

Memorandum

Date: November 13, 1998

Re: Analysis of the "Most Favored Nation" status agreement with China

Introduction:

This memorandum will address the "Most Favored Nation" (MFN) status agreement the United States has with China. MFN is an agreement that allows non-members of the "World Trade Organization (WTO)"¹ to participate in the same reduction in tariffs as countries who are members of the WTO. Using the MFN status agreement the United States has with China as a case study this memorandum will discuss the history, the criteria, the projected outcomes based on the costs and benefits of either renewing or not renewing the policy, as well as an analysis of the factors that lead to a decision to renew MFN status to China.

History:

As the world's most populous country, and for the past decade the fast-growing major economy, China plays a crucial role in the major international issues the United States international trade policy will face in decades to come. In accordance with the outlined guidelines for the agreement, each year the President and Congress decide whether or not to renew MFN status to China. Every year just before the vote on the agreement the President and Congress engage in serious debate over whether or not to renew the agreement. The main issues of debate range from maintaining the peace in Korea; a united international approach to the nuclear testing in South Asia; controls on proliferation of nuclear, chemical, biological weapons, and ballistic missiles; international crime and drug trafficking; pollution and global warming; human rights and religious freedom; the Asian financial crisis; and a more open relationship between the United States and China as a whole.

Although all of the issues the U.S. has with China are important there are two issues in particular that have become the center of debate. The issue of most importance is the growing trade deficit the U.S. has with China, which for the past seven years has totaled \$117 billion. The U.S. merchandise trade deficit with China alone was about \$39.5 billion in 1996. However, even with the large deficit U.S.-China trade has continued to climb. Moreover, with its rapid economic expansion, China's market will be increasingly important for the United States commercial interest. In some sectors, access to the Chinese market has become a critical element of U.S. producers' growth strategies. The United States believes that in order to build a balanced and sustainable bilateral trading

¹ The organization which replaced the "General Agreement on Tariffs and Trade (GATT)." WTO provides all of its members the same reduction in tariffs it gives any other member.

relationship, it will be essential to obtain greater market access for U.S. products and services in China.

The second major issue of concern is the United States' long-term interest in peace and stability in Asia. Regional security remains a key issue in U.S.-China relations. In 1996 MFN status became much more of an issue of conflict between the President and Congress as documents were released that China was continuing to violate the 1968 "Nuclear Non-Proliferation Treaty (NNPT)."² China not only sold Pakistan 5,000 ring magnets³ which could be used in centrifuges to enrich uranium for nuclear weapons but China also sold components for medium-range missiles to Iran. Moreover, in March of 1996 China stepped up its military activity towards Taiwan which included military maneuvers and war games. More recently China has played a key role in regional security issues in Asia including resolving the North Korea nuclear issue. The United States believes that it is extremely important to maintain a healthy diplomatic relationship with China as a way to help keep peace in Asia.

Criteria:

The MFN status agreement with China is used to address the following criteria:

- 1) U.S. Economic Interest
The MFN status policy is used to address this issue on three levels:
 - a. Reduce the trade deficit.
 - b. The preservation of 400,000 jobs invested in the U.S. trade industry with China.
 - c. The toughening of penalties on the pirating of U.S. intellectual property.
- 2) Domestic and International Security
 - a. Maintenance of military safety and stability of the U.S. and the world as a whole by ensuring that China no longer violates NNPT.
 - b. Regional security in Asia.
- 3) Relations with Chinese Government
Improve and stabilize the current diplomatic relationship the U.S. has with the Chinese Government.
- 4) Human Rights Concerns
Improved human rights in China and its territories. At least 1 million Tibetans have died under the heavy hand of Chinese rule⁴ since China invaded Tibet in 1949.

Options:

The President and Congress have two options to choose from:

- Do not renew MFN status.
- Renew MFN status.

² A treaty which prohibits the transfer of nuclear weapons technology to facilities not subject to international inspection.

³ "U.S. and China: Tethered by Trade," The Christian Science Monitor, May 25, 1996.

⁴ Ibid.

