

The Sleeping Giant Awakens  
The consequences of China's growth.  
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THAT CHINA'S NATIONAL PEOPLE'S CONGRESS convened last week is not news, though it provided the occasion for prime minister Wen Jiabao's first address to the rubber-stamping body, a 90-minute affair which, quite predictably, was well received. That China released two dissidents, Wang Youcai and Phuntsog Nyidron, may be news, if it portends a greater sensitivity to pressure from international human rights advocates and even a slight loosening of the regime's grip on the political system. That Wen announced China will address the economic imbalances that threaten to turn its phenomenal growth into an equally phenomenal bust is news. China has accounted for a larger share of world growth in the past seven years than has the United States, making the health of its economy important to far more than its own 1.3 billion people.

China's trade policy, and especially its burgeoning trade surplus with the United States, is now front and center in the debate over the propriety of George W. Bush's (somewhat) free trade policies. A combination of resurgent Democratic protectionism and a sluggish jobs market has Americans worried, and White House campaign-planners are trying to figure out how to counter that new recruit to the protectionist cause, John F. Kerry, without completely abandoning the president's commitment to free trade.

Voters' fears are understandable: As many see it, China is taking jobs away from textile workers, furniture makers, and appliance assemblers, to mention just a few industries decimated by imports. Free trade makes the U.S. economy stronger and more efficient in the long run, as the much-maligned chairman of the President's Council of Economic Advisers pointed out, to the consternation of Democrats and Republicans alike in Congress. But in a political season, the long run is a few months, and economists' assurances that it all will end up with rising living standards, lower prices, and job creation count for little. Nor do the worries of the White House seem to count for much in China, which seems unprepared to offer more than a token response to American fears--understandable, in the context of the economic problems of a nation that is in the grip of perhaps the most profound and rapid economic change ever experienced by a major country.

Consider this: Some 300 million of China's 1.3 billion people have moved from country to city since the economy was liberalized in the later 1970s. That about equals the total population of the 15 member states of the European Union, and is considerably more than the current population of the United States. By 2020, 250 million more Chinese are expected to leave their villages, putting an additional burden on urban infrastructures ill-equipped to handle that load. Little wonder that the minister in charge of the Chinese government's think tank calls the emergence of China as an industrialized country "the most profound social transformation in world history." And little wonder that the Chinese authorities are having difficulty coming to grips with the necessity of phasing out

inefficient state-run enterprises that at least have the virtue of providing jobs to the millions moving off the land.

Little wonder, too, that the economic consequences of China's growth are creating more than a few worries for the world's policymakers. It is well known that China's thirst for oil--imports last year were up over 30 percent--makes it the world's second largest importer (the United States remains a clear first, relying on imports for over half of the 20 million barrels per day it consumes, compared with China's six million barrels). So China is now a player in the intense game of oil geopolitics. It is investing in the search for oil in Azerbaijan and forging closer commercial ties with a Russia that hopes to capture a good portion of the Chinese market. And it is attending to its relations with Middle Eastern producers on whom it will increasingly depend for supplies, and for whom it is the world's fastest growing market, projected to import 10 million barrels per day by 2030, about as much as America now buys.

The implications are obvious: The Chinese may decide that their need for oil requires them to come down on the side of Saudi Arabia and other Middle Eastern producers when those countries unite to block U.S. peace initiatives and antiterrorist measures. And China's arms sales to Iran and Saudi Arabia will likely grow in pace with its need for Middle Eastern oil. In the case of Iran, those sales already include cruise missiles and what Gal Luft and Anne Korin of the Institute for the Analysis of Global Security call "key ingredients for the development of nuclear weapons."

Indeed, China's economic growth is putting pressure not only on oil prices, which are up almost 50 percent from pre-Iraq war levels, but on many of the world's commodity markets. Its need for metals (China is now the world's largest importer of copper, tin, and zinc, among other materials), coal, rubber, cement (China is the world's largest consumer), fabrics, and foods has tightened those markets. And its demand for the ships to move those goods is pushing the capacity of the world's bulk carriers to its limits, driving up shipping rates by some 550 percent since 2001, according to economists at Barclays Capital. All of which, Goldman Sachs economists figure, has pushed up commodity prices by 14 percent since the middle of last year.

