to craft a more consistent and effective economic policy vis-à-vis China.

South Korea has also been negotiating with China over more or less the same issues that concern the U.S. In 2015 South Korea agreed to a landmark free trade agreement with China, which lowered many tariffs, though not as far as the Korea-U.S. Free Trade Agreement. But South Korea and China were not able to agree on structural issues concerning trade in services and investment protection, including IPR protection. These issues were tabled for the future and are still outstanding. This is typical of China's approach of divide and conquer. Japan is also part of a three-way negotiation with China and South Korea. And South Korea and Japan are both part of the Regional Comprehensive Economic Program that China has recently signed with ASEAN and other Asia-Pacific partners. In all of these negotiations China's basic strategy is to negotiate down tariff rates so that China's manufactured exports can prosper while resisting agreements on modern issues such as IPR protection, services, investment, and cross-border data flows. Those latter issues are all important to more advanced economies like South Korea and the U.S., whose exports depend on IP, data, investment, and services.

Specific objectives of the U.S. and South Korea in Dealing with China

We would like to see China move as quickly as possible to developed-country norms for trade and

[5] Chad P. Bown. 2020. "US-China Phase One Tracker: China's Purchases of US Goods." Peterson Institute for International Economics. https://www.piie.com/research/piie-charts/us-china-phase-one-tracker-chinas-purchases-us-goods
[6] Econbrowser. 2020. Guest Contribution: "The Trade War Has Cost 175,000 Manufacturing Jobs and Counting". https://econbrowser.com/archives/2020/09/guest-contribution-the-trade-war-has-cost-175000-manufacturing-jobs-and-counting

investment. Specific features of this could include stronger penalties for IPR violations; redress mechanisms for firms that feel subject to forced technology transfer or other types of coercion; disciplines on state enterprises; and changes in laws and policies to make R&D subsidies WTO compatible. We will want to see this codified in various ways, and in particular to have provisions similar to KORUS. An agreement with China could be codified in a bilateral agreement between the U.S. and China, similar to what was envisaged for phase 2 of a trade deal. Ideally, similar provisions will be brought into the free-trade agreement among Korea, China, and Japan. If these different agreements have consistent treatment vis-à-vis key issues, this can be an effective way to discipline Chinese economic behavior. Similarly, if China and the EU successfully conclude a bilateral investment treaty that addresses sensitive issues, that too would be supportive of integrating China into the global economic system. Changes in Chinese policies will have even more force if they are included in larger agreements, and eventually in reformed WTO rules. A Biden administration can be expected to operate in a more multilateral fashion compared to President Trump, and that is likely to be more effective at changing Chinese trade practices.

We would like to see China more integrated into global economic institutions. China is a member of the IMF, World Bank, and WTO but not of the Paris Club. However, its weight in the IMF and World Bank (which are shareholding institutions) is far below what any reasonable assessment of its role in the world economy would dictate. The U.S. in recent years has resisted increasing the weight of China and other developing countries in these institutions. But recognizing their growing influence is necessary if we expect them to follow global rules and norms. The Paris Club may need to be renamed and relocated, but it will be important to get China and other emerging creditors into the club. The objective here is to bring Chinese development lending into line with global practices and to have China at the table when coordinated debt relief is necessary (as probably will happen with many poor countries hit by the pandemic and global recession).

We would like to sharpen and strengthen national security protections. The U.S. has the tools to restrict exports and inward investment for products that have obvious national security implications. The trick is to distinguish genuine concerns from bogus ones. We have been imposing a tariff on washing machines, for example, on national security grounds. We have also been imposing tariffs on our security allies, like South Korea, which makes no sense at all. The WTO provides wide latitude for countries to define their national security needs, but we invite abuse of the system when we abuse it. We are striving for what Hank Paulson has called, "small yards with high fences."[7] In other words, define a small number of national security technologies that get serious restrictions, but otherwise allow trade, investment, joint research, exchange of students and researchers – all of the foundations of an open innovation ecosystem. The U.S. needs to coordinate with alliance partners like South Korea on the definition of critical technologies and sanctions to protect them.

