CHINA’S GROWTH AND TRADE:
CONSEQUENCES FOR THE US ECONOMY

VOL. 27, NO. 1

FEBRUARY 18-20, 2012

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THE ASPEN INSTITUTE
Washington, DC
This project was funded by the Asia Foundation, ClimateWorks Foundation, the Ford Foundation, the William and Flora Hewlett Foundation, the Henry Luce Foundation, the John D. and Catherine T. MacArthur Foundation, Rockefeller Brothers Fund and the Rockefeller Foundation.

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The Aspen Institute
One Dupont Circle, NW
Washington, DC 20036-1133
Published in the United States of America
in 2012 by The Aspen Institute

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Printed in the United States of America
ISBN: 0-89843-567-6

Pub #12/008
1866/CP/BK
Table of Contents

Rapporteur’s Summary. ............................................................. 1
Matthew Anderson

China’s Future Growth and Its Consequences for the US ......................... 15
Barry Naughton

Trade and Finance Relations With China: Where Are American Interests? ........ 21
Daniel Rosen

Conference Participants. ........................................................... 27

Conference Agenda .............................................................. 29
The Aspen Institute’s Congressional Program conference on U.S.-China Relations was held in San Diego, California from February 18-20, 2012. In attendance were sixteen US Representatives and two US Senators along with eleven US and three Chinese scholars. The conference consisted of two extended roundtable discussions and six working meals. The aim of the conference was to facilitate a frank, informative and nonpartisan discussion about the implications of China’s economic policies for US national interests.

The conference coincided with a public discussion about China’s future intentions in the wake of Chinese Vice President Xi Jinping’s recent trip to the US. With continued trade frictions and anxieties about the geopolitical consequences of China’s rapid ascent, the background to the conference was marked by a relative unease with the current state and future projections of US-China relations. The upcoming election is only increasing the amount of attention that Chinese policies on issues ranging from Iran to North Korea to climate change are receiving. But the most salient issue in the context of US domestic politics and the focus of this conference is the extraordinary depth and breadth of US-China economic interactions.

Despite the tone of news coverage and commentary about China, the discussions were introspective and clearly oriented towards finding mutually beneficial solutions to US-China economic problems. There was some alarm and anxiety, but the tone was not so much of blame, but rather inquisitiveness. The members of Congress and assembled scholars approached the task at hand by first investigating the underlying nature of any tensions and then seeking ways in which amicable cooperation could resolve the problems.

The broad themes that dominated the discussion were:

- **Misunderstandings**: Both sides clearly don’t understand each other. More troublesome is that US constituents don’t understand China.

- **Rules of the Road**: The merits of the World Trade Organization (WTO) were examined extensively. Though it was widely agreed that the framework should be kept with needed updates and modifications, there were concerns that China was not living up to its obligations. Aside from the WTO, the main concerns about China’s trade relations with the US were:

  - **Intellectual Property Rights (IPR)**: There clearly is an issue with US IPR being abused in China. There is a debate about how serious it is and whether or not it is an intentional strategy for eroding US technological superiority.

  - **Currency**: The Chinese currency is widely believed to be manipulated,
but it is hard to say that it is still under-valued. This is a problem with other trade partners, too.

- Labor and Environment Standards: These are improving in China, though slowly. This is thought to be mostly a problem of development and implementation.

- US Strategy: The consensus was that the US does not have an energy or economic strategy. Within economics, the US lacks specific trade, investment and innovation strategies. Other developed countries that have benefited more from trade with China, namely Germany and Japan, might serve as models. The US has a long to-do list of how to retool the interaction between the public and private sectors, its approach towards foreign trade agreements, how to encourage and protect technological innovation and the roles of various agencies within the government that deal with trade and economic issues.

- Innovation Economy: After hearing the bleak prospects for US manufacturing, many members began wondering whether a US dependent on higher-end technology would be good for the country overall. Views were expressed that abandoning everything except for high-tech industry and research and development (R&D) would not be sustainable and bad for the economy overall. Other concerns were about how to get immigration and education policy right to maintain the US’s current lead in high-end technology.

- Energy: China’s rising energy demands are impacting the US economy. Other sources of energy must be adopted, but the US is facing stiff competition from the Chinese in these new fields as well.

Susan Shirk, the Ho Miu Lam Chair of China Studies at the University of California, San Diego, opened the conference by providing an insight into China’s domestic political dynamics and how those can affect US-China relations. Forty years after Nixon’s reengagement with the People’s Republic of China (PRC), American perceptions of that nation are still skewed, albeit in a different direction. The view from the US is of an unstoppable behemoth that is unified within and strategically decisive without. This simplistic view does not capture all the complexities of modern China. It is this perception of an unstoppable juggernaut that drives US anxiety. Contrary to this perception, Shirk presented the view that although China is clearly an emerging power it is a very fragile one internally.

It should not be forgotten that the whole system almost collapsed in the Tiananmen protests of 1989. A split of the Chinese Communist Party’s (CCP) top leadership that spilled over to the broader public fed into pre-existing domestic dissent. The convergence of internal protests (taking place in over 130 cities across China) and the international context of the collapse of other communist regimes led the leaders in Beijing to fear that their days were numbered. Only the People’s Liberation Army’s (PLA) loyalty to the top CCP leadership averted a greater crisis. Following the crackdown the CCP pursued three top priorities: preventing the formation of another large-scale protest movement, maintaining unity in the Party leadership and keeping the loyalty of the PLA. The pursuit of these goals still dominates PRC policy decisions.

Putting these political imperatives in context, Shirk moved on to examining the current leadership. To avoid the excesses of Mao’s one man rule, the CCP now employs a collective leadership marked by weak, non-threatening individual leaders. One leader stands as first among equals and serves as a link between the relevant institutions as the head of the Party, the government and the PLA. Internal Party reforms have made succession routine and relatively predictable with term limits and mandatory retirement ages. It is this more orderly system that allows us to assume Xi Jinping will be the next top leader. However, beneath the surface there is intense competition for the top posts that
threatens the cultivated facade of unity.

The recent emergence of Bo Xilai, Party Secretary of Chongqing Municipality, is an interesting case in elite Chinese politics. In addition to evoking neo-Maoist culture, Bo is unique in his very public campaign to ascend to the Party’s Politburo Standing Committee, the body of the nine highest officials in China. Bo’s campaigning and use of the media is more similar to candidates in a democratic system than to his peers who prefer behind-the-door negotiations for leadership promotions.

The phenomenon of Bo Xilai is enabled by a new media environment in China. Gone are the days of all media in China being mouthpieces for official propaganda. Since the introduction of competition and a loosening of censorship, traditional media outlets have had to capture audiences with stories that sell. This shift to “demand-side” journalism has led to stories about local corruption, tragedies and economic news. These stories not only feed the interest of the people, but serve a valuable watchdog role for the central government.

Staying on the topic of media in China, Shirk moved to the internet, which she describes as the most revolutionary force in the country today. Less censored than the traditional media outlets, internet sites and blogs feed a population hungry for unfiltered information. Though it may not be representative of mainstream views, the blogosphere can often turn into an outlet for anti-foreign nationalism. Given the weakness of China’s current leaders, there is a temptation to seize on these extreme nationalist sentiments to bolster an individual leader’s legitimacy. However, the internet concurrently presents another potential threat to a regime with a pre-existing siege mentality in that it could turn into an information cascade of dissenting views.

Shirk urged the participants to consider these domestic Chinese political dynamics. The pursuit of stability and preservation of the CCP as the ruling party will dominate all PRC economic and foreign policy. Therefore, in making policy related to China US officials should think how their words and actions will be interpreted by the many actors within China.

The discussion revolved around the following topics:

- **Civil Liberties:** It was asked if the recent news about cracking down on internet freedom, such as mandatory registration of names for bloggers, was part of a broader strategy to roll back some of the looser policies in censorship. Shirk feels that it is too early to tell if and how the government would be able to control the internet like other media. She warned that internet freedoms could become more restricted in the near future.

- **Stability:** It was observed that China’s protests have salient issues at their core (such as environmental issues, land seizures, etc.). In response, China has employed a three-prong strategy of making minimal concessions, blaming the local leaders and then arresting the protest leaders. Is this effective or is it just delaying a larger outburst? Shirk acknowledged that these tactics may not resolve the underlying issues but that dissent is not large enough or concentrated enough to threaten the regime. There is no organized opposition in China so these tactics are likely to continue working for the near future.

- **Historical Legacies:** Some scholars place a high importance on China’s ancient history and culture and believe they still influence current leaders. However, Mao actively sought to destroy these influences during his rule. The current administration has tried to revive aspects of China’s past, in particular Confucius, but these attempts have been rather unsuccessful so far.

