

**Managing the China Trade Challenge:  
Confronting the Limits of the WTO**

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*Over the past decade, the World Trade Organization (WTO) has proven to be an inadequate multilateral forum to address a series of grievances that the United States holds about Chinese economic policies that negatively impact global trade. As structured, the WTO has a series of structural inadequacies, including a gap in its available remedies to compensate for breach and a lack of consequences for failure to fulfill notification requirements. This has allowed China to enact industrial policies that breach WTO law for a limited period of time without consequence. Due to stalled negotiations, the WTO has also not adequately updated its law to reflect 21<sup>st</sup> Century realities, leading to gaps in substantive rules that can be applied against Chinese practices.*

*Because grievances against Chinese trade and economic policies are often shared by other countries, there is a longstanding belief that the United States would be better positioned to work collaboratively with its allies to reform the WTO to better equip the institution to deal with China-related trade challenges. While this strategy holds long-term promise, it is unlikely to bear considerable fruit over the next four years. This paper discusses the numerous obstacles that stand in the way, including most notably, the sharp differences between the U.S. and its allies, particularly the European Union, over the future direction of WTO reform. It argues that a strong emphasis must be placed on overcoming those differences in the next presidential administration. In the meantime, rather than pivoting toward primarily a WTO-centric strategy in the next four years, the U.S. must continue to engage in a multi-prong approach that includes direct bilateral engagement with China. Most importantly, it must buttress its own domestic capabilities for a growing strategic competition, while finding ways to manage persistent trade and economic tensions.*

The tensions arising out of China's trade practices are widely recognized as a major challenge to finding a constructive path toward managing an increasingly complex and interdependent relationship within China. Inside Washington, the China trade challenge remains a rare point of shared bipartisan consensus. Both Democrats and Republicans will concede that

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in the Xi era, the strategy of constructive engagement has failed to transform China's economic practices in directions sought by the U.S. and its alliance partners. Where they disagree, both within and across parties, is on what ought to replace such a strategy.

In a variety of other capitals outside Washington, trade officials will concede, perhaps begrudgingly, that certain of the Trump administration's amplified admonitions of Chinese trade practices are justified. Where they disagree, across both advanced and developing countries, is on whether to take a more jointly confrontational approach and, if so, through what forum.

To be clear, this is not to say that China's economic reform has ground to a halt in the Xi era. China remains one of the world's most dynamic, and openly experimental, major economies. Economic liberalization and accelerated reforms have taken place in China since 2012. However, a collective consensus is emerging that economic reforms in the Xi era have been spurred by domestic priorities as opposed to a need to accommodate foreign demands.

This stands in stark contrast to the 1990s when China needed to accommodate in order to gain admission to the WTO and claim its place in the global economic order. It also stands in stark contrast to the period from 2000 to 2012, when China once again needed to demonstrate periodic accommodation in order to attract foreign investment in more technologically-sophisticated sectors and to sustain a coordinated global response to the Great Recession. As State Councilor and Foreign Minister Wang Yi openly exclaimed, "China and the U.S. have different social systems, but this is the result of the different choices made by our people, which we must respect. . . . It is time for the U.S. to give up its wishful thinking of changing China or stopping 1.4 billion people's historic march toward modernization."<sup>1</sup>

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<sup>1</sup> Press Conference of State Councilor and Foreign Minister Wang Yi, May 25, 2015, available at [https://www.fmprc.gov.cn/mfa\\_eng/wjbxw/t1782369.shtml](https://www.fmprc.gov.cn/mfa_eng/wjbxw/t1782369.shtml).

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Dreams, however, are hard to kill. Especially among those old enough to recall the excitement of China's markets and society liberalizing in the 1990s and early 2000s, there remains sustained hope that the Xi administration marks simply a passing phase rather than delineating the start of a new era for Chinese reform and for U.S.-China relations.

This gives rise to an entrenched belief in certain policymaking circles. While articulated in many ways, the crude form of this deep-seated belief is something along the lines of following: A smarter approach than the Trump administration's unilateralist tariffs-oriented approach is to work in coordination with America's allies through a rules-based approach at the World Trade Organization (WTO) to apply collective pressure to spur China to curtail problematic trade practices.

Given the complexity of the China trade challenges, and the fact that much has been written about other dimensions by commentators (including myself), the organizers of the Penn Project on the Future of U.S.-China Relations have asked that I focus on this one particular dimension of trade challenge. This is the question of the role that the WTO ought to be given in the next U.S. presidential administration in addressing persistent tensions in U.S.-China trade relations. The WTO question is relevant both to the enforcement of existing rules (through WTO dispute settlement) applicable to China and to the creation of new rules (through formal WTO-organized negotiations) to deal with the China challenge. Importantly, the WTO remains the preferred pathway of most U.S. allies to address these issues.

This paper seeks to underscore the difficulties of a WTO-centric strategy for any joint alliance-based approach to tackle the China trade challenge during the 2021-24 period. Given the urgency of formulating a whole-of-government response with allies but the intrinsically glacial speed with which large multilateral institutions are capable of responding to issues tinged with

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geopolitical implications, it would be a mistake for U.S. policymakers to rely primarily on the WTO as the primary or preferred forum for working out the world's trade tensions with China. Instead, the next administration must develop a multi-prong approach.

This is not to say that the U.S. should minimize its engagement on China trade issues through the WTO or disengage from the institution altogether. As this paper will lay out, a lot of important work remains. But it is to say that it will be important for the next administration to remain level-headed about the limitations of a WTO-based approach and to not over-invest diplomatic capital in such a strategy.

In particular, as this paper will discuss, the WTO is itself in the midst of a crisis. The institution is in dire need of reform. Its role in negotiating new rules, monitoring compliance with existing rules, and adjudicating disputes are failing to function effectively. Moreover, there remains serious disagreements between the U.S. and its allies over the direction of these future reforms.

