5 NAVIGATING CHINA'S RISE

By Wing Thye Woo

China is growing rapidly through its outward orientation and engagement with the world economy. Its growth has provoked anxiety in the United States and concerns about its perceived unfair trade practices. The next U.S. president should enact policies that reduce the sources of anxiety, address trade practices, strengthen U.S. competitiveness, and develop a sustained strategy for working with China on international economic issues.

THE GLOBAL CONTEXT

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

China's key growth mechanisms have been extensive investments in export-oriented enclaves and a massive redeployment of workers from low-productivity agriculture to higher-productivity, labor-intensive manufacturing. About half the country's exports are produced by non-Chinese firms and joint ventures located in these enclaves; and wages have grown unevenly and much more slowly than productivity in many areas, reflecting China's enormous amount of surplus labor from rural areas.

As China's economy has grown, so has its engagement with and integration into the Asia-Pacific region through its "smile diplomacy"—it has settled regional territorial disputes, abjured the use of force in Southeast Asia, and actively promoted and supported regional cooperation. A growing network of regional political agreements and arrangements place China at the center—ranging from the ASEAN + 3 agreement at the head-of-state level (the three additional participants being China, Japan, and South Korea) to a dizzying array of regional and bilateral trade and monetary arrangements.

On the international scene, Chinese officials have pursued deft economic diplomacy, winning over potential adversaries. Despite some stark differences in the Doha Round negotiations for the World Trade Organization relative to developing countries like India, China has worked with other rising powers to shape these negotiations' agenda. Though the chronically large balance-of-payments surpluses of China indicate an undervalued exchange rate, it has managed to deflect serious interference by the International Monetary Fund.

However, in light of the experience of dealing with Japan's trade surpluses in the 1980s, it must be recognized that the adjustment of the bilateral U.S.-China exchange rate alone is not a silver bullet that would eliminate U.S. external imbalances. A huge appreciation of the renminbi—unaccompanied by a large, generalized appreciation of other Asian currencies—would significantly reduce only the bilateral U.S.-China trade imbalance but not the U.S. overall trade deficit because imports from third countries would replace imports from China. A drastic decline in the U.S. overall trade deficit would require policy actions on a broad front in both China and the U.S.—for example, budget deficit reduction in the U.S. and financial sector restructuring in China.

China's sustained rapid growth, along with that of India, has contributed to a big jump in commodity prices. The higher costs of inputs have two negative effects: reducing profits and hence lowering the supply of the final goods; and causing the prices of final goods to rise, thus preventing profits from absorbing the entire cost increase. This stagflationary (inflation-amid-contraction) situation has confronted the central banks in Europe and the U.S. with the difficult choice of contracting credit to blunt higher inflation or of expanding credit to offset reduced production. This dilemma is now complicating efforts to meet the new challenge of creating additional liquidity to calm the financial turmoil that started with the bursting of the U.S. subprime mortgage bubble in February 2007.

Inevitably, weakened demand in the U.S. and Europe is being transmitted to suppliers in Asia and elsewhere, in turn slowing down their growth, and hence moderating the commodity price boom. The lesson is that economic globalization has created such complex interdependence and new powerful actors that the guardianship of global prosperity has become a multilateral enterprise, in which widening cooperation (for example, in trade deregulation, financial flows and environmental commons) is paramount for avoiding unintended negative side effects.

THE CHALLENGE

China's growth has been accompanied by growing anxiety in the United States. While U.S.-based multinationals rush to establish a foothold in China's growing market and U.S. consumers stock up on "made in China" merchandise, American manufacturing workers, small business owners and politicians have become anxious about this latest wave of globalization. Though fears of a permanent loss of U.S. comparative advantage are overblown, concerns about an unequal distribution of the benefits and pains are not.

The adjustment pains reflect not only the integration of China but also that of India. Together, these two huge nations are adding 1.2 billion lower-wage workers to the global economy. With lagged adjustment of "capital," this puts downward pressure on the wages of similarly skilled workers elsewhere—while increasing corporate profits and the earnings of other complementary inputs.

At the same time, the large U.S. trade deficit and China's rapid rise have sparked accusations that China's economic strategy is unfair. The U.S. goal in promoting China's accession to the WTO in 2001 was to bind China to increasing responsibility in the international arena. Yet China has often failed to live up to its WTO commitments and rules on intellectual property, export subsidies and import deterrents. The U.S. Department of Homeland Security reports that nearly 70 percent of products seized for infringing on intellectual property rights originate in China. Chinese firms that meet specified export performance targets are eligible for tax rebates. And firms that choose Chinese-made equipment over imported equipment also qualify for tax rebates.

