U.S.–China Trade Conflicts and the Future of the WTO

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INTRODUCTION

While many trade policy observers focus on signs of life from the Doha round of negotiations, arguably more important to the long-run relevance of the WTO is how the United States and China politically manage a number of currently ongoing formal trade disputes. The cases are likely to become political flashpoints not only because they involve major U.S. exporting industries such as Hollywood, music and other media, as well as the struggling automobile firms, but because a full process WTO trade dispute—that would include targeted and WTO-sanctioned U.S. threats of retaliation—would be China's first such experience in the limelight. We provide a road map of what to expect from both countries in this WTO process, and we also identify a number of new issues likely to confront Washington and Beijing along the way. While we do draw lessons from how countries have used earlier WTO disputes to manage tensions in bilateral relationships, we also pinpoint limitations as to what can be learned from these earlier episodes given the complexities of trading with China. The politics of handling these particular disputes is especially critical for the international trading system in the context of a global resurgence of protectionist pressures amid the deepening economic crisis.

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THE SIMMERING TENSIONS

The World Trade Organization (WTO) has reached a watershed moment in its history. Two major trading powers—the United States and China—are formally taking their bilateral trade skirmishes to Geneva. The United States has a number of formal WTO disputes against China now ongoing, China has responded by initiating a major dispute of its own, and all signs point to the two countries digging in for a lengthy battle. The political theater surrounding the disputes may be worthy of a front-row seat, because the most immediate likely occurrence of a full-process trade dispute—complete with potential WTO-authorized threats of U.S. trade retaliation—would be China's first such experience in the limelight. Thus, while many WTO observers are focusing on signs of life in the Doha round of multilateral trade liberalization negotiations, how the United States and China navigate the uncharted waters of this other WTO battleground may prove to be even more important to the future of the rules-based international trading system. It is necessary to underscore this importance given the current fragility of the international trading system amid a global resurgence of protectionist pressures due to the deepening economic crisis.

The currently built-up stock of ongoing WTO disputes between the United States and China is one legacy of the Bush administration. In 2006, and in response to increased political pressure by the U.S. Congress, Washington initiated the current U.S. strategy of using the judicial forum of the WTO to manage bilateral trade frictions with Beijing. In March 2006, Canada and the European Community (EC) joined the United States in the first dispute by challenging China's discriminatory treatment of imported automobile parts (*Auto Parts*). In February 2007, the United States and Mexico challenged China's system of subsidizing domestic industries (*Domestic Subsidies*). In April 2007, the United States initiated two complementary disputes over China's treatment of imported movies, music, and books—both Beijing's failure to enforce American intellectual property rights protection and its creation of regulatory hurdles that impede Hollywood film studios and other media and publishing companies from distributing these products within China (*Intellectual Property I and II*). In March 2008, the United States, EC, and Canada initiated a challenge to the way China regulated foreign firms like Bloomberg, Dow Jones, and Thomson-Reuters that sought to provide financial information services to consumers in its domestic market (*Financial Information Services*).[1]

TABLE 1. CHINA IN FORMAL WTO DISPUTE SETTLEMENT, 2002-2008*

DEFENDANT	PLAINTIFF(S)	ISSUE UNDER DISPUTE	YEAR INITIATED, RESOLUTION
CHINA AS DEFENDANT			
China	U.S.	Value-Added Tax on Integrated Circuits (*Integrated Circuits*)	2004, China agreed to amend or revoke the measures at issue
China	U.S., EC, Canada	Imports of Automobile Parts (*Auto Parts*)	2006, ongoing*
China	U.S., Mexico	Refunds, Reductions or Exemptions from Taxes and Other Payments (*Domestic Subsidies*)	2007, settled in December 2007 with China agreeing to remove subsidies at issue
China	U.S.	Protection and Enforcement of Intellectual Property Rights (*Intellectual Property I*)	2007, ongoing*
China	U.S.	Trading Rights and Distribution Services for Certain Publications and Audiovisual Entertainment Products (*Intellectual Property II*)	2007, ongoing*
China	U.S., EC, Canada	Measures Affecting Financial Information Services and Foreign Financial Information Suppliers (*Financial Information Services*)	2008, settled in November 2008 with China agreeing to eliminate discriminatory restrictions on foreign firms
CHINA AS PLAINTIFF			
U.S.	China, Brazil, EC, Japan, Korea, New Zealand, Norway, Switzerland, and Taiwan	Safeguard on Imports of Certain Steel Products (*Steel Safeguards*)	2002, U.S. removed safeguard in 2003 after adverse Panel and Appellate Body ruling
U.S.	China	Preliminary Anti-Dumping and Countervailing Duty Determinations on Coated Free Sheet Paper (*Coated Paper*)	2007, terminated when U.S. did not implement trade restriction after negative final injury determination
U.S.	China	Definitive Anti-Dumping and Countervailing Duties on Certain Products from China (*AD/CVD*)	2008, ongoing*

*Notes: *Through December 5, 2008.*

While Beijing's immediate political response to the initiation of each new U.S. dispute was the expected public denouncement, the Chinese government had to feel some initial relief with Washington's decision to use the WTO to mediate increasingly tense bilateral trade relations. The threat of U.S. unilateralism had been significant throughout most of the Bush administration tenure due to a Congress that repeated the same anti-China refrain—a massive and growing bilateral trade deficit, an undervalued Chinese currency that is alleged to subsidize exports, and accusations of weak enforcement of substandard environmental and labor regulations.[2]