Therefore, a key goal of the next administration ought to be resolving differences between the U.S. and its allies over the future direction of WTO reform. Until this can be accomplished, it is unlikely that either the U.S. or its allies will be able to turn to the WTO effectively to grapple with the China trade tensions. However, as this paper will discuss, this is easier said than done. Indeed, on some reform issues, U.S. allies have remained quietly on the sidelines or even sided with Beijing, despite sharing a set of common grievances over China trade issues with the U.S.

Overall, the key issues confronting the next administration will be the same ones that have continuously befuddled U.S. trade officials throughout the first term of the Trump administration:

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(1) How to convince allies, who share many of the same China trade grievances, of the importance of formulating alternative approaches outside of the WTO to tackle these grievances, while not abandoning the WTO altogether;

(2) How to resolve differences within key allies over the future direction of WTO reform; and

(3) How to respond if/when WTO reform efforts ultimately prove futile but allies remain unwilling to pursue an alternative pathway and continue to emphasize a WTO-centric approach.

This paper will first present an overview of the current state of affairs, including an abbreviated version of the problems arising out of the China trade challenge for the U.S. Next, it lays out a series of structural issues that have prevented the WTO from serving as an effective forum to deal with the major Chinese trade practices deemed problematic by the U.S. and other trading partners to date. It will then turn to discussing gaps in existing WTO rules that prevent the U.S. and other countries from addressing a range of China-related trade issues.

The paper then shifts to illuminating the major points of disagreement between the U.S. and its allies over the future direction of WTO reform, with respect to both structural issues and the updating of WTO rules. Even if such differences can be resolved, the paper discusses a series of additional roadblocks that will need to be navigated. Finally, the paper concludes with some policy recommendations for the next administration to tackle the significant challenges ahead.

### Current State of Affairs

The U.S. complaints over Chinese economic policies that impact trade are longstanding and widely shared. Because these complaints are well-known, this section will provide simply a cursory summary. Additional details can be found in USTR's annual report to Congress on

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China's WTO compliance,<sup>2</sup> USTR's annual report on foreign trade barriers,<sup>3</sup> the American Chamber of Commerce's annual survey,<sup>4</sup> and the WTO's Trade Policy Review on China.<sup>5</sup> Although the laundry list of trade issues raised by U.S. businesses is long, they can be grouped largely into four main buckets:

- A wide range of industrial policies used to support Chinese firms in priority sectors, including formal practices directed by the state as well as informal practices of non-state actors whose behavior is influenced by the Party-state. Such policies include subsidies, investment restrictions, tax policies, informal guarantees, soft budget constraints, cajoling of technology transfer, government-backed investment funds, government procurement practices, standards, export restraints, etc. These policies are deployed across a range of industries, from those with excess capacity issues to advanced industries deemed critical for driving the next phase of China's innovation economy.
- The use of non-tariff barriers to limit the access of foreign players in select industries and to influence the behavior of foreign firms with access, so as to advance overall China's economic policy goals. Among the range of instruments used are regulations, licensing, standards, administrative approvals, investment screening, competition policy, etc. Again, these non-tariff barriers affect a wide range of industries, from agriculture and industrial products to services and technology.
- Intellectual property policies, including selective enforcement of existing IP laws, incomplete/weak laws for certain IP domains, and inadequate deterrence/prosecution of

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<sup>2</sup> USTR, 2019 Report to Congress on China's WTO Compliance, March 2020.

<sup>3</sup> USTR, 2020 National Trade Estimate Report on Foreign Trade Barriers, March 2020, pp. 99-124.

<sup>4</sup> AmCham China, 2020 China Business Climate Survey Report.

<sup>5</sup> WTO Trade Policy Review Body, Trade Policy Review - Report by the Secretariat - China, June 6, 2018, WT/TPR/S/375.

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commercial espionage. In addition, some have alleged that the state applies informal pressure on foreign firms to transfer key technology to its entities in China and that certain forms of commercial espionage may be formally or informally backed by the state, including through the military.

- Internet sovereignty policies that impair the ability of foreign firms to conduct business as they would in most other major jurisdictions and that favor the development of domestic technology firms.

China too has expressed its displeasure with a number of U.S. trade practices. These include the imposition of unilateral tariffs against Chinese products, investment restrictions on Chinese firms, and entity listings / restrictions that impair the ability of Chinese firms to access U.S. technology and capital. Additional details can be found in various MOFCOM documents<sup>6</sup> as well as the WTO's Trade Policy Review of the United States.<sup>7</sup>

A number of other countries, including almost all of the U.S. major trading partners, share U.S. concerns over the lack of a level playing field when competing against Chinese firms. Some countries, including some longstanding U.S. allies, also share China's concerns over particular U.S. practices, especially the imposition of unilateral tariffs. Most countries, therefore, do not wish to take sides overtly or to be drawn directly into the U.S.-China trade war — viewing both sides as harboring a series of legitimate concerns and preferring that these issues be resolved multilaterally at the WTO.

Furthermore, a major fissure has emerged within the Western alliance. Most U.S. allies continue to employ a constructive engagement approach of offering additional “carrots” to

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<sup>6</sup> For remarks and statements responding to recent U.S. actions, see the Ministry of Commerce's website at <http://english.mofcom.gov.cn/>.

<sup>7</sup> WTO Trade Policy Review Body, Trade Policy Review - Report by the Secretariat – United States, November 12, 2018, WT/TPR/S/382.

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China, through the form of market access and/or reduction of investment restriction uncertainties, as an inducement for China to address their longstanding complaints. The Trump administration, however, views this as an ineffective failed approach, which is allowing China to buy time to carry out its overall economic strategy to achieve technological autarky while also facilitating the offshoring of U.S. industries. Consequently, it has preferred the use of “sticks.” This includes tariff hikes, additional export restrictions, additional entity listings, etc. if the issues remain unaddressed. U.S. allies, in turn, question whether a directly confrontational approach will succeed, and worry that even if it does, it will harm their collective long-term interests because it undermines the WTO and the rules-based approach.