Projected Outcomes:

Do not renew MFN status:

Costs:

- No way to improve the trade deficit.
- There would be a severe blow to U.S. efforts to solve the Asian financial crisis. This crisis already affects the U.S. economy, as is seen by a drop in exports to the Asian region and layoffs at companies that export to Asia.
- Hong Kong's economy may be greatly damaged. As much as three quarters of U.S.-China trade goes through this port.
- China may implement even higher tariffs on their imports.⁵ China restricts imports through means including high tariffs and taxes, non-tariffs measures, limitations on which enterprise can import, and other barriers. The result is a pervasive and multi-layered web of trade barriers.
- No way to sanction China for violation of NNPT. National security questions such as the four-party talks on Korea and missile sales in the Middle East may be threatened.
- 400,000 jobs in the U.S.-China trade industry may be lost.
- No way to influence China to be tougher on the violation of intellectual property rights.
- Progress on human rights, as symbolized by the recent release of several well know Chinese dissidents, may be very difficult or even impossible. May also increase acts of aggression toward Taiwan.
- May inhibit good working relationship against drugs and international crime the U.S. has built with China.

Benefits:

- 40% of Chinese exports come from the U.S. Chinese economic structure will suffer greatly. This decision will put great pressure on the Chinese Government to reform its trade policies.

Renew MFN Status:

Costs:

- Trade deficit may increase.
- Tariffs may remain high.
- Pirating of U.S. intellectual property may not change

Benefits:

- Trade deficit may decrease.

⁵ In May 1996, for example, when U.S. decide "\$2 billion in Chinese goods, including silk and electronic products, would be subject to stiff tariffs...China responded with threats of counter-sanctions, including 100 percent additional tariffs on products ranging from cars to telecommunications equipment (George Moffett, "U.S. and China: Tethered by Trade," the Christian Science Monitor; May 25, 1996)."

- American industries such as telecommunications, aviation, the services trades and professions, high-tech manufacturing and agriculture will benefit from better access to Chinese market. Furthermore, 400,000 U.S.-China trade industry jobs, including future business interest in China, will be preserved.
- Continuance of the U.S. diplomatic mission with China.
- The U.S. will be able to use sanctions in order to pressure China not to violate NNPT and maintain regional security in Asia.

Analysis:

When analyzing the MFN status agreement it is easy to believe that it was renewed without outside influence; that the decision-makers, the President and Congress, did not make this decision without outside forces influencing their decision. After weighting the costs and benefits of the agreement renewing it seems to be the best choice. However, this agreement was not renewed in a vacuum. The renewal of the MFN status agreement with China reflects a policy where the interest of private industries guides the decisions of Congress and the President; private actors were given a large amount of influence in the decision making process. Private industry represents the rich and powerful in the U.S. political process. Presidential candidates and members of Congress know it is in their best interest to serve the needs of those who have the money to influence politics. The President and Congress need the financial support of private industry in order to win elections. It is to the advantage of private industry that MFN status be renewed because private industry has billions of dollars invested in U.S. trade with China. If this agreement were not to be renewed U.S. multi-national corporations would lose billions of dollars in revenue; therefore, in return for their financial support, the President and Congress support policies that support private industry. The approach to understanding these behind the scene actions in policy-making is called the public-choice approach. As the President and Congress decide whether or not to renew MFN status to China they are acting as social landlords waiting to be captured by renters. The renters in this case are private business. Multi-national corporations who have a vested interest in keeping trade open with China are willing to pay rent, campaign contributions, to the campaigns of the President and members of Congress. These private businesses are not interested in the growing trade deficit, nuclear arms problems, or human rights issues. They are interested in getting their needs met for the lowest amount of rent. The President and Congress are interested in the renter who is willing to pay the highest rent and in this case it is private business.

The MFN status agreement is an extremely complex agreement. It seeks to address four major issues--U.S. economic interests, domestic and international security, U.S. diplomatic relations with China, as well as human rights concerns. But because private industry is given a large amount influence over U.S. policy-makers the policy is both ambiguous and ambitious. The MFN status agreement is a trade agreement. It is used, however, to put economic pressure on China as a way to address the issues the U.S. has with China. As a result of the policy being used to address both private political interests as well as the problems the U.S. has with China, the policy becomes the center of an interesting debate. On one hand, the U.S. needs something to use as leverage in order to

hold China accountable for its actions. On the other hand, the U.S. is not able to be as tough on China as it should be when China violates agreements and policies because many U.S. private industries depend on U.S. trade with China. These corporations do whatever they need to do in order to insure the trade agreement is renewed. As a result policy-makers make decisions that are not based solely on equally weighted costs and benefits of not renewing or renewing the trade agreement for the nation, but on the costs and benefits of their own political interests.

In conclusion, it is often believed that policy-making is the result of discrete, rational acts and not the process of coming to terms with conflicting interests. Policy-making is a process during which choices are made, exclusions effected, and personal viewpoints imposed. To believe that this process is neutral is to be living with a false sense of reality. Personal realities become the information with which decisions are made. Financial realities determine the actual policies, which are inherently political. Policies are not created free from political interests.