There were many events that did nothing but add fuel to the political fire. In 2005, for example, the Chinese firm CNOOC attempted to acquire the U.S. oil firm Unocal and was rebuffed on the grounds of national security by Congress. The 2007 year was beset by an epidemic of product recalls and U.S. import bans related to China's exporters—due to claims of chemicals such as melamine and diethylene glycol discovered in pet food and toothpaste, lead paint found in children's toys, defective radial tires, and banned antibiotics applied to farmed seafood.[3] The first half of 2008 saw new topics seep into U.S.–China trade tensions—including the growing financial clout of sovereign wealth funds, the accumulation of foreign exchange reserves, and the threat that the United States would impose new border taxes to address failures to negotiate multilateral commitments to reduce carbon emissions and combat global climate change.[4]

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The scary item to note from this laundry list of U.S.–China tensions is that they all took place despite relatively *good* times for the U.S. economy and certainly well before the severe deepening of the financial crisis in the second half of 2008. Many expect U.S.–China trade frictions to only get worse in the face of an ongoing U.S. recession and worsening unemployment figures.[5] History provides many examples of how a bad domestic economy creates just the right conditions for politicians to shut off imports in a misguided and desperate attempt to save jobs.

Despite the fragility of the global economy and the risks it poses to the liberal international trading system, Beijing and Washington are unlikely to settle all of these (as well as any imminent) newly initiated U.S.–China WTO disputes without going through the formal WTO process.[6] For one, there is a tremendous amount at stake in terms of market

access, legal precedent, and politics. Second, each dispute requires many years of legal challenges and appeals that can be used to provide beneficial political cover to both sides. For the Obama administration, even simply continuing with the ongoing disputes that the Bush administration initiated will help diffuse some of the protectionist threat emanating from a Congress that is politically hostile toward China. Such a strategy could lead to tangible signs of Chinese reform "progress" that may be more difficult to negotiate in other settings. Third, it is not clear that the two indicators of greatest political concern to the Congress—the size of the bilateral trade deficit (still close to $250 billion for 2008) and the extent of renminbi currency revaluation vis-à-vis the dollar (appreciating since July 2005, but neither sufficiently quickly nor with sign of increasing market-oriented flexibility)—will see marked improvements anytime soon. Thus, Beijing also recognizes that if it were to settle the full complement of WTO disputes early, it would likely find itself the political target of new WTO disputes, if not something worse.

Given the current economic insecurities as well as the state of bilateral trade relations, are China, the United States, and the WTO *ready* for their frictions over auto parts, film, media, and intellectual property to be at the center of formal dispute settlement? In these WTO disputes, what starts as seemingly harmless legal maneuvering and argumentation often turns into political battles, threats, and legally-sanctioned implementation of actual retaliation, and media-fed worries of an all-out trade war. Successful use of the WTO's multilateral dispute settlement process to diffuse Washington-Beijing bilateral tensions is far from a foregone certainty. In order for the WTO dispute process to "work," both the United States and China need to act and react with political savvy and have an underlying, long-term commitment to the process and WTO system. Is China in particular sufficiently vested in the system? Is the system itself too vulnerable to hold up in such a politically sensitive and weak economic environment? As the history of formal dispute settlement reveals, a fully successful resolution to these and future disputes that the United States and China file against each other will involve dealing with some foreseeable, as well as many unforeseeable, pitfalls.[7]

The particular attraction to WTO dispute settlement is the potential for these legal disputes to not only diffuse political tension but also for their resolution to bring a "win-win" economic outcome to both sides—market access gains to U.S. exporters and reforms that enhance China's economic growth. Nevertheless, success is by no means a certainty, especially in the current international climate of such economic and political volatility. Missteps by either side through careless mismanagement of the

politics of the dispute resolution process could lead to stalemates and both sides becoming disenfranchised with the current rules-based trading system. Such an outcome would have serious consequences, as the WTO system needs both the United States and China to be confident and invested in the future of the institution.

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The bottom line is that we are in for some U.S.–China fireworks emanating from Geneva over the near term. There is value to a guide for what to expect along the way.

CHINA'S HISTORY IN THE WTO

While China is relatively new to the WTO—it formally acceded in 2001 as the Organization's 143rd member—it was actually one of the 23 founding countries of the 1947 General Agreement on Tariffs and Trade (GATT), the WTO's predecessor. In 1950, after China's communist revolution, the new government formally extracted China from the GATT and turned its economy inward. It was not until 1986 that China began formal negotiations to re-enter the rules-based multilateral trading system, and the most contentious and complex accession in the system's history was not completed until China was permitted to join the WTO in 2001.[8]

China's original desire to rejoin the GATT stemmed from several complementary economic interests. First, membership in the GATT/WTO affords a country nondiscriminatory treatment in trade relations—i.e., most-favored-nation (MFN) status—which would therefore put Chinese exporters on a level playing field with competitors in other countries, at least in terms of the import-restricting tariff policies they face.[9] Second, many countries have used the GATT/WTO as an opportunity to take on their own commitments to reform policies. For example, a commitment by Beijing to limit its own use of tariffs may be like medicine—while ultimately good to do unilaterally, vested domestic interests may make such a policy commitment difficult for China to swallow on its own. Hence, the GATT/WTO can provide a country that needs to wash down the medicine (tariff reform) with a spoon full of sugar (export market access promised by other members).[10]

China took on a number of such commitments as a condition of its WTO entry in 2001. It promised financial-services market liberalization, reductions of industrial and agricultural subsidies, the continued privatization of state-owned enterprises (SOEs), and improved enforcement of

intellectual property rights. These commitments promised implicit benefits to other WTO members, as well as serving to complement unilateral efforts—as these new efforts would be enforced by the potential for retaliation threats from WTO trading partners—to promote market-oriented reforms in its domestic economy.

