Navigating China's Rise
Develop a Sustained, High-Level Trade Strategy

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Summary

China is the single biggest—and, to many, the single—issue on the U.S. trade agenda today. When U.S. lawmakers talk about unfair trade or exchange rates, it is China that is likely on their minds. Any discussion of the state of U.S. manufacturing quickly finds its way to China's growing prowess. And China's rise lurks as a chief protagonist in even seemingly unrelated issues, such as energy security.

Because China is successfully pursuing an export-led growth strategy on a scale never seen before, its rise is sending tsunami-like waves to the farthest reaches of the global economy, creating tough challenges for some players and enticing opportunities for others. But its very outward orientation also makes China's continued economic growth highly sensitive to the opportunities posed by global markets and the rules that govern them.

As the chief architect of the current international economic system and today's biggest player, the United States still has a window of opportunity to shape those opportunities and those rules favorably. To do so will require that our political leaders reject both the hollow cheerleading for a benign globalization that spreads benefits evenly, as well as the false comfort that they can stop the clock or shield our citizens from the relentless forces of globalization. It will require America's next President to pursue a proactive and sustained strategy that not only addresses the rules governing trade across borders, but also for the first time vigorously implements the requisite domestic policies to ensure that a large majority of Americans thrive in the global economy. In

short, this will be a drastic departure from the too-busy-elsewhere policy of recent years.

Specifically, America's next President should:

- make preparing America for the rise of China and shaping the surrounding environment in our favor a top, sustained priority
- vigorously implement programs that equip Americans to compete in the global economy (encompassing innovation, education, and infrastructure) and provide social insurance in support of mobility and opportunity
- push for more rapid adjustment of China's currency as a critical component of a broader policy (not as a silver bullet) to induce appreciation in Asian currencies and to facilitate an orderly decline in global trade imbalances
- vigorously pursue a set of critical trade enforcement actions that have the greatest consequences for American competitiveness—with intellectual property theft and China's comprehensive subsidization of its exports as central targets
- undertake sustained economic diplomacy at the highest levels to shape multilateral and regional economic structures and agreements favorably

Context

In 1994, with public debate preoccupied with unbeatable Japan and low-wage Mexico, the Clinton administration undertook a behind-the-scenes high-level review of China's position and prospects. The conclusion? The best single lever the United States had for influencing China toward growing responsibility in the international arena, as well as domestic political reform and poverty alleviation, would be a robust set of trade commitments as a condition for its entry into the World Trade Organization (WTO). The difficulty would be to convince a reluctant Chinese leadership to move.

Today, political leaders are wrestling with a starkly different challenge: how to cope with a China that is poised to become the world's biggest trader. In just over a decade, Japan is selling more to China than to any other country for the first time

since 1873, there is talk of a regional currency arrangement anchored by the yuan rather than the yen, Mexican *maquiladoras* (assembly plants) are losing ground to lower-wage Chinese competitors, and China is challenging the United States as the top destination for foreign direct investment.

Export-Led Growth on Steroids

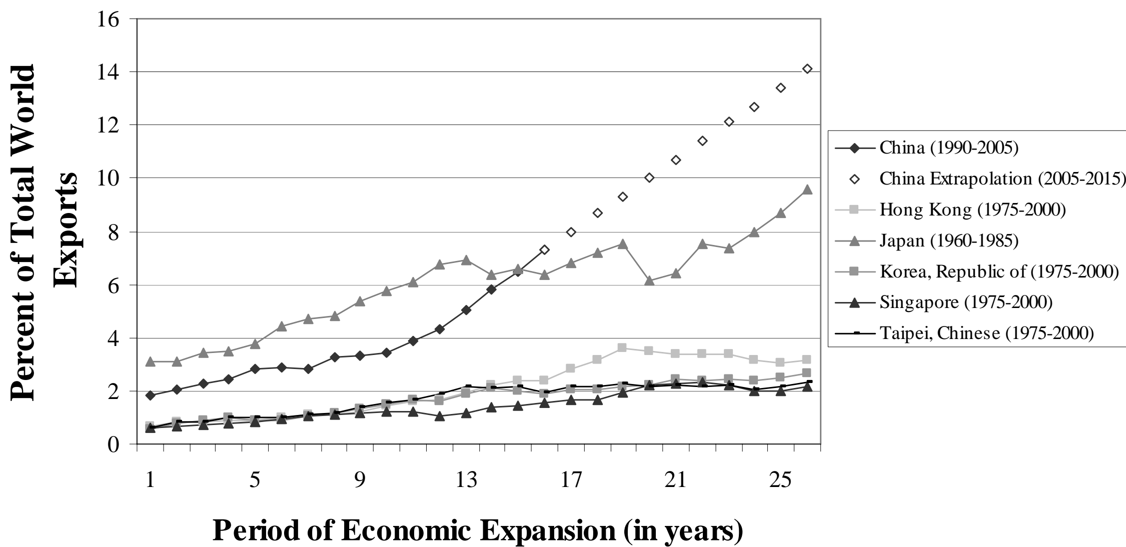
China is pursuing a classic export-led growth strategy, hinging on two features: foreign demand to fuel output growth and foreign direct investment to expand its production capacity. Because of China's massive scale, this outward-oriented growth strategy is generating tsunami-like waves affecting the farthest reaches of the global economy.