The recent spurt in oil and gasoline prices has only now made Americans notice the impact China is having on commodity markets. But the effect of Chinese growth on our trade deficit and, it is alleged, jobs, has been in the headlines since the start of the Democratic primary campaign. China is currently running an annual trade surplus with the United States in excess of \$125 billion (China has replaced Japan as the leading contributor to America's trade deficit), and whatever virtues supporters of free trade can cite for open markets, and however much they point out the irrelevance of bilateral trade balances, a figure as eye-catching as \$125 billion is forcing the Bush administration to make protectionist noises, and to pressure the Chinese to allow their currency to float upwards. Never mind warnings from Fed chairman Alan Greenspan that the Chinese banking system, with perhaps 40 percent to 50 percent of its loans "nonperforming" (bankers' euphemism for "can't make the payments"), is in no condition to withstand the rapid withdrawal of deposits that might follow such a revaluation of the currency. "Our

fight against nonperforming loans will be long and arduous," says China's bank regulator, as he struggles to get the banks in shape to meet foreign competition that will flood in 2006, when World Trade Organization rules require China to grant foreign banks full privileges.

So intent are the politicians to show that they are taking action that they have put a quota on our imports of brassieres and nightgowns from China. Of course, the production of these items will simply shift to Central America, and no new jobs will be created in the United States, but no matter. The old Reagan motto, "Don't just do something, stand there," can't survive the fear of losing votes in key states.

LAST YEAR, China's economy grew at the robust rate of more than 9 percent, the fastest in seven years and "a milestone in the history of China," according to Li Deshui, head of the National Bureau of Statistics. And that's according to official figures: Many experts say the actual growth rate was well into double digits. Not even the serious SARS outbreak could derail the Chinese economy, which seems likely to quadruple in size between now and 2020, as it has done in the past two decades.

Consider these indicators of China's economic performance:

- \* Tax revenues increased by 20 percent last year;
- \* Profits soared by 40 percent;
- \* Manufacturing activity is rising at an annual rate of more than 10 percent;
- \* China is now the most popular place on earth for foreign investors to put their money, with investors from America, Taiwan, and Hong Kong leading the parade;
- \* China added over \$400 billion to its foreign exchange reserves in 2003;
- \* If we correct for exchange rate anomalies, China accounted for a larger share of world growth in the past seven years than did the United States--25 percent versus 20 percent.

No need to go on with this parade of statistics, which gives comfort to all those who believe that rising prosperity, the emergence of an entrepreneurial middle class, and the accompanying opening of communication channels with the outside world will result in political as well as economic liberalization. But little comfort to those policymakers concerned with correcting imbalances in world trade.

Start with the fact that China has yet to live up to the commitments it made when it was admitted to the World Trade Organization. Add to that such insensitivity to the notion of intellectual property that China is home to manufacturers of "pirated" CDs, videos, and DVDs. Indeed, on a recent trip to China, Commerce Secretary Don Evans was able to purchase a bootleg DVD of Quentin Tarantino's Kill Bill days after it had been released in U.S. movie theaters. And keep in mind that China is insisting that access to U.S.

technology be part of any large-scale purchase contract: GE, for example, had to form joint ventures with China's state-owned power companies, which will have access to GE technology, in order to sell billions of dollars' worth of generating equipment to China.

But that is the least of the policy problems created by the rise of China as an exporting powerhouse, and it may well prove to be a transient one. The more difficult one is the insistence of the Chinese authorities on pegging their currency to the dollar. That means that no matter how large America's trade deficit with China becomes, no readjustment of currency values of the sort that a free market would produce can occur. In the absence of a fixed exchange rate policy, China's currency would rise, making Chinese goods more expensive in America, and American goods cheaper in China, reducing our trade deficit.

This has resulted in howls of "unfair competition" from affected American firms and their political allies. "Unfair" to competitors, of course, is another way of saying that trade with China has been a bonanza for consumers. For example, Wal-Mart accounts for a full 10 percent of the total U.S. trade deficit with China--which explains why the world's largest retailer is able to put such low sticker prices on those T-shirts, sneakers, and other products that American consumers have come to love. Consumers, however, are not as well organized as the producers whose oxen are being gored. A large coalition of business groups and a gaggle of congressmen want to impose a 27.5 percent tariff on all Chinese goods to offset that country's undervalued currency.

The tariff won't pass, but the Chinese may concede a token revaluation, say on the order of 5-10 percent, in a slight bow to international pressure that won't seriously reduce the growth of job-creating export industries. But unless their policy of sterilizing the flood of money that is descending on the country--draining money from the market by selling IOUs and tucking away the money received for those IOUs in the vault of the central bank--proves unable to contain inflation, it is likely that the Chinese authorities will hold to some form of currency pegging. As Wen told the People's Congress last week: The exchange rate should "maintain basic stability at a reasonable and balanced level"--Chinese for, "We agree with Greenspan that now is not the time to float our currency." After all, say the Chinese, last month we had an overall trade deficit of almost \$8 billion.

