How to Think about Trade with China
(Hint: It's not just Trade)

The last blog pierced the China meme – the premise that we need to do trade deals with countries in order to keep China at bay. But if trade deals with other countries aren't the way to deal with competitive threats from China, what is?

Part of the problem is that trade people look at China almost exclusively through the prism of trade, where membership in the WTO restricts the U.S. ability to take unilateral action. Yet there is a much broader concern with how Chinese firms compete in the world.

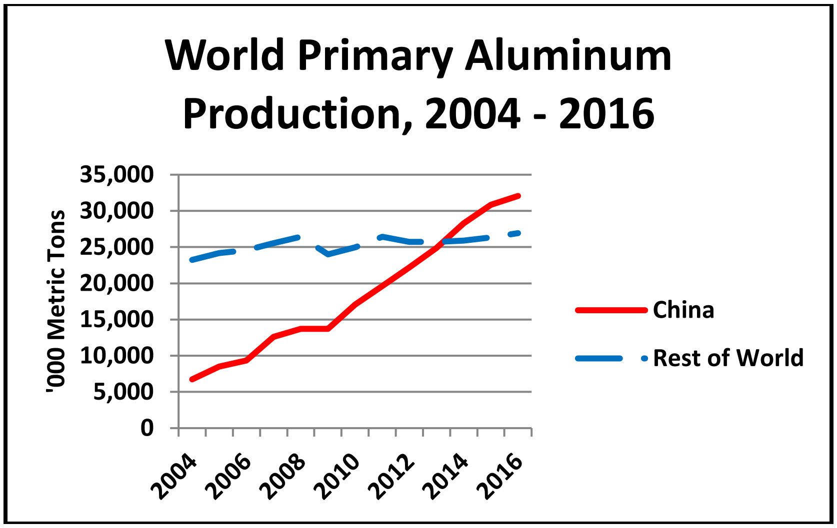
In a nutshell, the challenge the United States and others faces is this. The Chinese government identifies industries it wishes to grow. It incubates those industries. Companies within those industries often access global financial markets and, based on financial reporting subject to limited or no U.S. oversight, secure additional financing necessary to dominate a particular industry. The Chinese government keeps a watchful eye over these companies and actively supports consolidation and vertical integration to enable them to compete more effectively. Even after incubation, the government will provide subsidized loans if the capital markets are insufficient. While foreign producers are subject to market constraints – such as profitability – Chinese companies are not. They are able to dominate global markets, in relatively short order, driving foreign competitors out of business. This is true even when, or perhaps especially when, the Chinese government, in its execution of "state capitalism," miscalculates supply and demand. Whether driving foreign competitors out of business is the goal, or a byproduct, is not all that relevant. This is China's development strategy.

Trade tools are insufficient to address this kind of systemic challenge. If we want to be equipped to confront the competitiveness problems China poses, then we need to look, holistically, at a minimum of three areas: trade, antitrust, and financial reporting.

Jeans Today, Aluminum Tomorrow

Aluminum is a useful case study to highlight China's development strategy, the tools China uses to achieve that development, and the way these goals manifest themselves in terms of global competition.

China has no natural comparative advantage in aluminum production. As was the case with steel, the Chinese government used a web of incentives to induce production. These incentives succeeded. The chart below compares Chinese aluminum production with production in the rest of the world from 2004 through 2016:



In fact, the Chinese were *too* successful. As early as 2003, China began to realize it was overproducing aluminum. China's excess production depressed global aluminum prices. Various Chinese government bodies began to express concern about reining in "blind expansions." The government's pronouncements met with little success on the ground, and the chart above shows production continuing to soar even *after* the government publicly acknowledged the problem in 2003. The incentives were too alluring; in 2006, for example, a denim producer, Hongqiao, decided to become an aluminum producer – three years after the government professed to be concerned about overcapacity. Less than a decade later, this denim producer had managed to become the largest aluminum producer in the world, surpassing giants such as the Russian company Rusal, and the American legend Alcoa.

