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CHINA-IMPLICATIONS FOR THE WORLD ECONOMY

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There is little doubt that China's rise as a great economic power has become one of the dominant issues of our time. China has enjoyed nearly two decades of 8-9% GDP growth. The nominal value of the Chinese economy is about $1.6 trillion, ranking sixth globally, but adjusted for purchasing power differences, China today is the second-largest economy in the world.

The rising power and influence of the Chinese economy is demonstrated by the fact that China is now a larger consumer of more industrial raw materials than the United States. Although this has been seen as a cause of alarm in some US policy circles, it should be noted that at least half of China's commodity imports are used to manufacture goods which are then exported to other countries, according to economist Stephen Roach. China has growing trade deficits with other Asian countries, and there has been little discussion of the implications of China's commodity usage for resource-poor Japan, still Asia's largest economy and the second largest economy in the world. In general, key regional trends have been overshadowed by the debate over US-China geopolitics.

The current relationship is one of growing mutual interdependency, in which China plays the role of manufacturer and saver and the United States is services provider and consumer. Until recently, China's ability to provide the US with low-cost manufactured goods has softened the blow of oil price hikes for middle class US consumers, creating a benign environment for growth in both countries. Due to recent dramatic increases in the price of fuel, this might be changing soon.

Fuel prices have created new risks in the outlook for the US and the Chinese economies. Hurricane Katrina has shut down a large amount of US refinery production and prices can be expected to continue to rise throughout the winter. If the price of oil stabilizes at $70-80 per barrel, compared to $50 a few months ago, it could reduce China's growth rate by nearly 1% next year. The prospect of rising oil prices depressing the US economy at the same time will dampen the global growth outlook next year by .5-1% at a minimum.

It is important to examine a potentially more negative scenario for world economic growth, which would include a slowdown in US consumer spending which would negatively impact China's economy--a double whammy which could lead to a global recession. We do not believe that this is the most probable outcome because of pent-up demand for consumer products in China. China's consumers are now responsible for 16% of world GDP growth. However, if the Chinese government can no longer insulate state-owned enterprises from rising fuel and commodity prices (and there are signs that this is happening), increased unemployment and a slowdown in consumer spending could be the result.

Politically, China is relatively secure and the Communist Party is firmly in charge. It is true that protests and uprisings are increasing, and in spite of agrarian reforms farmers have been mistreated by local party officials on the payroll of real estate developers. However, we do not see a near-term case for the demise of the current Chinese government, nor its transformation to a democracy. China has managed a balancing act, providing economic goods while remaining an authoritarian, one-party regime. If China however experiences economic failure, its contract with its citizens would be broken.

HISTORICAL BACKGROUND

While many regard China's recent economic takeoff as a unique historical event, it should actually be regarded as the reemergence of China as a great power. The fact is China was the world's leading economy for many centuries before the British industrial revolution of the late 18th century. Professor Angus Maddison estimates that China accounted for a third of global output in the mid-18th century. As Jared Diamond notes: "Until 1450, China was technologically much more innovative and advanced than Europe. Chinese inventions before or during this period included the wheelbarrow, gunpowder, matches, cast iron, porcelain, magnetic compasses, sternpost rudders, paper, printing, paper money and a meritoric civil service."

The decline in the economic importance of China resulted from several factors, many of which are well-known. Britain launched the Industrial Revolution during the 18th century which vastly reduced the cost of producing many consumer goods. Britain and other European countries also dispatched seafaring adventurers to the far corners of the world to establish settlements and carve out colonies. The growth of trade promoted the expansion of the British Empire. China had dispatched vast fleets to Africa and Asia during the 15th century and maintained a robust trade in largely luxury goods with her Asian neighbors. The European powers then penetrated China during the 19th century while colonizing India. Following a period of countercyclical prosperity in the early 1930's (when China experienced 10% annual GDP growth) subsequent mid-20th century events, including the Japanese invasion and the Cultural Revolution brought a catastrophic decline. Between 1953 and 1977, China's share of global trade fell further, from 1.5% to 0.6%.

Although a major turnaround has been achieved, China's current economic success is not unprecedented. There were several countries in Asia and Europe which also enjoyed high rates of growth during their periods of economic takeoff in the decades after World War II. Japan's economy grew at an annual rate of 8.8% during the 1950s and 10.5% during the 1960s. West Germany's economy expanded at an annual rate of 8.2% during the 1950s. South Korea's economy grew at annual rates of 8.7%, 9.6% and 9.1% during the 1960s, 1970s and 1980s. Taiwan enjoyed growth rates of 8.5%, 10.0%, and 9.2% during the 1950s, 1960s, and 1970s. Singapore's growth rate was 9.2% during the 1950s and 9.0% during the 1960s. Israel grew at an annual rate of 10.7% during the 1950s while Iran achieved a growth rate of 10.0% during the 1960s. Brazil had a growth rate of 8.1% during the 1970s. Vietnam has enjoyed a growth rate of 7.6% since the early 1990s.

China's growth is different in sheer magnitude and scale, and base-line economic conditions. China has over 1.3 billion people compared to 4 million for Singapore, 22 million for Taiwan, and 120 million for Japan. China began its era of strong economic growth after 30 years of communism, as well as a decade of chaos during the Cultural Revolution (1966-1978). Other high-growth countries suffered massive damage due to war, but they possessed the basic framework of a market economy and the principle of private ownership of property. China is still in the process of establishing market institutions and the rule of law.

A comparison between the Indian and Chinese economies is quite instructive. In the 1950s, India's per capita income was 40% higher than China's. It remained above China's until the late 1970s, when China's per capita income exceeded India's for the first time in the 20th century. After 25 years of economic reform, China's per capita income is now more than double India's. The difference has been China's willingness, in an age of global trade, to open its doors to foreign investment.

There are several factors which explain China's economic success since the 1970s:

1) Agrarian Reforms. After the end of the Cultural Revolution, Deng Xiaoping introduced incentives to maximize agricultural output in the late 1970s. These incentives produced a large increase in the incomes of farmers and thus created a greater market for a wide range of consumer goods. China's farm output grew by 21% during 1979 alone, 12.1% during 1980, 11.5% during 1981, and 11.7% during 1982. It then averaged a growth rate of 8.1% for another six years. China's per capita food availability in the countryside rose from 1700 kcal/day in 1960 to 2570 kcal/day in 1995, well above the WHO's minimum standard of 2100 kcal/day.

