

Testimony of the Honorable Grant D. Aldonas
Before the Congressional-Executive Commission on China
“Ten Years in the WTO: Has China Kept Its Promises?”
December 13, 2011

Mr. Chairman and distinguished members of the Commission, thank you for the opportunity to testify. Having served as Chief International Trade Counsel on the Senate Finance Committee at the time of Congress’ consideration of permanent normal trade relations for China, I understand the critical role that the congressional leaders envisioned for the Commission.

I was fortunate, later, as Under Secretary of Commerce for international trade, to serve on the inaugural Commission and participate in its early work. I have enormous respect for the time and commitment you and the Commission’s staff have invested in examining China’s implementation of its WTO commitments, which remains central to our bilateral trade relationship with China. In my view, these issues also represent a critical determinant of China’s own evolution – politically, economically, and socially – in the years to come.

After briefly reviewing some numbers on U.S.-China trade over the past decade and discussing the impact of China’s on the WTO, I will return to those issues, particularly the impact of WTO accession on the development of the rule of law in China.

Effect of China’s Accession on U.S.-China Bilateral Trade

There are a number of ways one might measure the effect of China’s accession to the WTO. The most obvious is the sheer volume of trade that China’s accession has encouraged. U.S. exports to China expanded rapidly from a very small base of \$16 billion just prior to China’s WTO accession to more than \$91 billion a decade later in 2010. That amounted to an increase of 468 percent, as compared to a growth of only 55 percent in US exports to all other destinations over the same ten-year period.¹ That trend is continuing, with exports to China rising 32 percent in 2010, which represents faster growth than in any of the other top five U.S. export destinations.²

Having said that, our bilateral trade is extremely lopsided, as critics of China’s trade and industrial policies have pointed out. Our bilateral trade deficit with China has tripled over the past ten years.³ According to the Office of the United States Trade Representative (“USTR”), the U.S. trade deficit in goods with China was \$273.1 billion in 2010 – roughly a \$46 billion (20 percent) increase over 2009.⁴ Our bilateral deficit with China accounted for 43 percent of our total deficit in trade in goods last year.⁵

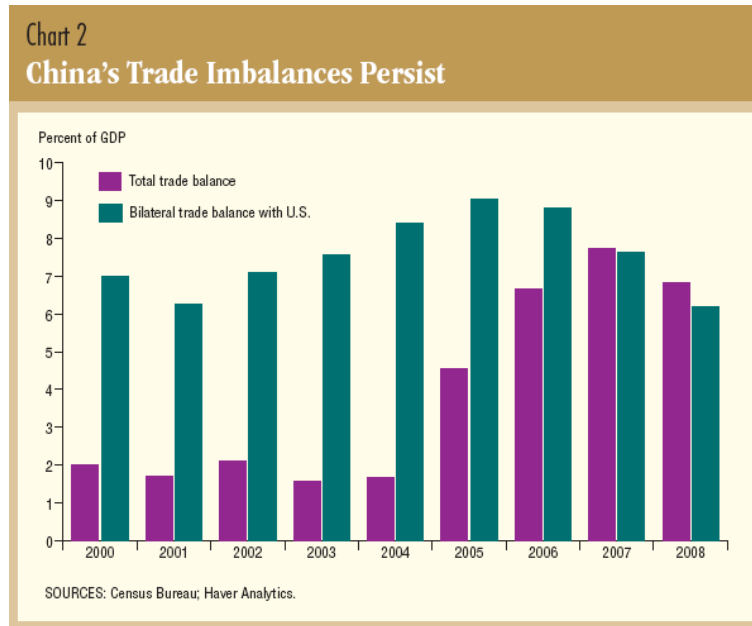
¹ U.S.-China Business Council, *US Exports to China by State, 2000–10*.

² *Id.*

³ China Data: Trade and Investment Since 2001 in *The China Business Review* (October-December 2011) 34-37.

⁴ Office of the United States Trade Representative, *U.S.-China Trade Facts* at

As the chart below highlights, our bilateral trade deficit with China has remained stubbornly high regardless of the broader shifts in both the U.S. and global economy.⁶



As I discuss below, there are a number of reasons why the deficit is not actually as large as the trade statistics suggest and while, in economic terms, bilateral deficits are far less relevant than our overall current account deficit when thinking about the health of the U.S. economy as a whole, it is still hard to explain the persistence of our deficits with China within the conventional framework of textbook economics.

The question is what to draw from that conclusion. In my own view, there is little that you can draw from the existence of the deficit itself in terms of the specifics of trade policy. Much like legal remedies under domestic law for tort or breach of contract, the tools that either the WTO or domestic law provide are designed to address specific infractions of the rules.