Not only were the incentives to produce aluminum too great, but the consequences of shutting down production were likewise too great. None of the local governments with aluminum producers wanted to bear the brunt of absorbing the job losses that would necessarily come with a rationalization of the domestic industry.

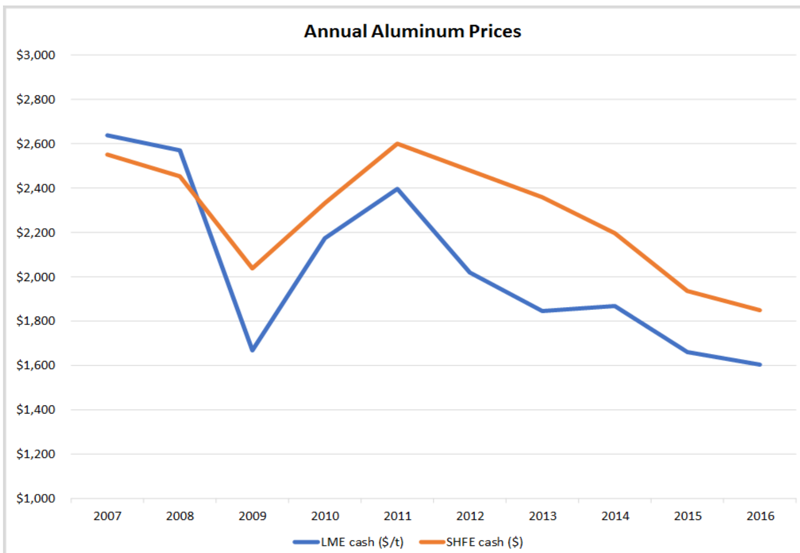
(1) Trade

With insufficient political will to curb domestic production, where was this excess Chinese production to go? To the international market. The trade consequences are well documented; a review of the filings in connection with the Trump Administration's national security investigation into aluminum imports shows job losses, smelter closings, and increased Chinese imports right through the value chain.

China doesn't export much primary aluminum – instead, it exports downstream products. Accordingly, exports of semi-finished aluminum products to the United States increased 239% between 2012 and 2016. Both U.S. and European governments have trade remedy orders in place against Chinese aluminum products, and the Trump Administration recently took the unusual step of self-initiating an unfair trade investigation into aluminum sheet from China.

In January 2017, the Obama Administration filed a complaint at the WTO alleging that Chinese subsidies had adversely affected U.S. aluminum producers. Japan, Canada, Russia, and the EU all requested to join the consultations, which have not yet occurred.

Beyond simply crowding out domestic production through exports, the Chinese overproduction problem has had an additional problematic consequence for producers subject to market disciplines: the excess production has tanked the price of aluminum.



While American companies are privately owned and must be profitable to survive, Chinese companies face no similar constrictions. Because of government subsidies, they are able to continue producing aluminum, even expanding production despite the fact that production with a cratered price is uneconomic. Under these circumstances, it is challenging to see how China is a "market" economy, though China insists it is – and is suing the European Union and the United States over it.

In short, China has chosen to export its domestic overcapacity problem, and thus to export smelter closures and job losses as well.

One of the more troubling consequences of this type of strategy is that it pits American producers and American consumers against each other. The Chinese have gutted the price of primary aluminum, which is the base price for all downstream aluminum products. By throttling American primary aluminum producers, China renders downstream American producers dependent on Chinese inputs. When American primary producers demand relief, the

American downstream producers protest because they are so dependent on cheap inputs from China. But what these protests overlook is the long term. The Chinese aren't going to be satisfied with the low value-added segment of the supply chain. They will move into the very segments of supply chain currently dominated by the American producers who object to relief; and as those producers find themselves on the ropes, they will look for the assistance they sought to deny to those who came before them. This dynamic recalls a quote attributed to Haile Selassie when he pleaded with the League of Nations to take action after Italy invaded Ethiopia in 1935: "It is us today. It will be you tomorrow."