2) Commitment to Open Markets. China has pursued a policy of market opening and integration with the global economy which is far more aggressive than those undertaken by Japan and Korea during the initial years of their economic takeoff. China's export share of GDP is about 36% compared to only 10% for Japan during the 1950s and 1960s. China has attracted over $600 billion of foreign direct investment or the third-largest stock in the world after the U.S. ($1.7 trillion) and Britain ($650 billion). During the first four decades after World War II, Japan and Korea discouraged FDI in order to protect local companies from foreign competition. On the eve of the East Asian financial crisis in 1997, there was only $17 billion of FDI in Japan and $12 billion in Korea. This policy helped nurture highly successful global companies in Japan but it produced great trade tensions with the U.S. and other countries. It would not be an exaggeration to say that China now has an economy far more dependant upon foreign trade than the US, Europe, and Japan. Her export share of GDP is three times larger than the other great economic powers. China therefore has a greater stake in an open global economy and the Doha trade round than any other industrial country. Despite this, we see a lack of confidence in the WTO and an increased Chinese focus on regional and bilateral trade agreements in the future. (See later section on China's export-led development model.)

3) Consumer Savings and Domestic Consumption. China has the highest savings rate in the world. It is ironic that in the largest communist country in the world, citizens can no longer expect to benefit from a social safety net. Previous entitlements, such as healthcare, education, and retirement have more or less disappeared and have incentivized the Chinese to save, rather than spend. As a result, China has been able to finance an investment share of GDP which approached 47% last year while still running a current account surplus. The resulting lack of dependence on foreign capital, coupled with limited currency convertibility, has enabled China thus far to avoid the dangerous scenario of the great East Asian financial crisis of 1997-1998.

At the same time, wages and have been rising and consumer spending has been steadily increasing. This is due not just to the purchase of goods but also to housing privatization. In the 1970s, the major goal of Chinese consumers was to purchase a bicycle, a wristwatch, and a sewing machine. In the 1980s, it was to purchase a washing machine, a refrigerator, and a color television. In the 1990s, it was to purchase a cellular telephone (there are 368 million) and a computer (one third of all urban households have one). Today it is to buy an automobile. Sales are currently running at 2 million per annum and could rise to 7 million within a decade.

4) Massive Infrastructure Development. As anyone who has visited China can attest, China has invested massively in infrastructure development. China has established a solid infrastructure which promotes industrial development. As of July, 2005 China had 368 million cell phone users and 33 million broadband subscribers, signaling huge growth in telecommunications. China has 30,000 kilometers of expressways, 10 times as much as India. China suffered power shortages last year but is now investing billions of dollars in new power-generating facilities,

including nuclear power stations and wind power. The Financial Times recently reported that China could have a power surplus by 2008.

Comparisons with India are again instructive in terms of China's "soft" infrastructure including health care and education. China's adult literacy rate is 90.9% compared to 61% for India. The literacy rate of Chinese women is 86.5% compared to 46.4% in India. China's life expectancy is 70.9 years compared to 63.7 years for India. China suffers 39 infant deaths per 1,000 births compared to 93 for India. However, the weakness of China's health care system remains a potential flash point. China is the world's largest consumer of tobacco, with all of the future health care costs that represents, and southern China is the breeding ground for some of the world's deadliest viruses.

5) Contribution of Overseas Chinese. While mainland China's economy was isolated from world trade flows until the mid-seventies, the overseas Chinese economies of Hong Kong and Taiwan grew quickly over the post-war period and now account for at least $200B of China's stock of foreign capital. The beneficial consequences of China's overseas network have not just been limited to capital infusion. The human capital and expertise provided by Hong Kong and Taiwan have undoubtedly helped China leapfrog transition to a market economy. Shanghai today owes at least some of her economic vibrancy to the fact that 500,000 Taiwanese live and work in the city. (This number represents 5% of Taiwan's total workforce.)

It is obvious from the data that Taiwanese firms are playing a decisive role in establishing China as a major factor in high-technology products. Taiwan accounts for 19 of China's top 100 exporters compared to eight each from Japan and Korea. Taiwan's investment is now officially estimated at $41 billion compared to $11 billion in 1997. Taiwan's exports to China have quadrupled from $10 billion in 1997 to $48 billion in 2004. China displaced the U.S. as Taiwan's largest trading partner in 2003 and took a hefty 36.7% of the island's total exports during the first half of 2005.

6) Improvements in Bureaucracy and the Rule of Law. The Communist Party has been significantly improving the educational standards of the people it appoints to high office. Among the 62 people running China's provinces, 32% have an engineering degree, 21% studied economics, and 6% have a math or physics degree. One third also have advanced degrees. Shanxi is now the first province to be run by two Ph.D.s. Many younger Chinese officials have studied abroad. According to UNESCO, some 50,000 Chinese students are now studying in the United States.

China has been more successful at restraining corruption than many other developing countries. The most commonly used measure of corruption is the Corruption Perceptions Index compiled by Transparency International. In 2004, China ranked 71st out of 145 countries with an average score of 3.4. In the rankings, zero is the worst possible score and 10 is the best. China's score does not appear very impressive but when adjusted for income levels it appears highly competitive with other countries. Within emerging Asia, China scores well above Indonesia, the Philippines, India, and Pakistan. It is on a par with Thailand but below rich countries such as Korea and Taiwan.

There are many signs that the government is attempting to crack down on corruption, including sporadic anti-corruption campaigns in the Chinese press. In 2004, 2,960 officials at or above the county level were investigated for corruption, including 11 officials at the ministerial or provincial level. While the number of corruption cases prosecuted by the government has remained in the range of 22,000-24,000 annually since the late 1990s, the number of senior officials being prosecuted has been steadily increasing.

