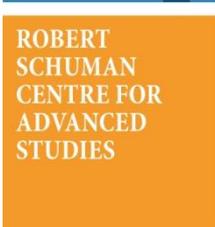




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China and the World Trading System:
Will 'In and Up' be replaced by 'Down and Out'?

L Alan Winters

European University Institute
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Global Governance Programme

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EUI Working Paper **RSCAS** 2015/82

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ISSN 1028-3625

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Printed in Italy, November 2015

European University Institute

Badia Fiesolana

I – 50014 San Domenico di Fiesole (FI)

Italy

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Abstract

This paper examines the integration of China into the world trading system, focusing on the size and nature of the shocks that this implied for the world economy and the reactions to those shocks proposed by policy makers and academics. While the WTO has acted as a forum in which many of the adjustment pressures created by China's rapid growth were dealt with fairly constructively, the recent shift by the United States and the EU to mega-regional trade deals, notably the Trans-Pacific Partnership, and that exclude China, marks a dangerous shift away from engaging the world's second largest economy as an equal in a cooperative fashion.

Keywords

China, WTO, TPP, imbalances, trade agreements

Introduction*

This paper examines the integration of China into the world trading system. It discusses the size and nature of the shocks that it administered to the world economy and some of the reactions to those shocks proposed by policy makers and academics. From its awakening in 1978 China was welcomed into the global economy and generated a huge boost in terms of output and incomes – the ‘in and up’ part of the title. Recently, however, concerns have been expressed about the Chinese economy crashing and imposing a negative shock on world demand, and steps have also been taken to exclude it from the major trade initiatives that we have come to term the mega-regionals – the ‘down and out’ part. It is too early to know about either of the latter phenomena for certain, but it is useful to consider some of the arguments in order that policy towards China does not run into a disastrous blind alley.

It is a great pleasure to honour Patrick Messerlin in this paper. Patrick has been one of the foremost exponents of applied trade policy analysis and advice over several decades with an unflinching focus on the key issues of the day. I will argue that integrating China into the global economy in a way that benefits nearly all presents perhaps the most important international trade and trade policy issue of our present era, and so it is no surprise that it is one which Patrick has addressed himself. Among the papers that you will find in his long list of achievements are:

- Walking with Giants, Project Syndicate,
- Redesigning the European Union’s trade policy strategy towards China,
- The Doha Development Agenda: Asian Challenges and Prospects,
- China in the World Trade Organization: Antidumping and Safeguards, and
- China’s Trade Policy post-WTO Accession.

This paper argues that the shock that the emergence of China is administering to the world economy is larger than any seen previously – and by a large margin. The shock has many manifestations but here, in line with Patrick’s great expertise, I focus on its effects on and via the world trading system. The paper suggests that, while the huge increase in global production that the success of China brings has generated widespread benefits, there will inevitably be some stresses and indeed possibly some losers. Some of these stresses are essentially microeconomic – competitive pressure on firms elsewhere in the world – while another set arises from the macroeconomic imbalances that China’s rapid growth has induced globally. Part of China’s integration into the global economy entailed her joining the World Trade Organisation (WTO) in 2001 and this has become a forum in which many of the stresses just noted have been debated: I note that China has adapted completely to the standard forms of behaviour within the WTO despite suffering from a number of asymmetries in her treatment by other members. One potential asymmetry that has mercifully been put on the back-burner for now is to bring exchange-rates within the purview of the WTO with a view to punishing China’s alleged under-valuation of its currency. But just as this danger passed another has arisen in the form of the mega-regional trade deals – notably the Trans-Pacific Partnership – which I argue are designed to exclude China.

Possibly the most important role of economists in policy-making – and one which characterises significant parts of Patrick Messerlin’s career – is to discourage policy-makers’ instincts to react inappropriately to challenges. The challenges that China have posed within the trading system have mostly eventually been dealt with fairly constructively, which is something both Chinese and western

* This paper is a substantially revised and extended version of the paper I gave at the conference in honour of Professor Patrick Messerlin at Yale Center for the Study of Globalization on 3rd and 4th December 2011 – ‘China and the World Trading System: Thrills, Chills - and a few Spills?’. I am grateful to colleagues at the conference for comments.

governments can take some pride in. However, I do not include the last mentioned response – the mega-regionals – in that set, and this paper ends by sounding a warning.

1. The macroeconomic shock

In the three decades following the Communist Revolution in 1947, China displayed a respectable but by no means spectacular rate of economic growth. After an initial fall, Maddison (2007, table 2.2b) puts the growth in gross domestic product (GDP) at 4.4 percent per annum over the period 1952 to 1978 and growth in GDP per capita at 2.3 percent; this growth was associated with a strong re-orientation from agriculture to industry. Over this period, China increased its share of world GDP from 4.6 percent to 4.9 percent. Arguably more important from our point of view, however, is that over the preceding two hundred years China had played little role in the world economy and that the decades of Communism did nothing to redress this. In 1950 China exported goods worth \$11.6 per capita of population at 1990 prices (compared with (war-torn) Japan's \$42.21) and by 1973 this had grown to \$13.26 (compared to Japan's \$874.87) – Maddison (2007, table 2.4). So far as international economics was concerned, China barely existed.

In 1978, China took the first tentative steps towards opening up, first internally, with the household responsibility system, and then gradually externally. The outlines of the rest of the story are well-known: China grew phenomenally in terms of GDP, in terms of exports and even, actually, in terms imports. Table 1 summarises the situation, starting from 1981 the approximate point at which it had discernible effects on the rest of the world.

Table 1: China's growth 1981-2014

	1981	2014	growth pa
Population (billions)	0.994	1.364	1.0%
GDP (constant 2005 US\$ billions)	228	5,274	10.0%
GDP, PPP (constant 2011 international \$ billions)	746	17,202	10.0%
GDP per capita, PPP (constant 2011 international \$)	750	12,609	8.9%

Source: World Development Indicators Online, 28th September 2015.

Note: the PPP data for 1981 have been estimated from data on a 2005 price basis and the conversion factors implied between the 2011 and 2005 bases, both collected from WDI Online in June 2011.

Rows 2 and 3 of the table show China maintaining aggregate growth of 10 percent per annum for over three decades, whether in (constant) market prices or international (PPP) prices. Moreover, China managed more successfully than other developing countries to control population growth – row 1 – with the result that incomes per head increased by 9 percent per annum. In an earlier work – Winters and Yusuf (2007) – I showed such strong growth is not wholly unprecedented, for Korea, Taiwan and Japan all showed similar trends for at least two decades. But two features *are* unprecedented, however: first, the differential between the super-growers' growth rates and that of the world economy during their growth-phases – see Winters and Yusuf, table 1.2 – and second, the combination of rapid growth and huge size. Table 2, which is partly based on a slide from McKinsey, makes the point powerfully. While it took Britain, as the only industrial country in the eighteenth century, 155 years to double income per head from the boundary of extreme poverty to well into middle-income territory, it took the USA and Germany about 60 years in the nineteenth century, Japan 33 years in the early twentieth century and China 12 years in the later twentieth century. And while the first four examples covered no more than 2.6% of the world's population at the start of their growth spurts, China's applied to more than 20% of it.

