DOLLAR & SENSE: THE BROOKINGS TRADE PODCAST

THE STATE OF CHINA'S ECONOMY AND US-CHINA RELATIONS

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DOLLAR: Hi, I'm David Dollar, host of the Brookings trade podcast. We're coming up on our third anniversary of the show, and I'm very fortunate to have with me Eswar Prasad, who was my first guest three years ago. Eswar is an economics professor at Cornell and a senior fellow at Brookings and a leading expert on the Chinese economy.

But first Brookings Podcast Network is launching a new show called "17 Rooms" about actions for the U.N. Sustainable Development Goals. So here's a brief introduction.

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JOHN MCARTHUR: Hi, I'm John McArthur with the Center for Sustainable Development at Brookings.

ZIA KHAN: And I'm Zia Khan with The Rockefeller Foundation. We're the co-hosts of "17 Rooms," a podcast about actions, insights, and community for the Sustainable Development Goals and the people driving them.

MCARTHUR: "17 Rooms" is a new way of getting people together to take action on the 17 Sustainable Development Goals. In this podcast, you'll hear our conversations with dynamic leaders shaping actions towards the Goals.

KHAN: "17 Rooms" is produced by The Brookings Podcast Network. You can download and listen to it on Apple, Spotify, or wherever you like to get your podcasts.

DOLLAR: Learn more at brookings.edu/17RoomsPodcast.

So, Eswar, welcome back to the show, great to have you.

PRASAD: David, it's a real privilege to be back on your podcast. I know it's gone from strength to strength, and it's been wonderful to be associated with each of the anniversary editions of your podcast. I really appreciate it, and I'm delighted to be with you on this show.

DOLLAR: One of Eswar's projects is a tracking system taking high frequency data and looking at the movement of important economies. And your latest TIGER projections show very sharp slowdown in both the U.S. and China. So let's take the China part of that. Why is the Chinese economy slowing down so dramatically?

PRASAD: So, it's a combination of factors, David. First of all, China is taking a very aggressive approach to its control of the pandemic with a zero COVID strategy. But more importantly, China seems very focused on its longer-term objectives of trying to maintain financial stability, reduce speculation in the property sector, and also to mitigate the environment environmental impacts of its growth model. So in trying to meet these longer-term objectives, China seems to be willing to trade off some short-term growth. So while the economy has been losing some momentum after a very sharp snapback after the very difficult initial period of the COVID pandemic, the government does seem to be willing to let growth slow in order to facilitate these medium-term objectives.

DOLLAR: So, as you say, the one of the visible signs of what's happening is the slowdown in the real estate sector, and some of that is in some sense generated by policy by tightening up the financial regulations. And it's definitely generated some anxiety with the big real estate developer Evergrande missing some international bond payments. Other real estate developers having trouble servicing their debts. So what is the risk of a real financial crisis in China? People talk about perhaps this is China's Lehman moment. How serious is this risk?

PRASAD: So, the real estate sector, as you know very well, David, is a very important part of the Chinese economy, and investment in the real estate sector in particular has been a key contributor to China's growth over the last couple of decades. So, losing that lack of growth certainly does matter to the Chinese economy, and a lot of Chinese household wealth is locked up in the real estate sector. So, that's an additional source of concern.

Now, my sense is that what the Chinese government is trying to do in terms of letting some air out of the speculative bubble that has built up in property markets may ultimately be good for those markets in the long term.

Now, there are some developers, Evergrande in particular, but a few of those as well, that have expanded very aggressively in real estate markets around the country, and they have done this on the back of borrowing from many Chinese banks. So there are a few Chinese developers and a few Chinese banks that are quite exposed to any slowdown in property prices now.

Will what is happening with Evergrande potentially spillover into the broader financial sector? Perhaps it could cause panic among investors who see further defaults coming. My sense is that it's unlikely to be the case. There seems to be, again, a longer-term play going on here. The Chinese government has thought about introducing more discipline to financial markets. And the notion of market discipline here is that investors should be careful about investing in property developers or lending to property developers or investing in companies that may not have sound finances, rather than expecting that the government will bail out any property developer, any financial institution, or indeed any corporation that gets into financial trouble.