- **Nationalism:** With China becoming increasingly powerful it appears that the Chinese population has become more nationalistic. Participants were concerned that increased nationalism and anti-for-
eign sentiments could become dangerous. Shirk believes that nationalism by itself is not dangerous, but anti-foreign or xenophobic variants of nationalism can be. The US has at times been the target of some anti-foreign elements and will likely continue to be as the flashpoints in the region increase. However, Shirk believes that maintaining a strong US military presence in the region while also boosting public diplomacy and economic interdependence can lessen the chances of disputes spiraling out of control.

- **Global Ambitions:** China’s success has caught the attention of many developing countries and allowed it to be very active abroad. Should the US be worried about this? China’s foreign presence has exploded, probably more than even its leaders anticipated. Although it is actively seeking resources, the overall record of China’s foreign presence in places such as Africa is thought to be positive and not imperialistic.

- **Syria:** Shirk thought the Syria veto at the UN Security Council was a gamble for China because it is still unclear how the situation will unfold. China does have a long history of espousing noninterference, but in this case, voting with Russia might be the main motivation.

Microsoft’s general counsel, Brad Smith, spoke about the complexities of doing business in China and how the broader economic relationship with China has implications for US competitiveness.

Barry Naughton, a professor of economics at the University of California, San Diego, believes that the next ten years will see even more policy changes in the economic sphere in China than have been seen so far. These policy changes will take place under the next generation of Chinese leaders, set to take power in all levels and sectors of the political system this fall. The short-term growth projections are good, but obstacles persist.

The first problem China will have to confront is the end of easy growth. Naughton likened economic growth up until now as being the product of “releasing a balloon under water.” Simply by allowing a young, relatively educated workforce with high female participation to move freely in the labor market, rapid urbanization and economic growth were almost inevitable. However, this era is coming to an end. Whereas 140 million workers were added to the labor force over the past 15 years, the next 15 years will see a shrinking labor force as a result of China’s One Child Policy; which will lead to lower economic growth patterns. If not for the government stimulus during the 2008 financial crisis, growth would likely have already slowed.

The second problem derives from the stimulus spending. The over-abundance of financial capital injected into the economy has encouraged many questionable investments that will have to be cleared off the books if they end up becoming non-performing. To add to this, many of the loans were made to local governments heavily dependent on land sales for revenue. This has created a precarious situation where investment has sparked general inflationary pressures, especially in the housing sector. Delicacy is required because any cure too strong may burst any real estate bubble and therefore transform local government debts into a mountain of non-performing loans (up to $1.5 trillion) for the banking system. Naughton believes that Beijing has the resources to overcome this problem, but is unsure about its political will to do so.

The final problem is the moribund reform process. Real, effective economic reform appears to have ended with China’s 2001 accession to the WTO. It is unclear if it is complacency or shifting political focus to social issues that has caused this. Whatever the underlying cause, the government has reverted to direct intervention in the past decade that has stymied further reform and even rolled back some previous successes.

The good news is that the leadership in China understands that the current model is
unsustainable. Incoming top leader Xi Jinping has commissioned a team of economists to come up with a new economic reform program. This team will have to find a way to capitalize on the infrastructure and educational investments that are at present being underutilized in the current system, which favors lower-end, labor intensive industries. The current model is losing its competitiveness due to wage increases, increased labor and environmental standards, increased credit costs and currency appreciation. To move into higher quality and sustainable growth, China will need to address the distortions that the government has created by suppressing costs and favoring state owned enterprises. These factors will lead to a stabilization of China’s trade imbalances, especially with the US, but will make it harder to continue rapid economic growth without further reform. The key will be how the new leadership will address these issues.

Ted Fishman, an author of books and articles about China, continued the session by taking a step back and looking at the complexity of China that makes it so hard to fully understand. There are so many dualities that almost any statement about China can be immediately contradicted without being incorrect. One duality is that China is both a threat and an opportunity at the same time. In addition to the complexity of China, its sheer size and scale has implications. China is so large that it does not have to intentionally try to be a threat or opportunity for it to actually be either. So, without even considering US interests, China can both threaten entire industries in the US with the “China Price” (which is in reference to the overall competitiveness of Chinese industries derived from economies of scale and cheap inputs of labor capital) while at the same time be extremely profitable to other sectors by providing an affordable manufacturing platform and/or a lucrative market.

Part of what stokes the “China is a threat” side is what Fishman identified as Chinese boosterism. Local governments in China lure US companies to move production to China through various incentives. The US often cries foul at this, but what is inherently wrong with it? The US has and continues to pursue similar tactics in attracting investment at the local level. This is one duality on the US side: At the national level US officials are belligerent towards China but at the local level officials are going to China to solicit investment.

The discussions focused on the following topics:

- **Green Industries:** China heavily subsidizes its green energy industry and potentially undercuts the US. There was debate about whether the US could or should compete. Some felt that if there could be benefits to China’s actions, like reduced emissions and cheaper goods (e.g., solar panels), that would compensate for any lost manufacturing. Others felt that the US is giving up on green technologies too early, and that there is still potential. The cases that receive the most attention in the US media are the low-end manufacturing firms that are losing. There are many high-value sectors in the US that are thriving.

- **China’s Prospects:** A range of discussions touched on the future of China. There was some concern about China’s impending demographic problems and whether immigration into China could play a role. It was made clear that there will not be a shortage of labor, just a dwindling supply that will cause wages to increase. There was concern that the US is already writing off China as a market, but that is imprudent. There is much potential for US companies in China since many of the needs of its economy are not produced there. Agriculture and services are examples of sectors with great potential. The presenters both cautioned that vested interests in China are beginning to be obstacles to the reforms needed for further growth. Corruption is one sign of this problem. Additionally, there may be bubbles inside
the Chinese economy that reform could inadvertently burst, thus creating large problems for the economy.

- **Innovation:** Two types of innovation were distinguished. The first type, that of high-value added and knowledge intensive innovation, is what the US focuses on with its university and laboratory system. However, incremental product and process innovation is where most jobs come from. US policy could help both by creating common assets that all actors can use (e.g., universities and national laboratories) and maintaining a conducive environment for venture capital, especially for middle-tier industries. Fishman added that the second type of innovation is usually from the shop floor up and with a decreasing manufacturing labor force the US will have to work harder at cultivating that type of innovation.

The key takeaways from the discussions were:

- **Mutual Misperceptions:** Both China and the US think the other country is stronger than it really is. Anxieties and mistrust most likely derive from these inaccurate perceptions.

- **Short-term Politics vs. Long-term Strategy:** Partisan battles in the US have focused on less important aspects while China is successfully executing long-term strategies.

- **Introspection:** Many of the problems don’t seem to be about China at all but about US failures. The lack of focus discussed earlier has led to a drift in policy, and the US economy has suffered for that. With sharpened focus, these problems can be overcome.

- **Technology Lead:** The instances of US companies forced to hand over technology or having their technology stolen in China are well documented. Is this hurting the US, which is increasingly dependent on high-technology exports? Also, what about the thousands of graduate degrees in science that the US awards to foreign students who go back to their home countries. Others noted that the fear of China rapidly surpassing the US in technology is overblown.

Andy Karsner of Manifest Energy led a discussion about the urgent need to address US long-term energy needs in the context of a growing China. China’s growth and change has been profound and is only accelerating. One of the most observable indications is the fact that for the first time since the discovery of oil in the 1850s, the US is not the driver of global energy demand. In the near future, China’s increasing consumption of oil will lead to a situation where Chinese oil imports will equal or exceed current US levels of oil imports. The demands of just China and the US would stress world oil supplies, to say nothing of the other emerging economies and their growing oil demand.

We have now entered a new “great game” for global energy resources. The world is being partitioned into two resource bases for the dominant energy players, the US and China. To compete in this new game the US needs a unified national energy policy. The US does have some energy policy in the form of ad hoc laws on the books. But these laws are neither comprehensive nor consistent enough to guide the US in addressing its increasing need for energy. In Karsner’s view, energy is at the juncture of where technology meets commodities. In order to compete with China, the US will have to ensure that its access to both of these inputs is adequate. Chinese investments in US resource extraction firms signify to Karsner that the Chinese understand this issue and are intent on gaining technical assistance from US firms.

In moving away from oil the US needs to be strategic in what it adopts. In the past, alternative forms of energy were benchmarked by the price of oil. Now the increasing price of oil means that everything already is or will soon be cheaper than oil. Therefore, price will not determine viability of different sources of ener-
gy, but rather the determinant will be the ease and cost-effectiveness with which those sources can be integrated into the economy.

The presence of shale gas on US soil has moved the benchmark to natural gas prices, which are much cheaper than oil. The huge surplus of natural gas that the US now has is likened to "manna from heaven." It offers the possibility for the US to finally be energy-independent and not vulnerable to threats from regimes that openly oppose it, like Iran. But whatever the benefits of natural gas, the US still needs a national energy policy that optimizes the mix of all potential energy sources. China has thus far been successful in gearing its policy towards attaining this optimization in its quest for the broader goal of energy security. The US needs to do likewise with more government involvement than has been present up until now. Markets cannot make strategy; they need the guidance of policy signals. For policy to be effective it needs to credibly signal durability. National performance standards and tax policy are components of this strategy. However, standards must be outcome-oriented rather than interest-oriented.

