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# Our Broken China Policy

*Beijing plays chess; America plays tiddlywinks.*

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BY IRWIN M. STELZER

China's president, Hu Jintao, is about to make a state visit to Washington, hard on the heels of a statement by Liang Guanglie, his defense minister, that "in the next five years our military will push forward preparations for military conflicts in every strategic direction." Not quite Nikita Khrushchev's "We will bury you," but close enough to give President Obama good reason to reset our overall policy towards the Chinese regime, including abandoning the outdated notion that trade is only about economics. President Hu knows better: Trade, overseas investment, currency manipulation—all, war by other means; all, about the place of nations in the world, a key part of the "strategic direction" in which he is taking his country.

The United States, meanwhile, continues its historic policies. Free trade. Reliance on the World Trade Organization to settle disputes. Occasional public complaints about China's persistent undervaluation of the renminbi, but refusal to declare the regime a currency manipulator. And conferences, conferences, conferences. All very 20th century.

China is doing something altogether different. The Communist regime sees trade policy as merely one strategic weapon in a war aimed at overtaking the United States as the world's preeminent economic and military power. Undervaluation of the renminbi is necessary to keep China's export machine running at full tilt to create jobs for the millions who are moving from the country to the nation's cities. Lacking democratic legitimacy, the regime claims the loyalty, or at least the submission, of its people principally through its ability to provide jobs and a rising standard of living, especially important now since at the end of this year Hu, the paramount leader and general secretary of the Communist party, retires in favor of Xi Jinping. The last thing Hu wants is a transition marred by social unrest.

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The Chinese know that at some point they will have to allow the renminbi to appreciate by more than the token amount of recent months if inflation is to be avoided and its people allowed some of the benefits of the greater purchasing power of a more valuable currency. But by then they will have accomplished two longstanding objectives. First, their vaults will be stuffed with an even larger hoard of American IOUs, enough to give them an important influence over U.S. foreign policy. "How do you deal toughly with your banker?" asked Hillary Clinton of then-prime minister of Australia Kevin Rudd at a luncheon last year. His answer is not recorded.

Secretary Clinton, of course, was expressing the widely held fear in policy circles that China might decide to dump U.S. Treasuries and dollars on the market, driving their value down and interest rates up. That would bring our economic recovery to a screeching halt—or worse. Yes, the value of China's dollar-denominated assets would decline, but if a broader geopolitical objective were served, that would merely be a cost to include in the military budget.

Second, by the time they are forced to allow the renminbi to appreciate significantly, the Chinese will have copied enough American and Western technology to be less in need of an undervalued currency—they will have made-in-China products, subsidized if necessary, that can dominate world markets even if their currency more closely approximates its market value.

China's leaders know that the exports that have been filling Walmart's shelves are becoming cheaper to make in other countries. So the idea is to replace them with more technologically sophisticated products. Every deal to allow a foreign company to tap China's vast market comes with a requirement that it turn over technology. The initial orders satisfy American executives, their eyes focused on the next quarterly or analyst's report. The Chinese, their eyes focused on 2020 and beyond, know that, the technology in hand, they can continue duplicating the factories and techniques and dispense with the American capitalists.

Chinese policy towards the energy industries provides perhaps the best but far from the only example. Westinghouse Electric recently completed a technology transfer as part of a deal to sell four nuclear plants

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to China. So, too, with the green energy business. The Chinese agree with President Obama: Solar panels are an increasingly important product and source of jobs. The main raw material is polysilicon, and when its price soared the Chinese poured cash into domestic plants and short-circuited the permitting process so that plants could go from groundbreaking to full production in a bit over a year; in the West that is a multiyear process. Result: China controls half the world market for solar-power equipment.

Move on to wind turbines. GE acceded to a Chinese government demand that it build a wind turbine factory in China if it wanted to tap its market. Now, subsidized state-owned contractors direct all their business to domestic manufacturers, who are also eating steadily into GE's U.S. market. The Obama administration has filed a complaint at the WTO—with no help from GE. Like all other companies that still see the Chinese market as one they must cultivate in order to grow their earnings, GE has backed off the public criticism of China in which it and others were temporarily emboldened to indulge when Google drew the line at accepting censorship and pulled out of China.