Corruption can be seen as a method of income redistribution for middle and low-level officials which occurs because of inefficiencies in the development of a modern bureaucracy. It can also be seen as the price China pays for its lack of a free and unrestrained press to rout out corruption. As education improves, legal standards are upheld at the county and township levels, and the press is liberalized, it is certain that corruption levels will decrease further.

Although no country with a population as vast as China's can completely rid itself of corruption or other crimes, we see a similarly positive scenario for the development of intellectual property rights in China. Just as the violation of trademarks was a key complaint of foreign companies in Japan more than 25 years ago, as its industries became global and its institutions strengthen, China too will become more rationalized in this regard. However, as Lawrence Lessig has outlined in *Code,* China as an authoritarian state will have to deal with the implications of the digital age in terms of ownership and control of content.

EXPORT-LED GROWTH MODEL

The trade statistics for China since the 1980s are truly impressive. China's exports have grown by 13% per annum since 1981 and by 18% per annum since 1991. China's share of world exports has risen from 1.1% in 1981 to 6.8% in 2005 and thus made China the world's third-largest exporting nation after the U.S. and Germany. If the growth rates of the past decade can be sustained, China could overtake the U.S. in 2008 and Germany in 2009. China's merchandise imports also have grown rapidly. Their growth rate has averaged 16% since 1991 and they are now 6.1% of the world total.

The Chinese export-based development model is in many ways unique but the closest historical analogy is Japan. Japan began to industrialize during the early 20th century. It already had a manufacturing sector which produced about 23% of national output. The manufacturing sector relied heavily on foreign capital goods but it did produce light manufactured goods for export to China. The US was Japan's largest export market because of its demand for silk. China was Japan's number two market but in contrast to the US it purchased industrial goods, not luxury products like silk. Chinese imports from Japan were cotton piece goods, matches, timber, paper, and machinery. In fact, China accounted for 75% of Japan's manufactured exports before the First World War. The Great Depression and World War II disrupted Japan's rise as a major exporter. During the late 1950s and 1960s, the rise in Japan's share of global exports was nearly as large as China's during the past ten years. Japan also had a voracious appetite for commodities and increased its imports from Australia tenfold between 1959 and 1974. But the export share of GDP averaged only about 10%, so Japan never came to depend as heavily upon foreign trade as China has during recent years.

Another key difference has been China's openness to foreign investment. There is little doubt that China's export success has been a by-product of the country's FDI boom. Foreign firms now produce about 55% of China's exports. If we look at the country's top 10 exporting firms, four are from Taiwan, three are from the US, two are from China, and one is from Finland. The two leading Taiwan export firms have sales of $8.1 billion each. The third-largest exporter is Motorola with sales of $5.7 billion followed by IIPC with sales of $4.1 billion. Nokia has exports of $3 billion while Intel has exports of $2.1 billion. Among the next 20 largest exporters, nine are Chinese, eight are from Taiwan, and three are from the U.S. The 31st-largest exporter is LG of Korea with sales of $1.3 billion. The largest exporter from Japan is Toshiba Information Systems. It ranks 44th with $1.1 billion of sales.

There has been a major change in the composition of China's foreign trade during the past decade. Although there was great excitement in early 2005 about a surge of Chinese textile exports as a result of the relaxation of global quotas, but the textile share of China's exports has declined from 24% in 1997 to 14% in 2004. Footwear has likewise fallen from 4.5% of China's total exports in the mid-1990s to only 2.5% recently. Conversely, exports of high and new technology products have climbed from less than 15% of the total in 2000 to nearly 28% in early 2005. China's trade balance in these products has swung from a $17 billion deficit in 2001 to a $4 billion surplus last year. China also became a net exporter of auto parts during the first half of 2005.

IMPACT OF CHINA'S EXPORT SUCCESS

The emergence of both China and India as players in the global economy is having a profound impact on how firms conduct business all over the world. It has greatly increased price competition and produced large savings for consumers everywhere. Despite the large increase in oil prices since 2003, bond yields have remained subdued because of investor confidence that inflation is going to remain restrained. The rise of China has coincided with a large rise in the profit share of GDP in all the industrialized countries and a sharp slowing in the rate of wage growth. Corporations have told trade unions and their employees that China is forcing them to restrain costs in order to remain competitive. Some politicians have protested the income distribution consequences of globalization but they cannot reverse the effect without resorting to highly protectionist trade policies.

China's export boom has also greatly increased its level of trade with other East Asian countries. China is now running large trade surpluses with the U.S. and Europe, offset by large deficits with Korea, Taiwan, ASEAN and Australia. In 2004, China had a trade deficit of $51.2 billion with Taiwan, $34.4 billion with Korea, $20.9 billion with Japan, $20.1 billion with ASEAN, $3.2 billion with Australia, and $1.8 billion with India. In East Asia, China had a trade surplus only with Vietnam ($1.8 billion). The East Asian countries have emerged as major suppliers of components and other material for reassembly as final manufactured goods in China. Korea, Taiwan, and Japan also provide China with a large volume of capital goods to help facilitate its investment boom. As a result of these changing trade flows, America's imports from East Asia have declined as a share of total imports while imports from China have increased sharply.

Growing Regional Cooperation

It is the globalization of China's economy which has provoked widespread concerns in Washington and elsewhere about the rise of China as a competitive force and potentially unfair trading partner. More attention needs to be paid to the forces of Asian regionalism which are strongly advanced and underreported in the English press. China is now attempting to promote more regional economic cooperation in East Asia. After rejecting Japan's proposal to create an East Asian IMF in 1997, it agreed to collaborate in the ASEAN +3 meetings of finance ministers and central bank governors. It is promoting the creation of an East Asian free trade zone (EAFTA) with ASEAN and potentially Japan and Korea. It is encouraging the plans for the East Asian heads of government to hold a summit conference without the US this November in Kuala Lumpur.

The US is very concerned about these Chinese initiatives (because it has not been included) but has not offered any clear alternatives. The Asians are determined to pursue more cooperation because of the devastating consequences of the East Asian financial crisis and perceptions of lack of positive leadership from the US. The trade initiatives are a natural by-product of China's emergence as a major economic power. Many assume that China and Japan cannot work together because of historical differences, and that this situation is permanent. This assumption could very well be incorrect.