What it points to, instead, is the risk of negotiating solely about border measures and other conventional trade policies or practices, when two countries operate from fundamentally different assumptions about the organization of economic activity, the nature of competition, and the role of the state in the economy in their respective home markets.

<http://www.ustr.gov/countries-regions/China>.

⁵ Id.

⁶ Wang, J., With Reforms in China, Time May Correct U.S. Current Account Imbalance in *Economic Letter – Insights from the Federal Reserve Bank of Dallas*, Vol. 6, No. 1 (January 2011).

If anything, the past ten years of China's participation in the WTO and the persistence of our trade deficits ought to give us pause before agreeing to allow Russia into the WTO, given the fundamental disjuncture between our assumption of the value of open and contestable markets, whether here at home or globally, and the assumptions that underpin Prime Minister Putin's vision of the Russian economy and the state's role within it.

The traditional arguments in support of free trade, which I fully endorse because of their power to undermine entrenched economic interests that have found a way to vindicate their economic interests through the political process, are ultimately an extension of our collective belief in the value and benefits of expanding human freedom generally. But, that is simply a very different basis on which to organize a society and economy than that which prevails in either China or Russia.

Much of what we see as pathological about China's trade policy is, in my view, an extension of a very different model of organizing its economy. The broader reaches of our trade policy and our international economic strategy have to come to grips with that conflict in a way that calls for better enforcement and new compliance tools simply cannot address.

Lies, Damn Lies, and Statistics

Without defending China's more mercantilist policies, it is still important to put our bilateral deficit in perspective. In part, our bilateral trade deficit with China reflects the structure of trade in a globalized world economy and the erroneous way in which our trade statistics account for the country of origin of goods imported into the United States.

China represents the final assembly point of a regional value chain in Asia that serves world markets, including that of the United States. While the value that China adds in many of the electronic goods it exports to the United States is limited, the WTO rules of origin that govern our trade statistics base the country of origin determination on the final "substantial transformation" of the product.

Substantial transformation is a term of art in the world of customs that attempts to describe a manufacturing processes that results in a shift of a good from one tariff category to another or result in a "new and different article of commerce," depending on the rule applied to the specific good. It is not a measure of the actual value added by that final "substantial transformation," which is what is really relevant when thinking in terms of our import statistics and the extent to which they accurately reflect the reality of global supply chains.

The fact is our rules of origin do not reflect that reality and overstate our both our bilateral trade deficit and our current account deficit in general. The best way to understand that is to think in terms of a specific good, like your cellular telephone.

In the case of Apple's iPhone, for example, the majority of the value in the phone flows from processes that take place in the United States. Another significant share of the value of the phone is made up of parts and components that are manufactured elsewhere in Asia. China serves as the final assembly point (i.e., the location of the final "substantial transformation") and, as a result, the iPhone enters the U.S. market with an origin mark that says "Made in China" and the full value of the phone registers as an import from China for purposes of our trade statistics, despite the fact that roughly 60 percent of the value of the phone is U.S. content and 35 percent of the remaining content comes from destinations other than China.

I do not want to overstate the effect, as substantial as it is in the case of goods like the iPhone. Chinese firms are moving up the value chain, which means that more of the value of the goods that China exports is likely to be produced in China to the extent that trend continues. That is, in fact, the point of China's "indigenous innovation" policy.

In the event, the indigenous innovation policy is likely to fail because it tries to force Chinese firms up the value chain, rather than forcing them to earn it. Equally important, China's rise in the regional value chain will largely come at the expense of other Asian markets, rather than the United States. But, suffice it to say that an increase in Chinese context of what they ship to the United States softens the criticism of our trade statistics that I outlined above.

Again, the question is what lesson to draw from the fact that our statistics fail to capture very much of the reality of global trade, including that part of it which is the U.S.-China bilateral relationship? The answer is that both our current statistics and our current conception of the economic challenges we face are badly out of date and do not form a reasonable guide from which U.S. policymakers can either assess those challenges or design policy options that might advance our interests.

What our approach to rules of origin and the statistics that flow from those rules reflect is an assumption about how industry is organized and how trade is conducted. Our rules reflect the extent to which we conceive of trade in terms of an arm's length sale between independent buyers and sellers in different countries, where the buyers and sellers are highly vertically integrated.

But, the reality of global trade today is anything but that. Well over 50 percent of all global trade takes place within the reach of companies and their overseas affiliates, rather than independent, vertically integrated firms, as was the case in the past. A still bigger share of world trade today takes place within the broader reach of the global supply chains such firms manage.