(2) Antitrust

Chinese producers' ability to compete internationally is facilitated by the government's view that industries must be managed. In the aluminum context, one of China's strategies for strengthening the industry in the face of self-created economic woes has been vertical integration and consolidation. In 2000, the Chinese government actually decentralized ownership of a number of smelters, ceding them to local authorities and creating a large producer that was owned by the central government. That entity, in its current form, is the Aluminum Corporation of China, or Chalco. However, as noted above, by 2003, China's overcapacity problem was significant enough that the government openly acknowledged it. The Chinese government "encouraged" aluminum producers to merge, not only horizontally, but also with producers of inputs such as alumina. The government has reiterated that policy on multiple occasions since then, and has extended beyond alumina to electricity – and the coal that is used to produce electricity.

As a result, China now has fewer, but larger, aluminum producers. Although they remain unprofitable, government largesse and dodgy financial reporting keep them going. Their integration downstream means that they are taking primary aluminum, producing semi-finished and finished goods, and exporting those goods to the United States and other countries. As the Chinese producers move down the value chain, U.S. producers (and others) are forced out, unable to compete with entities for which profitability is not a concern. Even niche markets where U.S. producers currently compete, such as autos and aerospace, are within Chinese sights.

To be clear, aluminum is simply one example of the Chinese government's view that consolidation and vertical integration are key components of a successful global strategy. In its 12th five-year plan, the Chinese government laid out a plan to dominate other industries too:

> Drive advantaged enterprises to carry out alliance, cross-regional merger and reorganization, and increase industry concentration with focus on automobile, iron and steel, cement, machine building, electrolytic aluminum, rare earth, electronic information and pharmaceutical industries . . . .

There is overlap with industries China has targeted in its "Made in China 2025" plan:

> 1) New advanced information technology; 2) Automated machine tools & robotics; 3) Aerospace and aeronautical equipment; 4) Maritime equipment and high-tech shipping; 5) Modern rail transport equipment; 6) New-energy vehicles and equipment; 7) Power equipment; 8) Agricultural equipment; 9) New materials; and 10) Biopharma and advanced medical products.

Indeed, one outcome of Emanuel Macron's visit to China is a discussion as to whether Airbus will construct more aircraft there (apparently to Airbus' surprise).

Unfortunately, U.S. courts have responded to anticompetitive Chinese conduct by being bamboozled into believing that violations of U.S. law are excused on "diplomatic" grounds. A notorious case involved Vitamin C*.* According to the facts before the court, the Chinese followed a familiar plan in their aspiration to become a dominant global producer: they imposed export controls, "facilitated" consolidation, implemented price controls, and by 2001 had captured 60% of global market share. Having attained that market share, the Chinese producers were then accused of colluding with an array of entities, including U.S. importers, to reduce supply, drive up prices and "maintain China's position as a leading exporter."

Vitamin C provides a blueprint for the Chinese to dominate, with impunity, any market they choose. The Chinese government can identify the market; structure the industry as it chooses; drive foreign producers out of business with low prices; cut supply to drive up prices; and then have U.S. courts condone the behavior on the grounds of international goodwill. If a jeans producer can become the largest aluminum producer in the world in a decade, then there is little reason to doubt China's ability to execute its strategy in other industries.

Under this scenario, what American industry is safe?

(As an aside, there seems to be a major flaw with the court's reasoning. The court concluded that Chinese producers could not both comply with Chinese and U.S. law because Chinese law set the price at which the exporters had to sell their products, and because of that conflict, declined to exercise jurisdiction over the Chinese producers. However, there is no evidence in the court's opinion that the Chinese exporters were *required to export.* The opinion merely states that *if* these companies exported, they had to do so at a certain price. Therefore, the court's opinion does not seem to explain how a "true conflict" between Chinese and U.S. law arose.)

In contrast to our system's effete deference to "diplomacy," which favors foreign malfeasors at the expense of our own producers, the Chinese government reportedly uses its antimonopoly laws to give its producers a leg up over foreign ones.