The main achievement of the new U.S. approach to date has been the Phase One trade agreement, signed in January 2020. While it addresses some lingering issues, it represents, at best, a temporary *détente* to prevent a further escalation of the ongoing trade war. Many structural issues, especially over industrial policy and digital/internet-related issues, remain unaddressed. Neither side has yielded on the most sensitive points.

The next administration therefore will face a continued elevated state of trade tensions with China. Among the multitude of questions that it will need to address are those over compliance with the Phase One deal and what additional threats (or possibly, concessions to Chinese demands) it will be prepared to carry out in order to spur greater concessions from China in the Phase Two negotiations. Furthermore, it will need to address what type of new U.S.-China trade relationship it will want to craft if no Phase Two deal is forthcoming. As noted earlier, such questions fall outside of the scope of this paper, which organizers of the Penn Project have requested focus on the WTO.

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Much of the rest of world has viewed the bilateral trade negotiations between the U.S. and China with suspicion. Even if the talks might resolve some of their complaints over both sides' trade practices, they fear being left on the sidelines. Instead, they favor a multilateral approach where they would be incorporated into the process.

This framing of the problem at hand may lead some to harbor a false impression that the China trade policy questions take the form of “either-or” binary choices – alliance-driven vs. unilateral; WTO vs. non-WTO. It is important to emphasize that not only is this framing incorrect, it is also overly simplistic and misleading. The Trump administration continues to employ a multi-prong approach, just as its predecessors did. What has shifted, as discussed above, is simply the reliance on “carrots” vs. “sticks.” For example, the U.S. has continued to work actively with allies, even while imposing unilateral tariffs. The U.S. has also remained actively engaged at the WTO, even as it criticizes some of the institution's shortcomings. U.S. Ambassador Dennis Shea has offered a number of WTO reform proposals, and the U.S. team remains actively engaged in ongoing negotiations.<sup>8</sup>

The right framing of the question is to ask what relative weight ought the U.S. devote to give to the WTO-centric approach currently favored by its allies in the 2021-24 administration to address the China trade challenges. It is this question with which this paper will attempt to grapple in the sections ahead.

### Structural Issues with the WTO

With 164 members, including all of the world's major trading nations, the WTO remains the preeminent multilateral institution for negotiating, monitoring, and enforcing trade rules. Yet,

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<sup>8</sup> See, for example, Statements by Ambassador Dennis Shea at the March 3, 2020 WTO General Council Meeting, which discusses several recent U.S. proposals and communications.

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it faces a number of structural issues. Over time, U.S. trade officials increasingly have become disillusioned over the efficacy of the WTO as a forum for dealing with the China trade issues. This frustration pre-dates the Trump administration, but U.S. calls for structural reforms to the organization have become more vocal in the current administration.

### Appellate Body Crisis

The U.S. has long expressed its discontent that actions taken by the WTO Appellate Body fail to comply with the WTO's Dispute Settlement Understanding and extend beyond its mandate. Certain countries share some of the U.S. complaints, but a fundamental disagreement exists, in particular, between the U.S. and the EU over past Appellate Body behavior in interpreting WTO treaties. Some of these cases involve the rights of the WTO members to take action in the form of trade remedies against dumping or unfair subsidization of imports; the most frequent target of U.S. trade remedies is China.

When the WTO failed to respond with any meaningful reforms to the Appellate Body, the Obama administration, to the dismay of its allies and other WTO members, began exerting its power in the appointment process, by blocking the appointment or re-appointment of certain individuals. In the Trump administration, the U.S. has gone one step further by systematically blocking the appointment of any individual to the Appellate Body until genuine reform is undertaken. Therefore, as of December 2019, the Appellate Body no longer had the requisite quorum of members necessary to function.

As a consequence of this action, WTO dispute settlement is crippled. Unless the two parties to a dispute agree not to appeal a Panel's ruling or to undertake an alternative appellate procedure, WTO disputes can be stuck in limbo. A party can simply appeal a case "into the void" – leaving the WTO unable to authorize any retaliation against any of its members that commits a

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breach of its treaty obligation and then fails to remedy it. Until this crisis is resolved and the WTO undertakes meaningful reforms to the Appellate Body to the satisfaction of the U.S., it will prove difficult, if not impossible, for the U.S. to rely upon the WTO dispute settlement to adjudicate any of its complaints against China.

### Remedies

WTO dispute settlement faces a second structural problem over its remedies. Unlike most courts and other adjudicatory institutions, the prevailing party in a WTO case is not entitled to compensation for past harm resulting from the other party's illegal actions. This is because WTO dispute settlement only allows for prospective, and not retrospective, remedies. In effect, this means that any government has a "free pass" to engage in an illegal act that breaches WTO law for a stretch of years until WTO litigation concludes. This remedies gap has proven to be an enduring source of frustration for U.S. businesses. In certain cases, despite the U.S. government having prevailed in its WTO dispute against China, U.S. businesses are unable to enjoy any commercial gain because actions taken during the "free pass" period (*e.g.*, illegal subsidies or domestic content rules) provide Chinese competitors with an enduring advantage. Meanwhile, China, along with other governments, are adept in taking advantage of this remedy gap to advance its industrial policy. However, unlike the Appellate Body, this is not an issue where the U.S. has pressed for structural reforms, in part because the U.S. itself is frequently targeted in WTO disputes and has not sought for the system to have stronger remedies.

### Notifications

In addition to its adjudication function, the WTO also fulfills a transparency and monitoring function. However, there are no recriminations for WTO members for late filings or

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non-filings of notifications as required under the WTO treaties. This is especially important for issues such as subsidies for which notifications of certain forms of subsidies are required.

### Developing country status

WTO treaties provides certain exceptions and more permissible rules for developing countries. However, there are no set rules for what constitutes a “developing country” – meaning that this is an issue of self-declaration. Hence, the system allows China to enjoy preferential rules in some areas, despite it being a larger trading power than many advanced economies.