Table 2: Chinese Growth in Long-Run Context

	doubling period		Initial population	
	years	duration	millions	% of world
Britain	1700-1855	155	9	1.4%
USA	1820-1873	53	10	0.9%
Germany	1830-1894	64	28	2.4%
Japan	1906-1939	33	47	2.6%
China	1983-1995	12	1023	21.8%

Note: Period for the doubling of GDP pc from \$1300 PPP to \$2600 Sources: Maddison (2006). World population data interpolated from Goldewijk (2005), except for 1983 which comes from World Development Indicators online.

Growth of the magnitude that China has generated affects global equilibria in many areas such as the UN Security Council or the International Court of Justice as well as simple economic ones. However, so far as other countries are concerned, those pertaining to the world trading system are the most immediate, direct and visible and quite possibly the most important. For example, exploding levels of international trade were a key contributor to China's successful growth model, and also to the aggregate levels of international trade, growth and prosperity elsewhere. And booming trade has also underpinned other aspects of China's international economic relations which have also proved contentious – for example, its aid policies or its massive levels of reserves and consequent role in international finance.

China's enormous appetite for natural resources, including food and energy, affects prices and availability elsewhere and raises incentives for production and investment in these international industries, regardless of whether they are used to produce goods for its own consumption or that of others. All international trade has distributional effects – which is why it is so contentious – but the introduction of a huge supplier at one end (the labour-intensive end) of the spectrum of comparative advantage has had profound competitive effects on other labour abundant countries, and these effects are gradually starting to spread to other countries as China develops other skills and comparative advantages. Moreover, the large production that China has made available has driven down prices for consumers, especially the poorer ones who purchase less sophisticated varieties (Broda and Weinstein, 2009).

The trade link also has institutional form in the shape of the WTO. While accession to the WTO must have boosted China's growth and integration, it correspondingly means that if anything did go wrong, the WTO would be damaged with a consequent loss of the other functions it plays in the world economy such as settling disputes, transmitting information and smoothing relations between other pairs of countries.

The changes in China's international trade are proportionately even larger than those in aggregate income contained in table 2. Table 3 shows that the growth of Chinese exports and imports averaged 16% for over three decades and that of foreign exchange reserves nearly 20%. These reserves increased from covering eight months' imports in 1981, at which point Chinese trade was more or less balanced, to nearly two years' worth in 2014, in which exports exceeded imports by about 20%. Moreover, China has shifted from being a net exporter of industrial raw materials to being a massive net importer.

Table 3: China's Changing International Trade

	1981	2014	growth pa
Exports \$ billions	14.6	2,343	16.6%
Imports \$ billions	14.6	1,960	16.0%
Fuels and ores as percentage of:			
Imports	6.0 *	28.7	
Exports	25.2 *	2.8	
Reserves \$ billions	10.1	3,900	19.8%
as % of imports	69%	199%	

Source: World Development Indicators Online, 28th September 2015. * refers to 1984, not 1981

2. The microeconomic shock for manufacturers

Given the size of the macroeconomic turnaround just outlined, it is not surprising that some sectors faced significant pressure and adjustment as a result of the emergence of China as a major manufacturer. I consider this pressure from three separate perspectives. First, Wood and Mayer (2009) consider the effect of China's arrival on global factor endowments and on the resulting changes in other countries' comparative advantage. While the emergence of China obviously contributed some land, capital and skilled labour to the world's endowments of factors of production, its principal and disproportionately large contribution was in unskilled labour. Wood and Mayer estimate that it raised the global ratio of labour with basic education to all labour by 7 to 9 percent and reduced the ratio of (land + natural resources) to all labour by 10 to 17 percent¹. The authors say 'Neither of these impacts is vast, but nor is either trivial'; I doubt if any such shock had been experienced over a period as short as two decades.

The consequence of these changes in the global aggregates was that many countries that had previously been able to trade as unskilled labour abundant countries now found themselves outside that class and having to behave rather as abundant in (middle-level) skills or in natural resources. The resulting adjustments, compressed into so short a period, were potentially quite dramatic. Applying a Heckscher-Ohlin model of world trade in which capital flows freely and hence may be ignored, Wood and Mayer calculate that these changes in endowments meant that *on average* other countries reduced the ratio of labour-intensive manufactures to primary production by 7 to 10 percent for output and 10 to 15 percent for exports. In East Asia, which had long appeared to be the most labour abundant region, these developments caused significant de-industrialisation. Elsewhere, Wood and Mayer argue, they were quantitatively less significant, although, as discussed below, they did still have an effect.

The second and third exercises to identify competitive pressure concern competition between Mexican and Chinese producers, most of which, I would argue, takes place in the US market. As a middle income producer of relatively labour-intensive manufactures Mexico might be thought to be particularly vulnerable to competition from China, especially given that within the North American preferential trade bloc NAFTA, Mexico has a specific comparative advantage in such sectors. Moreover the focus on third country markets as the locus of competition provides an important policy perspective, for even if Mexico chose to protect its own market from Chinese competition, it cannot unilaterally do so in the third markets in which the two suppliers meet.

¹ The differences reflect different ways of aggregating across countries. The smaller estimates weight countries' endowments together by their shares of world trade, the larger ones by shares of world labour force.

In the second exercise, reported fully in Iacovone, Rauch and Winters (2013), we look at the effect of Chinese competition on the survival chances and sales of Mexican firms both at home and in the USA. The sample comprises plant-level data for nearly all Mexican manufacturers (data on some small firms are missing) over the period 1994-2004. Over six thousand plants are covered and nearly three thousand individual products. As well as considering competition in a third market, the other innovation of this work is to allow the effects of competition to vary over firms – in most cases with plant-size – and products – with the importance of a product in its plant's total output.

The results are consistent and stark. While competition from China (measured as China's share of Mexican or US imports of the product concerned) seems to hit smaller plants and minor products quite hard, it has relatively little impact on plants' main products or on the largest of plants. In line with other literature on firms, one can take size as a good proxy for productivity, so the conclusion is that competition tends to drive weaker plants and products either out of business or to contract while leaving stronger ones either unaffected or even able to expand.