The existing WTO membership recognized China as a rising power with tremendous export capacity, a country with the potential to disrupt historical trading patterns. As a price for China's accession, the membership demanded that Beijing take on many more policy commitments than had traditionally been required of other acceding countries at a comparable stage of economic development. And while China has lived up to and perhaps even exceeded the pace of certain reform demands, in other instances the pace of reform has not been as quick as some members, such as the United States, would like. One result has been the initiation of these formal disputes.

Since its 2001 accession, China has been an extremely quiet member of the WTO. While the formal dispute resolution processes has been busy with more than 135 new cases initiated by WTO members against one another since 2001, perhaps surprisingly, China has been nearly silent. Prior to the recent flurry of cases begun in 2006, China had faced only one dispute, which it quickly settled—a 2004 *Integrated Circuits* challenge brought by the United States over China's allegedly discriminatory value-added tax on semiconductors.

Furthermore, although other WTO members have continued to discriminate against Chinese exports, Beijing has thus far taken the offensive to initiate only three WTO disputes of its own. The first case was started almost immediately after China's WTO accession, when it joined as a co-plaintiff a dispute that the European Community ultimately led challenging the U.S.-imposed *Steel Safeguards* import restrictions in 2002. The second case was a short-lived dispute in 2007 over *Coated Paper* that quickly disappeared when it turned out that China's challenge to a U.S. preliminary trade restriction was filed prematurely (in that the final U.S. restriction was never formally imposed). Finally, China initiated its third complaint in September 2008 and challenged newly imposed U.S. antidumping and countervailing duty (*AD/CVD*) import restrictions on Chinese-produced steel pipes and tubes, tires, and laminated woven sacks. While the initiation of this third case is too recent to reveal anything concrete about Beijing's overall strategy, there are reasons to believe it may have legs in the WTO dispute process. For reasons discussed in more detail below, this particular Chinese case may serve two roles—i.e., as both a

needed political counteroffensive to the repeated U.S. challenges as well as a dispute that addresses issues of systemic concern to China's exporters.

Nevertheless, because China's track record of how it handles formal WTO dispute settlement is largely a blank slate, its political (as well as litigation) strategies for managing the upcoming cases—especially *Auto Parts* and *Intellectual Property I and II* in which the United States is on the offensive—are largely unknown. Combined, the lack of offensive and defensive activity by China in formal dispute settlement is offset only by the fact that it has some WTO experience by signing on as a "third party" observer more than sixty times to monitor other countries' formal disputes.

If the onslaught of these new WTO disputes since 2006 were not sufficient warning to Beijing that it would now be treated as a major political player with responsibilities to the world trading system, formal notice was served in the immediate aftermath to the July 2008 collapse of the Geneva mini-Ministerial Doha round talks. Before the July 2008 collapse, China was not a major public player in the Doha round negotiations. And while even the alleged source of the Geneva ministerial collapse was a U.S.–India bottleneck over a relatively technical (and ultimately negotiable) developing country special safeguard mechanism to deal with agricultural import surges, then-United States Trade Representative (USTR) Susan Schwab used her morning-after press conference to politically admonish China. The breakdown could have been explained politically in any number of ways; nevertheless, the USTR made the calculated decision to highlight how the safeguard proposals would have provided China with unprecedented import market closing opportunities in key products for U.S. exporters—soy and poultry.[11] Unlike prior WTO ministerial collapses in Cancun in 2003 or Seattle in 1999 in which the public blame was placed squarely at the feet of the EC or U.S., the United States adopted a clear political strategy to shift significant culpability for this failure onto China.

RETALIATION LESSONS FROM *BANANAS* AND *STEEL SAFEGUARDS*?

In practice, using a WTO trade dispute to force another member to change its policy requires much more than sophisticated legal arguments and good lawyers. What will matter in these U.S.–China battles is also whether the USTR and Beijing can use the events *surrounding* the actual trade litigation to speed up the pace of Chinese economic and policy reform and to diffuse political pressure within the United States. The lessons of earlier WTO disputes foreshadow both potential strategies and likely flashpoints in future U.S.–China political relations.

The United States can potentially draw on lessons from its substantial experience within the WTO system. Not only is the United States the chief architect of the legal system, but it is also its most frequent litigant: the U.S. has initiated more challenges than any other WTO member, and it has also faced more challenges than any other country. In comparison, China is a newcomer to formal disputes. But while China suffers from a lack of experience, the United States lacks knowledge of what to expect from China in terms of strategy.

As is well documented, the WTO does not have jails, monetary fines, or any other system of external institutional enforcement to compel countries to comply with its legal rulings. While members' sense of international obligation and commitment to the system facilitate compliance and reform, it also helps if the complaining country is a large importer vis-à-vis the defendant country in a case, since the only "compensation" for noncompliance in the self-enforcing system comes in the form of limited authorized retaliation. Retaliation occurs extremely infrequently in these WTO disputes with good reason—it is a remedy that is economically damaging to both sides. However, the *capacity* to retaliate is frequently an impetus for policy reform.

The United States now consumes more than $250 billion in imports from China each year, so there is no doubt that the U.S. government has a credible means to retaliate by raising tariffs on Chinese goods. However, there is a political difference between blunt force retaliation and surgical retaliation. Whether these WTO disputes promote additional Chinese reform—the primary goal for the auto parts, Hollywood film, and intellectual property-intensive firms behind these U.S.-led disputes—may ultimately hinge on whether the USTR is able to identify the "right" Chinese exports to target surgically for retaliation.