Topics of discussion included:

- **Performance Standards:** The values of diversification and impartiality were brought up in regards to standards. Karsner reiterated that any performance standards adopted need to be outcome-oriented rather than interest-driven. In doing that, the government would not be picking winners and losers and would allow for multiple sources of energy to play into the mix. Of course, there are many vested interests that could serve as obstacles to an effective and impartial set of performance standards.

- **Natural Gas:** There was concern that the rush to extract shale gas could lead to environmental and safety problems. Karsner, as well as other participants, assured that the technology is mature and safe. Furthermore, transparent best practices could be mandated that would increase environmental protection and health safety.

Clyde Prestowitz of the Economic Strategy Institute offered the participants his opinion that the current frictions are not about rules of the game, but rather paradigmatic differences about what game is being played. Likening the US stance to playing a game of tennis, Prestowitz defined the US game plan as reciprocating strategically-placed volleys delivered with finesse and under the assumption that a final arbiter would determine the legitimacy of each move. This is in stark contrast to China, or any number of other trading partners from Germany to Brazil to Japan, that are playing a rougher game. Under the parameters of the differing games that US partners are playing, running interference on trade through currency manipulation, regulatory hurdles, IPR infringement and support for national champions is perfectly legitimate.

The US experience with Japan offers an example from the past of a trade partner playing a different game. The parallels between the US-China relationship of today and the US-Japan relationship of decades ago are numerous. However, it is the differences that the US should be alarmed by and therefore prompt reaction to the new challenge by China more urgently. The challenge from Japan came from a smaller country that was also a security dependent of the US during a time that the US was the largest creditor nation in the world. China, which is firmly outside of the US security sphere, if not at times adversarial to such a sphere, is much larger than Japan; and China has assumed the former US position as the largest creditor nation at a time that finds the US now the largest debtor nation. These differing dynamics of the US-Japanese experience make the Chinese threat to US economic interests that much greater.

The strategic industrial development game plan of some US trading partners, most auspiciously China, is simple. In this game plan,
the market outcomes, which in the American view are the only legitimate outcomes, are simply not acceptable. Instead, nations pursuing strategic industrial development will look to tweak their policies so as to incubate and protect nascent industries, while also poaching industrial supply chains from countries with less protection of their domestic industries. Currency manipulation is but one tool that these countries use. Savings rates are also at play in this strategy. China’s 50% savings rate can only be compared to two instances in US history, WWI and WWII, in which the US had a similar savings rate. According to Prestowitz, this is a strategic savings rate. These savings, derived from suppressing consumption, are then funneled into subsidies for domestic firms facing pressure from foreign industries that enjoy a natural comparative advantage. They are also used to provide incentives for foreign firms to relocate technology and supply chains to their countries. The case of Intel moving an $8 billion dollar production line to China in exchange for nearly $2 billion in incentives is an example of this tactic. Restricting market access to firms willing to relocate and share technology is another tactic in this strategy, as evidenced by GE’s plan to move avionics production to China. These firm-level decisions are good for the individual firms in question, but overall harmful to US industrial health.

Prestowitz offered a list of actions to improve the US’s economic health. It included reducing the influence of geopolitics on trade decisions, addressing currency imbalances and developing an investment strategy. Prestowitz believes the US is too involved in the world, and that is not only sucking up resources but distracting the US from reviving its economy. He also believes that the US status as the world’s reserve currency is now a burden for the US.

Among the topics of discussion were:

- **US Status as Reserve Currency:** The role of US currency in world trade, as well as other countries’ currency strategies, was a common theme. How should the US confront currency manipulators? Prestowitz thinks that although other countries are unhappy with China’s currency policies, they are scared of retaliation and therefore could not be counted on in a multilateral context. In his view, the US could unilaterally address the situation by placing a surcharge on foreign purchases of US Treasury Bills. When pressed if he believed that the US should ditch its reserve status, Prestowitz stated that it should. By taking away other countries’ ability to set their price through currency manipulation the US would be creating a headache for its trade competitors.

- **Trade Regimes:** Some participants were curious as to whether the benefits of trade agreements are pure fiction. Prestowitz believes that trade agreements can be positive. The US needs to identify economies that play by similar rules and pursue trade agreements with them. For those that follow different rules, the US should reciprocate their actions.

- **Examples for the US:** There are 35 countries that export more per capita to China than the US. This fact raised the question of: “Are we that bad, are they that good or is China picking on the US?” Prestowitz’s view is that countries like Germany (one of those 35) can compete with China and benefit from trade because, unlike the US, it has a coherent, unified strategy.

Dan Rosen from the Peterson Institute for International Economics led a discussion on the history of US-China relations, highlighting the inconsistencies. In the beginning, Cold War geopolitics was supreme and economics was only a means to the ultimate end in bolstering an ally against the USSR. With the dissolution of the USSR the US lost its strategic intent. Then the belief that there would be a convergence of Chinese and Western values was threatened after Tiananmen Square. However, the belief was that if the US furthered engagement China could be locked into the interna-
tional community and changed from within. This strategy was formulated during the apex of US power and while US economic growth was still impressive. Therefore, relative gains were ignored as the US was surely on the right side of history. During the current decade the consensus around engagement and eventual convergence disintegrated. US economic problems were contrasted by a rapidly advancing Chinese economy that more and more was viewed as occurring at the expense of the US. With the guise of countercyclical stimulus, the state sector in China made a strong comeback and stoked the fears that a rival economic ideology, that of state capitalism, was on the rise.

Rosen points out that it is still uncertain if the prominence of the state in the Chinese economy for the past half decade is a temporary backslide or permanent structural change. It appears that China still has much growth potential, but it will get harder as China has entered the middle income range. To achieve all that it has so far the state simply had to step back. Will it do so again?

A common misperception is that consumer spending is too low. The truth is that consumption growth has increased steadily and substantially but has been overshadowed by investment growth. Moving forward, it is government consumption that needs to grow so as to take the brunt of costs for expenses like healthcare and education. This would free up more consumer spending and help rebalance the economy. Investment needs to be adjusted too. Instead of shoveling it into projects like cement and steel, which have decreasing returns, investment should be redirected to the service sector.

Another misperception is that China’s growth is all due to exports. Historically, China’s export surpluses were modest with only a temporary spike in the middle of the last decade. China’s trade surplus is now back below 3% of GDP.

Rosen concluded by concurring with previous assessments that China’s current model is unsustainable. Over half of China’s growth had been attributed to increasing the amount of output derived from constant units of input (Total Factor Productivity, TFP). However, recently TFP growth has been collapsing. This has been hidden by the massive amounts of investment that have kept growth on pace, but this cannot be continued. Ultimately political reform will be necessary to remove the vested interests that are making sustainable economic growth suffer.

David M. Lampton, Director of the China Studies Program at the Johns Hopkins School of Advanced International Studies, followed up Rosen with some guiding comments. The first set was about China’s importance to the US. Lampton pointed out that, following the 2008 financial crisis, US exports dropped to every other country except China, where they increased by 10%. He also pointed to the fear of many that the massive amount of investment in China has been speculative and could be creating bubbles. Given these facts, should the US be concerned about a Chinese collapse? Rosen concurred that China was the engine of global growth through the financial crisis, and that buoyed US exports. However, the chances of collapse are very low.

Lampton followed with a look at the belief that China is systematically and intentionally breaking the “rules of the game” when it comes to trade. Is China playing by different rules? If so, was bringing China into the WTO a mistake; and is this rule breaking, especially disregard for IPR, aiding China in catching up to the US at the US’ own expense? Rosen contended that China typically adheres to the letter of the law, if not always the spirit. However, in some spheres, such as global investment flows, there are no set rules. As for the WTO, there was no real option on admitting China. In Rosen’s opinion, a strong China is in the US interest and the WTO admission was intended to make a strong China that is easier to deal with and enlist China as an ardent supporter of the US-led trading order. With regards to technology transfers, Rosen believes that any slip in the
US lead is from its own policies. If anything, he is impressed with how low-tech China is.

The discussion focused on the following topics:

- **Pollution**: How pollution in China affects stability, its role in the economic development of China and how the government is responding to it were broadly discussed. Rosen acknowledged that pollution problems in China are real and increasing. This has social stability implications. The government is responding to it, but suffers from reporting problems and misaligned incentives. Local officials are more inclined to pursue economic growth at the expense of environmental degradation, no matter how much the central government admonishes them to reduce pollution. There was debate about the extent to which lax pollution standards in China played in luring manufacturing from the US to China. There was also discussion about China’s traditional view that the US has polluted more and for longer and should therefore move first in international pollution agreements. But climate change is hitting China sooner and more violently, so it is gaining salience. One way to work with China would be to depoliticize pollution, offer US technical and regulatory assistance to China and also publicly acknowledge any progress.

