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FEATURE

The Rise of China and the Fall of the 'Free Trade' Myth

China's economic success lays bare an uncomfortable historical truth: No one who preaches 'free trade' really practices it.

By Pankaj Mishra

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'America first does not mean America alone," President Trump declared last month at the World Economic Forum in Davos, Switzerland. This sudden burst of pragmatism from an avowed nationalist showed what a difference a year can make. Denouncing the "false song of globalism" during his presidential campaign, Trump, on his third full day in office, canceled the Trans-Pacific Partnership, a regional trade deal with Japan and 10 other countries. He then denounced Canada, Germany and South Korea for exporting more to the United States than they import. He promised to renegotiate trade pacts with Europe, Canada and Mexico and get a better deal for American workers. In Davos, however, he reached out with conciliatory words to the very free-trading and globalizing elites he has consistently maligned.

Clearly, Trump's views on trade and globalization have evolved since his insurgent campaign. This may well be because of the rapid gains in the past year of a country he did not mention by name. In fact, Trump chose in Davos to affirm that "America is open for business" because it was in these same Alpine heights, three days before Trump was inaugurated as president, that China seized the opportunity to claim leadership of the global economy. With the United States seemingly in a protectionist crouch, China had become, despite all its problems, indispensable. "In a world marked by great uncertainty and volatility, the international community is looking to China," Klaus Schwab, the founder of the World Economic Forum, said last year while introducing his guest, the Chinese president and general secretary of China's Communist Party, Xi Jinping.

As the usual gaggle of hedge-funders, Silicon Valley executives and government officials looked on, Xi rose to defend free trade and globalization against the relentless attacks of Trump. "Some people blame economic globalization for the chaos in our world," Xi said. "One should not retreat to the harbor when encountering a storm, for this will never get us to the other shore of the ocean." Xi then confidently quoted Dickens. " 'It was the best of times, it was the worst of times.' These are the words used by the English writer Charles Dickens to describe the world after the Industrial Revolution. Today, we also live in a world of contradictions."

Never mind that Dickens was actually describing the world before the French Revolution. Xi's claim of openness was, to say the least, riddled with contradictions of its own. It is increasingly difficult for foreign companies to do business in China; Beijing's "Made in China 2025" industrial policy aims to increase "indigenous innovation" and self-reliance. When Trump, a year later in Davos, denounced such "unfair economic practices" as "industrial subsidies and pervasive state-led economic planning," there was little doubt which nation he had in mind.

Yet Xi is entitled to some of his rhetorical point-scoring. The financial crisis of 2008 greatly weakened the American economy, but it left China relatively unscathed. More important, China, whose share of world trade in the mid-1970s was less than 0.5 percent, is today the world's leading exporter — the hub of new and increasingly dense transcontinental trading networks that bypass the United States. "When the United States grows, so does the world," Trump claimed in Davos. But America's status as the linchpin of the global economic order is now endangered. The trading system China dominates has reduced the long dependency of Latin American and sub-Saharan African countries on American and European markets. China is now bringing to a close the first phase of globalization, begun by Europe and the United States in the 19th century. In the process, it is making East Asia the new center of the world economy.

It has fallen upon Trump, as president of the United States, to respond to this momentous historic shift, and he has done so with his characteristic mix of threats, boasts and volte-faces. But to grasp China's economic achievement, and its ramifications, it is imperative to ask: Why has a market economy directed by a Communist state become the world's second-largest? Or, to rephrase the question: Why shouldn't it have? Why shouldn't China's rise have happened the way it did, with state-led economic planning, industrial subsidies and little or no regard for the rules of "free trade"?

The economic success of East Asian countries like Japan in the 20th century had already invalidated the article of faith invoked by Trump in Davos: that nations can advance only by eliminating barriers to the free movement of goods and capital and by minimizing the role of government in the economy. But these historical lessons have long been obscured by economic orthodoxy, one that Trump's — and China's — unexpected ascents have now exposed to critical scrutiny.

In his most recent book, "Straight Talk on Trade," the Harvard professor Dani Rodrik castigates fellow economists for holding fast to a simple-minded view of free trade and globalization, one that he believes has caused economic chaos and political backlash across the West. "Are economists," he asks, "responsible for Donald Trump's shocking victory in the U.S. presidential election?" This might be overstating the case. But it is true that the argument that free markets equal progress was most eloquently and influentially advocated by the American economist Milton Friedman.