The key growth mechanisms in China are the same as those in the earlier growth of Japan and the four so-called Asian tigers (South Korea, Taiwan, Singapore, and Hong Kong): extensive investments in enclaves that manufacture export goods and massive redeployment of workers from low-productivity agriculture to higher productivity, labor-intensive manufacturing. Indeed, wages have grown unevenly and much more slowly than productivity in many areas, reflecting China's enormous surplus of labor from rural areas. With careful control of capital flows and high savings rates, foreign exchange reserves are now approaching an astonishing $1 trillion, facilitated by a current account surplus that is expected to exceed $170 billion (7 percent of GDP) this year.

In contrast to Japan, China has actively solicited foreign direct investment, eagerly absorbing the process and product know-how and managerial skills that foreign multinationals bring. As a result, fully half of China's exports are produced by non-Chinese firms and joint ventures located there; the proportion is 90 percent for exports of electronic and IT goods. It is hard to disentangle the story of China's spectacular rise from that of Wal-Mart, which—if it were a country—would be China's seventh-largest trading partner.

China's takeoff has been more rapid than those of the other East Asian economies, as a comparative look at export performance clearly shows (Figure 1). Indeed, by most accounts, China's growth performance has no precedent. China has maintained a 9.6 percent average annual growth rate for the past 26 years, lifting 250 million people out of poverty. China today ranks closer to middle-income economies than to developing economies on both education and health indicators.

Figure 1: Exports as a Share of World Trade During Takeoff



Source: Brainard and Woo, February 2007. Calculations based on IMF International Financial Statistics.

China's massive scale risks overwhelming the finer points of its development, often described in a breathless cascade of superlatives. Despite impressive achievements, Chinese authorities believe they are navigating an uncertain course fraught with risks of popular unrest, environmental degradation, stresses from rapid urban immigration. and inadequate social insurance and infrastructure.

No Economy Left Untouched

Around the world, nations are adjusting their economies in various ways to accommodate China's rise. The consequences are highly differentiated, depending on the existing mix of goods and services in a particular economy and its flexibility.

China's massive appetite for raw materials—now accounting for between a fifth and a third of global consumption of alumina, iron ore, zinc, copper, and stainless steel—has boosted commodity prices and improved export earnings for countries from Australia to Angola Nonetheless, in some of these exporting countries, the boom years are accompanied by concerns that China's resource demands and manufacturing prowess may frustrate their own attempts to diversify the composition of their exports.

In energy markets, China was responsible for one-third of incremental global demand in 2004 and is projected to account for 20 percent of incremental demand over the next quarter-century. Many credit China's voracious drive to lock up supplies of oil and gas with putting Africa back on the strategic map. While some African suppliers welcome the increased competition for their output, European and U.S. purchasers increasingly fear that Chinese investors, who are not subject to the same levels of scrutiny from shareholders and civil society, may undercut internationally agreed-upon social, environmental, and anti-corruption standards.

Another group of countries has not fared as well as African oil producers. Middle-income producers of labor-intensive consumer goods and other manufactured products, confronting a formidable lower-wage competitor, have few choices: cut costs or move up the value chain. Thus, while China's rise is creating export opportunities for resource-rich Brazil, Mexican manufacturing exports are suffering in this new head-to-head competition.

