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Conference Summary

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Robert A. Kapp is president of Robert A. Kapp & Associates, Inc. From 1994-2004, he served as president of the U.S.-China Business Council. Prior to joining the U.S.-China Business Council, he served (1987-94) as president of the Washington Council on International Trade, a member-supported private organization in the state of Washington primarily concerned with trade policy issues. He was executive director of the Washington State China Relations Council from its founding in 1979 to 1987 and again from 1992 to 1994 concurrently with his position at the Washington Council on International Trade. Dr. Kapp graduated from Swarthmore College and received his Master's and doctoral degrees from Yale. His advanced training was in East Asian Studies and History, and from 1970 to 1980 he taught modern Chinese history at Rice University and the University of Washington. From 1986 to 1991, Dr. Kapp was lecturer at the University of Washington School of Business Administration. He has published a number of scholarly studies in modern Chinese history. He also served as editor of *The Journal of Asian Studies,* a leading scholarly publication. Dr. Kapp is a member of the Council on Foreign Relations, the National Committee on U.S.-China Relations, and the U.S. Department of State Advisory Committee on International Economic Policy.

China and the World Economy Workshop

The Workshop on China and the World Economy, sponsored by the Atlantic Council of the United States and the Bureau of Intelligence and Research, U.S. Department of State, convened December 7, 2005, and January 9, 2006, at the Atlantic Council. The conference was chaired by Franklin D. Kramer of the Atlantic Council. Robert A. Kapp of Robert A. Kapp & Associates, Inc. served as rapporteur. The workshop was structured around "an examination of interpretive dichotomies," which provided the titles of the successive sessions. Banning Garrett of the Atlantic Council organized the program, and Cora Foley of the State Department offered welcoming remarks. The following is a summary of the main themes and comments raised during the two day workshop.

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December 7, 2005

Session I: China as a Challenge to its Own Leadership

***Presenter I:* Peter Bottelier – Hu's Inbox**

Peter Bottelier, the principal presenter of this topic, opened by noting that much discussion now surrounds the evolving "new line" embodied in China's economic plans for the next five years. The three agricultural questions, self-innovation, regional adjustment, opening up of a win-win "harmonious society," and economizing on energy use: what do these and other much-discussed new terms really mean?

The speaker chose to concentrate on the Chinese banking sector, long a focus of concern as a weak link in the overall chain of Chinese economic development activity.

China's WTO accession, with its provisions for entry of international actors into the Chinese banking sector, is driving PRC banking in the right direction. Chinese banks are now making serious progress toward becoming "real banks," rather than simply policy-loan windows operating at the behest of the central political authorities. He noted that three of the four largest Chinese state banks now have acceptable non-performing asset and capital adequacy ratios. This progress is intimately linked to ongoing plans to list major banks on major equity exchanges. The initial public offering of the China Construction Bank, for example, brought initial commitments of more than nine billion dollars.

The speaker noted the continuing skepticism of international rating agencies with regard to the big banks, but expressed his own expectation of continued improvement. The banks are stable. Their local portfolios are poor, but government guarantees count for much, and they are highly liquid (thanks in part to the insufficiency of alternative mechanisms of absorption for China's rates of household and other savings). Moreover, government-led efforts to recapitalize the top banks in recent years have been accompanied by drastic internal reforms.

Another indicator of the changing role of the major banks, according to the presenter, was that incremental lending now goes predominantly to other borrowers rather than to traditional state-owned-enterprises, for which the banks had long served as sources of economic handouts regardless of the quality of the loans involved. New lending activities increasingly include housing mortgages, as privatization of housing ownership creates a very large new lending field.

As China's biggest banks reform themselves to meet the requirements of IPOs and the impending foreign acquisition of equity stakes, a preference for share listings on the Hong Kong Exchange has appeared. The presenter noted that this reflected a desire to avoid the stringent and onerous requirements imposed by the U.S. Sarbanes-Oxley Act on bank listings on U.S. exchanges.

With regard to the well known problem of "bad loans," the speaker noted that much of the non-performing loans' burden had been cleared from the banks' own books and transferred to asset management companies where progress in unloading distressed assets has been slower than hoped for or anticipated. The huge increase in bank lending in 2003 and 2004 as the government sought to redress the damage caused by the economic slowdown following the SARS emergency could result in another leap upward in bad loans on the banks' books, if economic growth overall were to slow significantly; this is one reason for the government's uneasiness over any significant decline in growth rates at this time.