Figure 1: The effect of Chinese competition on product sales and exit

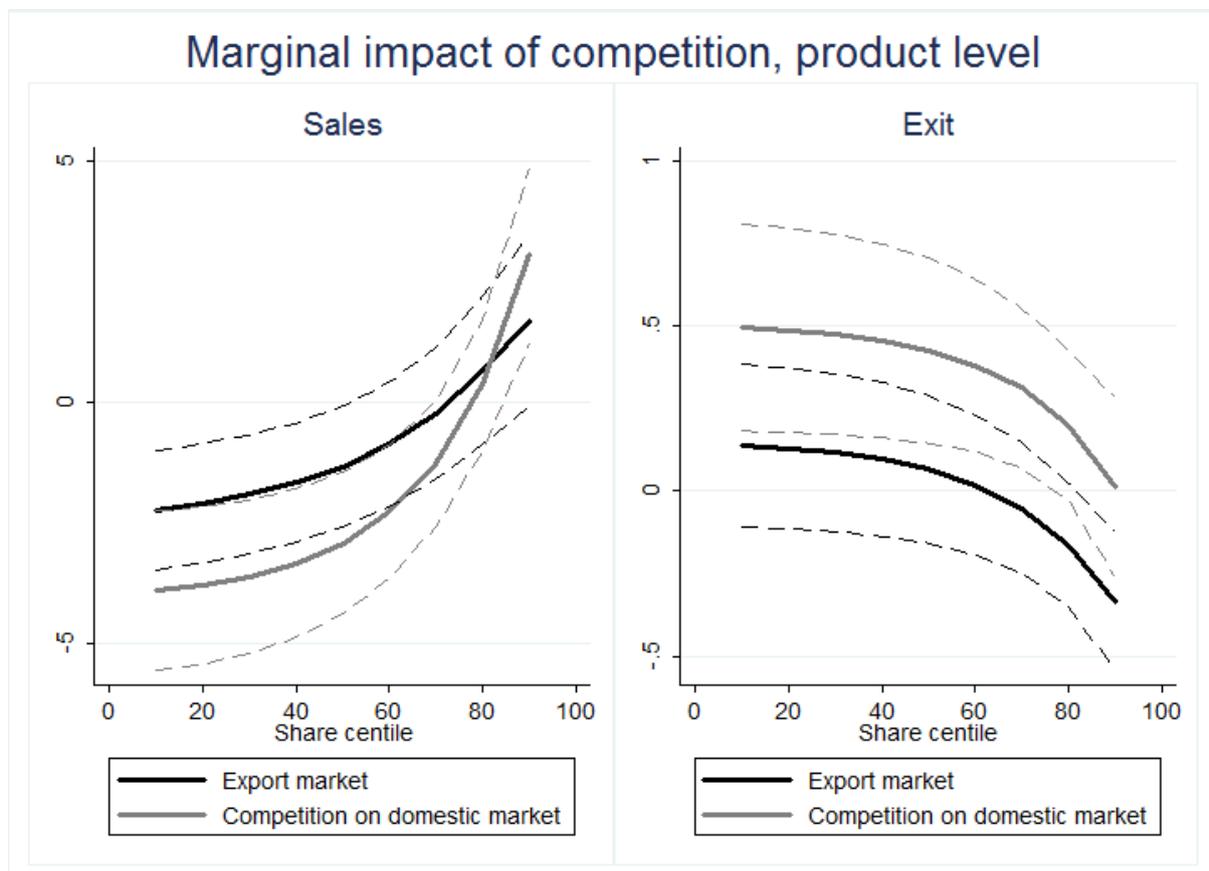


Figure 1 summarises Iacovone, Rauch and Winters' (2013) results for products. Similar patterns are uncovered at the level of the plant. The horizontal axis reports product size (position in the ranking of plants – centiles) and the vertical axis the marginal effect of an increase in Chinese competition on plant sales in Mexico (domestic) and the USA (exports) in the left-hand block and the marginal effect on the probability of the products being withdrawn from sale completely (exit) in the right-hand block. For small products (where, say, they account for 10 percent of a plant's total sales) the effect on sales is strongly negative – a 1percent increase in competition leading to a 0.4% decline in Mexican sales, whereas for products at the 90th centile, the effect on sales is positive - approximately 0.1% for export sales and approximately 0.3% for domestic sales. The broken lines are 95% confidence intervals and so one can see that the latter effect is significantly positive. Turning to exit on the right, the story is the

same. For small products (10th centile) the effect of a 1 percent increase in Chinese competition is to increase the probability of exit from the export market by about 0.1 percent and from the home market by about 0.5 percent. For large plants competition reduces the probability of exit – i.e. is associated with an increase in the chances of survival. We cannot identify the precise mechanism at work here, but it may well be that as Chinese competition eliminates weaker firms, sector-specific factors of production are released for stronger firms to take on.²

The stress is plain here. While Chinese competition may be quite a constructive force for the long-run growth of productivity and incomes – it helps to eliminate the weak and boost the strong – it is a political nightmare in distributional terms in most countries and is likely to raise serious calls for the management or even curtailment of trade. Giving in to this will mean benefits foregone in both China and its trading partners.

The final evidence of competitive pressure shows how Chinese competition constrains the export prices of Mexican producers in the US market. Pang and Winters (2012) use data at the 6-digit level of the Harmonised System classification between 1992 and 2008 to show that *on average* changes in Chinese prices on the US market induce changes in Mexican prices in the same direction and of a little under half the size.³ Chinese pricing has been very competitive over this period driven by China's strongly increasing productivity: for example, Hsieh and Ossa (2011) suggest that productivity growth in Chinese manufacturing sectors ranged from 7.4 percent to 24.3 percent and averaged 13.8 percent over 1995-2007. Thus while Chinese producers have been able keep prices down because their costs are falling, Mexican producers have felt obliged to follow suit partially, but with weaker productivity growth, have seen their margins squeezed. These results are consistent with the previous ones of exit and declining sales, but may also be partly additional to them. Iacovone, Rauch and Winters did not have data on margins and so it is perfectly possible that even though Mexican firms stayed in business, they did so with weaker margins and hence lower value added.

These last results also cast light on a further cause of concern that has been expressed about China – 'exporting deflation'. Much of this argument is of a macro nature, which I will deal with later, but if it is to be taken literally as placing downward pressure on prices, the mechanism must be as I have described here. A number of scholars have tried to identify the effect of Chinese growth on aggregate prices by relating prices in the USA or other developed countries to the quantity of Chinese exports e.g. Kamin, Marazzi and Schindler (2006). Such attempts have largely failed and led to the conclusion that China is not exporting deflation – e.g. Broda and Weinstein (2010). Part of the problem is that despite China's large size and openness, goods from China still only account for around three percent of US expenditure, and hence can have only a tiny direct influence on US aggregate price indices. If China is to have a discernible effect on such indices, it *has to be* by influencing the prices at which other producers sell, and this is the issue that Pang and Winters tackle directly.

These results do indeed suggest that China contributed to the 'Great Moderation' whereby western economies seemed more or less to have abolished inflation, despite operating at high levels of capacity utilisation and stoking up a huge credit boom. They are also, however, eminently reversible, and although current pre-occupations with China are more to do with China exporting deflation via declining demand and output – see below - when these cyclical phenomena have worked themselves out I would expect China to exercise very much less downward pressure on western prices.