History suggests that retaliation threats can be effective when countries take advantage of the reciprocity-based framework that the WTO process provides. The idea is to threaten retaliation that will mobilize the offending country's key export interests—the groups that stand to be hurt by the retaliation—and thereby create an ally that will push for reform from *within* the reforming country. Identifying and creating such internal allies is needed to give both the United States and China a chance for a "win-win" economic outcome. Examples from politically contentious disputes between the U.S. and EC during the WTO's first decade—e.g., *Bananas* and *Steel Safeguards*—can be used to highlight some of the strategic considerations for the USTR and Beijing to keep in mind.

TABLE 2. OTHER RELEVANT WTO DISPUTES

DEFENDANT	PLAINTIFF	ISSUE UNDER DISPUTE	YEAR INITIATED, RELEVANCE
EC	U.S.	Regime for the Importation, Sale and Distribution of Bananas *(Bananas)*	1996, failure to immediately comply leads to period of U.S. retaliation against EC exports of Louis Vuitton handbags, pecorino cheese, etc.
EC	Ecuador	Regime for the Importation, Sale and Distribution of Bananas *(Bananas)*	1996, Ecuador threatened to retaliate by withdrawing protection of EC firms' intellectual property
EC	U.S.	Measures Concerning Meat and Meat Products *(Beef Hormones)*	1996, failure to comply leads to prolonged period of U.S. tariff retaliation against EC firms
U.S.	EC	Tax Treatment for "Foreign Sales Corporations" *(Foreign Sales Corporations)*	1997, failure to immediately comply leads to period of EC tariff retaliation against U.S. firms
U.S.	EC	Continued Dumping and Subsidy Offset Act of 2000 *(Byrd Amendment)*	2000, failure to immediately comply leads to period of EC tariff retaliation against U.S. firms
U.S.	Brazil	Subsidies on Upland Cotton *(Cotton Subsidies)*	2002, failure to immediately comply leads to Brazilian threats to retaliate by withdrawing protection of U.S. firms' intellectual property
U.S.	Antigua and Barbuda	Measures Affecting the Cross-Border Supply of Gambling and Betting Services *(Internet Gambling)*	2003, failure to immediately comply leads to Antiguan threats retaliate by withdrawing protection of U.S. firms' intellectual property

Bananas was the first dispute to result in WTO-authorized retaliation. The United States successfully challenged the European Community's discriminatory import restrictions on Latin American-grown bananas that were distributed internationally by U.S. firms such as Chiquita and Dole. After the United States won the legal decision and the EC refused to reform its banana import policy, the U.S. sought authorization to retaliate. WTO arbiters limited the extent of the retaliation to roughly the amount of trade that U.S. exporters lost due to the EC banana policy, estimated at $191 million per year.

However, the United States was able to choose strategically the specific European products on which to levy retaliatory tariffs. The U.S. focused

its retaliation on exports of a number of luxury goods from France (Louis Vuitton handbags), Italy (pecorino cheese), and other European countries. One economic argument for targeting luxury products is that they have limited alternative markets if they are shut out of the United States, implying a substantial potential reduction in profits. A second argument is political—on the U.S. side, there is less chance of a consumer backlash resulting from a tariff-induced higher price of luxury handbags and cheeses, because these particular varieties were purchased by relatively few U.S. consumers in the first place. On the EC side, the U.S. strategy to hit a high profile industry with retaliation may better grab the attention of EC policymakers and increase the likelihood of reform—i.e., disposing of the illegal banana policy.

The *Steel Safeguards* dispute is a second clear example of how to design a retaliatory response to take advantage of political circumstances. This case involved the aforementioned EC challenge to the Bush administration imposing steel safeguard import restrictions in March 2002. The EC won its legal arguments, and by November 2003 it had already drawn up and made public its "retaliation list" of products that it would target if the United States refused to comply with the WTO ruling. The EC took advantage of the political sensitivity inherent in the upcoming 2004 U.S. presidential election season by concentrating its threats on products exported from swing states. The most highly publicized sanctions threatened to target Tropicana and citrus exports from the dangling-chad state of Florida—the site of the 2000 Bush-Gore recount controversy. Rather than risk alienating key interests before the election, the Bush administration reacted to the EC threat by dismantling of its WTO-violating steel tariffs in December 2003.

While this WTO legal forum has proved effective at managing some U.S.–EC bilateral trade tensions, are there lessons from such history for these Chinese disputes? When one of these new cases gets to the retaliatory-threat stage, the USTR will need to have identified specific Chinese export interests with the "right" characteristics. For these threats to be effective, the USTR will have to identify Chinese exporters that will spend political resources to help convince Beijing of the benefits of reform by informing them of the alternative—i.e., the cost these exporters face in lost profits because of failed reforms in other areas of the economy. To induce domestic Chinese policy reform, such exporters will also need to possess political access and clout in Beijing.

For a number of reasons examined in the next section, the USTR may find that identifying the "right" exporters for effective retaliation threats in disputes vis-à-vis China is much more difficult than anticipated.

ADDITIONAL COMPLEXITIES OF THE U.S.–CHINA DISPUTES

If history is a guide, the United States will win a sufficient number of legal arguments in one or more of these Geneva disputes in which it is on the offensive, and the WTO will request that China engage in policy reform. In the face of intransigent political forces within China that impede the pace of domestic reform, Beijing may find that thoughtfully constructed, credible retaliatory threats from WTO members such as the United States are helpful political tools to complement its own reform efforts. Chinese policymakers may find it effective to use one industry's realized economic costs (due to foreign retaliation) of failing to reform as ammunition in its fight for scaling back domestic subsidies, improving intellectual property enforcement, or increasing the benefits of competition obtained via additional import market access provided to auto parts firms, Hollywood film studios, or some other foreign industries.