Whatever happens with currency exchange rates, one thing is certain: China will do nothing to threaten the export-led job creation on which it will remain dependent until its own consumers can afford to carry the economy. Which may not be such a bad thing, from America's point of view. China has been sending us sneakers and electrical goods, and we have been sending it little bits of paper with the pictures of American presidents on them. Chinese authorities have been using the dollars they earn in trade to buy the U.S. treasury bonds that are being printed as fast as the Bush budget deficit rises. That helps to keep U.S. interest rates lower than they might be, which in turn is helping the American economy to grow at a rate the Bush team feels necessary if the president and first lady are not to start ordering packing crates in a few months.

And therein lies a long-term problem. Can the world's only superpower have sufficient freedom of action on the international stage if a potential adversary is in a position to

damage its economy? Put differently, can the world's largest debtor tell its largest creditors what to do should a clash of interests arise? Let's hope so. And let's hope, too, that the many experts who think the Chinese economy is overheating, and is beyond the control of the authorities, are wrong. ("China in 2004 feels like Nasdaq in 1999," warns the Wall Street Journal.)

The Tiananmen Square protests and the subsequent vicious crackdown were caused in part by consumers' inability to cope with rising prices, a bit of history that has the regime on the alert now that the first signs of inflation seem to be making an appearance--best estimates are that the current inflation rate is somewhere between 4 and 6 percent.

The threat of overheating is not unremarked by the authorities. Guo Shuqing, head of the State Administration of Foreign Exchange, has announced that restrictions on investment abroad by firms earning dollars will be relaxed, easing the growth of the domestic money supply. And Wen Jiabao last week said that tightened environmental and safety requirements would be used to slow the growth of the steel, aluminum, cement, and other industries that seem to be adding capacity at a rate unwarranted by prospective demand, stimulated instead by improvident lending by banks that already have made too many bad loans (some \$860 billion worth). The goal will be to bring growth down from last year's almost-10 percent to 7 percent.

As with other matters, this problem is more complicated in the Chinese context than it at first seems. Overheating produces inflation, generally considered undesirable. But a bit of inflation, driving up the price of agricultural products, is seen by the Chinese authorities as a handy way of redistributing income from richer urban consumers to poorer rural farmers. Absent such redistribution from city to country, the widening disparity between urban and rural incomes might cause serious unrest among the 800 million Chinese who have not migrated to the growing cities. In addition, rural poverty inhibits needed growth in consumer demand for the rising output of China's factories--which is why the premier announced last week that he was cutting agricultural taxes by 1 percent.

But the authorities worry that the inflationary process, once under way, will take on a life of its own, and prove impervious to efforts to keep it at useful but nonthreatening levels. Which explains why they have decided to slow the growth of the money supply and hold new bank lending to 13 percent below last year's level. "Money and credit have been growing too fast. The structure of credit is irrational and the financial system carries many problems and perilous risks," Wen Jiabao told a meeting of representatives of the institutions that make up China's financial sector.

IN THE END, of course, all of these economic issues--the trade deficit, competition for commodities, China's investment in U.S. Treasuries--pale into insignificance compared with the question of whether China will prove to be a vigorous but peaceful competitor on the world's economic and political stage, or a more belligerent player, intent on reclaiming Taiwan and pursuing other goals that put it on a collision course with America. Which brings us to the ongoing debate over isolation versus engagement.

In fact, this is no debate at all. We are in no position to isolate or refuse to "engage" China--it is simply too big a player on the international economic scene to treat as a Libya or even an Iran. The real question is whether the dynamics of Chinese economic development will increase the likelihood of the success of an engagement policy by providing the Chinese leadership with a greater incentive to preserve a stable order in the Asia-Pacific region than it had before the recent period of rapid economic growth. In short, will a richer China be more like us?

Bill Emmott, editor in chief of the Economist, points out that when Deng Xiaoping came to power in 1978, China was still getting poorer relative to the West, and was having difficulty feeding its growing population. As Emmott puts it, "Deng's solution was simple: 'capitalism,' which he called 'socialism with Chinese characteristics.'" And Deng added, "to get rich is glorious." No believer in capitalism could have put it better. Indeed, whatever our differences with China, we seem to agree on at least one basic economic principle: The path to national wealth lies in providing incentives to entrepreneurs to get rich by taking risks, and to workers to work hard to maximize their incomes.

So it is no surprise that the Chinese leadership has opened party membership to entrepreneurs, that several Chinese entrepreneurs are rich enough to be buying up and bringing home Chinese art treasures that had left the country, that China is now beginning to open its financial sector to international competition, and that a new generation of brand-conscious youngsters is snapping up everything from cell phones to laptops, sunglasses, and American and British university degrees. As Hung Huang, publisher of the Chinese version of Seventeen, put it to the Economist, "They are like any teenagers that you would find in a rich suburb of Chicago or St. Louis. They want the latest model, they want their computer, they want their camcorder, they want cool Swatches." Not to mention cars: Beijing is already choked with traffic, even though the automobile has only begun to replace the bicycle on China's streets. If the idea that "they" are becoming more like "us" is the good omen some take it to be, there is hope that these goods-hungry teenagers will grow into the goods-hungry adults that Americans believe are less likely to forfeit the good life by roiling international waters.