The presenter also placed emphasis on the growth of transparency in management and operational practices at the biggest banks. International auditing firms have been engaged by each bank prior to its IPO. As another indirect result of China's accession to the WTO, vast amounts of hitherto undisclosed information about the banks and China's financial system have thus come to light. While much remains to be done, very significant progress has been made since 2002, and the presenter expressed his expectation that further progress will continue to be made.

***Presenter II*: Joseph Fewsmith – Hu's Outbox**

Joseph Fewsmith, the second presenter in the session on "China as a Challenge to Its Own Leadership" offered a wide-ranging review of current systemic reforms within the Chinese Communist Party, interspersing his comments with commentary on the validity or inaccuracy of current interpretations of Chinese political evolution. His main contentions were as follows:

The PRC is searching for globalization and modernization without electoral democracy making expectations of the demise of the authoritarian regime premature. The notion that China, ideologically bankrupt and socially challenged, faces either democracy or state failure, ridden by a Party incapable of reforming itself is unlikely to prove valid. The Party is, in fact, serious about reforming itself. This means procedural regularization, as in the complex process of cadre promotion.

It also means that efforts to restrain the power of the number-one principle in each local organization, in light of excessive and often corrupt agglomerations of personal power by such individuals. Nevertheless, the networks that such number-one figures create around themselves provide the glue that can hold the local Party apparatus together, so dissolution of the power of low-level number ones poses a real conundrum. Similarly, at lower levels of the Party Congress system, a modest reform aimed at creating a more sustained and substantively-qualified network of members of township-level Party Congresses is in view, even though it is very limited.

Externally, some interesting experiments can be observed *vis à vis* the larger society. In the province of Zhejiang, known for its high degree of experimentation with market economics and private enterprise, one area has begun a process of "democratic consultation" in which any and all members of the township are invited to provide input to local party officials. Chambers of Commerce are alive and well, especially in South China: in Zhejiang, at least, officials are *not* appointed as heads of such Chambers.

The regime, the presenter noted, thinks that in some fashion it can revivify Marxism. He pointed to developments within the Chinese Academy of Social Sciences, where a new critique of "neo-liberalism" and the creation of another Institute of Marxism provide evidence in support of his assertion. The stripping of state assets by officials and holders of special positions has also sparked a "New Left" critique.

While the Party presents to the world an image of "soft power" and "peaceful rise" characterized by effective diplomacy worldwide and the new promotion of Confucius Institutes in other countries, the presenter noted that the image of a non-liberal system doing relatively well and being increasingly seen worldwide as "worth engaging" may not sit well politically in the United States.

Discussion

The first person to comment asked for elaboration of Chinese plans for further rural structural reform in 2006, as discussed in the recent National Economic Conference. He also took a more pessimistic view of the situation in the banking sector than the presenter, noting that the persistence of massive corruption and heavy capital flight volume with the collusion of the banks.

To the second presenter, the initial commenter noted the recent blast at neo-liberal economics by the famous Chinese economist Liu Guoguang and asked for the presenter's interpretation: if such a blast represented the "new middle" of the economic/ideological spectrum, the observer noted, that would be a sensational development.

This commenter also noted, in response to the "Outbox" presentation, that, in his view, the Party had been discussing much bigger reforms than the relatively small measures discussed by the presenter, but that in the past year or two the pace of Party reform actually seems to have slowed: for example, he pointed to a recent tendency for local Party First Secretaries to take over leadership of People's Congresses at the administrative level. Reform nowadays seems to be marginal and much less far-reaching than contemplated a year ago. The corruption issue seems to have been shelved. Talk of separating the Party and government from local-level enterprise operations has died away. Thus, the commenter asked, is Hu Jintao simply awaiting his moment to initiate really significant reforms, perhaps at the convening of the 17th Party Congress in 2007, or is he in fact abandoning much of the Party's reform impulse?

The presenter noted that "the days of Zhao Ziyang are gone." Separation of party and government is no longer a visible priority, perhaps because of the familiar aversion to creating "two centers" of power. This extreme caution is, the presenter observed, "the true Hu Jintao;" it is not that Hu is waiting for the 17th Congress to execute a major reform advance.