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In order for the United States to bolster the efforts of Chinese reformers, the USTR must keep in mind a number of factors as it decides how to structure retaliation threats. As the United States now imports more than $250 billion in goods from China per year, Washington will have many choices over potential products to target. The key question is: what additional difficulties for USTR arise because the potential reformer is China?

First, since Chinese politics are both non-democratic and non-transparent, it is not as easy as it was, for example, for the Europeans in the *Steel Safeguards* case. It's not as if the United States can simply look for a politically important region in China by searching for evidence of dangling chads, identify what that region exports to the U.S. market, and then use those products as the target of retaliation threats.

Second, most Chinese exports to the United States at the moment are not luxury products, thus also limiting the insights from the *Bananas* case. Lower-end products have many more potential consumers in the global economy and may be easily exported (deflected) to alternative markets if retaliation from Washington shuts them out of the United States. Therefore, deflection means that retaliation may not impose a sufficiently large loss of profits on the exporting Chinese firms. It is the specter of lost profits that

induces such firms to increase their engagement in the Chinese political process to encourage Beijing to speed up reform in the other areas of the economy that the United States is requesting. Furthermore, if these are not brand name Chinese products, it may be difficult for U.S. retaliation to generate enough media attention and public familiarity within China to impose sufficient pressure on politicians. Public knowledge of lost profits on recognizable products of national champions is less palatable to political leaders than widely dispersed losses to unknown entities.

Third, much of what China exports to the United States derives from subsidiaries of U.S.-based multinational corporations, and exports from such sources are clearly not useful retaliation targets. To begin with, Washington would prefer not to antagonize firms with significant U.S. shareholder interest. Perhaps even more importantly, the subsidiary of a foreign multinational may be much less likely to have the political connections within China needed to convince Beijing of the economic costs of failing to reform policies and bring them into WTO compliance.

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Another broad concern facing USTR is that even the exporters that are not subsidiaries of U.S.-based multinationals may be a part of a globally footloose industry. Plants in manufacturing industries such as electronics assembly or apparel frequently do not require much equipment or capital investment. While they profit from access to China's surfeit of low cost labor, their facilities can easily be disassembled and set up somewhere else—e.g., Vietnam, Bangladesh, Cambodia, or Malaysia. If these current Chinese industries become the target of U.S. retaliation, they may simply disappear from the Chinese landscape. They might reappear as producers of the same product in some other country or as producers in a different footloose industry within China. With low profit margins, footloose industries are also not the implicit allies the United States needs on the inside—they will not expend resources and political effort in Beijing to convince the Chinese government to reform other sectors of the economy.

Finally, it is also important to consider whether a potential alternative to strategically targeting particular exporting industries with high (prohibitive) tariffs—i.e., the strategy employed in disputes such as *Bananas*—could have a positive effect. For example, while it has been brought up in a

different (i.e., non-WTO consistent) context, for a number of years senators such as Charles Schumer (D-NY) and Lindsey Graham (R-SC) have called for a non-prohibitive, 27.5 percent import tariff on all Chinese products exported to the United States.[12] To the extent that Beijing is responsive to domestic political pressure and there is a "bottom-up" influence over Beijing's policies that is driven by industrialist demands, a U.S. effort to target all Chinese exporters with such a tariff potentially creates a collective action problem within China for the United States. Since each individual Chinese firm and industry stands to benefit from the removal of such a U.S. trade restriction, any individual firm's effort at convincing Beijing to undertake a reform that would get the U.S. policy removed generates "spillover" benefits to others. The well-known "free-rider" problem that would result means that each firm has an incentive to under-invest the political capital necessary to actually get the policy removed. Because the pain associated with the U.S. retaliation is too widely disbursed, an unintended consequence might be that the U.S. policy creates no reform-minded allies within China.[13] On the other hand, such concerns may be overstated if Beijing, as an authoritarian regime, is immune from domestic political pressure and adopts a top-down approach to policymaking.

The fundamental insight is the simple recognition that ultimate success of any conceivable WTO-sanctioned retaliation involves an extremely complex set of issues for the USTR. The most important information the USTR needs is knowledge over Chinese domestic politics, and who, if anyone, can be an internal ally to influence domestic reform.

PREPARING FOR FAILURE?

Inevitably, there will be missteps in the forthcoming legal disputes between the United States and China. Is a full-blown trade war an inevitable implication of failure to reach a successful outcome in Geneva? Is it likely to result in a collapse of the WTO? What if the USTR doesn't successfully identify retaliation targets to mobilize allies within China? Alternatively, even if USTR does identify receptive Chinese export interests for its potential retaliation threats, what if Beijing decides on other priorities and simply fails to take advantage of these disputes as an opportunity to complement its ongoing domestic reform strategies? It may thus be

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important to manage expectations about what WTO dispute settlement can accomplish.

There is, of course, precedent for a potential outcome in which Beijing ultimately chooses to live with the consequences of WTO noncompliance. The EC has been doing this for years, as it continues to face retaliation because of WTO-illegal bans on hormone-treated beef exports from the United States. Not to be outdone, Washington also has experience living with foreign retaliation—after disputes over export tax exemptions (*Foreign Sales Corporations*) and refunding to U.S. firms the revenue collected from antidumping duties imposed on foreigners (*Byrd Amendment*)—instances when the President could not convince Congress to enact legislation to reform U.S. policy rapidly enough to meet WTO deadlines. For reasons of domestic politics, China may face the need to do the same.