The most extensive adjustments have been in China's immediate neighborhood. The mid-1990s witnessed an active debate on whether China would follow the flying geese model of Asian exporters by orienting to the U.S. market—tucking itself between

Malaysia and Vietnam as the formation upgrades its industrial performance. Others predicted a scenario more like fighting cocks—with China vying with the region's other low-wage economies. Even after controlling for the productivity advantages of many of its neighbors, where China is narrowing the gap, China's labor costs per unit of manufacturing output (economists' favored measure of competitiveness) remain below those of Indonesia, Malaysia, the Philippines, Thailand, and Singapore.

While China's entry into world markets might have been characterized by strong regional competition in the mid 1990s, the past several years have witnessed growing regional integration. As a result, China's growth is now a boon for high-income Asian suppliers of capital and intermediate goods; China is now the first or second-largest export market for Japan, South Korea, and Singapore and runs trade deficits with those countries. Middle-income countries with diversified export sectors, such as Malaysia, Thailand, and the Philippines, also have benefited. But low-income countries such as Bangladesh, Cambodia, Sri Lanka, and Pakistan find that their exports are being displaced by Chinese-made products, without commensurate expansion of export opportunities into China.

China's spongelike absorption of foreign direct investment, especially from its neighbors like Singapore and Japan, has set off concerns about "hollowing out" and deindustrialization of these countries. Prior to 2001, many of the investment flows in the region were complementary—expanding production networks across the region, with processing and assembly operations concentrated in China. But the fall in foreign direct investment into the10-member Association of Southeast Asian Nations (ASEAN) after 2001 and the ballooning of investment into China suggest that these investment flows were more likely to be in competition with each other. This was especially so after China joined the WTO, which made its access to foreign markets more secure.

There is growing foreign apprehension about the speed with which China is moving up the value chain—using foreign investment to leapfrog to higher-value sectors. China's exports have been shifting from the labor-intensive manufacture of footwear, apparel, and lower-end consumer goods to office machinery and telecommunications

equipment. Many fear autos could be next. Stories of Chinese inducements to establish domestic R&D facilities, combined with rapid shifts in the composition of China's exports, are raising concerns that China could ultimately beat the United States and other advanced economies in their most sophisticated products.
The trade statistics are exaggerating the speed of China's march up the value-added chain because of growing fragmentation of production; countries are now increasingly specialized in making different components of a final good and correspondingly less specialized in making the entire final good. In 2005, China's exports of electrical machinery, apparatus and appliance were much lower than its imports of these goods; and China's export of scientific and control instruments, photographic goods, and clocks were much smaller than its imports of these items. While China's exports of final products are indeed moving into higher-value areas, Chinese workers are still predominantly undertaking more of the lower-value, downstream activities—with higher-value capital goods and intermediate inputs still the province of more advanced economies.

Smile Diplomacy

China's breathtaking export growth was already a dominant reality in the 1990s. The big surprise has been the deftness with which Chinese officials have handled adjustment pains in the region and the pragmatic determination of many of its closest neighbors to surf the wave rather than resist it. China itself has eased the adjustment through its "smile diplomacy," settling regional territorial disputes, abjuring the use of force in Southeast Asia, and actively promoting and supporting regional cooperation. While growing integration and reorientation toward China have been driven mainly by regional developments, America's preoccupation elsewhere and seeming disengagement have created a leadership vacuum that China has moved to fill.

American political discourse is filled with charges of unfairness and threats of sanctions, but, meanwhile, China's neighbors are pragmatically reorienting their political and economic networks to accommodate and benefit from China's rise. Within less than a decade, Asia's trade and investment relations have reoriented towards

China, weakening Japan's and the United States' gravitational pull. The emerging economic realities have been validated and reinforced by a growing network of regional political agreements and arrangements that place China at the center—ranging from the ASEAN Plus 3 (the three additional participants being China, Japan, and the Republic of Korea) agreement at the head-of-state level to a dizzying array of regional and bilateral trade and monetary arrangements.

Chinese officials also have pursued deft economic diplomacy at the multilateral level, winning over potential adversaries. Despite some starkly different interests in the WTO Doha Round negotiations, relative to developing country counterparts such as India, China has operated as a core member of the developing country caucus opposing U.S. and European positions. And, despite its conspicuously undervalued exchange rate, China has managed to deflect criticism and avoid serious interference by the International Monetary Fund (IMF).