Although we tend to see Asia's development from the Western vantage point, there are now scholars in Asia studying historic Asian regionalism, forming the intellectual basis for a united Asia. A highly developed network of intra-Asian trade flourished prior to the arrival of the Europeans 500 years ago, as the recent popularization of the voyages of Admiral Zheng He attests. According to Debin Ma, the tributary system of Ming China functioned as a network for commercial relations through trade concessions, and was integral to an early form of "proto-globalization". Ming Chinese traders, both official and private, traded luxury goods (including opium) throughout Cambodia, Siam, Japan, Brunei and Korea and Batavia. Now the products of global trade are more commonplace, and more essential, but the point is that China's economic integration with Asia is not new or surprising, and its development preceded European intervention.

CURRENCY POLICY ISSUES

China's currency policy is another example of how tricky it can be to work out newly-emerging issues of economic interdependency in a highly politicized environment. In many ways, the yuan's peg to the US dollar makes sense terms of the highly intertwined nature of the two economies. The great new issue in China's international economic relations during the past two years has been the exchange rate. China had maintained a fixed exchange rate against the U.S. dollar from 1994 until July of this year. During this period, there were large fluctuations in the real value of the RMB because of volatility in the dollar exchange rate and the East Asian financial crisis. During the late 1990s, the real value of the RMB appreciated by over 30%. But there was never any change in the nominal value of China's currency vis-à-vis the U.S. dollar.

In 2003, members of Congress became concerned about the rapid increase in the U.S. trade deficit with China ($125 billion) and began to allege that China was maintaining an undervalued currency to promote exports. They pointed to China's purchases of U.S. Treasury bills as an example of currency manipulation. China responded that it had maintained a stable currency through the East Asian financial crisis, when other countries devalued sharply, and was not guilty of currency manipulation.

China does not only regard its prudent behavior during the late 1990s as a good defense of its exchange rate policy. It also is concerned about exchange volatility at a time when its banking system is attempting to reduce $200-300 billion of non-performing loans. The government is apprehensive about public confidence in the financial system and the ability of Chinese companies to manage currency risk. The government has recently introduced forward markets for currency but it does not yet have any markets for financial derivatives. Moody's has warned that it might lower the credit rating of Chinese financial institutions if the government created greatly increased currency volatility.

As a result of congressional pressure, the Bush administration began to lobby China for a change in currency policy. At the 2003 IMF meeting, it helped to produce a G7 communiqué encouraging more currency flexibility in Asia. In 2004, Treasury Secretary John Snow made numerous appeals for China to modify its exchange rate policy. In April 2005, the Treasury produced a report threatening to allege that China was engaging in currency manipulation if it did nothing to modify the policy. The U.S. Senate also passed a resolution threatening to impose a 28% tariff on Chinese imports if the RMB was not revalued significantly.

China finally succumbed to this pressure in July by announcing a 2.1% revaluation of the RMB and the move to a managed currency basket. The central bank governor has not provided any details about the precise weights of the currencies in the basket but he has acknowledged the currencies include the U.S. dollar, the Japanese yen, the Euro, the Korean won, the Russian ruble, the Singapore dollar, the Malaysian ringitt, the British pound, the Australian dollar, and the Thai baht. The great surprise was the omission of the Taiwan and Hong Kong currencies because each country accounts for over 10% of China's foreign trade. If China used a trade weight for each country, the U.S. dollar would have a share of 19.5%; Japan would have a share of 21%, Europe a share of 20.7%, Korea 9%, and the other countries about 2-3% each. As China still denominates about 80-90% of its trade in dollars, it is quite likely that the dollar has a much higher weighting (say 60-70%) but there is no way of knowing exactly how high. China's decision to introduce the new basket represents a major change in both its exchange rate policy and monetary policy, but it is not yet clear exactly how the new policy will work. Most investment banks believe it will set the stage for a 5-10% revaluation of the RMB during the next 12 months but these forecasts are still highly speculative.

It has been said recently that the Chinese save money earned from their manufacturing jobs so that the Chinese government can lend money to the United States at low interest rates so that US consumers can mortgage their homes to buy Chinese manufactured goods. The geopolitical maneuvers behind China's currency policy change reflect highly divergent agendas in the world's capitals. The US has called for revaluation because of concerns among its manufacturers about Chinese competition. The US has neglected the interests of retailers such as Wal-Mart, which imports over $50 billion of goods from China, as well as the homeowners who benefit from the low interest rates resulting from China's currency intervention. The Bush policy is high risk. If East Asian central banks had not spent hundreds of billions of dollars on currency intervention, U.S. bond yields might have risen and thus dampened the housing boom.

The Europeans supported a RMB revaluation because they are concerned about the large US current account deficit. They fear that if Asia maintains stable currencies the full burden of adjustment will fall upon the European exchange rate and that it will appreciate sharply. The French would also like to weaken the dollar's grip on East Asia and encourage East Asia to diversify its currency reserves to include more euros. The French have long been obsessed with the issue of dollar hegemony and the capacity it gives America to finance large current account deficits easily. The Japanese were reluctant to lobby China for a currency revaluation because they also have intervened to hold the yen in a narrow trading range but they recognize that most of America's new protectionist sentiment is focused on China rather than Japan. As Japan has deployed troops in Iraq, they also do not expect the Bush administration to criticize their currency intervention. It was therefore a low-risk policy for Japan to support a Chinese revaluation.

A COMMODITY-FOCUSED FOREIGN POLICY

China's new role in the global economy has several implications for its foreign policy. China now consumes a larger share of global output of copper, aluminum, nickel, lead zinc, and iron ore than the U.S. China's steel production is over 300 million tons per annum or twice as large as the U.S. and Japan combined. China displaced Japan as the world's second-largest oil consumer two years ago and will soon be consuming over 7 million barrels of oil per day.