So there is this delicate dance going on where the government wants to convince markets that it is serious about this notion of market discipline. But at the same time, is a little concerned about the spillover effects. And what we've seen from the Chinese government is not a desire to step in and prevent a default by this large property developer Evergrande, but to make sure that homeowners who may have given deposits to Evergrande already are protected and that households in general are protected from the financial spillover effects of a potential Evergrande default. But I think the broader financial risks can be managed, and I don't think this is going to be necessarily China's Lehman moment.

DOLLAR: Eswar, you've written extensively about China's aspirations to have its currency, the yuan or the renminbi, become a major international reserve currency. So do these financial troubles and the measures they have to take to respond to that, do they set back to added bad agenda?

PRASAD: In the short run, certainly, they create some concerns among foreign investors who are quite critical to the increasing openness of Chinese financial markets and trying to get the renminbi to play a larger role in international finance. But again, there could be a potentially positive element to this if, in fact, Chinese financial markets become more subject to market discipline. If we end up with more stable financial markets and better regulated financial markets, that may actually help in drawing more capital into China and potentially also setting the base for the Chinese currency to be used more widely across the world in terms of international payments and perhaps even as a reserve currency.

My sense is that there are some changes on the ground that might increase the role of the renminbi as an international payment currency, including perhaps the digital version of the yuan that the Chinese central bank is now experimenting with. But I don't think it will fundamentally alter the dynamics among the major reserve currencies because after all, what matters for a reserve currency is not just the size of the economy that issues that currency or that economy's financial depth, but also the strength of that country's institutions—including an independent and largely autonomous central bank—the rule of law, and an institutionalized system of checks and balances. And while China is undertaking some financial market reforms, it doesn't seem very keen on moving forward towards those sorts of institutional reforms.

So I don't think the renminbi, even if it becomes a more important payment currency, which could well happen over the next few years if China plays its cards right, I don't think it's going to alter the dynamics among the reserve currencies in terms of the renminbi's international status.

DOLLAR: All around the world, there's some unusual features to this recovery that we're going through. It seems to me in many cases, you've got some sectors that are really lagging, often for obvious reasons. Other sectors are booming. We've got shortages in some markets. In the case of China, we also see this. You've got the problems of real estate that you and I just discussed, and overall slowdown. But it's interesting that their trade is booming. Their exports and their imports, both, are really booming this year. This is true for China's overall trade. It's also true for its trade with the U.S. This will hit a new historic high this year. And I'm a little bit surprised since President Biden left those 25 percent tariffs in place on about half of what we import from China, I'm surprised that this volume of trade between the U.S. and China just keeps going up. So do you have a reaction to that?

PRASAD: I think it is quite surprising given what we see in terms of the relatively weak recoveries, if not stalling recoveries, around the world. One of the interesting aspects of the recovery in the major economies, and this is true of both China and the U.S., is that consumer demand has remained very strong, even though investment has shown certain patches of weakness. That is to say, physical investment by businesses.

So consumer spending certainly helps China because China runs a pretty big surplus on its merchandise trade deficit, that is, its trade in goods. While China typically runs a deficit on its services account. And, of course, tourism, expenditures by Chinese students coming to universities such as mine, those have certainly fallen off a little bit.

But even on the merchandise trade we're seeing Chinese exports remaining very strong, and I think that speaks to the strength of consumption demand in the U.S. and elsewhere. And certainly, China is very well positioned to take advantage of that consumer demand given the structure of its exports, which are largely manufactured goods.

And it's interesting, of course, that despite some attempts to try to get the two sides talking at the highest levels, as indicated by the latest summit between President Biden and Xi Jinping, it appears that the tariffs that remain on Chinese imports into the U.S. have not significantly affected or dampened the demand for Chinese imports, which is still being propelled by consumption demand.

DOLLAR: You mentioned the virtual summit between President Biden and President Xi Jinping. Both sides had been at pretty great lengths to tamp down expectations about concrete measures, particularly on the economic side. So there weren't any concrete agreements in terms of economic policy. But overall, the meeting seemed to be a frank and somewhat more, friendly may not be the right word, but polite, frank exchange between these two powers. Did the summit leave you with any expectation that we might see some improved relations between China and the U.S. in the economic realm or in other realms?