The paradoxes of China's rise today are best illuminated by Friedman's querulous visit to the country in 1980, when China was desperately poor. The Nobel laureate from Chicago was then cementing his reputation as an apostle of free markets. He had just published "Free to Choose," a book that was written with his wife, Rose, and later turned into a television series featuring, among others, Ronald Reagan, Arnold Schwarzenegger and Donald Rumsfeld. Friedman's argument, that "the world runs on individuals pursuing their separate interests," would shape American economic policy for decades to come. He helped disparage the idea, exemplified most vividly by Franklin Roosevelt's New Deal, that government had a legitimate, and often indispensable, role to play in advancing economic development and protecting the vulnerable. As his keen disciple Reagan famously put it, "Government is not the solution to our problem; government is the problem."

Friedman's fervent advocacy of free trade and the efficiency of unregulated markets gave intellectual ballast to the so-called Washington Consensus. Free markets, the thinking went, not only generated wealth for all nations but also maximized consumer choice, reduced prices and optimized the use of scarce resources. Friedman's faith in the efficiency of markets came to constitute what John Stuart Mill referred to as "the deep slumber of a decided opinion."

Friedman was the most influential proponent of free trade since Adam Smith declared it, in 1776, the basis of the wealth of nations. But in 1980, few people in China, including the academics who invited Friedman to a lecture tour, knew that their American guest was an impatient, even volatile, ideologue.

A series of (often comical) misunderstandings ensued. Friedman complained about the Chinese man with a "terrible body odor" who received him at the Beijing airport; the man turned out to be one of his academic hosts. Friedman's lectures in praise of free markets were met with bewilderment. His assertion that capitalism was superior to socialism disturbed the Chinese greatly. Some of the more agitated Chinese economists went in a delegation to Friedman's hotel to lecture him about the achievements of their regime.

Friedman, who (erroneously) saw Japan and South Korea as brilliant examples of open, competitive markets, was understandably impatient in China; the country embodied everything that was wrong with government planning. Indeed, China in 1980 was just lurching out of Mao Zedong's calamitous experiments. Deng Xiaoping's government was trying to improvise new solutions to the country's economic backwardness, which officials thought had exposed China to humiliation in the 19th and early 20th centuries.

"Development," Deng said, "is the only truth. If we don't develop, we will be bullied." And national development, in Deng's view, could be achieved by a variety of means. His flexible attitude was summed up by a much-popularized Chinese maxim: "Cross the river by feeling for the stones."

The Chinese couldn't help bristling at Friedman's blunt dismissals of their government. Despite horrific disasters, the Chinese state had drastically raised literacy and life-expectancy levels. Also, the Chinese were then seeking a third way: They looked to Japan and Singapore rather than the United States for economic models that would accelerate growth without endangering the authority of the Communist Party. The Chinese saw little of value in an American proponent of laissez faire. Friedman left China, angrily claiming that his hosts were "unbelievably ignorant about how a market or capitalist system works."

Friedman died in 2006, shortly before the financial crisis of 2007 and 2008. The extensive political aftershocks of that crisis arguably include the election of a protectionist to the highest office in the United States, who has threatened to cancel decades of commitments to free trade at the risk of alienating his country's closest allies.

As bewildered (and appalled) as Friedman would most likely have been by Trump's demonization of free trade, he would have found it still harder to explain why China, run by a Communist Party, has emerged as central to the global capitalist economy. For the Chinese regime achieved this not by liberating its 1.4 billion citizens to maximize their private interests in unfettered markets but by controlling its currency, owning large businesses and intervening heavily in investment decisions by private companies.

Indeed, economic history reveals that great economic powers have always become great because of activist states. Regardless of the mystical properties claimed for it, the invisible hand of self-interest depends on the visible and often heavy hand of government. To take only one instance, British gunboats helped impose free trade on 19th-century China — a lesson not lost on the Chinese. Britain was protectionist before it was a free-trading nation. The United States itself was, while industrializing, the "mother country," as the economic historian Paul Bairoch wrote, "and bastion of modern protectionism." Its average tariffs in the late 19th century were nearly as high — 45 percent — as the steepest ones Trump has slapped on imports of washing machines. The philosophical father of economic protectionism is, in fact, Alexander Hamilton, the founder of the American financial system, whose pupils included the Germans, the Japanese and, indirectly, the Chinese.

No story is as instructive as that of the Japanese, arguably the most diligent of Hamilton's disciples. Post-1945 Japan preceded China as the hub of regional and intercontinental trade networks. Soon after its disastrous part in World War II, Japan helped revitalize Asia and by the mid '90s was the biggest investor and exporter in most

East Asian countries; it gave more foreign aid and sent more tourists to them and was the biggest buyer of their raw commodities. What's more, it offered a model for development that combined a market economy with state intervention — one that China was even then beginning to learn from.