China's growing need for raw materials which is encouraging an improvement in relations with commodity-producing countries. When Hu Jintao traveled to the APEC summit conference in Santiago last November, he announced $30 billion of infrastructure and energy investments in Brazil and Argentina to facilitate trade with China. China is now attempting to negotiate free trade agreements with Australia, New Zealand, South Africa, Chile, Saudi Arabia, and Kuwait. She has signed an economic cooperation agreement with Canada which could ultimately evolve into an FTA. China has reportedly deployed 4,000 security forces in the Sudan to protect an oil pipeline she built there five years ago with Petronas of Malaysia. Chinese firms are also attempting to invest in natural resource projects in many countries. They have obtained oil concessions in Angola, Iran, Algeria, Egypt, Indonesia, Gabon, Nigeria, Argentina, Venezuela and Ecuador. They have signed contracts to buy a large volume of LNG from Australia. They have committed to developing a billion-dollar nickel mine in Papua New Guinea.

China recently completed a series of joint military exercises with Russia, and has been trying to persuade the Russians to construct an oil pipeline to northern China in order to facilitate imports of Siberian oil, in addition to their pipeline to the Pacific coast to accommodate Japan. President Vladimir Putin has also suggested that China might be allowed to invest in the oil reserves of Yukos, the large oil company which was renationalized last December.

The National Security Council in Washington is concerned that China's need for oil could encourage her to pursue agreements with Iran in which weapons might be exchanged for oil. China has signed a treaty which would preclude her from selling Iran nuclear weapons but she could provide other forms of military technology in return for access to oil and gas reserves. China might be pushed further in this direction by the successful obstruction by the US Congress of the CNOOC bid for Unocal. The Bush Administration decision to remain passive, despite the fact that the bid did not pose any national security threat, was a de facto endorsement of China's decision to collaborate with non-US aligned states in its search for energy.

It is likely that China will compensate for the Unocal defeat by attempting to purchase other oil reserves in Canada, Australia, Kazakhstan, and developing countries which are open to foreign investment. It could also undermine America's national security interests in Venezuela by doing deals with President Chavez to lessen his country's dependence upon the U.S. In fact, after his recent visit to Beijing, Chavez announced plans to sell Venezuela's refining operations in the U.S. (Citgo).

China's Support for Global Trade

Another focal point of China's international economic policy is the Doha round of the WTO. China has not played a major role in the great conflicts over agricultural trade and services which have often separated the developing and industrial countries. China is now the world's third-largest exporting nation. At current growth rates, she could be No. 1 in three or four years. With exports at 36% of GDP, China's trade share of GDP is three times larger than the U.S., Europe, and Japan. China has a critical need to improve her access to markets and to lessen the risk of protectionism in the old industrial countries. A collapse of the Doha round would pose greater risks for China than for any other country. China is hedging its bets by establishing regional and literal agreements at a very rapid pace.

China- Military Threat?

China's high level of integration with the global economy lessens the risk that her reemergence as a great power will pose great military risks to the U.S. or other countries in the region. The fact is China has to be a good global citizen in order to enjoy the benefits of the multilateral trading system. There are territorial disputes over the Spratly Islands and some islands close to Japan, but neither side is threatening to use military force.

The major potential conflicts center on Taiwan and North Korea. China is firmly opposed to Taiwan making a formal declaration of independence. But the U.S. also favors a one China policy and also opposes Taiwan independence. In spite of its blustering, Taiwan is economically integrated with China, so it is difficult to believe Taipei will do anything which might provoke military action by the mainland. North Korea is threatening to develop nuclear weapons in order to guarantee her security. China has hosted the six-party talks to persuade North Korea to disarm. It is not yet clear what North Korea will do, and China's ability to force North Korea to disarm is far from clear. In fact, China's position vis a vis North Korea is similar to the US position with Taiwan. Both powers are in a position to persuade, but not command.

KEY ECONOMIC ISSUES

After two years of nearly double digit economic growth, the odds are high that China's growth rate will slow during 2006 and 2007. The government tried to restrain the capital spending boom by imposing credit controls on bank lending and raising interest rates for the first time in nine years. In 2005, it imposed new taxes on property speculators in order to dampen the housing boom gripping Shanghai and other cities. During recent months, the growth rate of money and credit has slowed to the 12-14% range from numbers as high as 26% during early 2004.

The Chinese economy will also be vulnerable to any slowdown in the U.S. or the European economies because of the major role which foreign trade now plays in the economy. The growth rate of exports has slowed from over 40% one year ago to 30% recently and could easily fall to 20% if the U.S. economy slows in response to Federal Reserve tightening and a cooling of the housing boom.

Banking Sector Vulnerabilities

The major goal of government policy is to reduce the growth rate of capital spending from 45% in early 2004 to 10-15% by the end of this year. In contrast to East Asia eight years, there is no external or balance of payments pressure on China to restrain growth. The country's current account surplus could rise to $120 billion this year. The government's major concern is the quality of bank lending. It became concerned last year that the boom was encouraging a growing number of high risk or marginally profitable investments which could lead to an upsurge of non-performing bank loans in 2006 and 2007. The government is very concerned about bank lending because it has a major legacy problem with lending in the big four state owned banks. After the banks were re-established during the late 1970s, their primary mission was to provide inexpensive credit to state-owned companies in order to promote full employment. They did not apply commercial criteria to their lending decisions. As a result, the big four state banks have large portfolios of non-performing loans worth at least $200 billion. The government has injected $60 billion of capital into the banks in order to prepare them for privatization, so it does not want the recent boom to produce another upsurge of bad credit.

As a result of its membership in the WTO, China's banking and financial sector is opening to foreign investment. Foreign financial services companies are interested in Chinese banks because of their huge markets and because currently, according to Goldman Sachs, only 10% of Chinese bank income is derived from activities other than interest income. Another positive development is that risk management issues are now being discussed and studied, an example being the Chicago Mercantile Exchange's recent agreement to provide its expertise in futures products to the Shanghai Futures Exchange and SAFE (People's Bank of China). These initiatives will strengthen China's financial system, but currently China's banks and brokerage houses, stock exchanges and other enterprises do not meet the standards of the developed world. Credit is still difficult to obtain for individuals and entrepreneurs, and according to Dr. Kelly Tsai, this has resulted in informal and unregulated shadow banking system which is at least 50% as big as the formal banking system. In spite of the fact that China has experienced enormous economic development, its stock market has underperformed other global markets due to the overhang of state ownership and its widely perceived corporate governance shortcomings. The price earning multiple has gone from 60 to 15 over the last four years.