- **Consumption**: There are cultural influences that encourage saving over spending, but that is changing. Consumer confidence is low in the household sector right now, but other indices show improving confidence in the economy. Overall, consumer spending has been healthy, just overshadowed by investment. Business spending needs to pick up.

- **Demographics**: Due to the One Child Policy and a natural demographic transition, the number of workers will max out soon. In order to continue growing economically, China will have to improve education and move up to higher value-added industries. The One Child Policy will probably be adjusted soon.

- **State Capitalism**: Most of China’s successful reform process was marked by a retrenchment of the state. Only recently has the state exerted more influence in the economy. The state-owned sector has expanded with easy access to credit but has been the least efficient in investment. In another five years there will probably be a large accumulation of bad loans due to state intervention.

- **Chinese Investment in the US**: About 300 companies have invested $16-17 billion dollars in the US, 2/3 of which are state-owned. So far their main targets are resource extraction firms. This does not imply strategic intent, though, since the driving force may be lack of investment opportunities inside China. Investment can and should increase.

- **Currency**: Questions were raised about if in fact the Chinese currency is undervalued and how important that might be. Rosen cautioned that it is not a static value and that it is hard to say precisely if a currency is not valued properly. China’s currency is manipulated, but harder to say if it is undervalued. Currency value did not play a large part in most of China’s growth, though it did not appreciate as rapidly as it should when China began growing quickly. Rosen doubts that a more aggressive US approach would produce any progress, but subtle prodding through mechanisms like the G-20 may work.

- **Other Models**: Discussion turned again to how the US may receive the same benefits that other countries are gaining from trade with China. Japan and Germany were often brought up as models that have national strategies that effectively identify
China’s needs and then help their exporters meet those needs. Germany also does a good job of helping small- and medium-sized firms. They also don’t consume as much as the US.

Among the takeaways gleaned from the discussion were:

- **Bipartisanship:** There is optimism and cooperation within the confines of the conference, but will this sentiment last after the conference is over so that US officials can create a coherent, consistent strategy?

- **Constituent Pressures:** It appears that a more subtle and strategic approach would work in most of our dealings with China, but US constituents favor more direct, forceful action.

- **Lack of Strategic Focus:** The US lacks effective energy and trade strategies and is too distracted with geopolitics to concentrate on economic issues, while China is concentrating on its economy and is winning in that sphere. But the US can overcome this by redirecting its attention and resources as it has in the past.

- **Complexity of Issues:** Many of the discussions seemed to contradict themselves or other discussions. The issues involving China are highly complex. The US does not have “a” relationship with China but many intertwined relationships. Some of these relationships are good, some are bad. But, overall, it appears that almost all of these relationships are underdeveloped.

- **Geopolitics:** The US will be dealing with China more often and in more geographical and policy areas. There was little to no mention of the Chinese military at the conference. There is so much concern in the defense community about how to address the rise of China as a military power, but would that only be another distraction?

Mickey Kantor, a former Commerce Secretary and US Trade Representative, sought to draw a nonpartisan link between trade and US national interests. Refuting some earlier sentiments, Kantor asserted that the globalized world we live in inhibits the US from ignoring geopolitics. The trend of globalization also makes it imperative that the US elevate the importance of environmental standards while also dealing with the sometimes conflicting interests of integration and sovereignty.

Moving forward, Kantor laid out three areas of focus for US trade policy:

- **Pursue enforceable trade agreements:** Kantor’s assessment was that the US has not been doing a good enough job of advancing trade agreements that have self-enforcing powers. The WTO is the exception to this. There is a problem with the status of presidential trade promotion authority. Without this tool, counterparts negotiating with the US will fear that any agreement reached will only be altered later during Congressional approval. This stymies efforts to advance beneficial trade agreements.

- **Advance the Trans-Pacific Partnership (TPP):** Though it is small and of relatively little value to the US as currently constructed, the TPP has the potential to further both US trade and geopolitical interests. The US should first reach out to Japan and then South Korea to join. With those two larger economies on board, the TPP would be more enticing to China. Kantor stressed that China should be invited after South Korea and Japan. Otherwise the TPP will be seen as just another US tool for containing China. By bringing China inside the TPP with Japan and South Korea the US could show its good will towards China while locking it into a system with high, enforceable trade standards.

- **Connect the dots between trade policy and foreign/security policy:** As the previous
point exemplifies, US trade policy should work with, not counter to, broader US national interests. To do this, some consolidation of agencies working on trade may be necessary, but coordination between the principals of trade-related agencies and of foreign policy and national security agencies should be mandated. By bringing together the relevant agencies in the fields of trade and foreign/security policy, trade can work for, rather than be sacrificed in the name of, other US vital national interests. The US also needs to focus on having clearly defined roles in the correct agencies. As an example, Kantor suggested that moving the Export-Import Administration under the USTR would make foreign counterparts take the USTR more seriously.

In closing, Kantor offered his views on China. He does not see China as a threat, but rather as an opportunity. In his opinion, the Chinese are the most like Americans of any Asian nation. The US can work with them, and it needs to, because of the many common interests. But the US must engage them within the proper trade regime and with a consistent strategy.

Topics of discussion included:

- **TPP:** There was much interest about the future of the TPP. Some wanted to know if the TPP is too strict on its admission requirements and, if so, is that done to purposely exclude China. Others wanted to know if focusing on Japan, with which the US can work with them, and it needs to, because of the many common interests. But the US must engage them within the proper trade regime and with a consistent strategy.

- **US Trade Agencies:** Participants wanted to know if the USTR is under-resourced and if that hinders its performance. There was also a question about the degree of autonomy with which the USTR can pursue trade policies. Kantor acknowledged that some cases are not pursued and others are slow to be resolved due to understaffing. As for the USTR’s autonomy, Kantor said that it fluctuates with administrations but that it is not uncommon for security or other geopolitical interests to take priority.

- **Free Trade Agreements (FTAs):** Participants wanted to know about the future of FTAs and how the US should pursue them. Some were concerned about dismissing labor and environmental standards as irrelevant to US interests. The US and many constituents do care about these issues and cannot ignore them. Others wanted to know if the US should adjust how it judges FTAs. Kantor thinks that FTAs have many different selling points and one of the main ones should be jobs. Not only do they create jobs, but international trade jobs pay more. They also have benefits in improving labor and environmental standards. Before FTA negotiations, many issues like environmental standards were not even on the radar for US trade partners.

- **Investment Prospects:** The US has had a rocky trade relationship with Japan in the past but the Japanese eventually invested a significant amount in the US and supported many American jobs. What can the US expect from China? Kantor feels that China might also eventually be a large investor into the US. A lot of pressure was put on Japan to produce in the US and invest some of its export earnings back into the US. The same could be done with China. Kantor stressed that the individual provinces in China could be important in this process.

- **Agriculture:** A short but lively discussion about agriculture came up at the very end. Many believe that China has great potential for US agricultural products. Kantor thinks that China will protect its farmers
but will have to balance that with affordable food for its growing population. If pitched as a way to lessen inflation and improve standards of living, Kantor contends that the US could see more access to the Chinese market for food products.

Yang Yao of the China Center for Economic Research and Li Xue of the Chinese Academy of Social Sciences offered a Chinese perspective of the topics discussed. Yang began by acknowledging that over the decade since its WTO accession, China has benefited more from the trade relationship than the US. Yang also recognized that these gains occurred within a system in which the US provides a disproportionate share of the public goods that undergird the international trading system. Yang used this acknowledgement to point out that it would be irrational for China to attempt to overturn the US-led international system that has benefited it so much.

Furthering this discussion, Yang offered three observations:

- **Trends of account surpluses naturally fluctuate and ultimately end:** Britain experienced current account surpluses from 1830 until WWI. The US similarly experienced surpluses from the end of WWII until the late 1970s. China is just now experiencing the large surplus because of the two concurrent forces of a demographic dividend that is swelling the ranks of the workforce and mass urbanization. However, the first trend is coming to a close because around 2020 China should start to see an absolute decline in the working age population. This will lead to China having by 2030 a similar dependency ratio as the US has today. Therefore, China likely has another two decades of current account surpluses. However, these will naturally balance out as the two forces disappear.

- **China is not out to overturn rules, but seeks pragmatic flexibility in their applicability:** China is gradually getting better about agreeing to and enforcing internationally-recognized rules of trade. Yang supports China’s incrementally taking on more responsibility in regards to abiding by these rules. But the lag in full adoption and implementation of these foreign-imposed rules is not a sign that China desires to do away with the current international system. Rather, due to its unique current stage of development, China needs flexibility from its trade partners. Two examples are IPR and currency exchange rates. In regards to IPR, Yang believes that problems in this area are only a function of development and that with time they will be resolved. With currency, Yang offered that it should not just be viewed as a price but as a tool for wealth distribution. Yang also pointed out the US decision to abandon the gold standard under Nixon and current US fiscal policies as examples of US use of currency policy to satisfy its own economic needs.