Our current system of trade statistics, and the deficits that those statistics tend to amplify, simply do not capture much about the relative competitiveness of U.S. firms and U.S. workers in the global economy. They are, in fact, materially misleading.

Seen in that light, one important lesson to draw from the first 10 years of China's participation in the WTO is that globalization has made hash of the way we used to understand the world in economic terms and that we will be doing the American people a terrible disservice if we continue to make trade policy, whether with China or with other trading partners, on the basis of measures that are more relevant to the 19th century, rather than the 21st.

One of the lessons my mother taught me was that the one sure way to get the wrong answer is to ask the wrong question. The way we measure our trade with China amounts to the same thing. It leads us to ask the wrong questions about the relationship and risks leading us to answers that will not fundamentally alter the underlying dynamic in any way that serves our economic interests.

Our Bilateral Trade Deficit with China in a Broader Economic Context

The more important point is not the statistics, however, but the nature of what a bilateral trade or current account deficit means in economic terms. Our current account deficit is a function of our domestic consumption and savings. Our own recent economic history illustrates that fact.

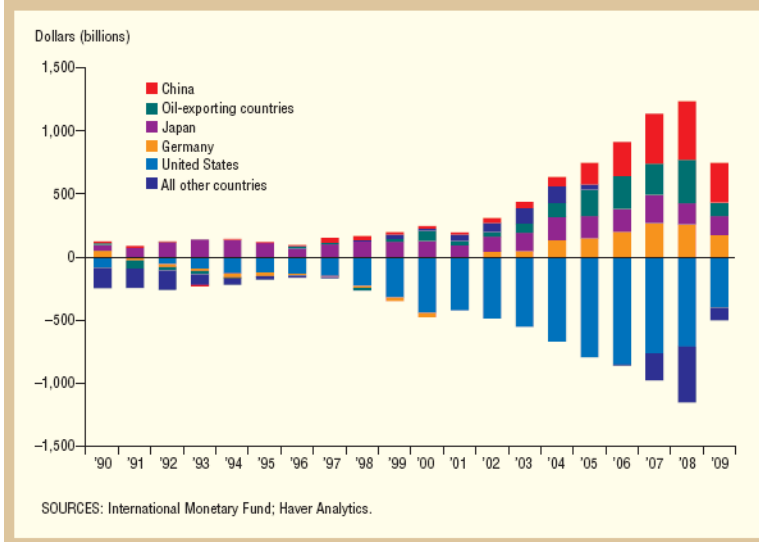
The borrowing binge that brought us the financial crisis was reflected in an extraordinarily low domestic savings rate, with imports making up the difference between what we produced and what we consumed. As U.S. consumers began consuming less and saving more in response to the financial crisis, our current account deficit fell from its high point in 2006 in advance of the crisis, at which point it hit a record 6 percent of GDP, to its current level of roughly 3 percent of GDP, which is about what it was in 2000.

The following chart from a recent report by the Federal Reserve Bank of Dallas illustrates that shift.⁷ While our current account deficit persists, it has declined sharply since 2006, as reflected in the decreasing light blue bar below the horizontal line.

⁷ Id.

Chart 1

U.S. Current Account Deficit Continues



The Commerce Department’s preliminary figures for the first half of 2011 indicate that the current account deficit turned down again in the second quarter of this year (from \$119 billion in Q1 2011 to \$118 billion in Q2), after expanding somewhat from January through March.⁸ That suggests that the deficit will remain roughly 3 percent of GDP for all of 2011.

In economic terms, a current account deficit of 3 percent of GDP should not be a major concern from the perspective of our economy’s ability to finance the borrowing that the deficit implies, which explains why economists focus on the overall current account deficit, rather than its make up in terms of trade with specific countries, and why they are not particularly concerned with the imbalance in terms of its impact on the prospects for U.S. growth.

I am, nonetheless, less sanguine than many of my friends in the economics profession, largely because the current account deficit has persisted for so long, even in the face of the recent deleveraging by U.S. households, when the standard textbook explanation of the deficit in terms of savings rates should have dictated a far more significant change. I agree that, within the confines of the way economists normally think about the economic effect of the deficit, it is true that our current trade deficit is less troubling than what we saw at its peak in 2006.

But, just like the discussion of our trade statistics above, I doubt whether that captures all that is to be understood from the persistence of the deficit. It seems clear that, if China – and Japan and Germany, as well – had all moved more significantly in

⁸ Bureau of Economic Analysis, U.S. Department of Commerce, News Release – U.S. International Transactions: Second Quarter 2011, Current Account (September 15, 2011).

rebalancing their economies away from exports toward domestic demand as they promised to do in various G-8 and G-20 meetings, the current account deficit would largely evaporate. It would, at a minimum, serve as less of a drag on our economic growth, and leave room for a greater stimulative effect from U.S. exports on the economy and employment opportunities here.