Chinese Corporate Sector—Profit Squeeze

Capital spending could also suffer from the fact that many Chinese firms have been experiencing a profit squeeze during the past year. They are suffering from large increases in raw material prices as well as escalating wage costs in the southern provinces experiencing labor shortages. The recent decision of the Chinese to revalue the currency could also squeeze the profit margins of export companies which do not have any pricing power. But the revaluation will enhance the profit margins of companies which depend heavily upon imported components and raw materials. The steel industry, for example, is anticipating a cost savings of 3 billion yuan ($308 million) from reduced iron ore import costs as a result of the revaluation.

Consumer Spending Continues

The sector which is likely to remain robust is consumer spending. It has been expanding at a 14% annual rate because of growth in employment and wages. Chinese households have a strong pent up demand for many consumer goods as well as better residential properties. This is particularly true in rural areas, where incomes have improved due to recent increases in food prices and other policy initiatives such as the planned elimination of taxation on farmers.

Retail spending should also benefit from the large foreign investments now occurring in the Chinese banking sector and the government's plan to privatize the banks and increase consumer credit. During the past two months, the Bank of America has announced a $2.5 billion investment in the China Construction Bank and Royal Bank of Scotland has announced $3.1 billion investment in the Bank of China. Last year, HSBC invested $1.75 billion in the Bank of Communications.

In the past, the major task of the big Chinese banks was to provide credit for the large state-owned companies. China experienced a major capital spending boom during 2003 and 2004 in part because of political pressure from local governments to fund big new development projects. As the banks are privatized, they will shrift from policy lending to commercial lending and will attempt to significantly increase the retail share of their business. The foreign banks have been attracted to China because they see huge opportunities for mortgage lending and credit card lending. Mortgage lending has already grown to 10% of GDP from practically nothing ten years ago, but it is greater than 70% of GDP in the Anglo-Saxon countries, so there is ample opportunity to expand it significantly in the future.

The Chinese government is committed to sustaining a high growth rate in order to create jobs for both young people and the millions of workers in state-owned companies which are likely to retrench during the next few years. But the decision to cool the capital spending boom will produce a cyclical slowdown to 7-9% output growth from nearly 10% during the next two years.

CHALLENGES TO GROWTH

While China's economy has enjoyed impressive achievements during the past decade, the country still faces major hurdles in sustaining a high level of economic growth. The risks posed by the global trading system are well known. The other challenges include sustaining domestic social and political stability, providing retirement income for a rapidly aging population, and protecting the environment. Chinese leaders increasingly talk about the theme of "sustainable development". Such a concept will require China to invest far more in conservation and protection of the environment than would have been possible under a command economy whose sole purpose was to maximize output.

Unemployment and Labor Mobility

The first major concern of social pundits following China is unemployment. During the past decade, China has lost over 60 million jobs in the old state enterprises. The job losses have caused the official unemployment rate to rise from 2.0% in 1985 to 4.0% recently. But these numbers are misleading for a variety of reasons. First, they do not include people who have lost their jobs but are still kept on the books of defunct companies while enjoying a modest income from the state. Nor does it include millions of workers from rural areas who have moved to the city and do not register as employed. There are no precise numbers of this population but many analysts believe that it exceeds 100 million. It also could rise sharply in the future as the productivity of the agricultural sector improves. If we make adjustments for these factors, China probably had an unemployment rate of 10% five years ago but the recent boom in the economy has reduced it to about 6.0%. According to government data, China has 752 million employed people.

Rural/Urban Divide

At present, China is about 38% urban compared to 20% in 1970. Its urbanization level is equivalent to the UK in the 1850s, the U.S. in 1911, and Japan in 1950. At the end of 2003, China had about 800 million registered rural people. This means there was a working age population in the countryside of about 500 million people. Current data suggest that about 375M people work on farms while the rest have jobs in the towns and villages. Many have left the countryside for jobs in the urban centers of southern China. Young rural women migrants tend to get jobs in factories while young men work in construction. It is estimated that China could feed itself if only about 150 million worked on the land, so there is a potentially large surplus rural population available for redeployment elsewhere. But the supply of workers in the age group 15-29 years is only 185 million and about 100 million of it has already left the land for urban centers. The great growth now occurring in the rural labor force is among older workers and it is not clear if they will be as mobile as the younger workers.

There also was a significant increase in China's food prices during 2004 which reversed years of decline in agricultural prices. In fact, the uptick in agricultural prices slowed the flow of surplus rural workers to southern China and helped to produce a labor shortage there.

China's farmers are not poor compared to other Asian farmers. They now appear poor only in comparison with China's urban residents. In 2004, Chinese farmers had an average income of 2,800 RMB compared to 10,000 for urban residents. China's agricultural per capita value added is about $375. Such a number seems modest but it is higher than in India, Vietnam, and Pakistan and broadly on a par with Thailand and Indonesia.

The government is very aware of growing income differentials between urban and rural workers. It is attempting to condition the farmers by greatly strengthening their property rights over land and abolishing taxation of farmers during the next five years. In theory, farmers began to enjoy property rights several years ago but the reality is they were often vulnerable to changes in land use dictated by local officials who took bribes from property developers. Civil disturbances have erupted throughout China has a result. Under the new regime, farmers will be able to enjoy permanent land use rights for thirty years. This policy will allow farmers to invest more with the confidence they have secure property rights. When Taiwan introduced land tenure in the early 1950s, its annual yields rose by 60% and farm incomes grew by 150%.

Growing Inequality

Many analysts are also concerned about the growing level of inequality resulting from the economic takeoff and transition to capitalism. According to U.N. data, China's Gini coefficient has risen from 24.0 in 1970 to 34.6 in 1990, and 44.7 recently. The increase in the Gini coefficient suggests that China has the potential for greater social tensions but it is important to compare the new data to other countries. China's Gini coefficient compares to 52.2 for Hong Kong, 48.1 for Singapore, 49 for Malaysia, 43 for Thailand, and 46.1 for the Philippines. Among other Asian countries, scores are lower for Japan (30.1), India (32.5), Korea (34.4) and Taiwan.