This is why the WTO rules that limit any U.S. retaliation are also a long-term benefit to the system. While the disputes in Geneva will feature political theater and rhetoric over impending trade wars, it is critical to highlight that retaliation is now simply a part of the process. One feature of the WTO that makes it especially attractive as an institution is that its rules and an impartial set of arbiters will ultimately limit the amount of retaliation the United States will be authorized to undertake to roughly the size of the trade lost due to the policies under dispute in the China cases. The rules are designed to prevent bilateral skirmishes over a few hundred million dollars of trade in auto parts, movies, music, and books from spilling over into an unlimited retaliation affecting hundreds of billions dollars—i.e., a retaliation that would cause the global trading system to become completely unglued.

Furthermore, there are signs that all parties to these disputes have been preparing for this day. As already mentioned, while China has been the primary litigant in very few WTO disputes up until now, it has been an official "third party" observer in over sixty disputes involving other WTO member countries, likely as a learning strategy. Furthermore, even the adjudicators are getting ready, as the WTO as an institution recently appointed a Chinese national for the first time to sit as a judge for a four year term as part of its Appellate Body, the judicial organ that handles all WTO dispute settlement appeals.[14] The WTO membership, including the United States, clearly gave China one of the prime insider positions within the judicial process out of recognition that Beijing's continued support of the institution and willingness to play by its rules is a critical element to the long-term survival of the WTO.

THE UNITED STATES' ALTERNATIVES TO THE WTO DISPUTE SETTLEMENT MECHANISM

It is also worth exploring the question of why the United States' ongoing approach of using formal WTO dispute settlement to manage trade tensions with China is better than some of the proposed alternatives. For example, how does this approach differ from a Congressional initiative on China of the type proposed by Senators Schumer and Graham, one that would unilaterally implement a uniform, across-the-board tariff on all imports from China?

The first legitimate consequence of any U.S. unilateral import restriction of the Schumer-Graham type is that the international focus and question of legality shifts squarely from China to the United States. There are no obvious WTO provisions under which the United States could claim it is not violating WTO rules with such a discriminatory policy, as it is a blatant violation of MFN. As for the subsequent chain of events, China would have little option but to respond, perhaps with a legitimate legal challenge of its own in Geneva. Ultimately, China could receive WTO authorization to retaliate, and the political question would shift to how China would choose to structure its response.

What are China's potential retaliation options? While China is the fourth largest destination market for U.S. exports—it consumed more than $65 billion in U.S. products in 2007 alone—this still comprised only 5 percent of total U.S. merchandise exports. Furthermore, because China is a developing country, the economic costs from tariff retaliation against imports from the United States would greatly exceed the benefits. So it is doubtful that China would turn to tariff retaliation.

Because China is a developing country, the economic costs from tariff retaliation against imports from the United States would greatly exceed the benefits.

However, it would not be surprising to see China turn to a strategy that has been employed by other developing countries at the conclusion of their WTO cases. For example, Ecuador, after winning its parallel *Bananas* dispute against the European Community, did not follow the U.S. lead by also seeking permission from the WTO to retaliate with tariffs against Louis Vuitton handbags or pecorino cheese. Instead, Ecuador threatened to stop enforcing European firms' intellectual property rights and requested WTO

authorization to legally violate its obligations under the TRIPs Agreement. It is worth noting that the United States currently faces two other disputes for failing to comply with WTO legal rulings in which the developing country plaintiff has received or is ready to receive WTO authorization to retaliate by failing to enforce the intellectual property of American firms—the tiny island nation of Antigua and Barbuda in the *Internet Gambling* case, and the major emerging economy of Brazil in the *Cotton Subsidies* dispute.

This raises an important irony with which to caution U.S. policymakers. Any potential U.S. action taken outside the WTO rules could realistically lead to a scenario in which China takes a page out of the developing country, retaliation-threat playbook. If China is given WTO-legal cover to violate U.S. intellectual property as compensation for United States' applying extra-WTO trade restrictions, the U.S. policy would end up hurting the same Hollywood and music industry export interests that the U.S. dispute filings at the WTO were designed to assist in the first place.

THE CHINESE RESPONSE TO A WTO SETTLEMENT

As the number of new WTO disputes initiated against China continues to rise and Beijing begins to lose some of them in Geneva, there is the inevitable threat of backlash within China. Some domestic groups will focus excessively on what will appear to be a one-sided dispute settlement process that sees China only as a target. There will be calls for China to withdraw from such an unfair system. Perhaps surprisingly, such calls have been heard periodically even in the United States, when U.S. policies were challenged and it lost case after case. For the United States, however, muting the critics was fairly straightforward—all that was needed was to remind them of the other half of the data. In almost as many disputes that it has been a defendant and legally "lost," the United States has taken on the role of plaintiff, challenged other countries' policies, legally "won," and improved foreign market access for its exporters.

One way for Beijing to increase Chinese confidence in the WTO system is to go on the offensive and initiate some disputes of its own.

Thus, one way for Beijing to increase Chinese confidence in the WTO system is to go on the offensive and initiate some disputes of its own, in part to balance public perception of its role within the institution. Despite these disputes frequently being "win-win" from an overall

economic perspective, it is no fun politically always to be seen as the accused and the loser—and traditionally in these disputes, the defendant loses most of the important legal arguments.

When China does begin its own trade dispute offensive, what will it choose to fight for? It is difficult to speculate with any confidence where China would focus its efforts, though there are a number of good reasons to believe that Beijing may emphatically pursue its recently initiated *AD/CVD* case against the United States. While the exact legal strategy that China will pursue in this particular dispute will only be revealed with time, a number of factors justify Beijing's strong political-economic motivations behind acting on such a case.