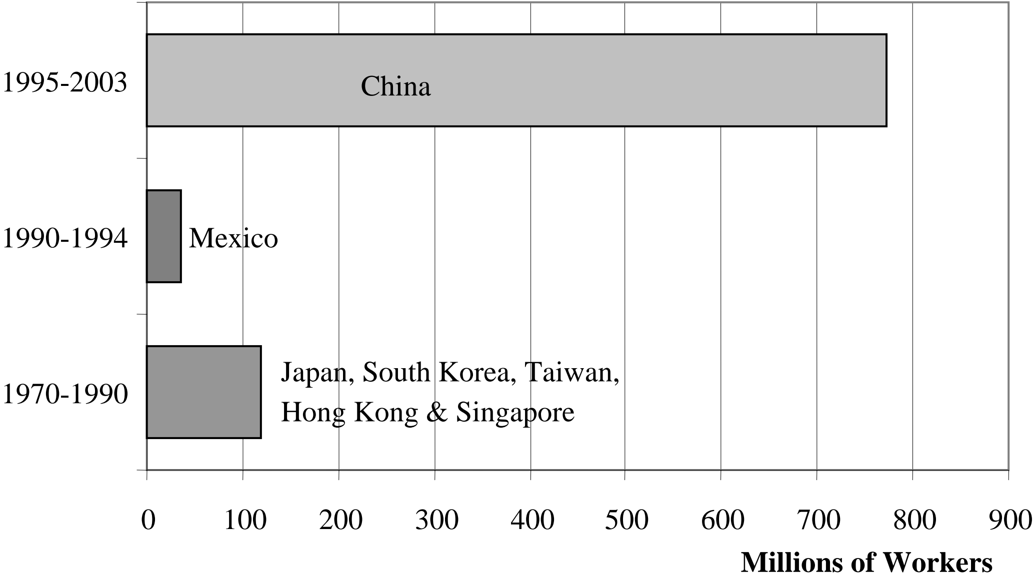
Global Workforce Expansion

In recent years, America's adjustment to China's newfound economic clout has been neither deft nor pragmatic. Feckless fulminations about China's unfair exchange rate and threats of retaliation have not been matched by an effective strategy to resolve tensions.

While U.S.-based multinationals race to establish a foothold in China's growing market, and U.S. consumers rush to stock up on merchandise bearing the "Made in China" label, American manufacturing workers, small business owners, and politicians evince palpable anxiety about this latest wave of globalization. Their concerns should be taken seriously. While fears of a permanent loss of comparative advantage across all our previous export strongholds are likely overblown, concerns about maldistribution of the benefits and pains likely are not. They may be all too real during the transition period until Chinese domestic demand rises sufficiently, exacerbated by ongoing currency misalignment.

The adjustment pains felt in the United States and other advanced economies reflect not just the integration of China into the international division of labor but also the integration of low-wage India, following quickly on the heels of the former Soviet bloc(along with technological progress that has made a variety of occupations newly vulnerable to automation and offshoring). China's decision to integrate with the global labor market expanded that market by 43 percent; adding India's workforce would mean a 70 percent expansion over a mere 10 to 15 years. Moreover, by most measures, the current episode of global labor market integration dwarfs previous expansions (Figure 2).

Figure 2: Episodes of Global Integration



Source: Brainard and Woo, February 2007. Calculations based on World Bank World Development Indicators, 2006.

With lagged adjustment of "capital," the entry of 1.2 billion lower-wage workers into the global labor force puts downward pressure on the wages of similarly skilled workers elsewhere—while increasing corporate profits and the earnings of other

complementary inputs—at least for some initial adjustment period. Casual empiricism lends support to this premise. In the last few years, corporate profits have risen to historical highs as a share of national income, while wages have fallen to historical lows. At the same time, income inequality in the U.S. workforce has increased, even controlling for education and demographic differences.

How much of this disparity is attributable to China's export growth, as opposed to the digitization of information, the decline of unions, increased immigration, and other factors? Estimates from the early 1990s suggested that less than 10 percent of the growth in income inequality between high- and low-skilled workers could be explained by increased trade. But inequality patterns appear to have changed starting in the mid 1990s. Economists David Autor, Larry Katz, and Melissa Kearney have pointed out that today it is the gap between the middle and top of the U.S. wage distribution (90-50 gap) that appears to be widening, rather than the gap between the bottom and middle (50-10 gap), which was the locus of earlier concern. They speculate that the role of trade and technology may be greater today, resulting in a squeeze in the middle. In addition, China's growth could be making itself felt indirectly. For instance, workers shed by Mexican *maquiladoras* squeezed by competition from China may well be adding to immigration pressures; and, growing competition from imports and offshoring contribute to the decline of unions.