To summarize, the structural issues above have crippled the ability of the WTO to deal effectively with U.S. trade grievances with China. The lack of consequences for failing to notify has resulted in delayed under-reporting of Chinese subsidies – hampering the ability of WTO members to monitor whether such subsidies comply with the letter of the law. The self-declaration of “developing country” status has permitted China to enjoy preferential status in certain areas, even as it has emerged as a trade superpower. The dispute settlement system, even if it were to function, fails to offer adequate compensation for illegal actions. All of this has allowed China to execute industrial policy in a range of industries from steel and aluminum to solar panels and semiconductors to serve domestic needs at the expense of trading partners.

As will be discussed in the next section, there are also substantive gaps in existing WTO law that require further negotiations. However, it is worth considering whether the creation of additional rules will be meaningful, if the structural flaws discussed above remain. The need to reform the WTO’s deficiencies with regards to notification, developing country status, and dispute settlement remain paramount, if the WTO is to become an effective forum to handle U.S. trade issues with China.

Substantive Gaps in WTO Rules on China-Related Issues

Structural issues are not the only problem which has contributed to U.S. displeasure with the WTO. Equally important is the fact that the WTO has also underperformed as far as its negotiating function is concerned. Only a few updates have been made to the WTO rule book since 1995, even as technology has seriously impacted trade flows.

As I have noted in previous work, existing WTO law was not crafted with the unique structure of China's political economy in mind.<sup>9</sup> While WTO law may be capable of addressing certain issues, there are a number of notable gaps which require the creation of additional rules and the updating of existing ones.

Note that there are multiple pathways through which new rules may be created. One of those is through a consensus process adopted by WTO ministers. Another, however, is through the use of so-called Annex IV plurilateral agreements, which are applicable only to a select set of countries that choose to opt-in. While the latter process may be easier in terms of achieving substantive agreement on the rules themselves, plurilateral agreements face two disadvantages: First, if the new rules are to be applied on a most-favored-nation (MFN) basis, some countries can "free ride" by not signing onto the new rules themselves but still enjoying its benefits. Second, existing WTO rules contain thresholds that must be met before a WTO plurilateral agreement is adopted; this means that countries that do not plan to sign on to the new rules themselves could nevertheless thwart their creation through deft use of procedural roadblocks or engage in "hostage taking" negotiating behavior to secure a concession in exchange for allowing a new rule to take hold, to which it would then not adopt.

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<sup>9</sup> Mark Wu, "The 'China, Inc.' Challenge to Global Trade Governance," *Harvard Journal of International Law*, vol. 57, no. 2 (Spring 2016).

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Some of the most glaring shortcomings in the WTO rule book, as far as substantive rules to address U.S.-China trade tensions, include:

### Industrial Subsidies

The WTO's Agreement on Subsidies and Countervailing Measures (SCM Agreement) allows WTO members to impose countervailing duties against importing products that benefit from subsidies given by a government or a "public body" deemed illegal.<sup>10</sup> The U.S. has raised repeated concerns that the Appellate Body's interpretation of "public body" is incorrect and too narrow. Consequently, the U.S. and others have argued that new rules are needed to address market-distorting actions taken by entities that are not considered a "public body" under the current definition. Concerns have also been raised that the list of prohibited subsidies is outdated and needs to be expanded. In addition, the WTO rulebook is viewed as inadequate to address instances where the market-distorting behavior results from informal guidance rather than any formal government policy. Examples include: (a) guidance provided through opaque Communist Party channels, and (b) informal suggestions given by individual Party officials to private actors in the financial sector or upstream entities. Present WTO rules, whether substantive or concerning the evidentiary burden, impair the ability of importing countries to deem the action to constitute a subsidy, even if it is clearly market-distortive.

### Structural Overcapacity

The U.S. and other countries have also argued that existing WTO rules have proven to be inadequate in arming governments with the ability to deploy policies to counteract Chinese subsidies and other actions that have resulted in structural overcapacity in key sectors (*e.g.*, steel, aluminum, shipbuilding, cement, solar, etc.) globally. Part of the problem, as discussed, is the inadequate remedies provided by WTO dispute settlement, but another part is the rulebook itself.

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<sup>10</sup> See Article 1.1(a)(i) of the Agreement on Subsidies and Countervailing Measures.

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The U.S. has argued that the WTO rules need to be updated to allow governments, whose industries face threats of structural overcapacity, to take more aggressive action beyond what is provided through safeguards and other existing forms of trade remedies. Those have proven to be woefully inadequate in protecting U.S. industries, leading the Trump administration to pursue additional unilateral measures such as the Section 232 tariffs.

### Technology Transfer

The U.S. and others have also emphasized the inadequacy of the existing WTO rulebook to address what amounts to a “forced” technology transfer. Similar to subsidies, concerns arise out of Chinese use of informal non-state channels and informal norms not openly articulated by a government official. Again, the concern is that the WTO rulebook is inadequate to counteract market distortions where technology transfer decisions are not made on a commercial basis but rather in response to opaque pressure from a foreign government communicated informally.

### E-Commerce / Digital Trade

WTO rules have also not been updated to reflect the range of digital trade issues that have emerged over the past quarter-century. These include concerns over mundane issues such as e-signatures, as well as much more contentious issues concerning government policies over data and source code review. While the WTO has commenced formal negotiations on new plurilateral rules for e-commerce, there are already signs of an open fissure between the U.S. and China over the future direction of these negotiations.<sup>11</sup> This is not altogether surprising, given the growing strategic rivalry between the two countries over technology industries.

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<sup>11</sup> Rachel Fefer, “Internet Regimes and WTO E-Commerce Negotiations,” Congressional Research Service Report R46198, Jan. 28, 2020.