We would like to undo the mistakes of the Trump administration with as little damage as possible to the U.S. economy. One of the challenges of dealing economically with China in the next few years is that we start with a confused and unrealistic policy. We want to get rid of the tariffs which hurt American firms and consumers, as well as our allies. We want to move away from managed trade. We want China to play a larger role in global economic institutions, not a smaller one. We want to protect genuine national security concerns while removing the crude protectionism put in place in national security's name. Yet it is not a good idea to make all these changes on day 1. The poor state of U.S.-China economic relations is not just the result of the Trump administration. China bears responsibility as well for dragging its feet for years on needed reforms. The diplomatic challenge will be to negotiate the removal of U.S. protectionism in return for serious structural reform, and to do this in concert with our allies.

Recommendations

Negotiate away the import tariffs aimed at China in exchange for a phase 2 agreement that addresses the main structural concerns. The U.S. will have to be realistic; China is not going to completely change overnight and the U.S does not have that much leverage. But there are reformers in China who would like to make significant changes to non-tariff barriers, investment restrictions, IPR protection, state enterprises, and subsidies because these changes are needed for China to sustain reasonable growth. So, significant advance is possible.

Recognize that managed trade failed and that the purchase targets were unrealistic and will not be met. But send a strong message at the presidential level that we will be closely monitoring actual export flows. Given China's rapid growth and a more open economy, our exports should be increasing rapidly (in contrast to the decline of the last few years). We could consider an indicative range for expected growth of U.S. exports, but definitely discard the product-by-product targets.

Drop the talk about trade balance and the exchange rate. The level of the exchange rate is

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[7] Paulson Institute. 2019. "Remarks by Henry M. Paulson, Jr., on the Delusions of Decoupling." https://www.paulsoninstitute.org/press_release/remarks-by-henry-m-paulson-jr-on-the-delusions-of-decoupling/

reasonable. The bilateral trade balance is not important. China does not have a large overall surplus. The U.S. current account deficit has also come down a lot; if we are worried about it, then the solution lies in macroeconomic tools, not trade policy. (In particular, we would have to reduce consumption and increase savings; not really a political winner.)

Coordinate our China economic policies with South Korea and other allies. This will involve dialogue with the EU as well as with Japan and South Korea, to agree as much as possible on priorities for specific Chinese reforms. Ideally, the U.S. and South Korea will both rejoin TPP and that could become the foundational agreement for Asia-Pacific trade and investment. We should together push for new members (eg., Indonesia, other ASEAN countries, even UK). It will be in India's interest to join but that is not likely to happen quickly. In a truly ideal world TTIP would go ahead simultaneously and the two mega-agreements would set similar standards and policies. China would have to join these trade agreements or risk being left out. At the moment it is the U.S. that risks being left out in the Asia-Pacific region as RCEP and TPP proceed without it.

Negotiate with China over its role in the international economic institutions. For example, we could trade a fair weight for China in the IMF for it joining the Paris Club (relocating and renaming it should not be a big issue). Similarly, we could trade a greater weight for China in the World Bank for it joining the Development Assistance Committee and making its BRI loans more transparent and concessional, with competitive procurement for projects. The U.S. joining AIIB would also encourage China to do more through multilateral fora than through bilateral finance. The general point here is that if we want changes in Chinese behavior, we have to be willing to anchor them in a role in the international institutions commensurate with ours.

Finally, in the national security sphere we need to rationalize our policy. Slowing China's growth or killing Huawei are not realistic national security objectives. Huawei will be damaged by the U.S. sanctions but is likely to survive with less technological input from the U.S. China is likely to continue to grow at least moderately well, especially if it pursues the kind of opening moves recommended here. It does not have to do that well to catch up with the U.S. in terms of overall GDP by 2035 or 2040, since it has four times as many people. So, we are going to have to live with a large China that has a very different system from our own. Clearly, we need to protect technologies with national security implications through export and investment controls, coordinated with our allies. But if we define too widely the parts of the economy affected, then we cut off important dynamism. Most of the economy should be open to trade, investment, joint research, and student exchanges. The U.S. has enormous strengths in its labor force, universities, IPR protection, deep capital markets, and flow of immigrants. If there is a level playing field we can expect American firms and workers to do very well and to benefit from trade and investment with China.

Similarly, South Korea already benefits enormously from trade and investment with China since it is more technologically advanced and sitting right on China's doorstep. If Chinese markets for hi-tech products and services are opened wider, IP protected more thoroughly, and the subsidies and distortions in China's system wound down, South Korea will be one of the main beneficiaries. Hence South Korea and the U.S. have a strong mutual interest in coordinating on China economic policy, rather than being divided.

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