As background, despite China now being a member of the WTO, many of its exporting firms continue to face discriminatory treatment by the WTO membership because a number of countries defy the fundamental principle of most-favored-nation treatment. The most poignant example is that China's exporters are the world's number one target of the politically contentious (and economically unjustified) antidumping trade policy, a policy that is the frequent subject of WTO litigation between other members.[15]

One element of the China–U.S. *AD/CVD* dispute stems from a U.S. trade policy decision made in March 2007, when the Bush administration reversed a 23-year-old U.S. policy that refused calls under the countervailing duty—or anti-subsidy—law for new tariffs against exports from China and other non-market economies (NMEs).[16] This policy reversal introduced a troubling inconsistency across U.S. unfair trade laws with particularly onerous implications for China. While China continues to be treated as a NME under U.S. antidumping law—so that the U.S. Department of Commerce has additional discretion with which to construct punitive duties—it is treated as a market economy under the U.S. countervailing duty law, so that it can potentially face trade restrictions under that policy as well.

Part of Beijing's argument in this *AD/CVD* dispute may be such a challenge to U.S. policy. The United States has initiated at least fourteen new countervailing duty investigations against a wide range of Chinese products since the March 2007 decision, and a number of them (e.g., steel pipe and tube, tires, and laminated sacks) have resulted in new U.S. import barriers that China cites in its WTO dispute initiation request. And while this dispute may be legally and politically important for China, it has the potential to be economically significant as well—especially if U.S. industries continue to use these policies to demand new barriers to imports from China in the face of the ongoing recession.

TABLE 3. UNITED STATES COUNTERVAILING DUTY INVESTIGATIONS AGAINST CHINA SINCE MARCH 2007

1. Circular Welded Carbon-Quality Steel Pipe
2. Circular Welded Carbon Quality Steel Line Pipe
3. Citric Acid and Certain Citrate Salts
4. Coated Free Sheet Paper
5. Kitchen Appliance Shelving and Racks
6. Laminated Woven Sacks
7. Light-Walled Rectangular Pipe and Tube
8. Lightweight Thermal Paper
9. Off-The-Road Tires
10. Raw Flexible Magnets
11. Sodium Nitrite
12. Tow-Behind Lawn Groomers
13. Welded Stainless Steel Pressure Pipe
14. Uncovered Innersprings Units

Notes: Through December 5, 2008. Compiled by the author from USITC "Trade Remedy Investigations," available at http://www.usitc.gov/trade_remedy/731_ad_701_cvd/investigations/active/index.htm, last accessed December 5, 2008.

CONCLUSION

After a five-year grace period following China's 2001 accession, Washington has since adopted a clear strategy to fully engage the forum of formal World Trade Organization dispute settlement to manage its bilateral trade tensions with Beijing. While this WTO forum has served well for more than ten years in arbitrating trade frictions between the United States and EC, it remains to be seen whether the U.S. and China are similarly able to use dispute settlement to steer clear of self-destructing political landmines over the near term—something which has important implications for the current, rules-based system.

Regardless of Doha round progress concerning any new and/or deep negotiating commitments, the established institutional framework of the WTO does continue to provide an important outlet for the major trading powers of the global economy—in this case the United States and China—to use dispute settlement to fight small skirmishes in a transparent fashion

that limits the spillover and prevents a full-blown trade war. Without the Geneva forum, there is much greater potential for the world to revert to the pre-GATT days of Smoot-Hawley tariffs, unbridled foreign retaliation, and the chaotic trading system of the Great Depression era.[17]

The economic downturn may lead to the greatest challenge to the stability of the international trading system since the Great Depression.

The deepening financial crisis has created a global macroeconomic downturn of unknown proportion. A global recession is likely to result in unprecedented political pressure for countries around the world to impose new trade barriers, and many of these barriers will violate the letter if not only the spirit of their commitment to the WTO. The economic downturn may lead to the greatest challenge to the stability of the international trading system since the Great Depression, and, we can expect the new and current era of dispute activity between the United States and China to provide the first litmus test of these major powers' commitment to rules and the relevance of the WTO in this new climate. These disputes may also be the strongest test to date of the resilience of what has been thus far a most remarkable WTO system. ■

ENDNOTES

1 WTO, "Dispute Settlement: The Disputes," <http://www.wto.org/english/tratop_e/dispu_e/dispu_status_e.htm> (accessed on February 5, 2009).
2 See Chad P. Bown, Meredith A. Crowley, Daisuke Nakajima, and Rachel McCulloch, "The U.S. Trade Deficit: Made in China?" *Economic Perspectives* 29 (4) (Winter 2005): 2-18; and Chad P. Bown and Rachel McCulloch, "Question and Answer: The Trade Deficit," *The American* 1 (2) (January-February 2007): 74-79.
3 U.S. Food and Drug Administration, "Recalls, Market Withdrawals and Safety Alerts Archive: 2007," <http://www.fda.gov/oc/po/firmrecalls/archive_2007.html> (accessed on February 5, 2009).
4 See Thomas L. Brewer, "U.S. Climate Change Policy and International Trade Policy Intersections: Issues Needing Innovation for a Rapidly Expanding Agenda," Paper Prepared for a Seminar of the Center for Business and Public Policy, Georgetown University, February 12, 2008 <http://www18.georgetown.edu/data/people/brewert/publication-34768.pdf> (accessed February 5, 2009); and for an economic analysis, see Ben Lockwood and John Whalley "Carbon Motivated Border Tax Adjustments: Old Wine in Green Bottles?" NBER *Working Paper No. 14025* (May 2008).
5 Indeed, this will not be limited to the U.S. and China as we are likely to see a resurgence in import-protection pressures manifesting on a global scale. In the most updated numbers available for its members for the first six months of 2008, the WTO Secretariat reported a surge in both new import restrictions and investigations likely to result in new restrictions. See the October 20, 2008 press release, "WTO

Secretariat reports surge in new anti-dumping investigations," <http://www.wto.org/english/news_e/pres08_e/pr542_e.htm> (accessed February 5, 2009).