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### Services

While trade in goods have received the most attention in ongoing WTO negotiations as well as in the U.S.-China trade war, services account for a substantial portion of U.S. exports and reflect an area where many U.S. firms retain a competitive advantage globally. Yet, requirements to open or liberalize markets for foreign service providers lag behind those for goods. Furthermore, there remains an asymmetry in the level of liberalization that the U.S. offers to Chinese service providers, as compared to that offered by China to American service providers. Discussions on how to further liberalize services among WTO members continues within the WTO, but they have been deadlocked for quite some time without significant hope that China will yield on U.S. demands to open up certain markets to its service providers or vice versa. In addition, because the SCM Agreement applies only to trade in goods, the existing WTO rulebook is much less detailed in constraining subsidies and other forms of market-distortive behavior that a government may employ to benefit its domestic services sector. As a result, the U.S. is deeply concerned about the inadequacy of the WTO rulebook to address possibly market-distortive Chinese industrial policies in domains such as artificial intelligence, which will have a large services component as well as national security spillovers.

### Investment

The WTO has traditionally had relatively thin rules concerning investment, preferring to leave the creation of such rules to bilateral and regional arrangements. At the World Economic Forum in Davos in 2020, however, ninety-nine WTO members, including the U.S. and China, agreed to launch formal negotiations focused on investment facilitation for development. The focus of these negotiations will be on investment facilitation measures such as “increased transparency on policies and regulations, streamlined administrative and procedural

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requirements, sharing of best practices, and coordination.”<sup>12</sup> As this initiative is relatively new, it is not yet clear how significant this attempt to negotiate new WTO rules for investment facilitation will matter in addressing U.S.-China trade tensions. Nevertheless, this is yet another domain where existing WTO rules are viewed as in need of upgrade.

In short, there are several elements of WTO law that have yet to be updated to reflect 21<sup>st</sup> Century realities. Unless updated rules can be created, and all of the major economies, including China, agree to be bound by them, it is unclear that the WTO is necessarily well-positioned to address many of the most pressing China-related trade issues confronting the United States.

To its credit, China has not resisted the possibility of new rules. Rather it has played its diplomatic cards very deftly by agreeing to allow reform discussions to proceed and seeking a seat at the table in the drafting of new/updated rules. Moreover, China has positioned itself as championing the interests of fellow developing countries; it regularly insists on new rules affording more policy flexibility to developing countries. Lastly, China has been happy to watch from the sidelines, as disagreements between other WTO members have prevented WTO negotiations from moving forward. In other words, it has tried hard to position the U.S. as the intransigent party responsible for the WTO’s current crisis, while presenting itself as a collaborative partner open to possible institutional reform. However, China has warned that such reforms must not target it primarily, but involve concessions made by all major trading powers.

### Differences Between the U.S. and Allies on the Future Direction of WTO Reform

The hope has been for the U.S. and its allies to present a united front to push China toward accepting new WTO rules that constrain its industrial policies and other economic

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<sup>12</sup> World Economic Forum, “Negotiations on Investment Facilitation at the WTO Gain Support at Davos,” January 24, 2020, <https://www.weforum.org/agenda/2020/01/talks-on-investment-for-development-move-ahead/>.

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practices deemed problematic. Yet, this has proven difficult in the past four years, due to serious differences of views between the U.S. and its allies. This is perhaps one of the least understood elements of the challenge confronting the U.S. when it deals with the China trade challenge. This section expounds on these differences.

For all the talk of the Trump administration acting unilaterally and ignoring U.S. allies, this has not been the case when it comes to trying to craft new WTO rules regarding China. The Trump administration has maintained, and even expanded upon, past U.S. practice of exchange and consultation with key allies. Following the WTO Ministerial meeting in 2017, the U.S., European Union, and Japan announced their intention to formalize this process of cooperation, which has come to be dubbed the Trilateral Process. In 2018, the three trade ministers agreed to try to coordinate on a series of joint actions.<sup>13</sup> Since then, trade officials have made considerable progress on a number of fronts in developing a coordinated approach, including most notably on industrial subsidies<sup>14</sup> and on notifications.<sup>15</sup>

Nevertheless, serious differences remain between the U.S. and its allies on a number of different issues. It may be tempting to ascribe the inability to bridge these differences to the Trump administration's confrontational approach with allies on other non-China trade issues, such as steel and auto tariffs. However, the tensions are not simply one resulting from personality clashes between current trade officials. Instead, the differences run much deeper and will outlive the Trump administration. Among the most serious tensions are the following:

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<sup>13</sup> Joint Readout from Meeting of the United States, European Union, and Japan in Brussels, March 10, 2018, <https://ustr.gov/about-us/policy-offices/press-office/press-releases/2018/march/joint-readout-meeting-united-states>

<sup>14</sup> Joint Statement of the Trilateral Meeting of the Trade Ministers of United States, European Union, and Japan, Jan. 14, 2020, <https://ustr.gov/about-us/policy-offices/press-office/press-releases/2020/january/joint-statement-trilateral-meeting-trade-ministers-japan-united-states-and-european-union>.

<sup>15</sup> Procedures to Enhance Transparency and Strengthen Notification Requirements Under WTO Agreements, 27 June 2019, JOB/GC/204/Rev. 2, JOB/GC/14/Rev. 2.

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### Appellate Body Crisis

In many ways, the Appellate Body crisis has brought into the open long-standing differences between the U.S. and EU over the proper role to be played by the Appellate Body in interpreting WTO law. The U.S. argues that the Appellate Body has overstepped its bounds by crafting judicial rulings that go beyond the negotiated text of WTO treaties, effectively taking away rights or adding new obligations not agreed to by U.S. negotiators. It also argues that the Appellate Body has exceeded its authority when overruling panels, issued unnecessary advisory opinions, and incorrectly elevated the significance of its past rulings. While recognizing that there is some merit to U.S. grievances, the EU disagrees sharply with the U.S. over its tactics as well as the scale of reforms needed to address the institutional failures.

In 2019, Ambassador David Walker of New Zealand facilitated an informal process to address these complaints over the Appellate Body, culminating in the creation of a set of principles designed to alleviate U.S. concerns.<sup>16</sup> The U.S., however, remains skeptical about how adherence to the Walker principles by the Appellate Body would be monitored and what consequences would result, if problems re-emerged.