The standard economic case for why deficits do not matter does not really come to grips with that reality. In a dynamic, \$14 trillion economy, we are fully capable of bearing the carrying cost of a relatively small current account deficit (at least as a share of GDP), but that does not exclude the possibility that persistent current account deficits may also reflect very differing systems of organizing our economies.

What that means in trade policy terms is complex in practice, but relatively easily stated in principle. Our goal in trade negotiations should be more than simply bargaining for reductions in border measures and other conventional trade barriers. Rather, our goal should be the pursuit of fully open and contestable markets, both because that is the most efficient way to organize economic activity and because it is the only mean of organizing economic activity that is consistent with our underlying belief in the expansion of human freedom.

We ought to bargain with that outcome in mind. The past 10 years of experience with China under the WTO reflects the fact that we did not bargain with that outcome in mind in the 13 long years it took to reach an agreement with the Chinese about their accession to the WTO.

Impact of China's Accession on the WTO

An alternative way of thinking about the effect of China's entry into the WTO is its impact on the organization. There, the record is mixed.

On the one hand, China has proved willing to submit trade disputes to the WTO's dispute settlement procedures and live by the WTO's rulings, even when those rulings went against it. More often, China acted to preempt legal rulings against it by the WTO dispute settlement process and bargained with the United States and other WTO members on a resolution of the specific dispute to avoid that outcome.

The first case brought against China under WTO rules offers a case in point. In 2004, the Bush administration filed the first WTO complaint against China. The U.S. complaint alleged that China had provided preferential treatment for domestic semiconductor producers and that the preferences violated China's national treatment obligations under Article III of the General Agreement on Tariffs and Trade 1994. The European Union, Japan, Mexico and Taiwan all joined in the consultations following the filing of the complaint. In the end, China negotiated with the United States and the other WTO members to eliminate the tax incentives.

In that sense, the WTO dispute settlement system worked as well as it could have. The Chinese tax preferences clearly discriminated against U.S. semiconductors once they entered the Chinese market, which violates Article III. Recognizing that norm, China acted to preempt the need for a definitive ruling and implemented a plan to bring itself into compliance.

On the other hand, China's unwillingness to consider any serious trade liberalization beyond the commitments it made as part of its accession process hampered the effort to negotiate a successful Doha round of WTO negotiations. Both prior to and at the launch of the round in Doha in 2001, the Chinese argued that they had, in effect, already "paid at the office." They wanted the liberalization's agreed to as part of the accession process to count toward their commitments in the Doha round negotiations.

It is genuinely hard to design a stance on negotiations that is more fundamentally inconsistent with both the dynamic that multilateral trade negotiations must foster in order to succeed or to define a stance that is more deeply inconsistent with the basis on which China agreed to accede to the WTO. Accession is a process by which a non-member comes to the table and, through negotiation, offers a package of proposed liberalizations that are equivalent to those already undertaken by the existing members of the organization. In that sense, China's accession was simply bringing China's trade regime into line with the existing commitments and liberalization that other WTO members had already made.

What accession does not do is guarantee that one party will be held harmless in future negotiations. Given that all China had done was accept obligations commensurate with other participants in the trading system, there was no ground to say that China should not be expected to contribute to the process of liberalization going forward, just as was true of every other member of the organization.

China's influence on negotiations within the WTO has taken one other form, which is also negative. To make a multilateral deal that was sufficiently attractive to other trading partners in the organization, developing countries were obliged to come up with offers or a methodology for reaching an agreement with other WTO members that would allow a deal to move forward, even though the obligations they would assume would not be commensurate with those of developed countries like the United States.

In the event, China's accession resulted in fewer offers and greater intransigence from developing country delegations. The reason is that the trade policymakers of any number of poorer developing countries could not contemplate tabling an offer to the United States that WTO rules would require them to "multilateralize" (i.e., they would owe the obligation to all WTO members under Article I of the GATT, its most favored nation clause). Their resistance to such a deal had nothing to do with opening their markets to the United States and everything to do with their unwillingness, in the process, to open their markets to Chinese goods for fear that Chinese imports would swamp their markets and result in the immiseration of any number of people who had previously been employed in competing industries.

In short, China's accession significantly complicated the negotiating dynamic within the WTO and made it more likely, although it was not the sole cause, that the Doha round negotiations would end in failure.