- **Change in US demeanor towards China:** Until recently, US policy vis-à-vis China had been underpinned by a conviction that engagement was the best route to dealing with China. Recently, though, engagement has been replaced with hedging. Yang pointed to US policies in the South China Sea, the presence of US marines in Australia and the promotion of the TPP as evidence of this shift.

Concluding, Yang encouraged the US to think more about how the above actions could be perceived by China and in turn justify elements within China, such as the PLA, to be more assertive in response. He believes that it is in China’s interest to maintain the current international system and work within the framework of agreements like the WTO. However, without a US approach that is more flexible to China’s current needs and capacities, US actions could motivate China to act in ways that are beneficial to neither.
Following Yang, Li Xue gave his own observations:

- **China overall has a positive view of the US.** From allying with China in WWII to aiding China’s reform and development, the Chinese can recall many positive contributions by the US.

- **Political reform in the short to medium term is unlikely.** The collective leadership will be powerless to enact real political reform, even if it desired to do so.

- **China may economically eclipse the US, but can’t do so politically.** The US domestic political system remains attractive as does its cultural influence. Additionally, US leadership in the current world order is too entrenched.

- **US-China relations will be civil, if unsettled at times.** The growing number of flashpoints and points of contention between the countries will inevitably create disputes. However, China’s top leadership and elites have extensive links to the US through family and financial connections that will serve as moderating influences to overt anti-US sentiments. There is still a strong domestic Chinese political consensus inherited from Deng Xiaoping that China should never openly challenge or be the enemy of the US. Finally, by 2020 China may be a source of up to $1 trillion in outbound investment, half of which will likely go to the US.

Discussion centered on the following issues:

- **Western vs. Chinese Values:** It appears to members that China always pushes back against human rights, labor standards and environmental standards. Some wondered if the US and China are speaking the same language on these issues. Yang feels that there is a similar understanding in China about these issues, except that China may value concepts such as access to food more than Western ideals such as freedom of speech. He thinks the US needs to show patience with China as most of the issues are a product of underdevelopment in China.

- **US Strengths or Weaknesses:** Independent courts and freedom of expression are cherished in the US. However, these are often used by the Chinese against US interests without offering reciprocity in China since it has neither. Do the Chinese view these as a weakness of the US and therefore factor them into a strategy? Yang does not believe that it is a Chinese strategy against the US. He thinks conditions in China are improving in both issue areas, especially courts. He thinks US firms should use Chinese courts more.

- **Is China Self-Absorbed?** In the US there is a tendency to think that every action in the world is taken with an eye on the US. Is this what is happening to China when it assumes that the US pivot to Asia, TPP, etc., are only about China? One participant offered the following assessment:
  - **South China Sea:** China has had a consistent position. However, so have the other countries but they are just now voicing their opposition to China’s position.
  - **TPP:** It’s about domestic politics and economics.
  - **Australia:** This is part of a larger pivot and reinforcing a treaty ally.

Yang contended that the TPP has no economic benefit for Japan or the US so it is likely a geopolitical move. Furthermore, the last two years have seen a series of US moves that many Chinese regard as clearly orchestrated towards China. He thinks that the US needs to give China more space. Its rise is inevitable, which makes peaceful relations between the US and China necessary for regional stability.
China’s Future Growth and its Consequences for the US

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Opinion has rarely been more divided about China’s prospects than it is today. Among respondents to a Bloomberg poll in December, 40% of American investment professionals expected a serious economic and political crisis in China in the near future. On the other side, predictions of the International Monetary Fund and Goldman Sachs are that China will grow more than 8% this year and that growth will accelerate in 2013, while inflation will come down. To some, China is a house of cards; to others, a virtually unstoppable economic engine. Each of these metaphors has some truth, but neither is really appropriate. The Chinese economy has enormous momentum, but it also faces tremendous challenges that will virtually compel changes in policy in the next year or two. The struggle to cope with current problems while also imposing new policies will create new risks and is already creating uncertainty. The new leaders who take over in China later this year will have to “shift gears” in economic policy. How effectively will they be able to do so? The answer will have enormous implications for the US.

The extreme scenarios for the Chinese economy—positive or negative—are unlikely to become reality in the next few years. The likelihood of a financial or other crisis in the next few years is small. Yet neither is it likely that China will simply sweep into the future, doing what it has in the past, and growing at more than 8% per year. Instead, Chinese policymakers will struggle to handle three large challenges on the economic front. These three challenges might interact in unpredictable ways, creating new risks. However, they also create significant new opportunities for dramatically improved policies.

First, China is nearing the end of its high growth era. China has already grown faster, longer than any economy in history. Yet while slightly superior, China’s performance basically echoes the performance of other East Asian economic “miracles.” The experience of those countries, beginning with Japan in the 1950s, has been that extraordinary growth rates can be maintained for about 25 years. The high growth phase of these economies corresponds with the period of maximum structural transformation: as migrants leave agriculture and stream into higher productivity jobs in industry and services, cities explode, and production and productivity soar. Export-oriented policies allow rapid growth to take place unimpeded by limitations of domestic demand. But this phase does not continue forever.

China entered its high growth phase from a lower starting point—at a lower income—than previous East Asian miracles, and it has lasted longer, and even today might not have reached the growth-phase ending level of income. Other signs, though, indicate China is already reaching the end. So many young workers have left the countryside, the remaining farmers, elderly and middle-aged now make up less than a third
of the national workforce. In most Chinese villages, all of the able bodied young people are gone for the cities. The abundant reservoirs of surplus labor in rural China are being drawn down. As a result, in the past few years there has been substantial upward pressure on the wages of unskilled workers (primarily rural-to-urban migrants). Migrant worker wages have been increasing about 12% per year the last two years. The giant Taiwan-based electronics assembler Foxconn, which has a half-million Chinese employees, last year agreed to double the wages it paid to unskilled workers in its main Shenzhen facility, and has shifted 200,000 jobs inland to Henan and Sichuan. These are classic signals of the end of the high growth phase.

Once it starts, China will exit the high growth era more quickly, in the next decade, than did its precursors. Due to China’s draconian birth control policies, enacted at the end of the 1970s, sharp demographic changes will reinforce structural change. Already, the labor force of permanent urban residents is declining as retirements are about new entries. Urban labor force growth comes entirely from migrants. The rural labor force growth rate will fall to near zero by the end of the decade. At a minimum, these changes imply a two or three percentage point decline in China’s long-run growth rate. More importantly, these changes in labor supply imply major changes in wages and competitiveness. Slowly but surely, China is beginning to lose competitiveness in certain labor-intensive manufacturing sectors.

Thus far, in order to keep growth rates high, China has resorted to extremely high investment levels. Much of the growth of investment was the result of China’s response to the global financial crisis. But high investment levels were also the indirect result of a host of other policies that strengthened the position of big firms (often government-run), and encouraged government investment in new social service sectors. China has kept growth high, but now devotes 46% of GDP to investment (over the last three years) much more than the 36% that went to household consumption. The household consumption share is only half that in the US. While this policy has succeeded in deferring the inevitable growth slowdown, it has done so by creating a set of four new interrelated problems.

The second challenge China faces is the management of these interrelated problems. The first problem is that China has tied up an enormous volume of resources in new assets, recently completed or still under construction, that have very low (or even zero) utilization. Best known are the massive infrastructure projects, such as airports, highways and, especially, high speed rail. These are expensive assets, amounting in value to more than that of GDP, whose long-term contribution to economic growth is unknown, certainly positive, but likely to be small. The high point of infrastructure investment came in 2009-2010, and helped keep China out of the global financial crisis. For the past year or two, infrastructure investment has been moderately scaled back, but it has been replaced by investments in so-called “Strategic Emerging Industries,” enthusiastically pursued by local government with the support of the central government. Overall investment has continued to grow and has maintained its share of GDP. The “Strategic Emerging Industries” initiative is, however, deeply problematic. Instead of investing in well-understood transport and utilities, local governments are now attempting to invest in cutting-edge technological sectors which most of them do not understand. Many of these investments will fail. We already see oversupply of solar panels pushing down prices, with dire effects on US solar panel manufacturers. It must be stressed that the same market forces are hammering Chinese solar panel manufacturers. The best ones get good press coverage in China and the US, while in the background, scores of new Chinese solar panel manufacturers are losing money and facing a future of bankruptcy or indefinite dependence on government support.

Closely related to the over-investment in infrastructure and new industrial sectors is the
problem that China’s banks have a large volume of loans on their books which are at risk of going bad. Most of the loans have not yet had time to become non-performing. Moreover, many of the loans have been extended directly or indirectly to local governments and their investment platforms, so the banks have implicit and explicit government guarantees. Thus, the bank balance sheets on the surface look healthy, but many difficult problems are buried there. The Chinese government faces the difficult task of determining who will bear the costs of the inevitable write-offs. Indeed, the third problem is that local governments have a completely inadequate revenue base. They have expanded mandated services in recent years, but remain dependent on increased transfers from the central government, plus revenues from land sales and housing development. Local governments have had little choice but to turn to banks to fund their ambitious projects, but their ability to repay those debts depends on their having a healthy revenue stream from developing real estate. Now, that revenue stream is being endangered by the fourth problem.