PRASAD: So you, David, have of course been at the table at such high profile meetings. I'd be quite interested in hearing your take as well. But my sense is that both sides have fairly clearly drawn their battle lines. We haven't seen a de-escalation of any of the hostilities, including the tariffs that were already put in place. But I think this does cool down the temperature between the two sides a little bit and sets the basis for technical negotiations on some issues where I think there is a huge gulf between the two sides, a large number of economic issues, as well as geopolitical issues. These goals may ultimately prove unbridgeable, but I think what is important is to make sure that the two sides maintain a dialogue so that there are no unfortunate accidents where one side misinterpret the other side's actions and very quickly you have an escalation of hostilities. It seems clear to me that both sides want to avoid that outcome.

I don't see a softening of positions on either side, though, when it comes to either trade or other economic issues, such as the protection of intellectual property rights, where the U.S. feels that China isn't doing as much as it ought to. And on the other side, on the geopolitical side, clearly China is indicating the importance of issues such as Taiwan, where it wants to minimize what it sees as interference by the U.S.

So essentially, the two sides are staking out very clear positions and drawing the lines that they don't want the other to cross. So I'm hopeful that at least this means that tensions will not escalate any further. But I don't see any clear path in the short term for those tensions being tamped down to a significant extent.

DOLLAR: Yeah, so I basically agree with that assessment, Eswar. I think the two sides were getting a little bit alarmed in the lead up to the summit. But the specific preparation, but this kind of drumbeat of potential war over Taiwan. I think that was becoming quite worrisome on both sides of the Pacific. So the meeting was successful enough to stabilize the expectation that both sides can live with the status quo in the Taiwan Strait for the moment. And so I think that's quite important just to take away the potential for some kind of mistake or misunderstanding.

It strikes me that on both sides, and I'm sitting on the U.S. side, so I think I'm more familiar with what's happening here is, domestic politics really constrain a lot of areas in which this relationship can be improved. So I think following the summit, we might see some somewhat small areas of progress where there was an agreement on visas for journalists, for example. That's actually quite important for the journalists and the media. Maybe we'll get to reopening the two consulates that were closed. Hopefully we can keep up the university exchanges, various things. So there could be fairly significant small progress in a number of areas. But as far as something large, like removing the tariffs in exchange for Chinese trade reforms, I just think the domestic politics in the U.S. are really not going to allow this to happen.

PRASAD: You're absolutely right, David. I think the domestic politics is a constraint on both countries. And maybe in that sense this meeting does portend some easing of those constraints on both sides because what both leaders did was to stand up to each other, so to speak, and made their positions very clear to each other. And having done that in this setting I think gives each of them a little bit of room to maneuver domestically. But as you correctly point out, is going to lead to any fundamental de-escalation of things already in place. But it does provide at least a basis for some marginal improvements that could set the stage for perhaps some more de-escalation in the future.

DOLLAR: Common storyline in D.C., Eswar, is that China is turning inward in various ways. And it strikes me that this is belied by the fact that China is out there actively negotiating new trade agreements. It's part of the Regional Comprehensive Economic Partnership that will begin implementation, I believe, in January. And it's surprised a lot of us by applying to join the Trans-Pacific Partnership, which is pretty high standard trade agreement. So you have a view on this? Are they turning inward or are they not turning inward? Is this a serious application to the TPP? Is that likely to be achieved?

PRASAD: So I think China does want to have it both ways. And you've written about things like the dual circulation strategy, David, where what China's trying to do is maintain its integration into the global trading system, while at the same time trying to become less dependent on the external sector for its growth and in particular to become less dependent on foreign innovation and instead try to encourage domestic innovation.

I think in terms of its position on the world stage, China is trying to do something similar. It wants to become self-reliant, self-sufficient in many ways. But at the same time, it wants to make sure that it is seen as the adult in the room, and certainly under the previous administration in the U.S., there was a void that China was trying to fill by arguing that it was going to uphold the multilateral trading system and other multilateral institutions that had come up in the post-Bretton Woods era.

So, I think China does want to make sure that it is at the table anytime a major trade agreement is negotiated, or any sort of major international agreements are negotiated because it wants to have its say. But at the same time, it does try to work through bilateral agreements where essentially it can prod other countries, which might be economically and politically weaker than itself in trying to fashion agreements that are more to its liking.

And of course, under the Biden administration, China might be getting the sense that the U.S. could potentially start rebuilding its relationships in the Asian region and elsewhere. And this might cause China, perhaps realistically or not, to view itself as being encircled by U.S. allies.

So I think China is strategically positioning itself as a counterweight to the U.S., I mean it has been doing this for a while, of course, in the Asian region and beyond, and making sure that it can stay as involved as it can in regional agreements in Asia and beyond so that it gets to stay involved in writing the rules of the game rather than ceding that ground to the U.S.