Flouting International Rules

As a relative newcomer that has rapidly joined the ranks of the world's top traders, China presents enormous challenges when it does not play by the established rules. Despite China's robust WTO commitments on intellectual property, the Department of Homeland Security reports that nearly 70 percent of border seizures of products infringing on intellectual property rights originate in China—more than ten times the rate for any other country. The U.S. Chamber of Commerce reports that 41 percent of businesses surveyed reported increased counterfeits of their products in China in 2005. The International Intellectual Property Alliance (IIPA) estimates that pirated copies make up 90 percent of China's market for business and entertainment software, music,

and movies. In total, counterfeits account for 8 percent of China's GDP and cause as much as $455 billion in losses to the global intellectual property industry—a problem likely to worsen as growing Internet usage in China creates opportunities for online piracy.

Inadequate intellectual property protection stems in part from weaknesses in Chinese laws and regulations, but the greatest problems involve implementation and enforcement—particularly criminal enforcement. Beijing's commitment is not sufficient; it must be matched by better enforcement on the part of provincial and municipal governments and the commitment of greater police resources to the task.

Ultimately, Chinese business leaders and officials must come to view the protection of intellectual property as vital to China's own development. There are signs that such a transformation is under way at the highest levels, as evidenced by President Hu Jintao's recent statements and by growing support for national research institutes, research-oriented universities, and large national enterprises. Meanwhile, a few carefully selected and vigorously pursued enforcement actions will be needed in order to demonstrate resolve.

China is also in serious violation of WTO principles in the continuation of various types of export subsidies and import deterrents. Firms that meet specified export performance targets are eligible for income tax reductions as well as VAT rebates, exemptions from contributions to some types of worker benefits, and discounted loans from state banks and local governments. Firms that choose Chinese-made equipment over imported equipment qualify for income tax refunds and VAT rebates. The tax system also encourages the transfer of jobs to China by offering lower income tax rates to foreign-invested firms (15 to 24 percent) than to Chinese firms (33 percent).

Develop a Sustained, High-Level China Trade Strategy

The next U.S. President will need a long-term, high-level strategy for addressing trade with China. Following are five elements essential to a successful approach.

Equip Americans to Compete

Critics of U.S. trade policy are right to protest that successive rounds of trade liberalization have been pursued with much greater vigor than have been critical domestic programs to equip a larger number of Americans to benefit from trade and protect those who pay the greatest price. It is time to right the balance. The key is to strengthen our comparative advantage in high value-added, innovation-intensive industries and empower our citizenry through appropriate training and incentives to take on new high-skill jobs. The President should prioritize national investments in key areas fostering American innovation and competitiveness that have been neglected in recent years—our science and technology infrastructure and education and training programs.

Provide Social Insurance to Support Mobility

A successful new strategy also requires updating a social insurance system that has not fundamentally changed since the introduction in the 1960s of Trade Adjustment Assistance. We should provide insurance protection including for health and pensions to minimize the burden on trade-impacted workers.

Currency Adjustment is Overdue

In a few areas of intense friction, the new administration must engage Chinese political and business leaders more effectively. In the short term, the distortions associated with China's undervalued exchange rate present difficulties not only for global adjustment but also for China's own macroeconomic management. Furthermore, as long as China's exchange rate is essentially unchanged, the other East Asian economies that compete with China in third markets also will prevent their currencies from appreciating significantly against the U.S. dollar, despite their trade account surpluses. There might be considerable disagreement on how to effect such a change and on the degree of currency misalignment. But this should not obscure the strong case for a significant appreciation of the *yuan*, which should be accompanied by further currency adjustments in the region, a credible plan for fiscal improvement in the

United States, and stronger growth in Europe and Japan. To this end, the United States could use coordinated multilateral pressure through the IMF and the G7—along with bilateral engagement—far more effectively.

Enforce the Rules

The United States must continue to advance the frontiers of innovation if we are to retain a leading position in the world economy and sustain our high standard of living. For that reason, China's rampant intellectual property violations should be a concern to our next President, no less than to corporate executives. American business executives too often feel squeezed between the need to establish a foothold in China's market and the near certainty that key process or product technologies will be vulnerable to imitation or theft.