The camels that trod the old Silk Road laden with spices and porcelain are being replaced by air and sea freighters hauling solar panels and all sorts of goods based on copied technologies and purloined intellectual property. Nothing seems to have changed since Lenin observed, "The capitalists will sell us the rope with which we will hang them."

There is worse. While Barack Obama and American supporters of free trade are congratulating themselves on a WTO finding that China is subsidizing the export of cheap tires, and negotiating a trade deal that might enable American carmakers to sell a few more vehicles to South Korea, the Chinese are establishing themselves in Africa, South America, and the Middle East to lock up supplies of minerals, oil, and food. This is about more than money and trade balances, or the pursuit of an economically efficient use of the world's resources obtained through an Adam Smith-like international specialization of labor. It is about the use of state resources not only to satisfy the legitimate needs of a growing economy, but also to obtain the power to influence the policies of other nations.

Thus, when Japan detained the captain of a Chinese fishing boat that collided with a Japanese patrol vessel, China's rulers banned the export to Japan of rare earth minerals crucial to the manufacture of many industrial—including defense—products. Their more recent decision to cut exports of those minerals by over 70 percent is seen as an effort to force companies needing the stuff to

relocate in China, which controls over 95 percent of the world's supply. The regime deems the nontrivial environmental costs of processing these minerals a small price to pay for the power their control confers. American liberals and greens prefer a more pristine environment.

Still another problem is the difference in attitudes towards foreign investment. The Obama administration's treatment and threatened treatment of earnings on foreign investments discourages companies from investing abroad. China, knowing that influence follows foreign investment, encourages it, even to the extent of offering to buy the bonds of broke European countries. Having already invested massively in resource-rich African countries such as Sudan, China is turning its attention to Latin America. In Argentina alone China's state-owned and subsidized companies have invested in a wide range of natural resource developments and in ports to facilitate the large-scale shipment of these resources to China.

Then, of course, there is India, a giant, fast-growing, democratic country that is now the prize in the 21st-century version of the Great Game. Barack Obama visited India and trumpeted his success in nailing down trade deals worth \$10 billion. The next month Wen Jiabao, China's premier, played one-upmanship and booked \$16 billion in deals, financed by China's banks, and announced he would open China's markets to Indian goods and double trade between the countries to \$100 billion annually by 2015. Lest there be any doubt that China expects India to adjust its foreign policy to its new dependence on the Chinese market, it warned India that criticism of the Chinese leadership could threaten "fragile" bilateral ties that would be "difficult to repair."

Even more important are two additional factors, one economic, the other military. Beijing has its eye on the dollar: not the jiggles in its value but its position as the world's currency of choice. Countries can already invoice and settle trade deals in renminbi, which more will do as China gradually makes its currency more easily convertible. No need for dollars.

Then there is the military consequence of this engineered shift of wealth to China. The regime is becoming increasingly aggressive in asserting its claims to disputed territories, and backing those claims with a massively expanded military. Major General Jiang Luming, head of China's Institute for Defence Economics, has called for China to double to 2.8 percent the portion of GDP spent on the military, still below America's 4.5 percent, but rising much more rapidly. Most important, the Dong Feng 21D missile with a range of hundreds of miles and capable of taking out an aircraft carrier is no longer merely "aspirational," according to Andrew Erickson, a

Chinese naval expert at the Naval War College. Defense analysts call this “a game changer” that will force the United States to withdraw carriers from areas in which they are now based and operate. China is also building a formidable nuclear submarine fleet that experts say will soon outnumber ours; has plans for several aircraft carriers; and is upgrading its already significant cyberwarfare capability and its anti-satellite weaponry. “If the United States can light a fire in China’s backyard, we can also light a fire in their backyard,” announced Colonel Dai Xu of the People’s Liberation Army.