Assessing Implementation and Measuring Compliance

A third way of thinking about China's accession is through the lens of its implementation of its obligations and its record of compliance with WTO rules. As I suggested a decade ago, China made a great effort to implement its WTO obligations in Chinese law in preparation for its accession. By some counts, those efforts included the amendment of well over 2,000 national laws and some 190,000 local laws and regulations.⁹

It is difficult to conceive of a shift our legal regime on that scale. Even the recently passed Dodd-Frank Wall Street Reform and Consumer Protection Act, which created multiple new government agencies, mandated 243 new regulatory projects, required the agencies to conduct 67 studies, and called for 22 periodic reports, pales by comparison. To put it in context, as big a piece of legislation as Dodd-Frank ultimately became, China had to amend more national laws than Dodd-Frank had pages.

Seen in that light, China's implementation of its obligations throughout the Chinese legal system in advance of its accession to ensure, at least as codified, that its laws conformed to its WTO obligations was a remarkable feat.

In my experience, China's efforts went considerably further. Both as a means of easing doubts about WTO and its potential impact on Chinese producers, as well as a means of informing the public about the impending changes that WTO accession would require, the Chinese government undertook a considerable campaign to educate the public about the obligations that China had assumed and the rights that would accrue to China and Chinese producers by virtue of the WTO agreement.

The Shanghai WTO Affairs Consultation Centre offers a case in point. The Shanghai People's Municipal Government created the center to provide a professional, non-government consulting institution to offer legal and policy advice on WTO affairs, as well as WTO-related training.¹⁰ Since its founding, the WTO Centre contributed significantly to the local implementation of China's WTO accession commitments in Shanghai through its advice to both the central and regional governments responsible for various aspects of implementation.¹¹

⁹ Wang, Y., WTO Accession, Globalization, and a Changing China in *The China Business Review* (October-December 2011) 31-33.

¹⁰ Gong, B., Managing the Challenges of WTO Participation: Case Study 11, Shanghai's WTO Affairs Consultation Center: Working Together to Take Advantage of WTO Membership, World Trade Organization.

¹¹ Id.

The WTO Centre has also played a constructive role in helping resolve disputes at a regional and local level. One early example involved the Centre's discussions with the U.S. Consulate in Shanghai regarding the auction of license plates, which were essential to the purchase and registration of a car.¹² The Consulate staff highlighted the fact that local authorities were operating two separate systems of auctions for license plates, with one set of rules for domestically produced cars and entirely separate and more onerous requirements for auctions involving foreign-made automobiles.

With that information in hand, the Centre entered into negotiations with the Shanghai Municipal Development Planning Commission to establish a single set of rules for the auction of license plates. The ostensible purpose was to "avert a potential trade dispute and protect Shanghai's reputation as a place to do business." The collaboration between the U.S. Consulate and the Centre resulted in changes in the system in a way that brought the auction of licenses into conformity with WTO rules.

Having said that, as early as 2002, we began to see significant departures in Chinese practice from the commitments to which China had agreed in the process of its WTO accession. In its second report to Congress on China's compliance with its WTO obligations, for example, USTR highlighted "a number of systemic concerns" that remained with China's implementation.¹³

A number of the individual actions involved discrimination in rebating value added taxes, one instance of which eventually led to the first WTO case against China, as noted above. The USTR report also highlighted continuing problems in the enforcement of intellectual property rights, despite the fact that the laws on the books had faithfully implemented China's obligations under the WTO Agreement on Trade-Related Aspects of Intellectual Property ("TRIPS"). There were clearly areas, like trading and distribution rights, where China's compliance lagged and there were disputes with China about the exact nature of the obligations regarding the branching of insurance providers in the Chinese market.

But, perhaps the most serious issue, at least in systemic terms, was the halting compliance with the WTO's obligations on transparency, with Chinese agencies soliciting the comments of Chinese industry without even making U.S. and other foreign companies aware of the potential regulatory action, much less aware of an opportunity to offer comment on the proposed rules. In addition, and perhaps not unexpectedly, the overall implementation effort was, according to USTR, "plagued by uncertainty and a lack of uniformity."

It also seemed that the willingness of Chinese officials to resolve implementation issues quickly had begun to wane. Rather than the attitude that informed the resolution of the auction of automobile licenses in Shanghai early on in the process, discussions on compliance began to take on the character of protracted negotiations with progress being

¹² Id.