The fourth problem is that the government faces enormous popular pressure to control inflation, which is manifest both in the increase in the consumer price index, and in the increase in housing prices. The government launched an assault on housing prices in April 2010, but it was not terribly effective. It is only in recent months that gradually tightening monetary policy has finally begun to “bite,” and started to have an impact on inflation. The consumer price index peaked in July at 6.5%, and has drifted down steadily since (to 4.1% in December), while housing prices have begun to decline since October. The fight against inflation has been aided by the easing of global commodity prices and a good harvest in China. Still, orthodox monetary policy has been the main reason for the recent improvement in inflationary conditions. Central bank officials are well aware that they need to stay the course in order to reestablish the credibility of their commitment to price stability. While they have more flexibility now that inflation has eased, they are not going to shift to an expansionary policy. As a result, continued tighter money will put local governments into a perfect squeeze, catching them between falling sales prices for their houses, and reduced ability to give loans to bridge them over their time of difficulty.

These four problems are obviously interrelated. Alone, each would be difficult, but not impossible, to resolve. China has the resources and macroeconomic conditions that potentially allow it to successfully manage any one, or even all four, of these challenges. Chinese saving rates are sky high, and overall indebtedness of both households and government is at moderate levels. Inflation has already been brought partially under control. Wasted investment cannot be brought back to life, and the challenge is rather in closing down under-performing projects ("stopping the bleeding") and controlling the financial after-effects. All of this is quite possible, but it takes the ability to make tough choices and confront the political implications of cutting off clients and shutting down under-performing projects. Over the last decade of growth and ample financing, such choices seemed as if they could be put off forever, but now the danger is that action is delayed until some kind of crisis arrives, touched off by some minor panic that sets off a self-reinforcing downward spiral. Tighter monetary policy makes it harder for projects to get funding, or to stay on life support. At some point, if some part of the problem is mishandled, it could lead to a collapse of public confidence. If housing prices, instead of stabilizing, seem to be launching on a long-term decline, demand for housing would eventually collapse, notwithstanding large pent-up demand. This kind of worry underlies the “China bear” anxieties.

The third big challenge is that China’s economic reform momentum has stalled out in the past several years, and desperately needs revitalization. In sharp contrast to the remarkable progress China made during the 1990s, China is now regressing. The regression has been
modest, but the role of state-owned firms, for example, has stabilized and, in some important sectors, increased slightly, in contrast to the dramatic shrinkage of the state sector in the 1990s. Government regulatory agencies set up at the end of the 1990s with the mandate of shaping fair competition with an even-handed, arm’s length approach, have failed to get the political support they needed. The reform regression has not been the result of a general abandonment of the goal of market reform. The urgency of reform fell away in the 2000s, after successful reforms in the 1990s and World Trade Organization membership after 2001 created blazing economic growth in the first decade of the new century. Why rock the boat, when everything was going so well, and everybody—including the Chinese government—seemed to be making money? In individual sectors, competitive markets have been sacrificed in order to pursue social goals through the most direct instruments available, which has meant direct government provision. Chinese Premier Wen Jiabao gave priority to improving social security for rural residents, creating a rudimentary health insurance system, and reducing the horrific accident toll in the nation’s coal mines: progress has been made in each of these areas, but in each case with some cost in terms of increasing the government’s reach, and rolling back the market. Then in 2008-9, the need to counteract the global financial crisis also led to a substantial extension of direct government intervention in the economy.

The result has been a pervasive feeling, both among businesspeople and among political elites, that the reform agenda needs to be revitalized. Incoming top leader Xi Jinping has commissioned three different teams of economists, in a kind of competition, to design a new comprehensive reform program. The idea is that by fall of 2013, a year after the turnover of power, a blueprint for further economic reform would be available. But the truth is, as of now, there is no consensus about the most pressing areas of need, or the measures that might promise the highest payoff. Thus, nobody knows what the focus of future reforms is likely to be, nor whether the new leadership will have the vision, fortitude and political support to enact an important new program of reforms. The result is a widespread sense that something needs to be done, combined with the belief that nobody knows what should be done, plus the fear that it might take a serious economic crisis for the system to actually begin doing it.

The incoming Chinese leadership group must respond to all three of these challenges at the same time. An extraordinarily capable leadership team might see that renewed economic reforms could enable the economy to make a successful transition to a slower, but healthier growth path. A program of deregulation, that allowed entry by new firms while cutting back government monopoly privileges, could provide new opportunities for China’s increasingly well-educated and middle-income population. China’s colleges today turn out the skilled workers required for a more sophisticated economy (over 5 million a year). However, for high-skilled jobs to actually replace the low-skilled factory jobs, high-value urban service jobs need to be thrown widely open to private firms and free competition. The government is already promoting “culture industries,” but hasn’t accepted the degree of creative freedom and open competition that are needed to make a success of those sectors.

The end of the high growth era creates numerous opportunities to fail. Earlier East Asian growth miracles often stumbled badly when the high growth era came to an end. Japan’s growth dropped sharply from over 10% to just 4.5% in the early 1970s, and then again dropped, almost to zero, in the 1990s. There is no rule about the transition from high growth. Korea tried to keep growth fast during the 1990s, and suffered greatly from the Asian financial crisis in 1997-98, partly as a result of that effort. But, unlike Japan, Korea after that crisis resumed growth at near 6% per year. China faces slowing growth, along with a huge looming consolidation of the government investment and financial sector, and with
the need to revive a stalled-out reform agenda. We do not know what choices the new Chinese leadership will make, but “business as usual” will not be one of their options.

What are the implications of China’s current challenges for the US? First, we are seeing the beginnings of a gradual, long-drawn-out rebalancing of the Chinese trade economy. The end of unlimited surplus labor is pushing up Chinese wages and forcing a restructuring of the Chinese export economy. Small nominal appreciation of the Chinese currency, the renminbi, against the dollar, combined with increased wages and inflation in China, add up to a moderate but significant real appreciation. That means that US deficits with China will stabilize, and China’s overall trade surplus will continue to shrink as a share of its GDP. From the American perspective, this process will be too slow, and will not bring back the jobs already lost. But in the aggregate, trade issues are likely to fade somewhat in the public mind.

However, conflicts will continue in individual high-tech sectors. China is pushing very aggressively into the Strategic Emerging Industries (SEI). The solar panel case currently moving forward will only be the first trade case relating to Chinese industrial promotion policies. There are 35 discrete industrial sectors covered under the SEI policies, and solar panels are only part of one of those. The irony is that these policies are very costly to China, and they create as many loss-making firms in China as they do in the US. These policies create a few winners and scores of losers. On balance, they do not present a challenge to the US’s overall technological leadership. It is entirely possible that Chinese policies will be scaled back—with substantial losses taken—within two or three years, after the leadership transition.

Beyond these predictions, China’s impact on the US will depend on the policy changes adopted by the new leadership. If they lack the political will or ability to introduce major new reforms, the US will experience negative effects. Stagnation of the reform agenda in China will gradually erode support for China among American firms. Increased prominence of large Chinese state-owned firms will become a more and more salient political issue as they expand internationally without commensurate liberalization at home. Most importantly, an attempt to maintain an unsustainable course of investment-led growth will eventually lead to a sharp correction, which would hit the global economy through a sharp decline in commodity demand and a sudden increase in Chinese industrial products dumped on global markets. However, Chinese policymakers are already trying to avoid such outcomes (in their own interests) by shifting economic policy. The shift towards tighter monetary policy (which has gained credibility from its success in taming inflation) creates a new dynamic in the Chinese economy, making government monopolies and extravagant investment programs more difficult to sustain. A more open capital account would have a similar effect, by making less sustainable the policies of financial repression that drain resources from the household sector. Ultimately, if China wants to make a successful transition to a healthy, prosperous middle-income country, it will have to adopt a new set of policies that give greater autonomy and flexibility to its own citizens and businesses. Its long-term aspirations should pull it in that direction. Its short-term problems should push it in that direction. However, the new leadership does not have enough of a public track record that we can judge their objectives and capabilities. Will they take advantage? If they do, economic tensions with the US will be defused, and there will be a substantial window opening for a rapid increase in mutually beneficial cooperation and exchange.
The Evolution of US Trade and Financial Interests With China Since 1979

American trade and financial interests with China have evolved since normalization of bilateral relations in January 1979. The American interest then—as when Nixon and Mao had set this diplomatic transition in motion seven years before—was geopolitical: to counter the influence of the Soviet Union and deepen China’s alignment with the West. Economic welfare effects—such as increased demand for American exports, reduced prices for American consumers, improved technological advancement or reduced demands on American taxpayers to finance the nation’s military posture in the Western Pacific—were alluring to many firms and individuals but not primary for the leaders shaping strategy. As late as President Reagan’s 1984 trip to China, the strategic value of the relationship for the US remained Soviet rivalry, though trade and financial links played a key tactical role toward that end. As President Reagan’s background memo for that 1984 trip defined his objectives:

- To promote a China that remains independent of the Soviet orbit.
- To encourage China’s effort to modify and liberalize its totalitarian system, introduce incentives and market forces in its economy, and continue expanding its ties with the major industrialized democracies.
- To help China modernize, on the grounds that a strong, secure and stable China can be an increasing force for peace, both in Asia and in the world, if the two objectives above are realized.