² In additional tests we show that skill-intensive firms fare better than less skill-intensive ones and that larger firms and products appear to be better placed to take advantage of the improved and cheaper flow of intermediate inputs that Chinese expansion entails.

³ The model is based loosely on a Bertrand model of duopolistic interaction with differentiated products, whereby producers compete via prices, as used, for example, in Chang and Winters (2002).

3. China and the WTO

The World Trade Organisation has rightly sought to become truly global in terms of membership and welcoming China in late 2001 was perhaps the biggest and most natural recent step towards that goal. China's accession has been analysed extensively – including by Patrick Messerlin himself – and I shall consider only a couple of issues concerning, respectively, China's integration as an active, but possibly not yet equal, member of the WTO and China's role in the ongoing Doha Round.

There was some interest – and concern in some quarters – as to how China would settle into the WTO institutionally. China has not had a great enthusiasm for joining organisations in which it played no formative role and the question arose of whether China would behave as 'regular club member', be disruptive or just maintain aloof. After fourteen years we can say with confidence that China has become a 'regular guy' pursuing, like other members, what it perceives as its own interests within the context of existing WTO rules and practices. Of course, this has been uncomfortable for others at times and some issues have proved more important to China than to other members, but there is no hint of fundamental differences in approach.

China has played a pretty active role in the achievement of transparency within the WTO. As Collins-Williams and Wolfe (2010) have observed, over the period to 2006-8, China made over 500 notifications on product standards to the WTO Committee on Technical Barriers to Trade (TBT), was active in the Subsidies and Countervailing Measures Committee and even participated in the Agriculture Committee. China has also been heavily involved in the WTO's dispute settlement procedures. It has more often been respondent than plaintiff but the surprising figure is the frequency with which it has taken third-party status – observing and making minor contributions to cases primarily involving other members. Most commentators see this last phenomenon as a conscious learning strategy by which China sought to develop the skills and experience necessary to handle its own cases successfully. Hsieh (2010) makes a strong case that China's lack of legal capacity has been a major constraint on its ability to pursue WTO disputes independently and may have led it to fare less well in the cases it has been involved in. As with so many issues that it identifies, China has set about redressing the lack of skills vigorously. WTO Centres were set up in several universities and Chinese scholars are increasingly active in academic and policy debate around trade policy and the trading system. Patrick Messerlin has greatly aided this learning process himself, by fostering links and fora in which Chinese and other commentators can meet.

Kennedy (2012) offers a detailed account of China's engagement in WTO disputes. He concludes that China has been playing the role of a "system-maintainer" by conforming to the practices of WTO dispute settlement, even as those practices develop. China has mainly used the system to challenge the differentiated treatment of its exports meted out by its two largest trading partners, the USA and the EU, at least some of which stems from what the Chinese consider to be an asymmetric and unfair Protocol of Accession. Kennedy argues that the cases that China has initiated arise largely in retaliation to occasions in which it felt that a particular partner was initiating 'too many' cases against China; that they were, perhaps, 'warning shots' about the problems that an uncooperative China could cause. Such retaliation is by no means unique to China. Moreover, China has never initiated a case against a developing country, even those that have participated in cases against China. Hence, overall, fears that China would disrupt the WTO's enforcement function have not materialised.

Two specific asymmetries have irked the Chinese: non-market treatment and export restraints. On the former, the EU and the US continue to deny China market economy status in anti-dumping cases, with the result that they both find it easy to hit her with heavier anti-dumping duties than apply to other countries. China sees this as unfair and offensive – and I sympathise. In principle, non-market treatment should cease in 2016 according to the Protocol of Accession, although there is talk that the USA and the EU may find a way to perpetuate it, and, in truth, if the proponents of non-market

treatment lose this tool, they will probably find another – e.g. the double jeopardy of simultaneous anti-dumping and anti-subsidy action – see Gatta and Vermulst (2012). Hence in many ways the issue is more symbolic than substantive, so given that only a fraction of trade is subject to anti-dumping action, it seems to me that in the grand scheme of integrating into the world economy, China has much more important issues to deal with.

The second asymmetry that has caused angst is that China is more constrained from imposing export restrictions than are other WTO members. Within the mercantilist mind set which conditions the structure and practice of the WTO, consciously restraining exports is almost inconceivable, and faces very few constraints in the WTO agreements: quantitative export restrictions are generally discouraged but export taxes remain entirely unconstrained for all but a few recently acceded countries. China is among these, having been required to commit to using export taxes on no products other than eighty-four products that were listed in its Protocol of Accession.

Every past GATT/WTO dispute concerning export restrictions has revolved around the accusation that a member has been reducing the price of an input to downstream producers and so enhancing their competitiveness unfairly (a mercantilist argument). And, at least in some cases, there has been a sub-theme that the policy involved has increased prices abroad. China has now been involved in two such cases – a dispute brought in 2009 over export taxes and quantitative restrictions on exports of bauxite, coke, fluorspar, magnesium, manganese, phosphate (yellow phosphorus), silicon (metal and carbide), and zinc, and one brought in 2012 on exports of so-called rare earths, tungsten and molybdenum. Both have been concluded with rulings that reject just about every argument put forth by the Chinese, and in particular rejecting claims that the export restrictions were necessary in order to prevent environmental damage and to conserve resources, both of which are recognised under GATT Article XX (paragraphs (b) and (g) respectively) as reasons to exempt countries from the ban on quantitative restrictions on exports. The problem for the Chinese in both cases was that domestic use of the minerals in question was increasing and/or domestic prices were lower at the same time as exports were being curtailed, although, in the rare earths case, these conditions largely disappeared soon after the case commenced.⁴

Chinese irritation was redoubled in the rare earths case by a slightly complex legal argument. The dispute panel and the Appellate Body of the WTO held that even if export restrictions were necessary to conserve rare earth resources, the Chinese did not have access to Article XX of the GATT, the General Exceptions clause, which recognises this as a potentially legitimate reason to control exports. This is because the article in the Protocol of Accession that deals with export restraints did not explicitly specify that it was subject to Article XX of the GATT. Thus although the Protocol of Accession and the rest of the WTO treaty are to be read as a whole in defining China's rights and obligations, it was successfully argued that this did not amount to permitting later documents (the Protocol) to appeal to earlier ones (the General Exceptions Article) except where this had been explicitly negotiated. Since access to Article XX had been negotiated in some cases but not for export restraints, the Appellate Body interpreted its absence in the latter as conscious and binding. There is no evidence that the members of WTO would have resisted such a direct appeal to Article XX, and so it seems to me that this is a case where the Chinese might ask the lawyers handling their accession process whether they had let their clients down!