Frustrated with U.S. actions leading to the Appellate Body paralysis, the EU has moved forward with like-minded partners to create a contingency arrangement to handle appeals between these partners in the interim.<sup>17</sup> Known as the Multi-Party Interim Appeal Arbitration Arrangement (MPIA), this plan is envisioned as a stopgap measure and operates under the existing WTO framework.<sup>18</sup> Fifteen other WTO members have joined the EU in adopting the

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<sup>16</sup> Informal Process on Matters Related to the Functioning of the Appellate Body – Report by the Facilitator, H.E. Dr. David Walker (New Zealand), JOB/GC/222, 15 October 2019.

<sup>17</sup> Statement on a Mechanism for Developing, Documenting and Sharing Practices and Procedures in the Conduct of WTO Disputes, JOB/DSB/1/Add.12, 30 April 2020.

<sup>18</sup> The MPIA operates under the framework permissible under Article 25 of the WTO Dispute Settlement Understanding.

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MPIA, including most notably China. The standoff has resulted in a split within the Western alliance. For now, Australia, Canada, Mexico, New Zealand, and Singapore have sided with the EU and China in adopting the MPIA – while Japan, South Korea, and others have chosen to remain outside of the MPIA, along with the U.S.

### Subsidies

While the Trilateral group was able to agree upon a large set of new rules needed to address industrial subsidies, it has been unable to reach common ground over whether additional changes to the treaty text is necessary to clarify the meaning of a “public body” in the Agreement on Subsidies and Countervailing Measures (ASCM). For a subsidy to be challenged under the ASCM or through countervailing duties in line with the ASCM, it has to be issued by a “government or public body.” The U.S. has expressed its displeasure over the WTO Appellate Body’s previous jurisprudence interpreting this term, which it views as incorrectly narrow. Given the interconnected nature and informal linkages between non-state entities in China and the execution of Chinese industrial policy, how this term is interpreted is of vital importance in determining the scope of possible trade-distorting industrial policies that could be targeted lawfully by trading partners. The U.S. and some others have sought to embed a more permissive interpretation of what constitutes a “public body” that diverges from past AB jurisprudence in select free trade agreements,<sup>19</sup> but other allies, including most notably the EU, have resisted this approach and the need to clarify the “public body” term in the ASCM itself.

### E-Commerce / Digital Trade

In WTO negotiations, the U.S. has consistently pushed for a “high-standard” agreement that would cover a wide range of practices with the potential to distort e-commerce trade today and possible forms of digital trade in the future. Among these are rules to ensure data flows and

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<sup>19</sup> See, for example, US-Mexico-Canada Agreement (USMCA), article 22.1 (defining a state-owned enterprise).

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prevent data localization, to prohibit source code disclosure and forced technology transfer, and to ensure fair treatment for digital products.<sup>20</sup> U.S. has also emphasized the need for additional rules to address cybersecurity issues, privacy practices, and digital taxes that may be trade-distorting.

China, on the other hand, has emphasized that the agreement ought to reflect “a reasonable standard of ambition” rather than the high-standard approach favored by the U.S.<sup>21</sup> China’s proposal emphasizes e-commerce facilitation measures – some version of which the U.S. also favors – but is most notable for what is lacking. The Chinese approach would favor discussions and consultations around the priority issues emphasized by the U.S., such as data flows, but not mandate any binding commitments. In that sense, the Chinese approach calls for greater respect of internet sovereignty principles and flexibility for governments to impose internet-related regulatory policies to achieve “reasonable public policy objectives.”<sup>22</sup> Finally, China has also submitted a proposal that would prohibit WTO members from limiting or blocking trade in ICT products necessary for e-commerce.<sup>23</sup>

While the negotiations are still in relatively early stages, the U.S. and China are clearly taking different positions that will be difficult to reconcile. Further complicating the negotiations is the fact that the EU has offered its own set of proposals which reflect its own view of digital governance that varies from both the U.S. and Chinese positions.<sup>24</sup> In addition, trans-Atlantic tensions over the proposed digital services tax also threaten to hamper greater U.S.-EU cooperation on other realms of cross-border digital governance.

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<sup>20</sup> See, for example, USMCA, chapter 19; US-Japan Digital Trade Agreement.

<sup>21</sup> Joint Statement on Electronic Commerce – Communication from China, INF/ECOM/19, April 24, 2019.

<sup>22</sup> Id.

<sup>23</sup> Joint Statement on Electronic Commerce – Communication from China, INF/ECOM/40, September 23, 2019.

<sup>24</sup> Joint Statement on Electronic Commerce – Communication from the European Union, INF/ECOM/43, October 14, 2019.

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Therefore, it is not at all clear that there is a common position among advanced economies as to what types of new rules for digital trade are required. An intense effort will be needed to reconcile trans-Atlantic differences over digital governance, if the WTO is to become more effective at tackling data and internet-related trade grievances with China.

### Technology Transfer

The Trilateral Group has raised the issue of what forms of additional rules might be needed to address the issue of “forced” technology transfer but has yet to develop any concrete proposals. One issue complicating this initiative is the question of what specific practices should fall within the scope of such a proposal. Given the use of informal non-state channels and informal norms not openly articulated by any government official in China, there are further questions of how one might meet the evidentiary burden of demonstrating that the state itself is engaging in trade-distortive behavior as opposed to foreign businesses making a commercial decision based on their understanding of prevailing regulatory practices and market trends. Again, this is yet another important area where the U.S., EU, and Japan have not been able to reach a common viewpoint as to what practices ought to be deemed impermissible.

### What to Do if WTO Reform is Not Forthcoming

Under the Trump administration, the U.S. has increasingly taken the view that it is being “played for time” by China at the WTO, as far as structural reform and rules updating are concerned. That is to say, China continues to execute on its industrial policies without consequence, while using its participation in WTO initiatives to provide a false pretense that it is open to compromise. The U.S. points to the failed multilateral effort to deal with steel and aluminum overcapacity as examples of how China has deployed this strategy successfully in recent years.