With the demise of the Soviet Union and the assertion of authoritarian instincts by the Chinese Communist Party at Tiananmen Square and around China in 1989, the calculus of US trade and financial interests had to be adapted. By this point significant American investments had been made in China and more were on the way, and manufacturing production chains benefiting Americans were in formation. Post-1989, the American strategic concern was no longer to counter the Soviet Union but rather the risk that hardliners would take the initiative in China itself in reaction to market forces (hyperinflation, unemployment) which had contributed to the unrest. China was no longer just a means to an end, but a potentially first-order economic variable in international affairs. A resurgence of anti-market leftism was palatable to neither economic conservatives nor human rights liberals in Washington, nor to the vanguard of American multinational firms bending over backwards to decode the rules of commercial success on the ground from Beijing to Shanghai to Guangzhou.

US policies to encourage globalization and enmesh China with international regimes included reciprocal trade liberalization, tech-
nology transfer and technical assistance, support for private investment flows and encouragement of international organization lending. In the 1980s the cost-benefit analysis of these policies was irrelevant to Washington, because the geo-political value was overwhelming and China had such a small and marginal economy. In the 1990s it remained secondary who was gaining more from economic engagement, for several reasons. First, the Soviet collapse demonstrated that western capitalism outperformed state planning hands down. If China chose to deviate from market reforms in order to glean short-lived economic advantages that would be their problem. Second, the direction of change was obvious: China was moving rapidly toward the market. Over the 1990s tariffs fell by more than half, foreign investment boomed, state-enterprise employment fell by the tens of millions, monopolies were broken up and competition was introduced. China’s World Trade Organization accession negotiations commitments were deep and exceptional. And third, while China was modernizing, US performance was even more impressive during the decade. Technological innovation centered on information and communications technologies (ICTs) fostered exceptional productivity gains; the fiscal footing and public debt of the United States were improved; and inflation and employment moved in the right directions. US trade and financial policies were facilitating China’s convergence with American norms, interests and institutions. As President Clinton put it, the United States was on the “right side of history”, and the American interest was to lock-in China’s transition.

After 2001, however, American trade and financial interests with China evolved further as the conditions that had obviated the need for a close accounting of economic relations in the past changed. First, the pace of reform in China slowed as individuals able to control industry and commerce in the early stages of market transition amassed enough wealth, power and influence to forestall reforms that would deprive them of outsized profits. Even before the global financial crisis it was becoming less clear to US observers that China would continue its convergence toward western-style economic norms as it grew in size and strength. Second, the crisis presented a perfect justification for self-interested vested interests and market-skeptical proponents of state capitalism to put the brakes on marketization in the name of counter-cyclical stimulus or prevention of instability. And third, regardless of philosophical debates about economics, China’s state capitalism appeared to deliver massive trade surpluses (and hence holdings of US debt), global market share, quicker recovery from recession, and progress in higher technology frontier industries. As the competitiveness gap between China and the US narrowed with these differential economic performances US policymakers came to fundamentally reconsider their faith in constructive engagement due to the accumulating reasons to be unsure how China and Chinese parties will behave in the future, and increasing consequentiality to that question given burgeoning Chinese capabilities. Helping China modernize brought trivial implications for US competitiveness in 1979; today, modest Chinese commercial achievements can effect employment and investment decisions around the world.

**American Interests Today**

It would be a grave error to conclude from this chronology that American engagement with China and an indulgent attitude toward mercantilism were the main factors in China halving America’s economic lead over 30 years. The introduction of competition, disassembly of totalitarianism, hard work and sacrifice by the Chinese people, and—to be honest—distraction from policy and regulatory reform in the United States were more significant considerations. Blaming China for our concerns is to misdiagnose them. Neorealist foreign policy thinkers such as John Mearsheimer at the University of Chicago argue that it is a mistake for the United States to engage with China in any manner that aids its modernization and...
thus diminishes the relative preponderance
of American power. This view has resonance
among some US policymakers today. However
it is incompatible with American values—there
is no indication, unlike with the Soviet Union,
of China seeking to undermine the United
States globally or otherwise promote insur-
gency. It is beyond America’s ability to execute,
given the interest in economic engagement
with China shown by the rest of the world. And
most importantly it is counter-productive to
US interests. The American interest is not to
suppress China’s development, but rather to
understand and influence that development,
strengthen the structural underpinnings of
potential US growth in light of both the sus-
tainable and unsustainable elements of China’s
economic awakening, and judiciously set priori-
ties for the external trade and finance agenda.

Understanding China
To anticipate how things will play out one
must understand how things are. As of the
end of 2011 China’s GDP is roughly $7 trillion
(using EIU figures—see chart 1), following
a year of 9.2% average growth—close to the
nation’s 30 year average rate. China is thus the
second largest single-country economy in the
world, half the size of the United States ($15 tril-
lion) and ahead of Japan (roughly $6 trillion).
Coming from a mere $400 billion at the start
of reform in 1979, China’s current economic
heft is impressive. But it is—all—the most
populous nation on earth. In per capita terms
China is languishing around 90th place (IMF,
2011), at roughly $5,300 a year—just 11% of
the US average (see chart 2 for an international
comparison). This tells us that there remains
plenty of “catch-up” growth for China to look
forward to. But it also tells us that to maintain
that growth, China must transcend the “middle
income trap” that it is only now on the cusp of.
Things that were a boon for getting from $400
to $5,000 per capita—such as lax intellectual
property rights protection—become an impedi-
ment from here forward.

The structure of China’s economy by expend-
titure is closely connected to American trade
and financial interests. Since its high in the late
1990s, household consumption as a share of
GDP has fallen to a low 33% in recent years—
the lowest of any major economy. This leads
many commentators to conclude that US policy
should seek to push up or advocate for increase
in real household consumption in China. That
is misguided. Chinese household consumption
is low as a share of GDP because investment has
been abnormally high, not because consump-
tion growth itself has been anemic. In real
terms, China’s household consumption growth
has been virtually the strongest on earth for
more than a decade. It is unrealistic (if not irre-
sponsible) to expect household consumption
growth to be higher in real terms. As invest-
ment subsides in the years ahead, the consump-
tion share of GDP will automatically be higher,
but that will not benefit American exporters
(or any other producers) per se. On the other
hand, at 13-14% of GDP, government consump-
tion has great potential to expand. Rather than
joining Beijing’s effort to blame households for
not consuming more, the US should encourage
Beijing to consume more on the households’
behalf, by paying for healthcare, education,
environmental remediation, parks and public
facilities, and other public goods.

Investment is nearly half of Chinese GDP—
47.8%. Over the medium-term there is little
doubt this will shrink as a share of GDP; in
other words it must grow slower than overall
GDP. Supercharged investment growth since
2000 spawned many legitimate concerns about
the consequences of Chinese growth. For the
coming five years however, the US should be
more concerned with better Chinese invest-
ment, rather than less. Instead of directing
money to over-capacity industries that create
no jobs, Beijing needs to incentivize investment
in myriad sectors that generate employment,
pay higher wages and add value for domestic
consumers. Those investment flows should be
intermediated in a market-determined interest
rate environment less prone to distort competition in China and abroad.

Finally, the net-export component of Chinese GDP is different than many Americans think. For most of the post-1979 period China was not reliant on export-led growth: it imported nearly as much as it exported. In the mid-2000s this changed, and China’s external surplus reached a massive and dangerous level. Today, net exports are back under 3% of GDP again (2011 estimate, down a full percent of GDP from 2010) and likely still moderating. Whether this moderation will continue is hotly debated in Washington and Beijing. Time will tell, but the US interest is to make room for the possibility that China’s external surplus shrinkage is not just temporary. RMB strengthening has been more than trivial, even if not enough to satisfy many Americans. If the surplus moderation to date continues then methodologies which previously computed RMB undervaluation will instead show near-equilibrium. The United States is better served at this juncture by policies to raise homegrown export competitiveness to German or Japanese levels, rather than further lambast Beijing for its currency regime.