¹³ USTR, *2002 Report to Congress on China's WTO Compliance*, December 11, 2002.

made only when the agenda was driven toward some action forcing event, like the advent of a meeting of the Joint Commission on Commerce and Trade.¹⁴

The slowdown in compliance became a growing concern and culminated in then-USTR, now Senator Rob Portman launching a “top to bottom” review of our trading relationship with China in 2006.¹⁵ The resulting report not only offered a compendium of the challenges that we faced in securing China’s compliance with its WTO obligations, it also identified a number of ways in which our enforcement efforts could be strengthened.

But, in re-reading the review in preparation for this hearing, what struck me most were two lines that captured the essence of the problem. There, the report states –

China’s ascendancy as a major international trading partner brings with it certain responsibilities for the maintenance of the multilateral, global trading system. As the size of its market and trade flows have increased, China’s constructive participation is increasingly critical to the international regimes governing trade practices – regimes that foster free and open markets, a level playing field, and transparent regulations.¹⁶

In a nutshell, those two lines capture what is most troubling about China’s rise as a trading state. If China’s leaders shared that perspective on the role that China should play within an international trade regime that affords China manifold benefits, my instinct is that there would be far less concern in Congress and in the American public about our trade with China and that we would have far greater confidence in the prospects for continuing collaboration going forward.

The Acid Test

In medieval times, there was great concern about various coins in general circulation that purported to be gold. Goldsmiths tested them with nitric acid to be certain that the coins were gold and weighed them to make sure that they were literally worth their weight in gold.

Nearly 10 years ago, while serving on the Commission, I had the opportunity to testify on China’s entry into the World Trade Organization (“WTO”) and its implementation of its obligations under the WTO. At that time, I emphasized two points. The first was that China’s compliance with its WTO obligations should be “the single most important measure of our bilateral relationship” and that “early, transparent, and

¹⁴ The General Accounting Office highlighted this perceive slowdown in hits 2008 report to the Chairman of the Senate Finance Committee. See United States Government Accountability Office, *Report to the Chairman, Committee on Finance, U.S. Senate, U.S.-China Trade: USTR’s China Compliance Reports and Plans Could Be Improved*(April 2008) (“In addition, our analysis revealed that China’s progress in resolving compliance issues appears to be slowing over time, especially since 2003 . . .”).

¹⁵ Office of the United States Trade Representative, U.S.-China Trade Relations:

Entering a New Phase of Greater Accountability and Enforcement - Top-to-Bottom Review (2006).

¹⁶ *Id.*

measurable progress on compliance” should be our primary goal. The second point I made, which I believed at the time and still believe, is ultimately the more important of the two, “is the inescapable link between WTO compliance and the development of the rule of law in China.”

I still think that the more important measure of whether China’s accession to the WTO served our interests and the trading system’s interests, as well as China’s, depends heavily on the extent to which it fosters a broader respect for the rule of law within China, a far lesser role for the state and the Communist Party in the operation of the Chinese economy, and the steady erosion of the system of *guanxi* – the connections that dominate both China’s politics and its commerce. That to me is the acid test of China’s compliance with its WTO obligations.

To understand why that is the case requires a step back from current debates over China’s currency policy or the industrial policy it has pursued under the rubric of “indigenous innovation” to look at the broader reach of Chinese history and the organization of Chinese society. It obliges us to understand the tension between two very different views of social and economic relationships that are at play in China and will define its future.

On one hand, there is *guanxi*, which has formed one of the organizing principles of Chinese society since Confucian times. On the other hand, there is respect for the rule of law, which has actually fostered much of China’s economic progress since Deng Xiaoping launched China on the path of economic reform in 1979. China’s progress politically, economically and socially will largely be defined by progress it makes from a system based on *guanxi* toward a system based on the rule of law.

That is not to say that *guanxi* is necessarily a bad thing. *Guanxi* describes a reciprocal personal relationship between two people in which one is able to prevail upon another to perform a favor or service. More broadly, *guanxi* refers to the advantages gained from social connections that begin with one’s extended family and continue through school friends, colleagues at work, and allies in politics.

In its most positive form, *guanxi* parallels much of Confucian thought, with its heavy emphasis on reciprocal obligations or *ren*.¹⁷ In that sense, *guanxi* can strengthen social cohesion. Unfortunately, *guanxi* can also foster corruption and nepotism and, in the process, undermine or obstruct the development of the rule of law. In that sense, *guanxi* practice can yield the exact opposite of *ren*.

¹⁷ The *Analects*, traditionally attributed to Confucius, captures that notion in a dialogue between Confucius and one of his students. Zi Gong, the student, asks, "Is there one word that may serve as a rule of practice for all one's life?" Confucius, the Master, responds, "Is not reciprocity such a word?" *Analects*, XV.24.