How did Japan, a country devastated by a world war that had few natural resources of its own, achieve economic primacy in Asia? Friedman's explanation in "Free to Choose" was that "free trade set off a process that revolutionized Japan and the lives of its people." Francis Fukuyama, who proclaimed the end of history in 1989, credited Japan's success to "economic liberalism" of the kind espoused by Adam Smith. But the Japanese followed a very different model, one adopted from Hamilton.

Japan learned early the political risks of economic stagnation. At the height of 19th-century imperialism, it signed a humiliating treaty that subjected its trade policy to the control of five Western powers, deprived it of the right to impose tariffs, set radically low import duties and gave foreign residents in trading ports extraterritorial status. Smarting from such insults, the conservative Meiji rulers of Japan became obsessed with regaining their sovereignty and protecting themselves from foreign tormentors.

In this endeavor, they looked to Germany. Unified in 1871, Germany was scrambling to catch up with industrialized Britain. To do so, it borrowed from recipes of national development proposed by Hamilton soon after the Americans broke free of their British overlords. In his "Report on the Subject of Manufactures," submitted to Congress in 1791, Hamilton used the potent term "infant" industries to argue for economic protectionism. Hamilton's father was Scottish. Born in the West Indies, then a British colony, Hamilton was keenly aware of how the British practiced protectionism: preventing colonies from competing while selling their own goods around the world. In his view, infant nations needed room to maneuver before they could compete with established industrial powers. The United States embraced many of Hamilton's recommendations; the beneficiaries were, first, the textile and iron industries and then steel.

It was Hamilton's formula, rather than free trade, that made the United States the world's fastest-growing economy in the 19th century and into the 1920s. And that formula was embraced by other nations coming late to international economic competition. Hamilton's most influential student was a German economist named Friedrich List, who lived in the United States from 1825 until the 1830s and wrote a book titled "Outlines of American Political Economy." On his return to Germany, List attacked the free-market gospel preached by Britain as sheer opportunism. In his view, the British could afford to kick away the ladder of protectionism they had climbed to the summit of global industry and manufacture. He was all for free trade, but only after young industries had been nurtured in a protective environment. Applying List's lessons, Germany moved with spectacular speed from an agrarian to an industrial economy.

The stakes were higher for Japan. There was hardly a country in Asia that had not been forced by Britain, Holland and France into unequal trade agreements. Economic liberalism was not a feasible option. The visible hand — the state rather than the market — was needed to guide development. Closely following Germany's example, Japan heavily subsidized its first factories, copied British design and imported foreign machinery and engineers. It not only protected many of its businesses from excessive competition but also guaranteed them a minimum profit.

When World War I disrupted Europe's monopolies in its Asian colonies, Japanese companies moved in with their textiles, bicycles and canned foods. Following Europe's free-trading imperialists, Japan had invaded and occupied Taiwan and then Korea, turning them into protected markets for its small industries. In a further refinement, the Japanese state bribed and coerced manufacturing companies. It gave them subsidies to export more, which in turn helped the companies fund innovations and become internationally competitive.

World War II proved only a brief interruption in Japan's policy of protection. Utterly devastated, Japan still managed to rid Asia of its European competitors. It was during the American occupation, as the historian John Dower notes, that Japan instituted what an economist described as the most "restrictive foreign-trade and foreign-exchange control system ever devised by a major free nation."

Given unlimited powers by their American occupiers to get the country going again, the bureaucrats of Japan's Ministry of International Trade and Industry laid the foundations of a world-class manufacturing economy. Nationalism was a great stimulus. As Dower put it, "National pride — acute, wounded, wedded to a profound sense of vulnerability — lay behind the single-minded pursuit of economic growth that created a momentary superpower a mere quarter-century after humiliating defeat." But Japan would have struggled had war not erupted on the Korean Peninsula in 1950 and made Japan the main source of American procurements. The path of Japan's protectionist state was now set — the country's prime minister, Shigeru Yoshida, would call the destructive Korean War a "gift of the gods."