Just as the motives behind US-China policy have evolved since 1979, so have the forces powering China’s growth. In the 1980s and 1990s China dismantled market barriers and reallocated resources from inefficient to more productive uses. These virtues were reflected in the “total factor productivity” (TFP) component of China’s growth—that is, growth from getting more out of existing inputs rather than simply pushing more people, land or capital into fields and factories. If one looks at sources of China’s growth in terms of capital, labor, education and TFP instead of by expenditures, fully half of China’s pre-2000 growth came from TFP. The high TFP resulted from technological upgrading (some stolen, to be sure), more market-determined allocation of resources, and structural adjustment in the mix of what China made. Instead of chasing Mao’s heavy industrial dreams of being a steel maker, Deng Xiaoping’s China used its abundant labor force to follow Japan, Taiwan and other Asian Tigers up the light manufacturing ladder. Unfortunately, during the 2000s a good deal of that virtue slipped away. The State and state-owned enterprises clung more tightly to resources rather than let them be reallocated to more productive uses through redistribution of taxes, dividends, interest payments, bankruptcy or competition. The households whose savings were used to finance growth saw their share of the capital gain achieved through the nation’s industrial growth go to zero! That is, effective returns of nothing on their trillions of dollars in hard earned savings. Little wonder they piled into real estate when given a chance.

An intense discussion of these developments is underway inside China. Prominent Party advisors are arguing publicly that “vested interests” are using a monopoly on political power to abuse the market, perpetuate their “rent”, and subvert further reform. It is as though the Sherman Antitrust Act (1890) had been aborted by the influence of the trusts it was created to break up. The anti-competitive effect of this combination of political and economic monopoly is choking off the TFP wellspring of growth. To make matters worse, China’s demographic dividends are running out too. This is why ever larger injections of capital are needed to sustain the same growth as in the past. China’s economists and development experts argue that the power of vested interests must be checked urgently: if the wellspring of productivity gains is not restored, growth will either plummet or depend on ever greater sums of “other people’s money”. However it is far from clear China is ready or capable of political reform.

The United States has an interest in understanding this internal Chinese debate so as not to overestimate future Chinese growth, underestimate the likelihood of major reform or disorder, or over-concede international economic authority to China on the basis on recent performance. Chinese growth will be lower come 2015 (perhaps 7.5-8%), and competition inside China and globally will be more intense due to pro-competitive regulation, though this will also expand the potential to export consumer-
oriented products to China. Investment in heavy industry will give way to more investment in consumer markets, services and technology. A return to domestic reform will leave China less eager for international affairs for a while.

China’s leaders are well aware of this diagnosis of socio-political decay: future President Xi Jinping’s former academic advisor is among the most outspoken advocates for renewed reform. Whether Xi and his fellow elites have the will and talent to rekindle reform, or instead can only muddle forward preventing the worst by hiding liabilities and taking advantage of foreign assets, is impossible to know at this juncture. The United States can watch for indications, encourage a global-minded outcome, adjust accordingly and prepare for the fallout if a growth slowdown becomes destabilizing.

**China Policy Begins at Home: Strengthening America’s Hand**

Ironically, at the same time China will likely outpace Organisation for Economic Co-operation and Development growth rates for the coming decade no matter which path it pursues, thus approaching parity with US GDP around 2020-22. Rightly or wrongly that will prompt anxiety. Whether the US reacts to that milestone with confidence or dread will depend on the success of efforts to strengthen domestic competitiveness starting today, which will take a decade or more to bear fruit. The domestic elements of such a program are not the subject of this essay, but include reallocating expenditures from consumption to investment, fashioning incentives to bolster innovation in traditional and new industries, and elaborating a culture of competition in the global marketplace to replace the soon-to-be-bygone self-satisfaction as the world’s largest economy.

The United States should recommit itself to the market-oriented internationalism it has championed for almost a century. Recently some have pointed to the “strategic rejection of free-market doctrine”, and relative merits of state capitalism—or as the Chinese call their variant, “capitalism with Chinese characteristics”. Others counsel that the US forego free market principles or pursue “reciprocity” with China—for instance on inward direct investment approvals. Whether informed by the hope that the US could plan its way out of economic malaise, or could somehow defend market principles by threatening to throw them out the window, these suggestions are to be avoided. First, as suggested above, the outlook for Chinese medium-term growth is in serious doubt, and the past decade’s achievements depended upon financial repression which is utterly undesirable. Liabilities are building up in the Chinese system. Reform is held hostage by self-serving special interests propagating “fantasies of instability” to frighten away questioning. China’s leadership is deeply concerned. Now is not the time for the United States to hedge its bet on consumer-oriented, contestable market principles and join the vogue for state capitalism. Second, even where there are short-term advantages to be had from “hybrid economics”, the United States would be playing China’s game, not its own. If competition is to be bought with political favors, palaces and subsidized loans, then the US will not be working from a position of strength versus China; if international competition is to be based on rule of law, innovative capacity and environmental sustainability, then the tables are turned on Beijing.

China’s understanding of international economic norms and regimes is still very much “under construction”. Beijing’s choice between US-style financial regulation and its past industrial policy approach is at a tipping point. There is no definitive international norm for financial intermediation systems; there is no objectively “correct” interest rate or regime to discipline China’s preferences in this regard. If US financial sector reforms deliver growth and competitiveness, then the allure of government-driven finance will be diminished and China’s willingness to converge on US norms enhanced. This underscores the importance of US domestic reform. China is still in learning mode with regard to trade and investment flows as well.
US officials insist to Chinese counterparts that discreet national security concerns are the sole basis for rejecting a foreign direct investment overture, but some politicians explicitly threaten to interfere with such investment flows for non-security related motives. This undermines reformist Chinese policymakers as they debate colleagues over the shape of investment regimes to come. America’s trade and financial interest is to see China’s internal debate over the future of economic policy regimes come out in a liberal direction.

Figure 1: Gross Domestic Product (GDP), 2011 (US$ trillion)

Figure 2: GDP per Capita, 2011 (US$ thousand)
China’s Growth and Trade: Consequences for the US Economy

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February 18-20, 2012

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Chinese growth has been proceeding for about thirty years at an average annual rate of about 10 percent. In the process of achieving this growth, there have been several imbalances, both national and global, that have been created. First, China’s high level of investment has created a savings glut that creates domestic inflationary pressures, periodic bubbles, and cheap capital abroad. Domestically within China, it has created an imbalance between low domestic consumption and high levels of exports, leaving Chinese poorer in some dimensions than they would be otherwise and the world awash in exports that are cheaper than they would be otherwise. China’s leaders know they need to rebalance, and say they are trying to do so, but have achieved only modest results.

Discussion Questions

- What has been driving Chinese growth for such a long period at such a high rate?
- The Chinese economy is facing inflationary pressures and investment mechanisms are proliferating with little overall monetary control. Can these forces be contained? Is China vulnerable to a sustained and deep growth slowdown?
- How is the growth slowdown in the US, Japan, and Europe affecting growth in China and what strategies are the Chinese adopting to insulate themselves from these effects?
• Beijing says it seeks to rebalance its economy toward domestically-driven growth. Is it making progress?
• What is the impact of Chinese growth for the last three decades on American jobs—the number of jobs, variances by sector, and the pay American workers receive for their work?
• What US policies would best promote American job creation, the creation of better paying jobs, and stable overall growth in the United States in light of China’s role in the global economy and its growth prospects?

China and American Energy Interests and Opportunities
Remarks by Alexander Karsner
Former Assistant Secretary of Energy; CEO, Manifest Energy

US Economic Engagement With China and Implications for American Jobs
Remarks by Clyde Prestowitz, Economic Strategy Institute

Roundtable Session
Trade and Finance Relations With China: Where Are American Interests?
Daniel Rosen, Peterson Institute for International Economics

China and the United States are each other’s first or second largest trade partners depending on how it is calculated. China is America’s fastest-growing large-export market, even as the trade deficit with China (generally) continues to grow. Moreover, China is America’s largest foreign creditor in terms of its holdings of Treasury bonds and debt. China has amassed enormous foreign exchange reserves, about two-thirds of which is in dollars. This gives rise to the following issues:

Discussion Questions
• What are the domestic and international trade and finance strategies and global conditions that have allowed China to be so successful over a long period of time? How many of these practices conform with accepted trade and finance practices?
• Relatively speaking, which of the following practices have been most injurious to America’s trade and economic positions: subsidies, intellectual property rights violations, non-tariff barriers, industrial policy, etc.?
• What have been the largest benefits the US has derived from its trade and financial relationship with China and how can the net costs and gains be assessed?
• How successful has the US been in using the World Trade Organization dispute resolution mechanism to address its grievances with China?
• What policies should the US pursue to best address the inequities of the current relationship while preserving the mutually-beneficial aspects?
• What are the prospects for, and challenges of, Chinese direct investment in the US?
How Trade Underpins US–China Relations
Remarks by Mickey Kantor
Former US Trade Representative and Secretary of Commerce

Does the 21st Century Belong to China?
Film Screening of the June 2011 Munk Debate featuring:
Pro: Niall Ferguson, Harvard University
    David Daokui Li, Tsinghua University
Con: Henry Kissinger, former US Secretary of State
    Fareed Zakaria, CNN and Time Magazine

How China Views the US as an Economic Partner and/or Competitor
Remarks by Yao Yang
China Center for Economic Research, Peking University
Visiting Scholar, University of Washington