China's growing influence in the Asia-Pacific region has been matched by America's neglect of its important regional allies. The U.S. has neglected the 21-nation Asia-Pacific Economic Cooperation forum's economic agenda; as a result, regional policymakers have learned to bypass the United States in favor of Asia-only forums. And while the U.S. has devoted its energies to negotiating bilateral free trade agreements with selected East Asian countries, it has neglected the ASEAN + 3 approach that increasingly dominates the region's economic architecture.

China has now overtaken the U.S. as the biggest emitter of carbon dioxide in the world. And China's greenhouse gas emissions will continue to grow faster than U.S. emissions because of China's continuing industrialization and growing use of coal as a fuel. Any international agreement on controlling emissions would fail without the full participation of China and India. Because China is responsible for only a tiny part of the stock of atmospheric carbon dioxide, and its per capita emissions are only a quarter of America's, the notion of "common but differentiated responsibility" has to be the guiding principle in the U.S. bargaining stance in global negotiations on climate change.

AMERICA'S OPPORTUNITY

The next U.S. president will have the opportunity to:

> **Enact policies that address domestic anxiety about how American workers will fare in an increasingly globalized economy.** The president should prioritize national investments in key areas that foster American innovation and competitiveness that have been neglected

in recent years—science and technology infrastructure, and education and training programs. The president should update the social insurance system to reduce the pain of increased worker dislocation. The U.S. should provide protections for health insurance and pensions, improve the unemployment insurance system and implement a wage insurance program to minimize the burden on workers facing job transitions.

> **End the chronic external imbalances of the U.S. and China.** Because there would be considerable disagreement on how to encourage a change in China's policy of undervalued currency and on the degree of misalignment, the U.S. should use coordinated multilateral pressure through the International Monetary Fund and the Group of Seven—along with bilateral engagement—far more effectively. The U.S. should also engage on a technical level with China to support efforts to accelerate the development of nonstate financial institutions to fully intermediate savings into domestic investments, and to reduce the excessively high savings rate—both of which would reduce China's external surplus. Because trade imbalances reflect economic conditions in both countries, it is fundamental to recognize that improving the competitiveness of the U.S. economy and putting the U.S. fiscal house in order are fundamental to restoring U.S. growth and its trade balance. Mutual recriminations (China bashing) and the obsession with a single silver bullet (exchange rate adjustment) would only accentuate the tensions over trade imbalances. Instead, the optimum solution will be based on mutual actions on multiple fronts.

> **Emphasize China's obligations to enforce WTO rules on the protection of intellectual property and on the creation of a level economic playing field.** The next administration will need to employ a multipronged approach, combining engagement and technical assistance with the use of dispute resolution mechanisms to enforce rights in a handful of consequential cases.

> **Pursue a concerted strategy of shaping international structures and arrangements to handle China's rise.** The U.S. should woo its natural allies in the Asia-Pacific region with parallel interests, rather than abandoning the field to China's smile diplomacy, as in the past five years. The next president should mount a concerted diplomatic effort to accelerate and deepen involvement in broader regional integration initiatives, such as those centered on the Asia-Pacific Economic Cooperation forum and ASEAN + 3.

> **Take a leadership role—given U.S. membership in the International Monetary Fund—in brokering expanded IMF "chairs and shares" for China and other countries commensurate with their economic heft in return for a more muscular surveillance capacity that might lead to meaningful currency realignment.** The U.S. should also actively sustain a high-level multiagency mechanism as a vehicle for bilateral engagement across a range of issues.

> **Understand that one key to avoiding a clash with China over how to prevent an environmental Armageddon is to devise win-win technological solutions to the challenge of climate change.** The U.S. should take the lead in establishing an international clean energy research consortium to create synergy among the national efforts to accelerate the emergence of renewable energy and clean coal technology. This consortium would coordinate and fund experiments on new clean energy technologies in China because China, on its own, would have little incentive to develop these new technologies, which can be easily appropriated by other countries. Because China is building one power plant each week to sustain its high rate of economic growth, it is the ideal location for these experiments on how to harness alternative fuels, burn coal cleanly, and scale up prototype green power plants.

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