Speaking to the question regarding rural structural changes, one presenter indicated that the 11th Five Year Plan may provide clues. The rhetorical emphasis on "restoring balances" likely will involve attempts to raise rural consumption levels. Meanwhile, one should look for plans to improve rural infrastructure, such as broad rural electrification schemes or even rural internet access programs.

Commenting further on the state of the banking system in response to the commenter's skepticism of the banks' health, the presenter offered the view that the banking system is *not* worse off than it appears. Changes in management quality and the professionalization of bank boards are real adjustments. To support this perspective, he noted that it would be impossible to completely fool the international accounting community, which, as noted above, has moved into the examination of the major banks in a massive way. The presenter excluded the Agricultural Bank of China, however, from his optimistic portrayal, calling it a "basket case."

The greatest concern regarding the banking sector, the presenter noted, was the multitude of smaller banks and rural commercial institutions. Lending from these smaller banks remains out of control, and they are much more vulnerable than the biggest banks. The possibility of runs on such fragile rural institutions is a challenge that Beijing might have to face.

While foreign equity participation in the major banks has begun, government dominance of those institutions is not in doubt. Overseas banks such as Bank of America are planning to place large numbers of qualified personnel in the Chinese banks in which they invest equity, at least for the first several of years.

Another commenter on economic conditions offered several points of interest. Liu Guoguang's blast at neo-liberal economics represents not a call for a return to Soviet-style economics, but rather a familiar argument that simply planting the "drop dead liberal economy" into an inhospitable national environment will not yield desired results. Current financial orthodoxy, he claimed, takes the financial systems of developed countries as its goals.

On another point, relating to the apparent caution or hesitancy in further pursuit of reforms, the commenter offered the view that the NGO sector in China continues to grow rapidly while the government remains relatively relaxed, unless it perceives an NGO to be bent on overthrow of the regime. He also noted that the upward transfer of local financial responsibility from the townships to the county level, a major change now underway, is likely to serve as the "launching pad" for intergovernmental fiscal transfers as a part of the regime's new emphasis on the alleviation of inequalities of wealth and social wellbeing among different regions.

The initial presenter suggested that premature reform of China's banks into arms-length commercial entities would not have served Chinese economic growth as well as the later-stage reforms now underway. The Party is now driving those reforms. But more is needed: bank reform and independence must be advanced toward a system of "administrative capitalism." Full enactment and implementation of a bankruptcy law, greater professionalization of bank management and direction, overall adoption of real "hard budget constraints" – these goals must be achieved.

Movement is headed in the right direction. The State Assets Supervision Administration Commission (SASAC), the recently-created entity entrusted with administrative responsibility for hundreds of failing state-owned-enterprises, recently advertised 25 top posts in such enterprises for international applications.

The next commentator pointed to two paradoxes. First, if the regime is turning its greatest attention to rural development, why does the Agricultural Bank of China remain so un-improved? Second, why are so few political reforms actually implemented, in spite of so much discussion of a huge range of political reforms (for example, the idea of establishing 50 smaller provinces, eliminating the prefectural level of administration)?

The questioner's interpretation of diminished reform rhetoric by the central leadership is that the leadership aims to diminish popular expectations in order to prevent popular disappointments, but that incremental progress is still likely.

To a question about improving the economies of rural areas in the face of the continued weakness of the Agricultural Bank, the first presenter was of the opinion that the regime's emphasis will be on the fiscal side. Rural China remains seriously deprived of social services. Fiscal reforms will aim to provide a higher level of redistributable resources to rural communities. In addition, a boom in rural infrastructure creation can be anticipated, and the reform and amalgamation of rural credit cooperatives is already moving ahead strongly.

The presenter expressed greater caution in regards to the rural banking sector. Major banks have introduced globally recognized terminologies for the classification of loans. The integrity of the audit/analysis process in evaluating the banks' conditions will be crucial. Smaller banks may "get away with murder." The phenomenon of the China Banking Regulatory Commission Bank Examiner is still in its infancy. In short, the rules are in place and known, but implementation remains uncertain.

The second presenter, returning to the question of the apparent lack of central leadership on major political/administrative reform, concluded that we are seeing today a deliberate effort to "do things but not to talk so much about them."

