China's Faux Comparative Advantage

The economics textbooks don't anticipate a state-directed economy that disregards the rule of law.

Container ships at a port in Qingdao, China. PHOTO: AGENCE FRANCE-PRESSE/GETTY IMAGES

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In textbook economics, trade is a win-win: Two countries trade freely based on comparative advantage and share the resulting gains, improving welfare in both countries. America's trade with China is as far from that model as the Earth is from Mars.

Historically, the U.S. has had a comparative advantage in manufacturing because of its high rates of technological innovation, correspondingly high rates of capital investment and worker productivity, strong protections for intellectual property, and wide availability of low-cost energy. Yet since joining the World Trade Organization in 2001, China has come to dominate traditional manufacturing. By 2015 it accounted for 28% of global production of autos, 41% of ships, more than 50% of refrigerators, more than 60% of televisions, and more than 80% of computers and air conditioners.

As is evident in government documents such as China 2025, China increasingly threatens to dominate the industries of the future: artificial intelligence, autonomous vehicles, blockchain systems, robotics, high-tech ship manufacturing and more. These technologies have profound strategic implications.

In large part because of China's dominance in manufacturing, the U.S. last year ran a bilateral trade deficit in goods of $375 billion, or more than $1 billion a day. Contrary to the textbook model, whereby currency adjustments help rebalance trade, the U.S. trade deficit with China has been persistent—more than $4 trillion cumulatively since 2002—and growing.

Why is the textbook model failing? The answer is that China's faux comparative advantage is the result of its state-directed investments, nonmarket economy, and disregard for the rule of law.

The problem's taproot is Chinese intellectual-property theft and the forced transfer of foreign technology as a condition of accessing China's market. These illicit practices, including widespread cyberespionage, allow Chinese companies to move rapidly up the innovation curve at much lower cost than their foreign competitors, which must recoup the cost of research and development through higher prices.

Other forms of economic aggression contribute to China's faux comparative advantage. To protect its market, China erects high tariff barriers—e.g., its auto tariff is 10 times that of the U.S. China has high nontariff barriers, too, including intrusive licensing requirements and foreign-ownership restrictions that keep the playing field tilted in favor of Chinese companies.

To gain global market share, China showers its state-owned and state-financed enterprises with subsidized land and capital, myriad export subsidies, and lucrative tax preferences. To prevent the adjustments predicted by the textbook model of trade, China has historically undervalued its currency.

Most broadly, China's "going out" strategy involves leveraging sovereign-wealth funds to capture the industries of the future. Three of the world's 10-largest SWFs are from China, and China Investment Corp. has close to $1 trillion. These funds regularly scour technology-rich communities like Silicon Valley, Boston and Austin, Texas, seeking to purchase the crown jewels of American innovation. Since its founding in 2009, for example, Sinovation has accumulated $1.2 billion in total capital and has invested in almost 300 startups.

While the U.S. welcomes foreign capital, China perverts the investing process by targeting American companies based on strategic and military goals rather than pure economic considerations. Because high-technology acquisitions often generate spillover benefits for the Chinese military, its SWFs are often willing to pay distortive prices, far above what the free market would dictate.

At times the brazenness of China's economic aggression has been breathtaking. In 2006 China's State Nuclear Power Technology Corp. signed an $8 billion joint venture that resulted in the transfer by Westinghouse of more than 75,000 construction and technical documents on its signature AP1000 nuclear reactor. Meanwhile, Chinese cyber operatives allegedly were illegally penetrating Westinghouse's Pennsylvania computers and information systems to acquire technical documents from its extensive R&D efforts.

By 2015 China had broken ground on a plant to construct its cloned Westinghouse reactor, the CAP1400. Today, as Westinghouse has struggled to stay out of bankruptcy, China is constructing reactors in Pakistan and Romania, is scheduled to build them in Argentina, Britain and Iran, and is bidding on projects in Saudi Arabia, South Africa and Turkey.

The biggest threat China's faux comparative advantage poses is to the global trading system itself. The gains from trade will not accrue to all the partners when one of the largest is engaged in such market-distorting behavior.

It is in the name of fair, reciprocal and ultimately free and prosperous trade that President Trump is standing up to China's intellectual-property theft and other unfair trade practices. The president has the backs of American workers, farmers and businesses. He deserves the support of a world now being victimized by China's economic aggression.

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