Having said that, however, I am comfortable with the outcome from a systemic perspective. The use of export restrictions to keep domestic prices for consumers down became quite widespread during the food price hike of 2005-08, but, as is well understood, such behaviour typically increases prices for everyone else. Sharma (2011) states that 31 out of 105 countries covered in an FAO survey imposed food export restrictions between 2007 and 2010, and Anderson and Martin (2011) estimate that 45 percent of the increase in world rice prices, and 30 percent of the increase in world wheat prices, over

⁴ Karapinar (2011) offers a good discussion of the raw materials case. Bond and Trachtman (2016) cover the rare earths one. In the interests of transparency I note that I advised the European Commission in the latter case.

2006-08 were due to 'insulating behaviour', which included export restrictions and the relaxation of import restrictions. The immediate distributional effects of these restrictions are clear enough, but more worrying for the long term is what such behaviour does to the case for relying on international markets for critical products. Like Patrick Messerlin, I have spent a large part of my career trying to persuade governments that food security is not the same as self-sufficiency, and I still believe it. However, if the cost of adjustment to shocks is to be borne solely by food importers rather than importers and exporters together, the price volatility which importers face will be great, and many governments will be tempted to forego the benefits of the international division of labour in order to avoid accusations that they are putting their citizens at risk of food shortages. That is, by refusing to sell, exporters are in danger of destroying their markets in the long run, to the cost of both exporters and importers.

Thus, in both food and materials, export restrictions are a particular challenge to the world trading system because for most members there are no restraints on export taxes provided that they are not so high as to constitute export bans. And even then restraints on quantitative restrictions recognise environmental exceptions, which might weaken them. Export restraints are just as disruptive to international trade as are import restraints, and so I would make a high priority of negotiating an agreement that disciplined their use. Maybe, as a country that has already largely submitted to such disciplines, China might lead such a negotiation.

A second alleged challenge to Chinese integration into the WTO is the Doha Round, which some, particularly in the USA, hold to be stalled because China is offering too little. That China should offer a good deal of liberalisation is accepted by everyone, including the Chinese, but here I think other countries are making a mountain out of a molehill. China's accession process was long-lived and entailed a huge amount of reform and liberalisation. The Doha Round was initiated as the accession process drew to a close, and was billed both to last only three or four years and to be substantially about continuing the business of the Uruguay Round. In 2001, when it started, no-one expected China to play an active role at all. Now fourteen years on, the Doha Round is still underway and China has more than trebled the size of its economy. Clearly China might now be expected to contribute something – and indeed China has agreed to do so – but the demands made of China for deep cuts in tariffs on manufactured products from the levels agreed at accession seem quite unreasonable to me. For sure, China cannot stand aside from the general liberalisation that a successful conclusion to the Doha Round would entail, but to blame China for the effective demise of the round by not coming up with more, seems to me a travesty. Having said that, however, I do believe that China needs to come back to the WTO with more liberalisation – see Section 5 below – but not in the context of the Doha Round.

4. Global Imbalances and Chinese Growth

The biggest 'crime against the world trading system' of which China has been accused is its huge current account surpluses over 2005-11 and the massive stock of international reserves that they gave rise to, and which still largely persists. The corresponding deficits elsewhere were held to drain demand out of partner countries (exporting deflation from a different perspective) and the imbalances are frequently named as a major cause of the financial crisis of 2007 onwards. There a little truth in both statements, but it is important to keep them in perspective. Moreover, seven years on from the crisis, after the Chinese surplus has substantially eroded, we can start to observe a certain (misplaced) nostalgia for the 'old' way of running the world economy.

Macro-economically the imbalances reflected, but also permitted, the boom over 2002-2007, with the surplus countries able to increase their output and employment strongly and the deficit countries to maintain high levels of consumption and demand. Of course, we can now see that such growth was unsustainable and that adjustment had to occur, but absent the financial crisis (which was not caused by the Chinese, even if it was facilitated by them), it is not clear that over-heating *per se* created

particular large problems. In the event, however, massive adjustment has been required of the world economy; both private and government sectors have retrenched to try to restore their balance sheets, hence cutting demand on a very broad front, and the financial sector nearly collapsed and has subsequently cut back lending viciously, further curtailing demand. The Chinese government played a very constructive role in addressing the immediate crisis, by supporting Chinese and world demand through a huge investment boom funded by extensive borrowing. This helped to support aggregate demand and also substantially reduced the Chinese trade imbalance. As discussed below, in the longer run, however, this response arguably stored up problems for later.

China did not cause the financial crisis, which rather arose from the combination of light regulation and macro-economic stress in the new millennium. Rajan (2009) argues that partly because competitive pressures from China and other low-cost producers constrained real wages among less skilled workers, American policy-makers looked to private credit markets to boost their spending power; this, in turn, caused the real estate boom and the stock of toxic mortgages that so burdened the financial system and private portfolios. On the supply side of the credit market, the low returns associated with the loose monetary policy behind this distributional policy and the 'great moderation', led banks to incur far too many risks in the search for profits. One should not blame any of this on China, but it is the case that the high level of Chinese reserves and the absence of local instruments with which to absorb high savings in China granted these mistakes huge space in which to work their mischief. The fact that China deposited its surplus dollars in New York kept the merry-go-round running far longer than it would have done in other circumstances.

An important question is what lay behind the surpluses? Macroeconomics is basically the process of unpicking the relationships between many endogenous variables. While clearly booming exports and stagnating imports were the proximate causes of the Chinese current account surplus, they were not the underlying causes. Export growth accelerated from about 2001 partly as China's accession to the WTO drew in FDI from Japan, Taiwan and Korea. There was also a significant fall in import growth after 2004 mainly as net import of heavy industrial products fell. This partly reflected a build-up of the stock of equipment over the preceding few years, but also the shift in Chinese capabilities so that domestic supplies increased strongly. These changes are partly exogenous and partly symptoms of more fundamental forces.

One causal candidate for the surplus is China's exchange rate policy, which since around 2004 has been associated with moderate undervaluation. Identifying over- or under-valuation is not straightforward and while some undervaluation of the Renminbi is clear, claims of major undervaluation seem misplaced. For example, between 2005 and 2010 unit labour costs in China increased by about one-third and the nominal effective exchange rate appreciated by 14%, and between 2010 and 2013 the figures were over half and 11% respectively.⁵ That China chose to keep its real exchange rate relatively low stems from three strong policy imperatives. The first was to sustain employment growth in its export industries with the twin related objectives of maintaining its high rate of export-led growth and of preserving 'Social Harmony'. Chinese policy makers were conscious of a trade-off between political reforms and economic returns, which can be crudely characterised as that for as long as employment and real wages keep growing fast the population will tolerate the constraints on political freedoms and not seek to disturb the Communist Party's hold on power. Many commentators spoke of a 7 percent per annum threshold below which social unrest will occur, but I am aware of no analysis that supports this threshold formally. Policy-makers undoubtedly recognised that a slow-down in growth was inevitable at some stage but found it much more comfortable to postpone the difficult adjustment a bit longer.