Session II: China as a Producer and as an Innovator

Presenter I: **Thomas Rawski– China as a Producer**

Thomas Rawski, the presenter in this segment proposed two different interpretations of China's economy today, a "cellular economy" and a market economy. In the cellular economy scenario, provincial or other local protectionisms prevail, along with the emphasis on geographically constrained self-sufficiency. Competition is antithetical to the operation of such a cellular economy.

The presenter finds instead, a competitive market system. The arrival of high-productivity firms forces others to improve or die. Quantitative evidence, he suggests, shows a growing congruence of labor productivity rates within industries, indicating that the process of adjustment resulting from increased competition is underway. The sectors adduced included manufactures of television, automobiles, and machine tools.

The presenter argued that local protectionism, while persistent, does not triumph over growing tendencies toward national market integration and national competition. The speaker's emphasis on this phenomenon in export-related industries drew from the comment that export prowess should not be equated with full national competitiveness.

In the automotive sector, the presenter noted that the "defect rates" of component suppliers to multinational auto-makers' Chinese facilities are very low, while defect rates from component suppliers to Chinese parts makers are extremely high. This suggests that in the case of the latter manufacturers, "transformation" of the old system has not occurred, because customer standards have not risen, while in the internationally invested auto sector, high customer standards have driven quality transformations down the supply chain.

In machine tool manufacture, a belated upgrading of Chinese industry is only beginning to show results in the export of low-end numerically controlled machines. Automotive, aviation, and the national defense sector demand higher-level machines and at this end of the market, China remains only at the prototype stage. China's plans show evidence of "capability" to produce at these higher levels, but the impact to date on markets is minuscule, and complaints about the quality, service, and timing of delivery, as well as other aspects of Chinese machine production, remain widespread.

The presenter noted that while the growth rate of research and development (R&D) expenditure as a percentage of GDP is now higher than the growth rate of such expenditures in the United States, the rate itself remains less than half what it is in the United States, and the R&D content of Chinese exports is increasing only slowly.

The sources of momentum for further improvements in Chinese industrial production, the presenter noted, are probably as follows:

- China's increasing integration into global research networks, including multinational corporate R&D networks;
- New forms of foreign direct investment in China;
- Acceleration of the growth of private business enterprises in China;
- The outward flow of Chinese foreign direct investment, e.g. into purchases of more technically advanced enterprises located outside China.

***Presenter II*: Denis Simon– China as an Innovator**

Denis Simon offered a portrait of a China moving rapidly from serving simply as a low-cost labor provider to the international economy toward providing increased value through its scientific and technical assets. This reflects, importantly, the conclusion of many multinational corporations (MNCs) that "winning in China" will be a key contributor to healthy corporate bottom lines far into the future. Seeking to secure markets in China, competing MNCs are thus placing more advanced technologies more rapidly into the PRC. The proliferation of Chinese formal and informal commercial and cooperative relationships also contributes to the increased pace of technological advance in China.

Thus, China is now emerging as a high value-added producer in global supply chains. Chinese talent in science and technology (S&T) is now part of the global talent reservoir.

China's authorities are concerned about possible interruptions in the flow of technology into China, particularly the possibility of tightening U.S. restrictions on technology flows. This is a key driver behind the heralded pursuit of domestic technological innovation within the PRC.

The buzzword of the 11th Five Year Plan, the presenter noted, is translated as "independent innovation." Fear of American technology restrictions, the pressure of international competition, the high costs of technology licensing, concerns over the national security implications of dependence on foreign technologies, and a persistent excessive emphasis on the role of government as a source of innovation underlie the new concern for "independent innovation."

Against this background, China has embarked on a broad process of S&T "stock-taking." This "stock-taking" includes the following elements:

- A focus on building a more integrated "national system of innovation";
- A growing emphasis on the development of new, indigenous technological standards – "a new technological architecture to redefine rules, structures, designs and standards currently in place;"
- Increased emphasis on enterprises. The role of government remains under discussion. Sixty percent of current R&D spending comes from enterprises;
- The complex composition of R&D expenditure itself; and
- A primary emphasis on the cultivation and utilization of human talent. Science and engineering talent remains in short supply, and short-term shortages are at hand.