What makes China distinctive is the sharp increase in the Gini coefficient since 1970. The other countries all had much higher Gini coefficients in the 1970s. China has simply caught up with them because of the transition from communism to a market economy.

China's Emerging Middle Class

The financial press is now full of stories about China's new population of millionaire entrepreneurs. These people have earned large fortunes from sectors as diverse as food manufacturing and the internet. Forbes magazine publishes a list of China's wealthiest people every year. In 1999, a Chinese businessman needed $6 million to make the list. In 2004, he needed $144 million. The wealth of the 100 people on the list has increased from $15 billion in 2001 to $29 billion last year. It is instructive to compare the Forbes data on wealthy people in China with Russia because both countries have been in transition from communism. The Russian millionaires are much wealthier than their Chinese counterparts. In 2004, they had a net worth of $137 billion compared to $29 billion for the Chinese. They controlled assets equal to 25% of Russia's GDP compared to less than 2% for the Chinese. The source of wealth in China is also far more diverse than in Russia. The wealthy in China made their fortunes in sectors such as retailing, electronics, agriculture, property, finance, and heavy industry. There is not one sector which dominates. In Russia, the wealthy obtained their riches primarily from privatizing state owned companies in the natural resource sector. The Russian list of the wealthy is also relatively static whereas there is a 30-35% turnover rate in the Chinese list every year.

There is the perception that China has developed a huge middle class centered in urban areas. Actually, the growth of the middle class (defined as earning more that $10,000 per household per year) is both smaller and more dispersed, reaching well into rural China. Less than 50M people in China are middle class, but interestingly, according to the Chinese Academy of Sciences nearly half of all Chinese consider themselves middle class. Whatever the criteria, this group is growing and as soon as 2020 could form a solid majority.

Regional Inequalities & Differential Development

The other great concern of China's social critics is regional inequality. During the first decade of economic reform, the growth rate of real GDP in western and central China was less than 1% slower than the growth rate of the east. During the second decade, the growth differential grew to 2%. As a result, real per capita income in central China fell from 65% of the coastal level in 1980 to 53% in 2000. In western China the ratio fell from 53% to 41%. The differential resulted from both fiscal decentralization and an over concentration of foreign direct investment in the coastal provinces. Investment in the west fell from 48% of the east coast level in 1980 to 33% in 2000. The government has recently attempted to reduce the regional income disparities by boosting infrastructure investment in the west and encouraging foreign firms to look inland for plant locations. The fact that there are now labor shortages in southern China could also force foreign firms to look west for surplus labor.

China's need for commodities has also recently given a boost to some of the inland provinces which have natural resource endowments. Inner Mongolia's economy has enjoyed three years of 16-20% GDP growth because of its rich land and mining resources. Shandong province has been number two in growth because of its mining, electricity, gas and water industries. In the first half of 2005, Henan province had an investments growth rate of 47.4% compared to only 10.4% for Shanghai and 17.2% for Guangdong.

Aging of the Chinese & Other Demographic Trends

The second great challenge confronting China is a demographic one. The country is aging and will someday have a shrinking population. The introduction of the one child policy in the early 1970s means that with a population of 1.3 billion today, it will likely peak at 1.45 billion by 2030 and then begin to decline. The introduction of the one child policy caused the birthrate to plunge to 9 per 1,000. As a result of the falling birthrate, population growth has declined to 0.7% from 2.6% during the early 1970s.

An unintended consequence of the one-child policy was to encourage female infanticide. As a result, the newborn gender ratio of girls to boys is 1:1.17 and the number of boys under the age of 9 is 12.7 million greater than the number of girls. In the global population, the ratio of boys to girls is 1:1.04. If China's birth trends continue, there will be 30-40 million more men of marriage age in 2020 than women. This will also require an adjustment in the manufacturing labor force to include young men as well as young women.

The other factor influencing the composition of the population is raising life expectancy. It has increased from 42 years in 1950 to 60 years in 1970 and 71 years recently. As a result, China's baby boomers should live 50% longer on average than their grandparents. This combination of a low birth rate and rising life expectancy will produce a significant aging of the population. In 1975, the elderly population of China was only 60 million. In 2003, it was 120 million. In 2025, it will double again and by 2050 it will exceed 300 million people.

Other Asian countries are also experiencing aging populations. Japan's population will soon shrink and it will have 35% of its population retired by 2050. Korea also is aging and will have dependency ratios higher than Japan or China in 2050. What distinguishes China is its poverty. Unlike the Japanese, the Chinese are concerned that they will grow old before they grow rich.

Inadequate Pension System

The aging of the population raises a number of disturbing questions. How will China finance pensions for such a large population of elderly people? Can China sustain high growth then it has to divert significant resources to the retired? What will happen to the national savings rate? In the past China's state companies had a pay as you go pension system. It funded retirement out of ordinary cash flow. Under the so called "iron rice bowl", workers obtained health care, housing, and education from their employers. There were no pensions or retirement savings. China is now trying to create pensions for the urban population. In 2003, there were 155 million urban people in the government's pension system.

Under the new scheme, retirement income is provided on the basis of pay-as-you-go contributions and private savings. There is a 13% tax on salaries which provides pay-as-you-go income. There is a further 11% payroll tax which is accumulating in pensions. Individuals are also given the choice of contributing to enterprise annuity funds if they want to save more.

The current system is likely to run a surplus until the year 2030. Some banks estimate it could be as large as 4-6% of GDP per annum until 2020. But a present, pension contributions are averaging only 2% of GDP per annum because of low participation rates for workers and high participation rates for the retired in collecting income. As a result, the accumulated pension surplus is only 0.4% of GDP. The outlook for the surplus is far from precise because it is necessary to make assumptions about factors such as the rate of return on assets. In recent years, China has offered a low return on fixed income assets and negative returns on equities.