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The U.S. has argued that to prevent this Chinese strategy from succeeding, it is necessary to apply greater pressure on China to “up the ante” if no results are forthcoming. Under the Trump administration, this has primarily taken the form of tariffs, but also through the use of other trade instruments such as technology controls and investment restrictions. The U.S. would like the EU, Japan, and others to join it in increasing pressure on China and to up the stakes for China if WTO reform proves futile. However, allies generally believe that the more confrontational approach is counterproductive because it would harden Chinese resistance, and greater patience is needed to wait for WTO efforts to bear fruit.

In short, there remains a major difference between the U.S. and its allies on the efficacy of a “sticks-based” approach toward pushing China to adopt new WTO rules. That difference has become ever more pronounced in the Trump administration, but it is likely to persist even if a new U.S. trade team takes hold.

### Why Even if Alliance Differences Can be Resolved, Resolution at the WTO Will Prove Difficult

In theory, because there are so many issues in play at the WTO, some form of a limited bargain might prove possible. Not only would such a bargain help to de-escalate the ongoing U.S.-China trade war, it would shift the foci of present tensions toward a more institutionalized rules-based mechanism for future resolution. Shifting to a multilateral forum might also advantage U.S. bargaining power because the U.S. could call upon a coalition of allies to cajole China into agreeing to new WTO rules and structural reforms, rather than shouldering this burden alone. This all sounds highly promising, when considered in the abstract.

Unfortunately, the promise disappears once one dives into the nitty-gritty of current political economy constraints on all sides. The reality is that it will prove difficult for the next

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U.S. presidential administration to rely upon a WTO-centric approach, at least in the 2021-24 time frame.

As far as China is concerned, the dual economic shocks of the trade war and the global pandemic have sharpened the leadership's determination to prioritize economic growth. At the most recent National People's Congress, China's leadership doubled-down on its industrial policy model. This makes it even more difficult to push forward on new rules on subsidies, not just in China but also in other countries facing economic difficulties in the wake of the pandemic.

Second, in the wake of growing tensions with the U.S. over Chinese technology firms, Chinese leaders have also re-emphasized their determination to achieve greater technological self-sufficiency. This means that China, in the near-term at least, will be reluctant to adopt any new limitations on technology transfer, digital trade, e-commerce, or services that might interfere with China's ability to deploy industrial policies to foster their technological aims.

With so many of the key substantive areas likely deemed off the table by China in the near-term, and with WTO dispute settlement still paralyzed by the Appellate Body crisis, there will be an open question about whether it is worthwhile for the U.S to even work with China on a more limited WTO reform package. The practical questions over how a joint agreement could be reached will prove difficult to execute for two reasons.

First, just as is true of the Phase One and now Phase Two negotiations, there is an asymmetry in demands at the WTO, with the U.S. placing many more demands on China than vice versa. To offset the perception that China is simply caving to foreign pressure on trade, Chinese officials have emphasized repeatedly the importance that any trade deal be balanced. This means that the U.S. will have to offer some concession of value that Chinese officials could

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trumpet to a domestic audience. However, each of the areas where the U.S. might have some form of concession of value to offer China at the WTO is one where any administration would face political backlash from important interest groups at home. For example, the national security establishment will balk at any attempt to curb investment screening reviews through an investment facilitation agreement. Internet companies will balk at any concession to scale back the ambition of a digital trade / e-commerce agreement that does not include rules on ensuring data flows, in line with what China is seeking.

Second, even assuming that the U.S. and China hypothetically could achieve joint agreement on a limited reform package, in exchange for allowing this package to proceed, other developing countries will seek concessions, most likely in the area of agriculture or additional rules for special and differential treatment. With American farmers already having borne a disproportionate share of the burden for the U.S.-China trade war, it is unlikely that the next U.S. administration would demand additional sacrifices by this constituency at the WTO. And so long as China does not back away from its claim that it remains a developing country, it will be difficult for any U.S. administration to agree to additional special and differential treatment in rules for developing countries when China may be able to take advantage as well.

So long as trans-Atlantic differences persist and developing countries remain skeptical, China's rational strategy will be to continue its status quo approach. For the foreseeable future, China will partake actively in WTO discussions and initiatives without offering major concessions at the negotiating table. Meanwhile, China will continue to push aggressively with implementing its strategic initiatives, both at home and overseas. This includes the strategic policies and "dual circulation" approach emphasized in the upcoming Fourteenth Five-Year Plan.

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It also includes outbound initiatives including the Belt and Road Initiative, the Regional Comprehensive Economic Partnership, and the Digital Silk Road.

With the Appellate Body stuck, China knows that its industrial policies will not lead to any formal sanction through WTO dispute settlement. And with the Trilateral Group unable to reach a common understanding yet of what it is seeking on new digital trade rules or new rules on forced technology transfer, China will prioritize execution of as much of its industrial / technology upgrading strategy as it can, while its practices remain unconstrained by any new rules.

### Conclusion and Policy Recommendations

For all the talk of the WTO-centered, alliance-based approach being a preferable alternative strategy for resolving the China trade challenges facing the U.S., it will be an extremely difficult strategy for the next presidential administration to execute. That is not to say that it should not invest in such a strategy. But this paper has argued that it is important to consider this strategy as only one part of a multi-prong approach.

The numerous complications outlined above – whether among alliance partners or considering domestic politics – mean that success through a WTO-oriented approach is far from guaranteed. Indeed, it is quite possible that the WTO will continue its drift toward lesser relevance in the coming decade. Even if U.S. trade diplomats are able to execute a WTO-centered, alliance-based strategy successfully, given the glacial pace of multilateral diplomacy, it will take at least five to ten years, if not more, for this strategy to begin to reap dividends. Hence, it would be unwise for the U.S. to put the WTO at the center of its China trade strategy. Instead,

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the U.S. must continue to hedge through a number of other non-WTO approaches, as the U.S. has in both the Obama and Trump administrations.