Hu Jintao has deemed "independent innovation" the "core of national competitiveness." This is not a return to Maoist notions of "self reliance," the presenter asserted, but rather a heightened emphasis, above all, on China's ownership of its own intellectual property, animated by the fear of foreign pressure. The central elements in the notion of "independent innovation" are a market economic environment, proper use of global science and technology, and government policies on intellectual property rights (IPR), taxes, banking, and government procurement.

The major obstacles to China's "independent innovation" efforts are:

- A lack of home-grown core technologies. Three-fourths of Chinese patents go to foreigners. Few patents in China have yet been established by Chinese patent-holders.
- A tendency to overemphasize the "small but inclusive" enterprise structure, which militates against the more effective integration of small and medium-sized enterprises with large ones;
- Insufficient financing for non-state-owned firms;
- A perceived un-level playing field, in which foreign firms enjoy preferential treatment; and finally,
- A persistent emphasis on instant benefits and quick success.

China is now ranked third worldwide in overall R&D spending. Of total R&D spending inside China, only two percent is accounted for by foreign firms.

Human talent is a vital focus. With Chinese science and technology talent costing about one-fifth of comparable U.S. talent, China faces significant shortages of technological manpower in the immediate future[1] (2005-2010), if the economy continues to grow at roughly nine percent per annum. If the economy were to slow significantly, the possibility of excessive unemployment among S&T personnel could still arise. Only 25 percent of science and engineering graduates currently take S&E jobs upon graduation.

The presenter stressed that the emerging focus on "independent innovation" is an important step. It is likely to entail the strengthening of tax and related policies in a manner conducive to heightened scientific and technological innovation. In the area of standards, China is in fact moving in the direction of a "rule-defining" role, and will continue to emphasize the development of indigenously-derived standards. Foreign firms will likely increase their active technological deliveries to China. The problem of IPR ownership and protection will diminish as Chinese entrepreneurial innovators establish ownership of their own intellectual property. The Chinese diaspora will continue to contribute to China's development and ownership of intellectual property. But Chinese "technological nationalism" remains a factor that could in certain circumstances interfere with the rapid development of China's capacity to innovate.

Discussion

The lead-off commenter took a somewhat cooler view of Chinese innovative ability. In his view, the widespread "culture of innovation" observed by the principal presenter is not yet evident. Sectors, he noted, display the ability to catch up quickly, but when a shift occurs in global technological paradigms, they fall behind and must catch up again.

Furthermore, the matter of who will control this "independent innovation" is unresolved. Foreigners perceive that the concept, as discussed by the Chinese political leadership, implies a heavy state role, which is in fact contradictory to genuine innovation. Further, he observed, except for the 2008 Olympic mascot, there is little evidence that the government is moving to establish effective IPR protections. In this commenter's view, China remains a huge export processing machine with major incentives to steal others' intellectual property, but without the structures necessary to support innovation broadly across its economy.

The principal presenter argued that, at the top of the political system, it is no longer only Vice Premier Wu Yi who recognizes the costs of the current system. In his view, political power is now falling into place behind the notion of "independent innovation," and the term means not only state ownership but enterprise ownership of ideas.

After several attendees pointed to the role of foreign invested companies operating in China as producers of a high proportion of China's exports and to the fact that Chinese companies' innovations tend to be in the realm of incremental improvements rather than in high-return-

[1] The lure of higher wages abroad may be a smaller incentive for Chinese talent to remain in China.

on-investment technologies, the presenter argued that while China is not yet a globe-beating innovator, the process of becoming one is underway. Incremental innovation, he pointed out, is a step in the development of China's innovative strength.

The presenter, in response to a reference to Japan's economic growth trajectory, suggested that comparisons with Japan are not entirely appropriate. Japan, for one thing, concentrated its industrial development in a few sectors, while keeping its economy relatively closed. China has opened in all sectors: there is "no place to hide." Thus the effects of the latter-day phenomena of globalization and the information technology "revolution" produced in China today a different picture than that produced by Japan in the 1960s and 1970s.

To another participant, the underlying issue in relation to the entire question of increased entrepreneurship in China is the question of ongoing incentives at local government levels. To date, allowing all levels of government to exercise their entrepreneurial instincts has left government embedded in the enterprise economy. Thus, enterprises engaged in IPR piracy are often as beneficial to local officials as "legitimate" enterprises. The commenter asked whether the central government be able to redefine incentive structures for officials at the local level? The outcome is unclear. In the coal sector, local officials simply ignored higher-level orders to divest from local coal enterprises. The IPR problem in China, which foreign businesses unanimously consider to be worsening exponentially, has an element of political economy and geography to it and has serious implications for the future of China's "independent innovation".