If the government can restructure the stock market to improve returns, the pension fund surplus could earn higher returns and thus delay the period when a deficit might develop.

There are various ways China could attempt to resolve the pension problem. It could reduce benefits, raise taxes, issue debt, or sell state owned assets. As with the debate about America's social security system, all the choices are controversial. The government debt/GDP ratio is only 30% so borrowing is an option. China also has more opportunities for asset sales than many other countries. The government still owns about 150,000 non-financial enterprises with a potential market value of nearly 10 trillion RMB or 80% of GDP. These assets are of varying quality but the fact that government has closed many loss-making enterprises means that its remaining portfolio has more potential market value than in the past.

Sustainable Development

One of the greatest challenges confronting China's government is the environment. China is the world's third-largest polluter after the US and EU. The economic boom of the past two decades has taken a toll on China's environment. Damage from the use of coal – which accounts for 68% of China's primary power production – is equivalent to 8-10% of GDP and causes over 250,000 deaths annually. Acid rain now falls on about 30% of China's land area.

China signed the Kyoto Protocol in 1998, but as a developing nation is not legally bound to meet emission targets. However, along with India and Australia, in July China backed a US plan that focuses on technology development rather than emission targets.

In 2001, China accounted for 13% of global carbon emissions, ranking as the second largest producer of CO_2, and the government expects that by 2020, China will account for 18-19% of global emissions. When a team of experts and Yale and Columbia Universities ranked 146 countries in the 2005 Environmental Sustainability Index, China came in at 113th, below Angola, Burundi, and Iran. In 2001, the World Bank reported that for sulfur dioxide, 13 of the 20th most polluted cities were in China. About 75% of China's lakes and almost all coastal seas are polluted.

China's arable land base has been steadily contracting because of urbanization and infrastructure development. Between the early 1980s and mid 1990s, net annual farmland loss averaged between 100,000 and 1 million hectares. A recent report alleges that 6.7 million hectares has been taken out of cultivation since 1996, with 2.3 million leaving in 2003 alone. The average per capita availability of farmland in China has fallen to less than 40% of the world average and is now below the FAO's warning line of 0.05 ha. The per capita farmland available to U.S. farmers is 200 ha while in Europe it is 50 ha. In Asia as a whole, it is 1 ha. China has laws which say that only 5% of arable land within a locality can be transferred to alternative uses but the law is widely ignored. In 2004, the Chinese government's newspaper reported that there are 6,015 new development zones with a total land area of 35,000 km – more than the total land area of China's cities and Taiwan.

China also faces growing problems with access to water. China ranks fifth in global water supply but its per capita availability of water is only 25% of the world average. In the 1990s, China overtook the U.S. to become the world's leading water consuming nation. China has an abundance of water in its southern provinces but major shortage in the north. The north has 24% of China's water but two thirds of its arable land and half of national grain output. Growing urban and industrial demand has meant that farmers have decreased access to water. As a result of poor resource management, it is estimated that water shortages cost the economy output losses equal to 5% of GDP during the 1990s.

China has problems as well with energy supplies. Its per capita endowments of energy are well below global averages. Its reserves of crude oil are less than 11% of the global average. Its natural gas reserves are a mere 5% of global average. Despite an abundance of coal, its per capita reserves are half of global averages. Nuclear power and hydropower play a small role. China has magnified its problems with energy demand by restraining prices. The cost of gasoline in China is well below global levels and recently helped to produce shortages. The government announced plans recently to improve the fuel economy standards of automobiles in the future. While such a policy is laudable, China cannot address problems with either energy inefficiency or carbon emissions unless it is prepared to increase the price of energy to consumers.

CONCLUSIONS

China is now in the midst of one of the most profound economic transformations to occur in any country during the past two hundred years. It has achieved one of the highest rates of output growth in human history and is clearly poised to emerge as a world economic super power during the next few decades. There is great apprehension in Washington, Tokyo, and elsewhere about China's reemergence as a great power but China has been stressing repeatedly that it does not intend to make the mistakes of Germany before 1914 or Japan during the 1930s. It wants to make a peaceful transition to great power status.

China also faces major domestic challenges in continuing this transition. It must address problems with corruption, increasing income inequality, and the environment. After two decades of focusing primarily on maximizing output growth, the Communist Party is now placing much greater emphasis on managing the social and environmental side effects of the economic takeoff. This change in policy could both dampen growth momentum and increase the risk of political instability. But China cannot sustain its economic boom without addressing the externalities associated with rapid output growth. There is not insignificant risk of policy accidents as China attempts to address its numerous challenges.

The U.S. and Japan should not regard the rise of China as a threat. They should view it as an opportunity for trade and investment in the short-term and an opportunity to promote the spread of capitalism in the long-term. There is little doubt that China will remain an authoritarian country during the next few years but when the fifth generation of leadership assumes control in seven or eight years there will be growing social pressure for more political freedom. China could ultimately become at least as liberal as Singapore's de facto one party state. In thirty or forty years, it could join Taiwan and Korea as multi-party democracies. There is no way to predict precisely how the transition will occur. But in the long term it will be difficult to sustain a robust capitalist economy without expanding the freedom of political expression. Transparency, including freedom of the press, will be required to bring China's stock market in line with its economic growth.

What should the direction of US policy be towards China? When Hu Jintao visits New York later this month, President Bush will discuss with him three key issues: trade, terrorism and Taiwan. But Mr. Bush should also strive to use the meetings to discuss the larger more strategic consequences of China's new role in the global economy. He should stress that the U.S. will be open to Chinese investment despite the political debacle with the Unocal bid. He should encourage Mr. Hu to believe that the U.S. will help to protect the sea lanes now critical to China's growing raw material imports. He should open the door to more cooperation on all national security issues of importance to both countries. There is no simple way to overcome the recent historical distrust between the two countries but China has become too important a country for the U.S. to treat on the basis of old suspicions. On the contrary, as China becomes a major player in the global economy, there are a growing number of issues where there can be a convergence of American and Chinese interests. If the U.S. can focus on the opportunities for cooperation, it could be surprised by how harmonious a relationship develops with China as it seeks to continue on the path of capitalist economic development.