(3) Financial Reporting

Much of the emphasis in the discussions over trade with China focuses on state-owned enterprises. However, the aluminum case study exposes the danger of putting too much weight on the distinction between state-owned enterprises, and "private" enterprises.

As noted above, in the space of a decade, Hongqiao, a private company, became the largest aluminum company in the world. How did Hongqiao do it?

Until 2010, Hongqiao was a bit of a sleeper in terms of aluminum production and sales. In 2007, the company sold 184,000 tons of molten aluminum, but in the first nine months of 2010, it sold 633,000 tons. Its profitability skyrocketed as well. Hongqiao reported the following adjusted net profits for 2007, 2008, 2009, and the first nine months of 2010:

	2007	**2008**	**2009**	**2010 (9 months)**
Adj. net profit (RMB millions)	605.9	(67.3)	276.6	2,086.7

Hongqiao's adjusted profits increased *tenfold* between 2009 and the first nine months of 2010.

In what is surely not a coincidence, Hongqiao decided in 2011 to list itself on the Hong Kong Stock Exchange. JP Morgan was the global coordinator – the same company that later got into trouble for its cozy relationship with Chinese officials.

A careful review of the prospectus betrayed the smoke and mirrors underpinning the company's stratospheric increase in profitability. For example, Hongqiao claimed that one of the reasons its profitability jumped in 2010 is because it switched suppliers and, through negotiating prowess, was able to procure alumina, a key input for aluminum, at an improved price. (Prospectus, at 7). That sounds good, until you realize that before the switch, Hongqiao had been acquiring alumina from a related party – at cost. (Prospectus, at 42) Did Hongqiao change suppliers to an *unaffiliated* party, and somehow get a better deal than *cost*? The new producer had simply acquired the old producer's facilities, eliminating any argument that there the new supplier was somehow more cost-effective. (Prospectus, at 42)

In fact, the "new supplier" turned out to be a local state-owned enterprise, and the United States has contended that it subsidized Hongqiao. In short, it seems as though Hongqiao and a local SOE collaborated to boost the company's numbers in advance of the IPO. This is another reason to be cautious about assuming that the only beneficiaries of government freebies are SOEs.

Beyond alumina, there are similar questions about Hongqiao's reported prices for electricity and coal, two other significant inputs.

Despite the suspect information in the prospectus, Hongqiao's IPO was successful. What did Hongqiao do with the money? It expanded. And expanded. And expanded. In 2010, Hongqiao had 916,000 tons of capacity. In 2014, that number had more than tripled, to 3.1 million tons. In that context, it becomes clear why the local SOE had an incentive to help Hongqiao spruce up its numbers: jobs.

What's particularly surprising about the capacity expansion is not only that the Chinese government had been ringing alarm bells about overcapacity for a decade, but the price of aluminum had been dropping steadily since 2011. Yet Hongqiao's expansion continued apace. In the meantime, Hongqiao's profits also continued to soar:

	2011	**2012**	**2013**	**2014 (6 months)**
Net profit (RMB millions)	22,928.4	24,226.1	29,227.6	17,305.1

This off-the-charts profitability was in stark contrast to other aluminum producers -- including SOEs in China. Complaints started to roll in that something was amiss. Deloitte resigned as Hongqiao's auditor in 2015, ostensibly over audit fees. But Hongqiao was a media darling; Bloomberg Gadfly, for example, dismissed the complaints as fits of envy by less efficient producers.

In the meantime, the Chinese government was well aware that producers other than Hongqiao were failing. As the price declined, the government accelerated its issuance of notices purportedly seeking to address overcapacity. Yet despite these concerns, Hongqiao's expansion continued at a breathtaking pace.

Then a couple of short-sellers did what Hongqiao's cheerleaders had apparently failed to do: they read the IPO prospectus. And the 2014 bond prospectus. What they found led them to claim that Hongqiao's financial reporting was bogus.

The first short-seller report, in November 2016, didn't have much impact. But a second report, in February 2017, was so compelling that Hongqiao's stock price began to tank, and the company suspended trading.