In the 1950s, Korea and Taiwan, both former Japanese colonies, inherited Japan's institutions and protectionist practices. This was most striking in Korea, which was intensely poor in the early 1950s; its few industries were built by Japan during the 1930s. South Korea, too, found solutions for its problems in Friedrich List rather than Adam Smith. The country's leader, Park Chung-hee, the military general who came to power in 1961, had worked for the Japanese colonialist regime. A fervent autodidact, Park was also deeply familiar with German theories of protectionism. (The economist Robert Wade reported coming across whole shelves of books by List in Seoul bookstores in the 1970s.) During his long years in power, Park nurtured South Korea's *chaebol* business groups — Hyundai, Daewoo and Samsung — and boldly ventured into steel-making.

Because the United States saw Korea, Taiwan and Japan as a buffer against Communism, it helped promote such neomercantilist strategies — a mix of import substitution and export-oriented industrialization. American cold warriors also gave their strategic allies unhindered access to U.S. markets while tolerating the closure of their own to American investment. By the time the United States realized that its biggest Asian ward had grown too big, it was too late. Japan had taken many products invented in the United States (automobiles, consumer electronics) and manufactured them more cheaply and with superior quality. By the 1980s, Japan had supplanted the United States in aid and investments in East Asia. When the United States sought to limit Japanese exports, the Japanese responded by deepening their investment in Asia, moving factories and improving industrial skills and technology wherever they went.

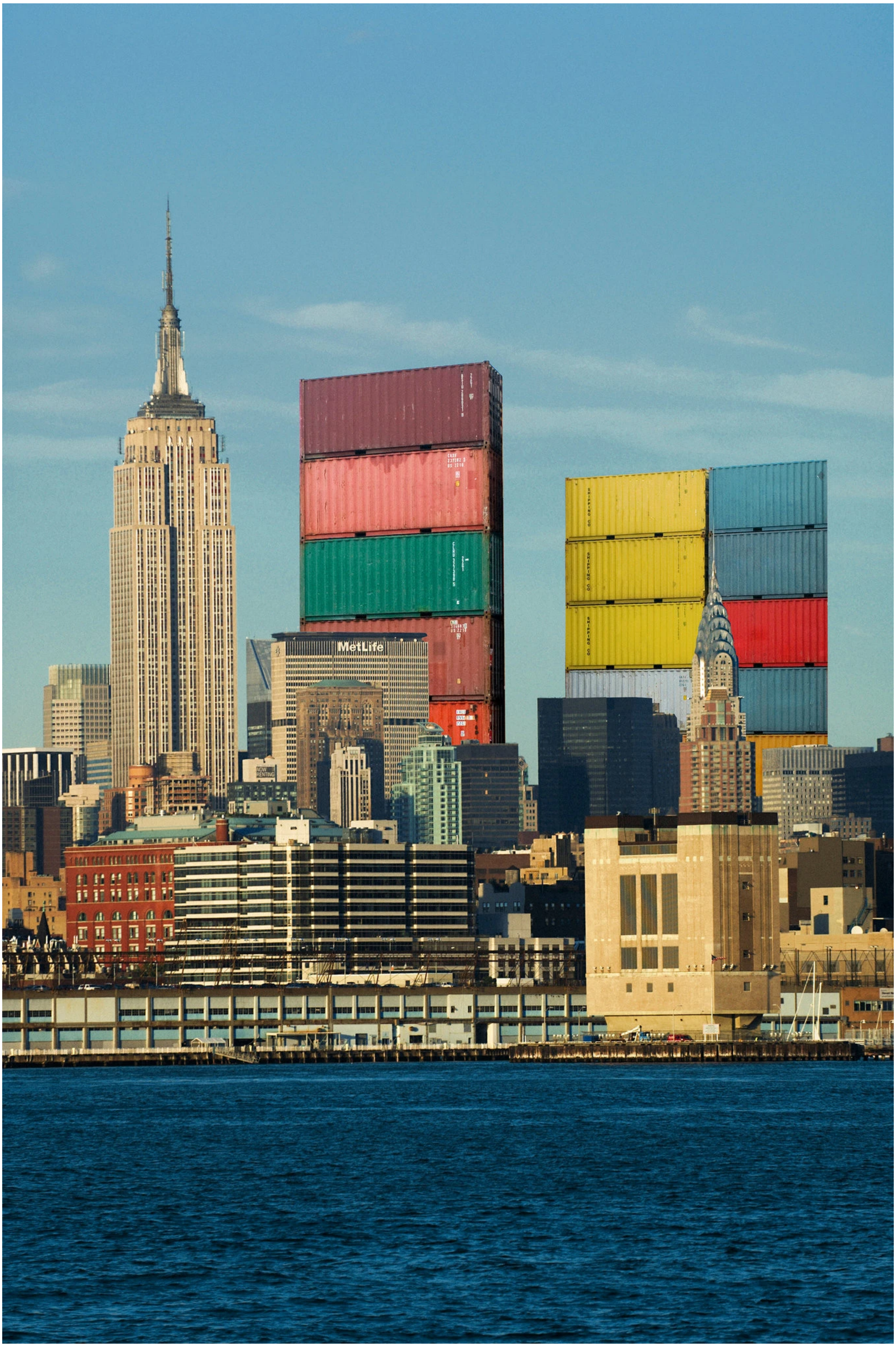

Illustration by Tamara Shopsin. Source photographs: Getty Images.