The next President must emphasize China's obligations to enforce WTO rules on protection of intellectual property and on creation of a level economic playing field. To address the immediate problem, the next administration will need to employ a multi-pronged approach, combining engagement and technical assistance with dispute resolution mechanisms to enforce rights in a handful of consequential cases. After all, securing such enforcement rights was the object of hard-fought negotiations around China's WTO agreement.

Proactively Shape the Environment in Our Favor

Advancement of these individual goals would be far more effective—and the evolution of the bilateral economic relationship far steadier—if the United States simultaneously pursued a concerted strategy of shaping international structures and arrangements to handle China's rise. Our next President needs to get us back into the coalition-building game in Asia, before arrangements that exclude the United States predominate. We should be wooing natural allies in the region whose interests parallel ours, rather than abandoning the field to China's charm offensive, as we have over the past five years. The United States has neglected the 21-nation Asia-Pacific Economic Cooperation (APEC) group's economic agenda; as a result regional policymakers have learned to

bypass the United States in favor of Asia-only forums. While we devote our energies to negotiating bilateral free trade agreements with selected members of ASEAN, we are neglecting the ASEAN Plus 3 approaches that increasingly dominate the region's economic architecture.

The fact is that the larger the economic grouping, the finer the division of labor, and the greater the economic benefits generated. This proposition is accepted by many East Asians, who for security reasons would prefer to see the United States no less active than China in promoting economic integration. The next President should therefore mount a concerted diplomatic effort to accelerate broader regional integration initiatives, such as those centered on APEC or perhaps ASEAN Plus 4, with the United States being the additional member.

The next U.S. President has a unique opportunity to shape global and multilateral structures to better reflect current realities. There is ample reason to do so, since the choices China makes today on key issues such as energy and the environment will have enormous consequences for future generations. On energy, as the world's largest oil consumer, the United States shares some interests with the second-largest consumer, China. Thus, the United States should actively seek to incorporate China into arrangements designed to manage global supply disruptions, such as the coordinated release of strategic petroleum reserves through the International Energy Agency.

Within the IMF, the United States could take a leadership role, brokering expanded "chairs and shares" for China and other Asian countries commensurate with their economic heft, in return for a more muscular surveillance capacity that might lead to meaningful currency realignment. The United States should be leading a campaign to reinvent the G8 to integrate the remaining members of the so-called BRICs economies—Brazil, Russia, India, and China—recognizing that the current membership is not adequate to address today's global imbalances or other key global challenges. We also should actively pursue a high-level multi-agency mechanism that could ensure

sustained bilateral engagement across a range of issues, rather than the episodic transactional encounters that have dominated our relations with China in recent years.

Concluding Observations

China's rise is a seismic event. The United States has an enormous stake in shaping China's evolution through bilateral, regional, and global institutions and arrangements. Those in business and government who view China's growth as a benign development have erred by advocating a hands-off approach. Now they are finding their hands tied in the face of growing backlash at home. Those convinced of the ultimate benefits of China's rapid ascent and those disturbed by its distributive consequences alike have an interest in revamping the economic structures that could shape its rise favorably.

In parallel, and working with foreign partners where possible, the new administration should deploy the tools the United States secured in the WTO and the IMF to demand action on areas of genuine economic friction, such as the undervaluation of the *yuan* and rampant intellectual property theft. China's WTO violations make up a long list and involve sectors vital to America's economic future. The United States should use the WTO adjudication process to address these issues wherever possible, so as to secure international support and to demonstrate the strength of the hard-won WTO rules.

The history of the 20th century provides ample reason to fear the rise of new economic and political powers, as well as powerful grounds for optimism. The ascendancy of Germany, Japan, and the Soviet Union at the beginning of the last century created mayhem, but the most important country to rise and prevail in the 20th century was the United States, which became the chief architect and upholder of a largely peaceful and prosperous international order. Now, confronted with the ultimate need to make room for China, the United States should take actions that will encourage China to march onto the world stage responsibly, just as the United States did a century ago.

About the Authors and the Project

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Opportunity 08 aims to help 2008 presidential candidates and the public focus on critical issues facing the nation, presenting policy ideas on a wide array of domestic and foreign policy questions. The project is committed to providing both policy solutions and comprehensive background material on issues of concern to voters.

Additional Resources

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