⁵ Unit labour costs from US Department of Commerce (<http://acetoool.commerce.gov/labor-costs#fn4>) and exchange rate data from IMF eLibrary.

The second imperative was to self-insure against a repeat of the 1997-8 crisis in which many Asian countries felt abused by the international system and specifically by the International Monetary Fund in return for emergency borrowing. Quite consciously and at times explicitly they said never again would they risk falling under the influence of the 'Washington consensus'. The result was a massive accumulation of reserves throughout most of Asia and I believe that China was part of that movement based on its observation of its neighbours rather than its own direct experience. In both of these objectives, past exchange rate policy had been extraordinarily successful and we should appreciate the difficulties that policy-makers face in shifting to a different strategy at the behest of other countries.

The third imperative was that a large and rapid exchange rate appreciation would have created large paper losses in Renminbi for the holders of dollar assets. To the extent that these were the commercial banks there could easily be a messy banking crisis, for received wisdom is that the banks are already burdened by very high levels of non-performing loans. While the Chinese government has the resources to support and re-capitalise the banks if necessary, it is very nervous about processes which it cannot fully control and dislikes acting under duress. Of course, the nearly US\$4 trillion of reserves now held by the Bank of China will also show large paper losses as appreciation occurs, but these are easier to gloss over than those in the commercial sector.⁶

The true cause of China's large current account surplus was macro-economic imbalance – high net savings by the household, corporate and government sectors. Chinese households have high savings relative to those in many developing countries, but, at about 20% of GDP, not unprecedentedly so.⁷ Moreover, given the very rapid rate at which China's population is aging, the one child policy and the relative lack of government-provided services and pensions, high savings seem rational and likely to persist. Much more unusual are enterprise savings which accounted for about 20% of GDP in the mid-2000s. Lane and Schmukler (2007) argue that these reflect the low (zero) dividends paid by private (state) firms coupled with policies that boost enterprise profits strongly – subsidies to inputs such as land and borrowing and low wages supported by rural-urban migration. Until these distortions are addressed and ways found to switch corporate profits into consumption (possibly via the government account with taxes and social expenditure), the imbalances will not be permanently cured.

As noted above, China leaned into the wind as world demand collapsed in 2008-9 by stimulating official borrowing and investment and was praised for doing so. However, as was argued at the time and has subsequently proved correct, the investment exacerbated Chinese excess capacity in manufacturing and significantly increased the stock of bad debt. Hence this policy made the inevitable cyclical downturn as these positions were unwound deeper and longer and made the climb towards a long-run sustainable growth path even steeper. As was already clear in 2007, this path requires the Chinese economy to switch from investment and exports as drivers to domestic consumption and innovation. The combination of a steep cyclical retrenchment with a dramatic change in growth strategy and the inevitable slowing as the economy gets closer to the technological frontier and the population ages poses a significant policy challenge for the Chinese government. Growth has started to fall from around 10% p.a. in 2010-11 to around 7% in 2013-14 and possibly lower in 2015 and at least some commentators now fear not a Chinese boom but a Chinese bust which will suck demand out of the world economy, especially that for commodities.

It is impossible to be sure, for we have never seen a combination of forces such as we now face, but I suspect that China will weather the storm. Growth will certainly be lower in future, but over the next few years, I would expect it still to be quite buoyant – e.g. 5% or 6% p.a. – so that China will continue to converge on the west and will also provide a significant impetus to world demand. This view is based on the confidence that I have in Chinese policy-making: it is always possible to imagine better,

⁶ The losses are just as real, however, and as Larry Summers has observed, China is very far from maximising its economic returns by building up such reserves of inevitably depreciating assets.

⁷ See Vincelette et al (2010) figure 2 for the data.

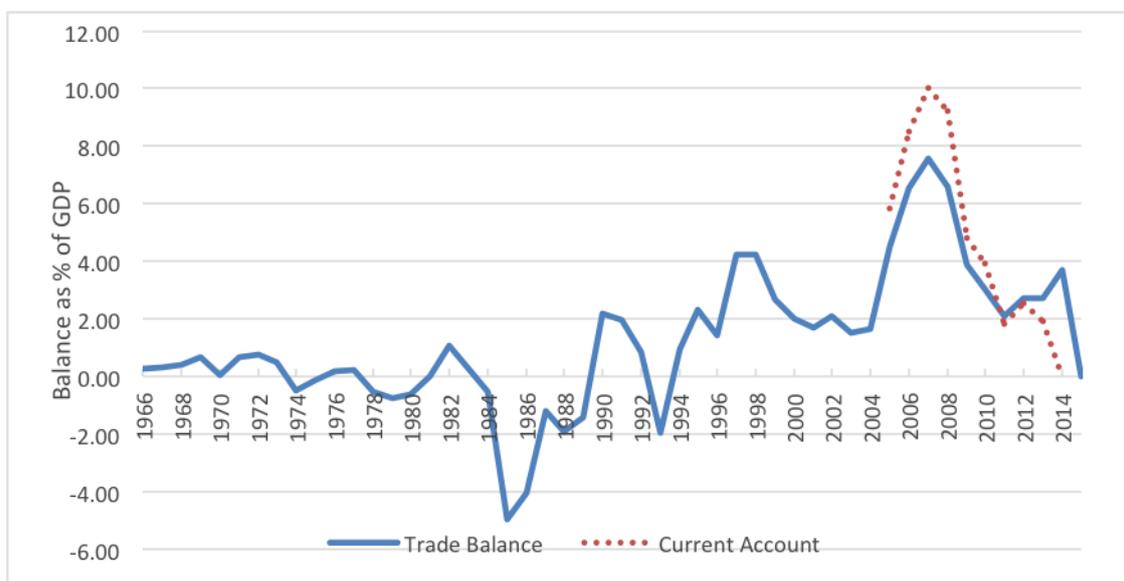
but when one considers the quality of the Chinese transformation over the last few decades, it is hard not to believe that Chinese policy-makers understand their position fairly well.

5. Excluding China?

China's formidable growth has provided a series of challenges for the current high-income countries and the international institutions that they tend to dominate. These range from the serious competitive threat that China has posed to western industry (and hence, perhaps, incomes) through the challenge to the western liberal economic model to the strategic challenge as China starts to seek influence in its region and in the world commensurate with its economic power. Thus the western attitude to China has evolved from welcoming in the 1980s to a much more defensive posture in the 2010s, which has sought, *inter alia*, to curb China's ability to capture markets. In this section, I consider two examples of such exclusionary behaviour, one fortunately rendered moot by circumstances but the other immediate and real. This is the 'out' in my title.

The first goes back to global imbalances. Some commentators – e.g. Rodrik (2010) – appealed to something like figure 2 to argue that trade and trade policy lay behind China's massive current account surplus:⁸ crudely the argument was that because the surplus boomed as a percentage of GDP shortly after China's accession to the WTO, the latter must be responsible for it. I deal with this at some length for two reasons: first Patrick Messerlin and I have both argued over the years that the interventionist conclusions derived from this view were wrong; second, the problem has now largely dissipated on its own, which suggests that the rush to change institutions to solve it was as unnecessary as it was dangerous to the world trading system.