6 In December 2007, the U.S. and China settled the *Domestic Subsidies* case by submitting a memorandum of understanding to the WTO that proposed to eliminate the subsidies that U.S. had been challenging. In November 2008, the U.S., EC, Canada, and China settled the *Financial Information Services* case by submitting a memorandum of understanding to the WTO that proposed to eliminate discriminatory restrictions on foreign firms from providing service to the Chinese market. See USTR press release, "China to End Restrictions on Suppliers of Financial Information Services Challenged by United States in WTO Dispute," November 13, 2008.

7 See Chad P. Bown and Joost Pauwelyn, eds., *The Law, Economics, and Politics of WTO Trade Sanctions* (Cambridge, UK: Cambridge University, forthcoming); and Robert Z. Lawrence *Crimes and Punishments? Retaliation under the WTO* (Washington, DC: Institute of International Economics, 2003).

8 See WTO, "Accession of the People's Republic of China," 23 November 2001, <http://docsonline.wto.org/imrd/directdoc.asp?DDFDocuments/t/WT/L/432.doc>, (accessed February 5, 2009).

9 See Chad P. Bown, "China's WTO Entry: Antidumping, Safeguards, and Dispute Settlement," in Robert Feenstra and Shang-Jin Wei, eds., *China's Growing Role in World Trade* (Chicago, IL: University of Chicago Press, forthcoming).

10 Classic examples of research that put the GATT/WTO into such an economic framework include Kyle Bagwell and Robert W. Staiger, *The Economics of the World Trading System* (Cambridge, MA: The MIT Press, 2002) and Bernard M. Hoekman and Michael M. Kostecki, *The Political Economy of the World Trading System: The WTO and Beyond* (New York: Oxford University Press, 2001). For a more legal-political perspective, see Kenneth W. Dam, *The GATT: Law and International Organization* (Chicago, IL: University of Chicago Press, 1970), Robert E. Hudec, *The GATT Legal System and World Trade Diplomacy* (New York: Praeger Publishers, 1975), and John H. Jackson, *World Trade and the Law of GATT* (New York: Bobbs-Merrill Company, 1969).

11 Ambassador Susan Schwab, United States Trade Representative, "Press Briefing," July 30, 2008, <http://www.america.gov/st/econ-english/2008/July/20080730111738dmslahrellek0.4839594.html&distid=ucs> (accessed February 5, 2009). Indeed the press conference reference to India was minimal, as the USTR's other example of India's imports of palm oil as a product with significant import surges to trigger the proposed special safeguard mechanism could not have been in reference to U.S. exports, given that U.S. exports of palm oil to India in every year between 2001-2007 were zero (United States International Trade Commission Dataweb, <http://dataweb.usitc.gov>, (accessed February 5, 2009)); see also ICTSD, "Agricultural Safeguard Controversy Triggers Breakdown in Doha round Talks," August, 7, 2008, <http://ictsd.net/i/news/bridgesweekly/18034/> (accessed February 5, 2009).

12 See, for example, U.S. Senate Press Release, "Schumer-Graham Announce Bipartisan Bill to Level Playing Field on China Trade: New Tough Approach to Force China to Stop Currency Manipulation or Risk Being Slapped with Large Tariffs on its Exports," February 3, 2005, <http://schumer.senate.gov/SchumerWebsite/pressroom/press_releases/2005/PR4111.China020305.html> (accessed February 5, 2009).

13 For case study evidence on some of the elements involved here, see Scott Kennedy, "Transnational Political Alliances: An Exploration with Evidence from China,"

Business & Society 46 (2) (June 2007): 174-200; Scott Kennedy "China's Porous Protectionism: The Changing Political Economy of Trade Policy," *Political Science Quarterly* 120 (3) (Fall 2005): 407-432; and Scott Kennedy, *The Business of Lobbying in China* (Cambridge, MA: Harvard University Press, 2005).

14 Ms. Yuejiao Zhang from China was appointed to a four year term that runs from June 1, 2008, to May 31, 2012. The six other current Appellate Body judges are from the U.S., Italy, Japan, South Africa, Brazil, and Philippines. Country representation from prior Appellate Body judges also includes Australia, New Zealand, Germany, India, Egypt, and Uruguay. See WTO, "Dispute Settlement: Appellate Body Members," <http://www.wto.org/english/tratop_e/dispu_e/ab_members_descrp_e.htm>, (accessed February 5, 2009).

15 Data on China as a target of foreign antidumping can be found at Chad P. Bown, "Global Antidumping Database," Current version 3.0, June 2007, <http://www.brandeis.edu/~cbown/global_ad/> (accessed February 5, 2009).

16 See Department of Commerce, "Press Release: Commerce Applies Anti-Subsidy Law to China," March 30, 207, <http://www.commerce.gov/opa/press/Secretary_Gutierrez/2007_Releases/March/30_Gutierrez_China_Anti-subsidy_law_application_rls.html> (accessed February 5, 2009).

17 See Douglas A. Irwin, Petros C. Mavroidis and Alan O. Sykes, *The Genesis of the GATT* (Cambridge, UK: Cambridge University Press, 2008).