Wholly apart from the benefits to society that may flow from guanxi and its principle of reciprocal obligation, guanxi also represents a rational economic response to what Nobel Laureate Ronald Coase identified as the challenge of overcoming transaction costs in organizing the production of any good or service. Corporations and other forms of business association, in Coase's view, owe their existence to the fact that producing within the structure of a single enterprise, rather than contracting for the same services with independent suppliers in the market, reduces the transaction costs associated with searching for prospective suppliers, bargaining with them for their services, and policing and enforcing the contract against them in event of breach.

In the absence of the rule of law, transaction costs rise significantly because of the difficulty of policing and enforcing any contract with outside parties. The certainty the law provides is, in one sense, a substitute for the assurance an entrepreneur otherwise derives from close family relationships or, in the case of China, guanxi and the network of reciprocal obligations it implies.¹⁸

Relative to a system without laws, guanxi works efficiently. The opposite, however, is not true. Guanxi is not more efficient than a system of sound laws with adequate processes for enforcement.

As Douglass North, another Nobel Laureate has pointed out, "When transaction costs are significant, then institutions matter. A set of political and economic institutions that provide low-cost transacting makes possible the efficient factor and product markets underlying economic growth."¹⁹ At least in so far as it contributes to economic growth, the rule of law – one of the political and economic institutions to which North refers – trumps the informal networks that either family or a broader network of guanxi provides.

It is currently fashionable to denigrate the "Washington consensus" and to suggest that countries like China, South Korea, Singapore and Taiwan succeeded with heterodox policies that were deeply inconsistent with the market liberalization for which the alleged consensus called.²⁰ But, the reality is quite different, as North would have predicted.

¹⁸ Janet Landa explained it well in saying, "[c]entral to the economics of property rights-public choice theory is the recognition that laws and institutions are important in promoting the efficiency of an economy. One of these institutions is the law of contracts. Contract law, via its role in constraining traders from breach of contract, reduces transaction costs and hence facilitates exchange. But how do traders cope with the problem of contract uncertainty in an environment where the legal framework is nonexistent or poorly developed?" At least in the case of China, the answer, according to Landa, was the development of networks based on guanxi. J. Landa, A Theory of the Ethnically Homogeneous Middleman Group: An Institutional Alternative to Contract Law in *The Journal of Legal Studies*, Vol. 10, No. 2 (June 1981) 349-362.

¹⁹ North, D. C. (1984) 'Transaction Costs, Institutions, and Economic History', in *Journal of Institutional and Theoretical Economics*, vol. 140, pp. 7-17.

²⁰ John Williamson coined the phrase "Washington consensus" as a means of describing a set of ten policy recommendations that had the support of the International Monetary Fund, the World Bank, and the U.S. Treasury. Those prescriptions for heavily indebted developing countries included, (1) fiscal policy discipline (i.e., avoidance of large fiscal deficits relative to GDP); (2) a shift in public spending away from subsidizing specific industries toward the provision of pro-growth services like primary education, health

Each of the Asian countries that economists like Dani Rodrik of Harvard regularly cite for their success in defiance of the Washington consensus actually share much more with the consensus and with each other in than the critics suggest.

Most importantly, in all of the supposedly heterodox cases, countries relied heavily on the legal institutions that underpin a market economy – private property, freedom of contract, and the enforcement of property and contract rights. Indeed, China’s economic success did not really begin until those institutions migrated from special economic zones more deeply into the Chinese economy as a whole.

Understanding that fact is key not only to understanding China’s progress, but also to understanding the extent to which that progress is at risk. China’s implementation of its WTO obligations helps illuminate the point. The evidence suggests that, in broad terms, “[e]conomic governance in China has become much more routinized and transparent in the last ten years, particularly in response to the requirements placed on China if it wished to become a member of the WTO.”²¹

Per Douglass North, that should not surprise us and recent empirical studies reinforce the point. To the extent that guanxi developed as an institution centuries ago in China as a means to foster trade in the absence of a more formal legal system, we should expect that it would give way in the face of China’s development of such a system of laws.²² The reality is that developing and maintaining a guanxi relationship is not cost free. Rather, it is “a time-consuming and expensive endeavor.”²³ Reliance on the rule of law is the more efficient, more productive and lower cost option, if that system of laws is available.