Equally important, China's leaders seem to recognize that the continued success of their nation's economy depends on important institutional reforms, most notably the institution of the rule of law to protect private property. As Gregory Chow, emeritus professor of political economy at Princeton, notes, "A modern market economy requires the existence of a set of rules of the game for the economic players who compete in the market place." He goes on to cite China's Bankruptcy Law of 1986 and Commercial Bank Law of 1995 as important examples of "a set of legal institutions to enforce the rules of the game governing economic behavior in a market economy." Others are not so certain that the new bankruptcy laws are optimal, but the point remains: Movement appears to be in the right direction. The Wall Street Journal, the self-professed champion of free market capitalism, captioned a recent editorial "From Mao to Locke," and expressed joy at China's decision to add to its constitution a clause stating that "lawful private property is not to be violated." Of course, those who have watched the changing definitions applied

to the word "lawful" by another reforming Communist, Vladimir Putin, are right to urge a wait-and-see attitude towards what might be, but is not certainly, an important reform.

That leaves the knotty question of China's refusal to protect intellectual property rights, a policy that has forced Blockbuster to abandon efforts to break into the Chinese market. Some in the business of creating movies, music, and other intellectual property tell me that their pleas will fall on increasingly receptive ears as China and its homegrown industries accumulate more and more of their own intellectual property. They say that it will be self-interest, rather than international pressure, that will finally persuade Chinese authorities to crack down on counterfeiting and other forms of theft of intellectual property. At the same time, these American creators of intellectual property are keeping pressure on the Chinese to recognize that not all property is theft.

Those who predict that self-interest will persuade the Chinese to join international efforts to protect intellectual property base their hope on a little appreciated aspect of the development of the Chinese economy. Contrary to popular perception, China is not a low-tech manufacturer. As the Congressional Research Service notes in a recent report: "In the past decade, the most dramatic increases in the value of Chinese imports to the United States have not been in sectors such as footwear and apparel--traditional labor-intensive industries in which China is already quite competitive--but in advanced technology sectors, such as office and data processing machines, telecommunications and sound equipment, electrical machinery and appliances." Japan's Pioneer Corporation is just one of an increasing number of firms that have moved high-tech manufacturing plants, and research centers, to Shanghai, where Sharp, NEC, and Toshiba are busily recruiting Chinese engineers to staff their new research centers and laboratories.

So China and its many emerging manufacturers have an increasing stake in supporting a stable regime for the protection of intellectual property. Even more important, an increasingly prosperous China has a larger stake in a stable world order, which may be one of the reasons that it appears to be cooperating with our efforts to defuse the controversy with North Korea. And more important still: China is creating an entrepreneurial and middle class that must have open access to information if it is to prosper in global markets. Which may be why China has recently opened its media industries to greater private investment. As a result of commercialization of media outlets, the proliferation of cable channels and new magazines, and the spread of the Internet, "The government is losing the levers to control the media," according to Liu Junning, described by the press as "a Beijing scholar and advocate of democracy."

No one should doubt that there will be problems between the United States and China in the years ahead. For every sign of progress, there is a sign that such progress may prove ephemeral. The media provide a good example. The liberalization that some see is no done deal: "We must insist on the correct leadership of public opinion," says Zhu Hong, of the State Administration of Radio, Film, and Television.

Nor is it certain that such economic reform as is now being allowed will continue if liberalization in the economic sphere threatens the hold of the regime on political power.

Again, we have the Putin model: Privatization and liberalization are fine, so long as they don't threaten the hold of the regime on the political process. And only a Pangloss would believe that such liberalization as will occur in the economic sphere will create sufficient freedom of religion and respect for human rights to satisfy those of us who value those freedoms and rights so highly. But (and here I suspect I differ from some of my colleagues in these pages) we cannot remake the world in our image. What we can do is encourage such developments as reduce the threat to our own safety. On that list we certainly should include encouraging the spread of economic reform and affluence in China, while continuing to support the drive of the newly affluent for greater freedom, and holding fast to our alliance with Taiwan.

Such a policy--avoiding protectionism, encouraging economic growth in China while holding to our principles--is within our grasp. After all, we are not without cards to play: China needs our markets every bit as much as we need the Chinese to buy our government's IOUs. Perhaps more: Closure of our markets to China's goods would inconveniently drive up prices in Wal-Mart, but would result in massive unemployment and social unrest in China. China's trade surplus is America's weapon. That's something the Chinese have to keep in mind when discussing geopolitical issues with us.

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