Ernst & Young, which had replaced Deloitte in 2015, resigned a few months after the report was issued, in a spat over whether Hongqiao's books needed an independent review. Perhaps concluding that Big Four audit firms were insufficiently pliable, Hongqiao replaced EY with Baker Tilly. However, Baker Tilly was no more pleased with the arrangement than its predecessors, and also resigned. Hongqiao seems to have given up on American accounting firms and chose a home-grown, Chinese auditor instead.

In the meantime, Hongqiao's inability to supply audited financial statements left it in danger of defaulting on its significant debt obligations. This was the perfect opportunity for the Chinese government, which was at this point the subject of a U.S. WTO complaint alleging that subsidies had adversely affected other countries' aluminum companies, to allow Hongqiao, and its outsized capacity, to die a natural death. But the government didn't do that. Instead, it bailed Hongqiao out. To be sure, Hongqiao has, so far, been forced to shutter some capacity that was illegal to begin with. But more than anything, that action tends to highlight that Hongqiao's illegal capacity was tolerated until the company was outed.

Hongqiao's stock has begun trading again.

Shortly thereafter, a Hong Kong court issued an apparently unprecedented injunction banning the short seller from publishing any further information on Hongqiao. This blog would have linked to the short seller reports, including their sassy rebuttals to Hongqiao's attempts at self-defense, but those reports have vanished from the web.

The story of Hongqiao illustrates the fact that a company's status as an SOE is not always dispositive of whether government largesse will be directed its way. Policymakers who fixate on SOEs alone will be in danger of addressing only part of the problem. At the end of the day, if China is faced with a decision to terminate jobs in China, or to continue to export the job losses, China is going to export the job losses.

The government lifeline was just what Hongqiao needed. It provided enough time for Hongqiao's new auditor to conclude that its financial reporting woes were cured; for the company to resume trading its stock; and for a judge to successfully quash the kind of unflattering research that is essential to properly functioning financial markets.

What Aluminum Shows Us

Aluminum provides a roadmap for Chinese domination in other industries – industries where Americans may currently feel complacent about our producers' advantages in areas such aeronautics, information technology, and pharmaceuticals. The Chinese government chooses an industry; the government incubates the industry; the industry undercuts foreign producers; the government intervenes in industrial planning to arrange mergers and integration as needed; when more capital is required, companies, relying at least in some cases on dubious financial reporting beyond the purview of U.S. inspectors, turn to global financial markets and/or further government largesse.

What Can We Do?

The foregoing presents a bleak picture for the prospects of American competitiveness. While the Chinese government is committed to bolstering its companies – and has identified the next generation of markets it intends to dominate -- American companies can't rely on our own courts for help.

Certainly American policymakers should craft a comprehensive strategy to consider how the United States will compete in the face of this kind of industrial policy. In the meantime, however, the U.S. government is not without tools. But it has to be willing to use them.

- *Trade.* The irony is that the United States, as one of the chief architects of the GATT regime, sought to foreclose the ability to act unilaterally – *i.e.*, outside the ambit of the organization. Accordingly, the U.S. ability to act unilaterally is limited (assuming compliance with our international obligations is a priority). This is one of the reasons that traditional trade policy will likely be an insufficient mechanism to address concerns arising from Chinese competitiveness. As noted above, however, the Obama Administration did file a complaint with the WTO in January 2017. The Trump Administration has not yet moved the case forward.

  In addition, President Trump can impose duties pursuant to the national security authorities referenced above. While the United States largely ceded its ability to address trade issues unilaterally, the GATT does have an essential security exception, and that exception is self-defining. Moreover, Congress first gave the President this type of authority in 1955, just a few years *after* the United States signed the GATT. Congress was fully aware of the agreement when it nevertheless concluded that international trade could erode the country's ability to protect itself, and accordingly Congress gave the President the authority to adjust imports as needed to address those concerns.