Is that system of laws available in China and has the WTO contributed to its development? The answer seems contradictory – it is no and yes. The system of laws that would eliminate the need for guanxi is not yet available, but it is clear that the

care, and infrastructure investment; (3) tax reform to broaden the tax base and lower the rates in order to diminish the incentive for tax avoidance; (4) reliance on markets to determine interest rates; (5) flexible exchange rates (largely as a means of avoiding overvaluation and the damaging effect it has on the competitiveness of local industry); (6) trade liberalization, particularly with respect to imports; (7) liberalization of barriers to inward foreign direct investment; (8) privatization of state enterprises; (9) deregulation of markets (i.e., elimination of regulations that impede market entry or restrict competition); and (10) legal security for property rights. The term Washington consensus has, however, taken on a broader and more pejorative meaning largely due to criticisms of the IMF and World Bank by economists like Joseph Stiglitz of Columbia, who dismissed the policy prescriptions as “market fundamentalism.”

²¹ Smart, A., and J.Y. Hsu, *The Chinese Diaspora, Foreign Investment and Economic Development in China*, *The Review of International Affairs*, Vol.3, No.4, Summer 2004, 544 – 566.

²² See, e.g., Carr, J. and J. Landa, *The Economics of Symbols, Clan Names, and Religion in The Journal of Legal Studies*, Vol. 12, No. 1 (Jan., 1983) 135-156; J. Wilson and R. Brennan, *Doing Business in China: Is the Importance of Guanxi Diminishing?* in *European Business Review*, Vol. 22, Issue No. 6 (2010) 652 – 665.

²³ Ying Fan, *Guanxi’s Consequences: Personal Gains at Social Cost*, *Journal of Business Ethics*, Volume 38, Number 4 (July, 2002) 371-380.

process of implementing China's WTO obligations has contributed to greater certainty and transparency in the legal system, to the extent it exists.²⁴

What then might alter the situation positively or negatively? On the positive side of the ledger, the United States could lead the way in developing a very different type of trade agreement in its trading relationships elsewhere in Asia – one that focused as much on commitments to the underlying institutions of a market economy as it did on conventional trade barriers. The opportunity exists to build that sort of arrangement in the current negotiation of the Trans-Pacific Partnership, should President Obama choose to use it. All of the countries that are currently a part of those negotiations share a commitment to open and contestable markets, both domestically and internationally.

The value of such an arrangement in the context of our relationship with China is straightforward. China will not be pressured into doing anything that it views as inconsistent with its interests (or, more accurately, that the Communist Party leadership thinks is inconsistent with its continuity in power in Beijing). But, if there is an alternative to investing in China that offers greater certainty and commensurate rewards, it may well be that China cannot afford to remain outside such an arrangement. The door to China's access to such an arrangement should remain open, but only to the extent that it is willing to conform to the underlying assumptions of open and contestable markets domestically, as well as internationally.

Having said that, the far greater likelihood I fear is that the tension between *guanxi* and the rule of law is already being tipped toward *guanxi* as a result of the impending generational shift in China's leadership. China is transitioning from a generation that survived the Cultural Revolution and became inherently conservative in its approach to the generation that, as Red Guards, brought China the Cultural Revolution. Their approach is one of greater obeisance to the memory of Mao and less obeisance to the pragmatic approach that informed China's economic rise. That includes less of an inclination to observe the "niceties" of the rule of law, despite the potentially damaging consequences of that approach for China's prosperity and evolution toward a more prosperous and freer society.

While I think the WTO rules have influenced China positively in terms of its legal development, I doubt whether they have the strength or the roots in Chinese society after only 10 years of somewhat halting implementation and observance to offset a more powerful demographic shift that is currently under way in China.

²⁴ As one author put it, "[g]iven the problems of performance and enforcement in the Chinese legal system, *guanxi* relations play an essential role in providing predictability to legal actors. While the role of *guanxi* can be limited by formal law and legal processes, the formal legal system [in China] remains incomplete and would have little effect at all were it not for the informal mediating mechanisms such as *guanxi* relations. Thus, the complementary relationship between *guanxi* and law will continue to characterize the Chinese legal system for the foreseeable future." See Potter, P., *Guanxi and the P.R.C. Legal System: From Contradiction to Complementarity in Social Connections in China: Institutions, Culture, and the Changing Nature of Guanxi*, T. Gold, et. al. (2000) 183.

When I appeared before this Commission 10 years ago, I made the point that the “[o]bservance of the law in any society must become a habit -- it must be woven into the fabric of social relationships.” That does not describe China today, where the ancient role of guanxi remains relatively stronger than the rule of law.

The danger to China, as well as to our trade relationship and the institution of the WTO may well come from the rise of the so-called “princelings” of the ascending generation, who owe far more to guanxi than to the rule of law. I doubt that they can envision China’s progress apart from their own. It is exceedingly hard to see how observance of the law becomes a deeply ingrained habit throughout Chinese society if the political leadership of the country does not practice it as well.

Thank you.