**T**his combination of economic success and military prowess has world leaders wondering whether the Chinese version of what has come to be called state capitalism is more likely to be the model for the future than the U.S. market-based version of capitalism. After all, China avoided many of the problems that afflicted America when its financial system almost collapsed, and is growing at multiples of the rate the U.S. economy is eking out.

“A ‘Beijing consensus’ has been gaining ground, extolling the virtues of decisive authoritarianism over shilly-shallying democratic debate,” reports the *Economist*. Tony Tan, deputy chairman of the Government of Singapore Investment Corporation, one of the oldest and largest sovereign wealth funds with over \$100 billion under management, told a recent gathering of financial and government leaders in Davos that emerging countries are reappraising whether they should use a “system of free markets . . . and minimum interference by the state. . . . State capitalism, interference by the state, has served [some countries] well.”

Of course, the recent financial crisis is not the sole reason that the American model is less revered than it once was. The increasing affluence of state capitalist countries such as China, the reliance of the United States on supplies of oil from state-owned companies, and the trek of capital-short banks and other investors to the offices of sovereign wealth funds all contribute to the notion that the road to prosperity might lie through nations’ capitals and with government officials rather than through Wall Street and with financial houses.

But there is good news, news that trumps all of these problems. Democratic governments are intrinsically more flexible than despotic ones. China’s rulers are not infallible, any more than are ours. But they are less likely to hear, much less respond to, criticism and therefore more likely to overreach and less likely to change even a mistaken course of action in the absence of serious external pressure. Tiananmen Square is not the ideal place for a Tea Party

demonstration. Thus, China’s increasingly aggressive foreign policy has spurred its neighbors to action, hastened by the increasing sense in the region that America is furling its security umbrella. Japan, Australia, and India are shoring up their military capabilities, that last to counter what its prime minister, Manmohan Singh, calls China’s “new assertiveness” and the regime’s attempt to secure “a foothold in South Asia.”

The possibility of such policy blunders by rulers shielded from criticism is not restricted to foreign affairs. On the domestic front, the inherent contradictions of China’s centrally managed economy are more than trivial. A system that does not rely on prices to allocate resources is having trouble containing inflation: Food prices are rising at a rapid rate despite a nervous regime’s effort to control them by raising interest rates, and inflationary expectations are rising even faster. Not all of the American dollars flowing in can be removed from circulation by the usual process of sterilization by the central bank; some are adding to inflationary pressures that have forced the regime to raise the minimum wage repeatedly, most recently by 21 percent. Inefficient state enterprises continue to sop up resources, the emphasis on job-creating production is causing environmental problems, and competition from lower-cost suppliers in Asia and Latin America is cutting into the profit margins of China’s manufacturers. Most of the initial public offerings (IPOs) by Chinese firms have flamed out after an initial blaze of glory on stock markets. Meanwhile, the pressures of mandated growth that takes no account of pollution and other costs (estimated by a Chinese think tank to have risen by 75 percent in the past five years to a minimum of 4 percent of GDP) are reaching a point where Beijing is from time to time uninhabitable—think the Olympics.

These weaknesses in the Chinese system, less well reported than our own, are only one reason why the parlor game of forecasting the date on which China’s GDP will overtake America’s is not a particularly useful policy guide: It was this mindless projection of trends in the mid-1980s that led some analysts to predict that Japan’s would now be the world’s largest economy, just as it entered a decade of stagnation. There are two other reasons.

The first is that total GDP does not measure even material success. At about the time that China catches up to the United States in total GDP, its per capita GDP will still be one-fourth that of America, its per capita consumption even less.

Second, the new Great Game is about international clout, the ability to project power, not the ability to subsidize the production of sneakers, T-shirts, or even solar panels. In that game, only some of the points go to the owner of the largest GDP; most go to the country that

most intelligently allocates resources between its military and its domestic needs, between groups within its country, between the demands of the young and the needs of the elderly. There is no reason to believe that the system that brought starvation to millions when a wrongheaded leader was in charge, that has a stake in refusing to admit error, and that can survive only by denying its best and brightest access to all the information the world has to offer is slated inevitably to replace the United States as the world's most powerful nation—any more than there is reason to believe that it is inevitable that the dollar will be replaced as the world's reserve currency, or that America's military will be reduced to impotence, or that our economy will remain mired in financial difficulties and low growth. In the Sino-U.S. jockeying for supremacy America has enormous advantages.