Especially in the Xi administration, where non-trade issues are likely to create additional frictions in the U.S.-China bilateral relationship, neither side will have sufficient flexibility to maneuver to make the types of ambitious compromises necessary to jumpstart WTO reform. Reform will be made even more difficult by the weak state of the global economy in the next two to three years, which will create additional pressure on governments to retain policy flexibility rather than curtail that flexibility in agreeing to new trade rules. Furthermore, the WTO itself will be in the midst of a leadership transition itself in 2021, and its new Director-General will require some time to put her new agenda in place.

Again, this does not mean that the WTO should be ignored by the next administration. But it does mean that the next administration should set realistic expectations that the WTO is unlikely to deliver much in terms of finding a way forward on China-specific trade issues in the near future.

Five policy recommendations follow from this conclusion:

- 1) Seek to resolve Trans-Atlantic differences over key WTO-related issues, including most notably, reform of WTO dispute settlement and digital trade

The U.S.-EU relationship is a key axis that will determine whether a joint alliance-based approach to tackle China trade issues through the WTO stands any chance of being effective. The next administration should realize that this relationship is fraying, at least in the trade realm, and work to revitalize it. Doing so will prove difficult given that the divergent positions are longstanding and entrenched; yet, both sides stand to lose if they cannot bridge their differences. Until Washington and Brussels can work out their disagreements and differences on key WTO

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reform issues and resolve the WTO Appellate Body crisis, WTO rules – even if they can be successfully updated – will not prove to be any form of meaningful constraint on Chinese trade practices. In particular, it will be critical for the U.S. and its trans-Atlantic partners to work to bridge their differences over cross-border digital governance and reform of WTO dispute settlement.

### 2) Focus intensely on policies to counter / offset China's industrial policies and ensuring supply chain resiliency for vital strategic industries

Whatever administration is in the White House in 2021, it should hold the assumption that China's industrial policies will remain in place for the next four years and accept that bold structural reform of the Chinese economy is unlikely in the same period. Any initiatives to seek such change through a multilateral process at the WTO should have a medium- or long-term time horizon, as they will not bear fruit in the next four years (and possibly not ever). Consequently, the administration should place even greater emphasis on the need to develop supply chain resiliency for key strategic industries, whether in technology, healthcare industries, industrial goods, or services. The U.S. will need to work with allies to commit greater funds toward joint initiatives to counter the commercial advantages that Chinese firms gain from the Party-state's industrial policies, whether directly from state tax-related policies or indirectly through investment funds or other financial vehicles, so that U.S. and Western firms are not placed at a disadvantage.

### 3) Continue to address China-related trade issues through the Trilateral Process, and seek to socialize the norms through multiple multilateral forums beyond the WTO

For all of its trade frictions, one avenue of promise that has emerged from the 2017-20 Trump administration has been the Trilateral Group coordination mechanism between the U.S.,

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EU, and Japan. This process should be continued in the next administration, with the hopes that the allies can reach further agreement between themselves. Given that the WTO reform process is likely to prove slow in the next four years, the U.S. should work with its allies to socialize the norms that come out of this process in other multilateral forums, such as the G7, G20, OECD, etc.

- 4) Invest actively in ongoing WTO negotiations so as to advance U.S. and allied priorities, and work to support the next WTO Director-General if an ambitious reform agenda is put in place.

As noted in this paper, WTO negotiations remain very active, with several points of contestation at play in the coming four years. The next administration should invest heavily in resources for these negotiations. It should also work actively to shape the policy direction of the next WTO Director-General in an ambitious reform-oriented direction and offer strong support if the next WTO Director-General is able to follow through. Even if the WTO is unlikely to be effective in rising to the challenge posed by “China, Inc.,” it would be a mistake for the U.S. to cede its authority within the organization by scaling back on its activity within the institution itself.

- 5) Continue to focus on bilateral and regional negotiations with China as the key venue for discussing U.S.-China trade frictions, while increasing coordination with U.S. allies.

U.S. allies have been unwilling to adopt a more “sticks-oriented” approach toward negotiating with China. They have also been loath to put in other policies to dial up the pressure on China, even if meaningful Chinese concessions are not forthcoming on common issues such as industrial subsidies and digital trade through multilateral discussions. This orientation shows few signs of changing, even with a new trade leadership team in Brussels and a new government

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in Tokyo. Yet, for the reasons discussed above, the WTO is unlikely to prove effective as a negotiating forum on China-related trade issues in the next four years.

This places in the U.S. in a tricky situation of having a different posture altogether from its allies. U.S. trade officials therefore will have to navigate a precarious position. On the one hand, the use of a “sticks-oriented” approach has provided the U.S. with greater leverage to negotiate bilaterally with China, as compared to its allies. For the foreseeable future, the U.S. will need to continue to rely on direct bilateral negotiations – whether through the Phase Two trade agreement negotiations or some form of regular high-level discussions at the ministers’ level – to advance U.S. interests in a somewhat transactional model. On the other hand, the U.S. must assure allies that it remains committed to working with them, and that the bilateral process will not derail alliance-based efforts. It will be important for the U.S. to lead the way in creating an even more robust coordination mechanism among its allies to ensure demands are jointly made across various bilateral or multi-party negotiations with China.

Overall, the next four years ought to be about making a greater investment in working through differences within the alliance, with the goal of adopting a more coordinated approach to the China trade challenge. At the same time, the U.S. must recognize that multilateral reform processes are slow and take years, if not decades, to bear fruit. The WTO will not be the easy panacea for solving U.S. trade grievances with China. So long as the WTO remains an inadequate forum, the U.S. must continue to find other ways to manage persistent tensions, including through a transactional model. Most importantly, the U.S. must not forget to invest in the necessary policies back home to buttress its own competitiveness. Regardless of whether one likes it or not, one must accept the reality that the economic and technological competition with China is unfolding on a terrain not fully bound by enforceable legal rules.