Figure 2: China's Trade Balance and Current Account (% of GDP)



Source: World Development Indicators Online, 28th September 2015.

Note: Trade Balance is the difference between exports of goods and services and imports of goods and services, both as a percentage of GDP; WDI Online no longer reports the Chinese current account on a BoP basis before 2005.

⁸ Figure 2 reports the trade balance over a long period but the current account only since 2005, because these are the only data now in WDI Online. In the earlier version of this paper I used current account data over the period 1980-2011 and they told exactly the same story.

Rodrik's argument starts with the assertion that economic growth (and certainly China's growth strategy) requires a rapidly growing tradable manufactures sector, because this is typically where the highest productivity activities are found. An intense focus on this sector does not occur with market forces alone because of a variety of market failures – poor property rights protection, unrequited spillovers between firms, coordination failures, etc. which impinge disproportionately on this sector. Hence activist polices are required and have, says Rodrik, been used in virtually every case of successful growth. Countries have variously used polices like directed credit, production subsidies, export subsidies and protection to achieve tradables growth. Exchange rate undervaluation can also be used, and is historically associated with rapid growth, and its use as a growth policy is attractive because it does not require sector-specific interventions which are both difficult to design and liable to capture.⁹

One of Rodrik's innovations is to stress that growth is related to the production of rather than to exports of tradables. This means that if a country can simultaneously increase the demand for tradables along with their supply, it can grow rapidly without a large trade surplus. Subsidies, possibly bolstered by protection to prevent demand seeping abroad, are the obvious route to do this, and this is the way in which industrial policy works. Rodrik argues that optimal intervention would see all countries using subsidies to cure their local market failures and that in this case the spillovers between countries would become irrelevant because each country would be at its optimum. According to Rodrik, the problem until 2011 was that WTO membership prevented China (and other countries) from using subsidies, so that the government had to turn to exchange rate undervaluation as a second-best tool to boost tradables. But undervaluation must inevitably lead to surpluses, he argues, and that is why the WTO is responsible for the global imbalances. The 'obvious' solution to this, which is explicit in Rodrik (2011), is to restore the legitimacy of trade/industrial policy, specifically subsidies, and to manage exchange rates multilaterally.

Rodrik's writing is seductive, but his analysis is wrong in several respects. First, there are many ways to boost tradables output that are WTO-consistent – for example, improving logistics, labour training and education and consumption subsidies. They are arguably less immediate and direct than straight production subsidies but they are not ineffective. Second, subsidies/protection are just as dangerous to the world economy as are trade surpluses. Consider, for example, the intense reactions of partners' industries to subsidies elsewhere which can easily set off subsidy wars of the sort that we saw in the 1930s (which also saw competitive devaluations as well, by the way). The idea that the optimal intervention offers a stable solution to the global policy game is a chimera – almost certainly this situation is characterised by a prisoners' dilemma in which country A wants to subsidise and to prevent country B from doing so. There is no guarantee that a subsidy-permissive regime would not degenerate into a subsidy free for all with massive intervention.

Third, it is also hard to manage exchange rates. The global community has many times called for exchange rates to be managed by the IMF and has always failed; efforts through other groups such as the Group of 7 have only rarely succeeded. The USA has no intention of surrendering its exchange rate sovereignty to the IMF or an equivalent body and so no WTO-like enforcement mechanism for exchange rates is imminent. There is just no evidence that countries that compete in subsidy space as Rodrik would allow would willingly surrender their policy space in exchange rates. I am not arguing that some coordination over exchange rates is not desirable, but that it is foolish to believe that it will be at all reliable.

If Rodrik's idea to ditch the subsidies disciplines of the WTO and replace them with an exchange rate code seems dangerous, the pressure from some commentators to take exchange rates into the WTO, and hence to make them subject to the WTO Dispute Settlement Mechanism, seems equally so.

⁹ Undervaluation's disadvantage of taxing the consumption of tradables appears to count for rather little with governments focussed on growth.

(Mattoo and Subramanian, 2009, make the case and it has been taken up by several US Congressmen and European politicians). The complexity of measuring undervaluation is great and so the whole basis of a dispute will be contentious, and still more so will be the identification of the government manipulation that is alleged to cause it. Mattoo and Subramanian say these calculations should be done by the IMF and that their doing it on behalf of the WTO will somehow make it politically less contentious than the WTO's doing it on its own behalf, but I do not see why. Part of the way in which WTO's codification of trade interventions is effective is because it replaces political pressures with technical definitions with a very narrow focus. The process is not perfect, but it tends to draw the political poison. There seems little chance that with something as complicated as macro-economic outcomes and management, the same trick will work – see, for example Staiger and Sykes (2010) on the difficulties of even defining exchange rate undervaluation in WTO terms.

It is difficult to see how trade sanctions will address exchange rate frictions effectively: trade sanctions will not cure macro-economic distortions, at least not without massive cost. Moreover, because they would be aimed against the whole tradables sector, they would largely lack the ability that 'regular' sanctions have to switch the cost of one tradable sector's protection to another exporting one. But that is not the big worry. The latter is that trying to use sanctions in this way will inflict major damage on the WTO as an institution, and that by giving it an impossible brief we will destroy the value that we currently reap from the WTO and take for granted. The WTO has neither the structure (all decision-taking is in Committees of members, none is by the Secretariat which might be better able to maintain a technical view), nor the institutional robustness to be able survive the sort of contentious and high-stakes decisions that dispute panels and the Appellate Body would have to take in exchange rate cases. Having failed in such cases, the magic that currently leads to high degrees of compliance with WTO decisions would be destroyed and we would be left with little leverage against 'regular' violations. And once this happened the chances of other cooperation – e.g. that in Committees on other business – would also disappear. In other words, I fear that hanging the exchange rate mill-stone round the WTO's neck would bring it down.

The second example of 'out' is the so-called mega-regional trade deals – particularly the Trans-Pacific Partnership (TPP) but also the Trade-Atlantic Trade and Investment Partnership (TTIP).¹⁰ The former is a trade agreement recently concluded, but not yet ratified or implemented, between twelve Pacific countries – Australia, Brunei Darussalam, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, the USA, and Vietnam. They have a combined GDP of \$27.8 trillion, (37 per cent of the global total), total trade of \$11.6 trillion (26%) and have a combined population of about 802 million (11%).¹¹ There are several possible motives for the USA proposing the enlargement of the pre-existing Pacific-4 Agreement into the TPP in 2008. For example, it may have been an attempt to revive the flagging Doha Round in the WTO; or an attempt to re-interest US business in international trade policy, which was necessary because it had expressed next to no interest in the Doha Round; and to some, it was a way for President Bush to embarrass the Democratic Party because they would have to choose between a pro-business position (supporting TPP) or a pro-labour one (opposing it). Virtually all Americans agreed, however, that it was a chance to bind a significant number of partners in to the American conception of economic policy and many believed that in doing so they would counter China's growing influence on East Asian countries.