A question arose from the audience as to how quickly the wage differential for S&T personnel in China and in other countries will diminish. One participant predicted, in line with comments offered by Joseph Fewsmith, that the global economy will attain even greater salience to China's economic development trajectory in the future. He predicted as well that Chinese foreign policy would become even more accommodative, so as to preserve and enhance China's integration with the global economy, especially in the knowledge sector.

The second presenter pointed again to China's uneasiness that conditions in the world economy could change. Thus, the Chinese space program, he maintained, reflects China's sense that U.S.-China cooperation in the space sector could not be depended upon. Other factors driving China's quest for innovative significance, in his view, are a national desire for recognition as a technological leader and a desire to capture high-value-added financial streams associated with S&T innovations. The speaker, noting that U.S. industrial firms are now positioning to move *en masse* to China, and are expecting to move significant R&D or engineering functions to China or India, make vitally necessary an enhanced dialogue between the U.S. Government and American industry.

Session III: Keynote Presentation

The discussion opened with remarks by Franklin Kramer, the workshop chairman, who focused on four words: "duality," "vulnerability," "capability," and "consequence."

In regard to "duality," he pointed to the dichotomies that characterize Chinese social and economic realities at present; for example, the dichotomy of urban and rural society. He suggested that the future of Chinese reforms would be defined by these major dualities.

As to "vulnerability," he questioned: will China's current defining economic characteristic, a country with low labor costs, persist indefinitely? What impact will rising labor costs in China have on prices worldwide? Will labor cost trends in China engender foreign reactions? And further, when Chinese-made autos arrive in the United States, what will the American reaction be? Energy presents another area of potential vulnerability. What, he asked, are the implications of projected increases in Chinese energy demand? Another potential vulnerability lies perhaps in the area of currency: What would happen if the dollar dropped precipitously and heavily against the Renminbi (RMB)?

In regard to "capability," he reflected that many governments excel at showcasing innovation in particular sectors, as in the Soviet Union's space and naval sectors. But key innovation often arises from small companies, universities, and specialized laboratories. Will the Chinese develop that kind of innovation quality?

And finally, "consequences." Will the government's avowed intention to address rural social and economic problems affect the overall market environment? Are the consequences of corruption itself actually harmful to economic growth? Indeed, does intellectual property protection actually *help* economic growth?

Following the presenter's remarks, an audience question sparked a discussion about whether foreigners are making money in China. While one participant noted that many companies book profits through offshore locations like the Cayman Islands, making true determinations of profitability in China remains problematic. Other participants offered comments suggesting that, taken as a whole, U.S. corporate subsidiaries in China made approximately $3 billion in 2004 on an investment stock of approximately $13 billion, and that, if licensing fees and other sources of revenue are included, that amount rises to approximately $9 billion. By comparison, U.S. companies made roughly $16 billion in Mexico and $28 billion in Japan in the same period, but investment levels were also significantly higher than in China.

Another participant pointed out that it is the political system, not the legal system, that provides protection to foreign investors in China, and that foreigners are actually better protected than local investors. While the details of returns on investment for U.S. firms remain cloudy, many companies invest in China because they perceive a large and growing market within the PRC. Of a total of $600 billion in profits by the Standard & Poor's 500 companies, he said, ten percent is accounted for by Chinese trade, i.e., not only resultant from investment within China but from exports to or imports from the PRC.

In this regard, another participant pointed to the emergence in the past five years of an "East Asia manufacturing system," with China as a net importer from all of East Asia and a net exporter to the United States and Europe. In this system, China must have access to the North American market to maintain economic growth.

Session IV: China as an Employer and as a Consumer

Presenter I: Arthur Kroeber– China as an Employer

Arthur Kroeber posed two opening questions:

- Will economic growth continue to meet employment requirements?
- Can China move to greater reliance on consumption for economic growth?

His answers: "Yes" to number one, but "No" to number two.