DOLLAR: That observation naturally leads to my last question, Eswar. Part of the Biden administration's strategy is to build a coalition of democracies to confront China on different issues, including trade and investment. And after about a year now of this administration, I'm wondering what's your assessment of how this is working out, particularly how this is playing with our different democratic allies in the Asia-Pacific and globally?

PRASAD: Again, as you know well, David, it's a very difficult position that many of China's neighbors, as well as many of China's trading partners around the world, are in. Over the last administration, it became clear that many long-standing relationships that the U.S.

had with its traditional allies could not be counted upon anymore. And the world, of course, recognizes that the political environment in the U.S. is quite volatile, so they cannot really count on any promises that the Biden administration makes to other countries to protect their backs as being viable long term promises that will be sustained by future U.S. administrations. At the same time, I get the sense that many countries, particularly in the Asian region, are a little concerned about getting too close to China's embrace in terms of either the economic or the geopolitical dimensions.

So certainly there is an openness to the U.S. again trying to expand its influence in Asia and beyond as a counterweight to China. But I don't think that's being necessarily embraced with open arms by even traditional U.S. allies who have become a lot warier about the twists and turns in domestic U.S. politics that might in turn affect U.S. relationships with its allies. So I think if the U.S. was really serious about rebuilding its alliances with both its traditional allies and with its democratic partners around the world, it's going to be a long and difficult slog. And certainly the fact that domestic political constraints prevent the U.S. from reengaging with the Trans-Pacific Partnership, which has gone on without the U.S. and, as you recently pointed out, China is now trying to participate as well. Those dynamics, I think, suggest again that the world is trying to move on from the reliance on the U.S. to provide leadership in those areas, and that's not a great position for the U.S. to be in.

DOLLAR: And I think we have to recognize that these different partners we're talking about, their situations are quite different. They have different interests. South Korea: very deeply integrated with China economically, and they can't get a resolution of their tension with North Korea without Chinese cooperation, in some sense. And then you've got other countries that are in quite different situations. India is not strictly speaking an ally of the United States, but it seems to be moving into a closer strategic partnership with the United States. You have a sense of how all this plays in India?

PRASAD: Certainly any approaches by the Biden administration or indeed any U.S. administration to forge a closer relationship with India is going to be welcomed by India, which sees itself having an increasingly aggressive neighbor on its borders, and is very concerned about China increasing its influence in the Asian region and even around the Indian subcontinent. So any attempts by the U.S. to strengthen its relationship with India will, of course, be received favorably. But I think India again recognizes that the U.S. may not be an entirely trustworthy partner when crunch time comes because it has interests of its own that may not be fully aligned with India's interests.

And there are certain areas, including climate change, where the two sides seem to have similar objectives, but not a strategy that goes in parallel in terms of how to achieve that objective.

But certainly on geopolitical geostrategic issues and possibly even economic ones, there is a possibility for a stronger relationship. But that would require unwinding some of the tensions, especially on the economic front that arose between the two countries, with the U.S. taking some aggressive trade sanction measures against India that have not been rolled back yet and the U.S. having some concerns about India's commercial and trading practices. So there is some room for optimism that this bilateral relationship can be strengthened. And of course, in the shadow of China, that hope becomes somewhat stronger.

DOLLAR: I'm David Dollar, and I've been talking to Eswar Prasad about the Chinese economy and U.S.-China relations. Eswar was my first guest three years ago and a lot of unusual things have happened in the world over this three-year period. So it's great to come back and touch base with you, Eswar, and update what's happening with China and with China-U.S. So thank you very much.

PRASAD: It has indeed been quite a journey since your broadcast started, David, but I'm very glad we have your podcast to keep us well-informed and on the straight and narrow, so it's really been a privilege and pleasure. Thank you.

DOLLAR: Thank you all for listening. We'll be releasing new episodes of Dollar and Sense every other week, so if you haven't already, follow us wherever you get your podcasts and stay tuned. Dollar and Sense is part of the Brookings Podcast Network. It's made possible by support from producer Fred Dews, our audio engineer Gaston Reboredo, and other Brookings colleagues. If you have questions about the show or episode suggestions, you can email us at podcasts@brookings.edu, and follow us on Twitter @policypodcasts.

Until next time, I'm David Dollar and this has been Dollar and Sense.