In 1994, when I first left India to travel to Southeast Asia, I found Japan everywhere, as both promise and rebuke. The renovation of Thailand, South Korea and Taiwan under Japanese auspices was then an established fact — and a standing reproach for us in

India, which had failed to match East Asia's success in manufacturing and trade. Like most countries in the world after 1945, France as much as Japan, India embraced a model of state-led development. Its aim, as in many nations liberated from colonial rule, was not so much the growth of private wealth as the strengthening of national power. Friedman described Indians in "Free to Choose" as deluded followers of Mahatma Gandhi, idly spinning cotton in cottage industries subsidized by the state. India, he said, was blind to industrialization and, furthermore, believed in central planning. This was a caricature: India had an ambitious industrialization program, and its economy mixed private markets with state-owned enterprises, even if its historical experience of British rule predisposed it to suspect that free trade benefited only developed industrial economies. Nevertheless, Friedman was broadly right in his view of India as a social and economic laggard.

India, following a model of import-substitution growth, barely participated in world trade. Its factories produced shoddy goods that you bought only because there were no alternatives. And so I was dazzled by what was on offer in Southeast Asia. The emblems of pop American culture — Kentucky Fried Chicken, McDonald's, Madonna — were everywhere. But the most seductive consumer goods were almost invariably Japanese: Sony, Sanyo, National, Mitsubishi, Hitachi, Fuji.

Feeling inadequate before East Asia's progress, many middle-class Indians longed for what Chalmers Johnson, in a book about Japan's unique growth, called the "capitalist developmental state." In such states, skilled bureaucracies led by authoritarian leaders promoted a project of national development (while either paying lip service to, or ignoring, democratic norms). Private entrepreneurs made socially beneficial investments; government policies helped build their comparative advantage while also facilitating social stability with land reforms, education and other efforts to address income equality.

The "developmental state" assumed that market failures were to be expected and that the state played a necessary role in designing industrial and financial policy. These included not only trade protection and government subsidies but also, as the political economists Robert and Jean M. Gilpin wrote in "Global Political Economy" in 2003, "selective credit allocation and deliberate distortion of interest rates in order to channel cheap credit to favored economic sectors." Governments were, in fact, very much part of the solution, as even the World Bank, beholden to the Washington Consensus, grudgingly acknowledged in its well-known 1993 report, "East Asian Miracle." The high-performing Asian economies, it noted, "have achieved unusually low and declining levels of inequality, contrary to historical experience and contemporary evidence in other regions."

The hero of many middle-class Indians was the authoritarian leader of Singapore, Lee Kuan Yew, whose success in turning Singapore from an economic backwater into one of the world's major commercial cities was much admired by Deng Xiaoping. We might have also revered, had we known more about him, South Korea's technocratic despot Park Chung-hee, who accomplished economic goals with the help of highly trained managers, and who also appeared to reduce inequality and build what we in India sorely lacked: social cohesion.

But little did I know that Hamilton (and List) would achieve their greatest influence in post-Mao China. "The rise of China resembles that of the United States a century ago," the Chinese scholar Hu Angang writes. He is not exaggerating. Friedman may have been right that the Chinese Communists were hopelessly ignorant of how free markets work, but ending state intervention in the economy was never on the agenda. After Mao, Chinese leaders looked to Japanese and other East Asian developers, just as the East Asians had once looked to Germany.

The first investments in China in the 1980s came from Japan as well as from transnational Chinese business networks based in East Asia. China benefited from the market networks, management and technical know-how that accompanied these investments. Encouraged by the Clinton administration, it entered the World Trade Organization in 2001 and quickly seized the opportunity — limitless export markets — opened by American insistence on free trade.