  The way this Administration handles aluminum (and steel) could be a blueprint for future administrations. The United States has comparatively few options in the trade space, precisely because it succeeded in imposing its architectural philosophy on the multilateral trading system -- that WTO Members should, generally, be restrained from acting unilaterally. In the trade arena, the United States had historically preserved its options to take unilateral action through antidumping, countervailing duty, and safeguard proceedings, but not only are those proceedings not always equipped to address the problem presented, but the WTO has eroded the U.S. ability to use these tools – one of the Trump Administration's signature grievances with the institution, aggravated by the recent Canadian WTO challenge to the very underpinnings of U.S. trade remedy law.

The Trump Administration is also investigating Chinese practices with respect to technology transfer and intellectual property. It is not clear what action, if any, will result. The statute under which the Administration is conducting the investigation gives the President broad authority – including the ability to breach trade agreements – to address any concerns. Typically the end result of these types of investigations, if problems are found, is the filing of a WTO case. However, the current Administration has indicated that it is not as concerned as prior Administrations with adhering to WTO strictures.

More broadly, the United States might need to consider reinvigorating past discussions around having an industrial policy. Largely dismissed today as statist policy advocated by the left, the idea of industrial planning found support amongst such renowned free-trading capitalists as Pete Peterson, namesake of the Peter G. Peterson Institute for International Economics. (Judith Stein, The Pivotal Decade, at 39) Peterson supported having a tripartite committee – government, business, and labor – to figure out how have a government planning mechanism.

- *Antitrust.* The noxious outcome of the *Vitamin C* litigation should be reversed, or otherwise prevented from recurring, perhaps through amendments to antitrust legislation to clarify that jurisdiction obtains even in the case of conflict of law. Moreover, plaintiffs in that dispute pursued a private right of action; federal antitrust officials might consider taking more aggressive action against anticompetitive behavior *sua sponte.*

  While some believe that antitrust issues can be addressed in trade agreements, there is reason to proceed judiciously. At the outset, recall that one of the reasons the United States has few trade tools to deal with the problem is because we gave them up through binding agreements. We should not be in a rush to make the same mistake in antitrust. In that regard, TPP included a competition chapter, but it enshrined the consumer welfare standard that is currently subject to extensive debate in the United States. It is not at all clear that adherence to a consumer welfare standard will produce desirable results in this particular area; as some have noted in a glib plea to do nothing about the demise of the U.S. aluminum industry, consumers are beneficiaries of China's approach toward aluminum. It's workers and businesses that are feeling the pain. It is equally unclear that a consumer welfare standard will address the problems critics cite with respect to alleged abuses of Chinese antimonopoly law.

This blog has previously cautioned that these agreements can unduly tie the hands of Congress and the Executive Branch, by fossilizing standards that might otherwise be subject to reconsideration domestically. Including a consumer welfare standard in trade agreements not only deprives Congress and the courts of opportunity to revisit whether that standard is appropriate, but it may make it more difficult for the United States to tackle competitive threats from abroad.

- *Financial reporting.* With respect to financial reporting, federal legislation requires any company listed in the United States to have its audit workpapers available for inspection by the U.S. Public Company Accounting Oversight Board, whether the auditors are American or not. The Chinese government has successfully thwarted U.S. efforts to inspect these workpapers, invoking its infinitely elastic "state secret" law to prevent firms from disclosing the documents while resisting PCAOB efforts to negotiate a meaningful agreement that would authorize U.S. inspectors to review the documents. In response, the Securities and Exchange Commission, which has the authority to delist these companies, has instead effectively condoned Chinese defiance by imposing woefully minimal fines on non-compliant audit firms. The SEC recently appointed an entirely new Board to the PCAOB. Will this Board be more aggressive? If so, will the SEC back it?

  Hongqiao would not have been subject to review by American audit overseers because it is not listed in the United States, but other Chinese companies, including Chalco, are, and would. However, Hongqiao did make it clear in its IPO prospectus that its shares would be offered to qualified institutional buyers in the United States, which could be a basis for establishing jurisdiction in U.S. courts. (Prospectus, 246)