Start with the rule of law. Investors in American assets need not fear waking up one morning to find that Vladimir Putin's *siloviki* own their company and that an arrest warrant has been issued for them. Or that their intellectual property has been stolen and turned over to a state-owned company.

Because property rights are secure, and intellectual property protected—overprotected, some critics contend—America remains the source of most of the world's innovations and the home of most of its great entrepreneurs.

Then there is demography. Unlike Europe with its shrinking, aging, and increasingly ethnically fractured population, or China, aging rapidly because of its one-child policy, with no safety net in place to protect the elderly, America is blessed with a relatively young population, with native-born Americans augmented by immigrants, many of them Chinese, coming in response to the lure of the American Dream (ever heard of the Chinese dream or the German dream?), a tribute to our still-excellent (in some areas) institutions of higher learning.

The American military, meanwhile, remains the most potent in the world, and we are blessed with an abundance of natural resources which, with sensible policies, can be augmented by acquisition of the overseas resources that China is now securing for its future use.

There is time to fix things: "The Chinese currency is still a long way from replacing the U.S. dollar as the world's reserve currency," writes Chi Lo, CEO of HFT Investment Management in Hong Kong. "China's navy is still a dwarf compared with the U.S.," an Asian defense attaché in Beijing tells the *Financial Times*. All we need are sensible policies.

■ Stop apologizing. It is absurd for an America that can accommodate Nancy Pelosi and Sarah Palin, assimilate millions of immigrants, and otherwise allow freedoms that the Chinese regime would not tolerate to bend a knee

to that regime. Or to allow some low-level official to wag a finger in the face of the leader of the free world, as one Chinese bureaucrat did in Copenhagen, without his bosses fearing a response. The world noticed.

■ Open our doors to the talented Indians, Chinese, and others clamoring for visas so they can study here and contribute to our ability to maintain world leadership in innovation.

■ Recast trade and tax policy so that the incentives facing the private sector coincide more closely with the broader public interest. Recognize that private corporations, charged with maximizing shareholder value, cannot factor into their operations all of the externalities, most especially national security considerations, that China's state-managed companies are required to consider.

■ Re-do trade policy to end the continued advantage provided to China by its currency manipulation and theft of intellectual property and to offset the pressure on American companies to be accessories to that theft.

■ Expand the definition of technology transfers barred because they might threaten national security. GE claims its joint venture in avionics, the brains of military jet aircraft, transfers only nonmilitary technology, but the recipient is a Chinese company that, according to the *Wall Street Journal*, "makes fighter jets and helicopters in addition to civilian products."

■ Forget about adopting a military strategy that concentrates solely on wars of the sort in which we are now engaged. They may prove to be the "last wars" for which the military is notoriously prone to plan, rather than the next wars, which seem to be what Liang has in mind. Do whatever is needed to maintain superiority in the Asia-Pacific region, as our allies and potential allies are urging us to do.

■ Get our economic house in order and reduce dependence on our creditor in chief. If that means some tax increases, well, the Tea Party will just have to live with it. If that means some reductions in entitlements and other programs, well, the liberals will just have to live with it. And if that means an end to—let's be realistic, a reduction in—corporate welfare, well the corpocracy will just have to live with it.

In the end, it's the policy, stupid. Lawrence of Arabia, at least according to David Lean's film version, countered Arab belief in inevitability, that "It is written," with the retort, "Nothing is written." It truly is not written that we must continue to pursue the self-destructive policies of recent years. Tocqueville noticed that the greatness of America "lies . . . in her ability to repair her faults," and Churchill observed that Americans "can always be counted on to do the right thing . . . after they have exhausted all other possibilities." We have. ♦