Once Japan became the leading investor in Asia, regional production chains began to link those countries with one another. As Korea, Hong Kong, Singapore and Taiwan moved up the technology and value chains, they invested in developing countries, like Vietnam and Indonesia. This process of regionalizing investment and production, which largely dispenses with Europe and America, has now been accelerated by China's rise as a manufacturing power. The biggest investor in Vietnam today, for instance, is South Korea, whose biggest trading partner is China.

The success of China's state-led economy presents, in many ways, the same economic (and ideological) quandary that Japan unexpectedly threw up before the United States when, in the 1980s, it became the world's leading creditor. A regional trading system dominated by China will make Asian countries less likely to enlist in American geopolitical objectives. Locked into boundary disputes with its neighbors, China has accelerated the militarization of the South China Sea, acquiring more than 3,200 acres of land on reefs and outcrops and installing runways, ports and hangars. But it has also abandoned its abrasive attitude, making determined efforts to pivot Asia away from Trump's America. And it seems to be succeeding.

With China offering generous infrastructure deals to the former American territory of the Philippines, President Rodrigo Duterte announced that "it is time to say goodbye" to the United States — previously he threatened to ride a jet ski to a Chinese man-made island in the South China Sea and plant his country's flag there. Other rival claimants to parts of the South China Sea — Malaysia, Vietnam and Brunei — have also moved closer to Beijing since Trump's election. Smaller countries like Cambodia and Laos now resemble Chinese client-states. China is also trying to repair long-strained relations with Japan by inviting investments by Japanese multinationals.

These attempts to win over major American allies in Asia complement Xi's ambitious One Belt, One Road initiative, which aims to put China at the center of global affairs through a network of trade links and infrastructure projects stretching from Asia to the Middle East to Africa and Europe. Investing more than $1 trillion in more than 60 countries — ports in Pakistan and Sri Lanka, high-speed railways in East Africa, gas pipelines in Central Asia — the initiative can claim to be the largest overseas investment drive ever undertaken by a single country. The 11 European Union members and five non-E.U. Central and Eastern European countries that have joined the China-led political and commercial group called 16+1 have all signed major infrastructure deals with China, enhancing Beijing's influence in the E.U. The remaining 11 members of the Trans-Pacific Partnership have gone ahead without the United States; they are expected to sign a final agreement in March.

By pulling out of the TPP and threatening trade sanctions, Trump encouraged Japan to seek a deal with Europe that shuts out the United States. Britain, another stalwart American ally, is considering joining the TPP. China, meanwhile, is hectically negotiating more than a dozen trade agreements in Asia while proposing its own alternative to the TPP, a trade agreement called the Regional Comprehensive Economic Partnership. China has also intensified efforts to build alternatives to such Western international institutions as the World Bank and the International Monetary Fund. In 2014, China inaugurated, against staunch American opposition, the Asian Infrastructure Investment Bank, whose members now include all Asian states except Japan.

There is little doubt that Beijing is presenting itself as a benign alternative to the United States. In a speech just before his second term as the party's general secretary, Xi claimed that there were more takers internationally for Chinese "values." China, he said, offers "a new option for other countries and nations who want to speed up their development while preserving their independence."

It was always wildly optimistic to suppose that China would eventually be integrated into an American-dominated order and persuaded, if not forced, to adopt its norms. A postcolonial Indian like myself, who traveled to China and read in its modern history and literature over the last decade and half, could only be skeptical of such claims. It was never less than clear to me, whether in the suburbs of Lhasa, Tibet (demographically altered by Han immigration), or in the bookstores of Shanghai (stacked with best sellers with titles like "China Can Say No"), that the quest for national sovereignty and regained strength defines China's party state and its economic policies.

Belying predictions of doom, China has again demonstrated the power of what Dower, speaking of Japan, called "national pride — acute, wounded, wedded to a profound sense of vulnerability." The United States never knew this single-minded ambition of the historical loser to avenge his losses; American leaders now reckon with it at home, in the wake of a nationalistic backlash against free trade and globalization. Some confused policies and mixed signals have accordingly defined the American position on China. During the American presidential campaign in 2016, all the main candidates, Bernie Sanders and Hillary Clinton as well as Trump, opposed the TPP, which was intended to contain China in its own region. Then, in Trump's chaotic first year, the United States seemed to be forced back by Hamilton's shrewd East Asian disciples into its historical role as the mother country of protectionism. Trump now says that America first does not mean America alone, and he is open to rejoining the TPP. There may be more such reversals ahead. For Trump is only just beginning to acknowledge, after a year of bluster, the formidable challenge of China and the arduous effort needed for the United States to match its most determined and resourceful rival yet.

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