The details of the TPP were secret throughout its negotiation and are still secret even now after its conclusion. However, leaks and past form give us a reasonable idea of what it entails. Petri, Plummer and Zhai (2011) show how the trade agreements signed by the USA are deeper than the more traditional shallow agreements already signed by various Asian countries. For example, modelled in the US image, the American agreements provide for stronger liberalisation of agriculture, government procurement and e-commerce, significant labour clauses, significant restraints on state-owned

¹⁰ More detail of the arguments in the rest of this section are to be found in Winters (2015).

¹¹ All statistics come from WDI online (accessed 11th September 2015) and refer to 2013

enterprises and much stronger intellectual property protections.¹² Progress in these dimensions is necessary if the TPP is to offer significant economic benefits because much of the trade it will cover is already subject to tariff and often other preferences (e.g. via US agreements with Australia, Canada, Chile, Mexico, Peru and Singapore, ASEAN, P-4).

The TPP is ostensibly open to any Pacific country that wishes to join it; initially this was also true of the negotiations, but in 2013 the members declared that potential members would have to wait until the agreement was signed before starting to negotiate. So why does it exclude China? The clauses on intellectual property rights, procurement, agriculture and state-owned enterprises, and possibly others as well, would involve China in huge reforms that would clearly stretch its political consensus severely, possibly to breaking point. Moreover, whereas it seems inevitable that the TPP will allow Vietnam long adjustment periods and a degree of latitude in enforcement, any realistic reading of Sino-US relations demonstrates that China would receive no such concessions. Thus while the TPP was open in principle, it was effectively closed to China.

Most of what the US model entails is actually sound policy and many TPP countries will benefit considerably by adopting it. Nonetheless even where the reforms are desirable, several TPP members will probably have to approach the US norms faster than desirable, and possibly faster than they can effectively administer. But there are also areas in which the TPP is not in the interests of most non-US members – for example, the vigorous intellectual property protections, Investor-State Dispute Arbitration and the labour clauses. They accept these, however, because the TPP is a single package and it grants them strongly preferred status in US trade policy.

Once the members of TPP have accepted these norms, they will naturally press, along with the USA, for other countries to adopt them. Thus there will be a coalition accounting for nearly 40% of world GDP proposing a particular set of rules within the world trading system and it will become very hard for other countries to sign agreements with the members that do not go so far. Thus the TPP is essentially an attempt to define trading standards not merely for its members but for the world. I argued this in Winters (2014), but now it is official: in his weekly radio address as the TPP was agreed, President Obama said "without this agreement, competitors that don't share our values, like China, will write the rules of the global economy" (<http://news.yahoo.com/obama-jabs-china-defends-tpp-trade-deal-131620791.html>). If China, India or Brazil felt that these disciplines were too arduous or just did not fit their needs, the world trading system would be effectively be sundered and given that the TPP would be attractive to smaller economies and that the latter would probably be offered quite accommodating terms, the split would probably deepen through time rather than the opposite.

All of these effects would be even more marked if the other current locus of economic weight - Europe – were part of the coalition, and that in my view is essentially what the Trans-Atlantic Trade and Investment Partnership (TTIP) implies. The agenda of TTIP has many parallels with that of the TPP and seeks to go further with deeper agreement on regulatory issues. An avowed aim is to 'contribute to the development of global rules that can strengthen the multilateral trading system' (<http://www.ustr.gov/about-us/press-office/press-releases/2013/february/statement-US-EU-Presidents>) and 'to enshrine Europe and America's role as the world's standard-setters' (European President Van Rompuy at <http://www.whitehouse.gov/the-press-office/2013/06/17/remarks-president-obama-uk-prime-minister-america-european-commission-pr>). This reads very much like an agreement to cooperate to make sure that outcomes in the trading system are as the US and EU want them – and with around half of world GDP between them and a further 15% in the rest of TPP, it suggests that the choice facing others will be capitulation vs. exclusion.

¹² For example, the press reports that TPP intellectual property protections will be even stronger than in the US-Korea Free Trade Agreement, which is well beyond the WTO's TRIPs. They give considerable advantages to the current owners of intellectual property and probably hinder the development of alternative loci of innovation.

Some time ago Patrick Messerlin suggested that the EU and China should reach a trade accord of their own. While I do not like discriminatory arrangements in principle, it would at least offer an alternative locus of rule-writing to the TPP. In fact, the Europeans are currently wholly devoted to negotiating TTIP. This has a further advantage for the US-centric approach: while TTIP is dangled in front of them there is next to no chance that the EU will seriously engage with China. It is true that the EU is negotiating a Bilateral Investment Treaty with China – although these negotiations have a very low public profile in Europe – but there is no discussion of it going any further.

To conclude, while direct efforts to exclude China from effective membership of the world trading system by introducing the notion of exchange rate manipulation as a cause for trade remedies have failed, the indirect approach of building a rule-making coalition which can more-or-less impose rules on the rest of the world seems to be making progress. Thus in terms of my title, I do indeed fear that China might be ‘out’ over the next decade. As China’s growth continues, its economic and political power will grow and this exclusionary approach puts me very much in mind of Cordell Hull’s strictures about discrimination: “you could not separate the idea of commerce from the idea of war and peace. ... wars were often largely caused by economic rivalry conducted unfairly.” (Hull, 1948, p 84)

6. Concluding Thoughts

China’s economic rise has been remarkable – faster and far larger than we have ever seen before or could even have dreamt of three decades ago. The benefits in terms of increased global output and income are large and, at least to the extent that these are manifest in rising commodity prices, they are shared with some of the poorest countries in the world. Adjustment to such a shock is inevitably painful at times and in places, and I have identified a number of such instances in this paper. However, while the first twenty-five years of adjustment to China’s emergence were characterised by strong Chinese growth and pretty accommodating policies among established powers, the period since 2005 has been characterised by increasing angst on the part of other countries. This in turn has led to move from a position that was generally fairly accepting and welcoming (with some exceptions, of course) to one in which the prevailing sentiment, especially in the USA, appears to be one of fear and exclusion. The events I have discussed here certainly do not suggest that the advanced nations face no costs in adjusting to China, but I would argue that they can also be large beneficiaries and that some of the issues that have concerned them have cured themselves in the natural course of events. Thus I do not believe that we are well advised to rush to change the world trading system rules in order ease stresses perceived to be emanating from China. Rather we should seek to preserve the multilateral system that is the pinnacle of the post-war settlement and seek to engage China as an equal in a cooperative fashion. Thus this paper concludes by expressing considerable reservations about the creation of mega-regional trading agreements that exclude – arguably consciously and intentionally – China, the second largest economy in the world.

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