Beginning with an historical observation, the speaker noted that in 1800 China's was the largest manufacturing economy in the world. The country had a long history of pre-industrial manufacturing, which served as the basis for the modern entrepreneurial bent in contemporary China. Yet, by 1950, China's share of world industrial value added was negligible. All of that changed between 1980 and 2005. Today, China accounts for nine percent of global GDP, and the United States for 23 percent. Thus, the presenter stated, China is "returning" to its natural position and its natural proportion of world economic activity.

Today, he suggested, China resembles the United States in the late 19th century and Japan in a similar period in its rapid creation of large-scale manufacturing capacity. Continued rapid growth of manufacturing capacity will be the key definer of China's economic development over the next decade.

The main growth engine in the economy is the movement of rural labor into urban industry. The economic outlook in China ten to twenty years from now depends on the availability of additional labor resources and the ability to generate jobs for rural migrants to urban environments. The speaker was optimistic that China will succeed, as it concentrates on the development of new industrial clusters and "dense supplier networks" or on the infrastructure necessary to support a robust supply chain. Urbanization, he noted, creates high investment demand, and the shift of production from the state to the private sector now underway is an additional growth engine.

While the United States continues to lecture China on the need to increase domestic consumption, the presenter argued that a massive boost in consumption-driven growth is unlikely in the next five to ten years. For that period, China's growth strategy is likely to rely on high levels of investment. After all, he noted, China's current high rates of personal and household savings are partly a reflection of low government spending on key social goods such as education and health care.

Low savings in the corporate sector reflect the absence of mechanisms for distribution of corporate profits outside of the company itself. Profits remain within the company generating them, and capital markets remain highly inefficient. This trend also hinders the growth of consumption.

To generate higher consumption, the speaker pointed out, several things would be required:

- An increase in overall, long-term wealth;
- A government decision to spend much more heavily in such areas as education and health care – this is unlikely to occur;
- Significant capital market reform to distribute corporate profits more equitably throughout the economy; progress in this area remains slow.

To a question as to whether China's projected growth rates will be sufficient to avert increased unemployment, the speaker indicated that current government projections of average 8.5 percent growth in the next five year plan, while conservative, are likely to be sufficient to meet China's employment demand. He noted in addition that the government continues to lengthen the amount of time that students are required to remain in school, in part as a way of modulating the flow of new labor into the labor market. The speaker also noted his expectation that manufacturing employment, which has been declining as a result of massive state-owned-enterprise reforms and restructurings, will rebound.

A participant wondered whether improved productivity in Chinese industry would have adverse employment effects. The speaker responded that China's educational system is the "key factor" in the country's social advancement. He pointed to a rapid increase in the numbers of Chinese people returning to education or achieving higher educational levels, and to the rise in popular spending on education. Of critical importance will be the maintenance of equitable access to education, in the eyes of a public eager for opportunity and a brighter future.

***Presenter II*: Kenneth Lieberthal– China as a Consumer**

The presenter on this next topic noted, following up on the above comments that Chinese university matriculation had risen by 400 percent since 1998.

In taking up the topic "China as a Consumer," the speaker chose to focus on government requirements for goods and services. He raised two central trends as critical determinants of those requirements: continuing urbanization and the growing need for environmental amelioration.

The scale of rural-to-urban migration is enormous, and accelerating. It is unstoppable over the next 15 years. There is excess population in rural China; cultivable land is actually diminishing; and rural production adds only a very small amount to GDP. The marginal productivity of rural labor is near zero. *Any* production from urban employment is likely to be higher. Despite the migration of between 120 and 140 million people from rural to urban environments in the past thirteen years, the rural population of China today is the same as it was thirteen years before.

Moreover, obstacles to entry into the cities are declining, even as the conversion of cultivable land to suburban and urban uses drives more agricultural dwellers from the land. China's strategy, the speaker pointed out, calls for accelerated urbanization, as part of the quest for a reasonable ratio of productive workers to dependents in the urban sector.

By 2020, China expects the rural to urban migration to equal two-thirds the population of the United States. This has significant consequences for the development of infrastructure to meet that migration: roads, health facilities, schools, power, water and sewage systems, and housing.

At the same time, the speaker expects that, broadly speaking, this urbanization trend will generate more disposable income in the economy. The regime's plans call for three mega-centers – Beijing/Tianjin/Tangshan, the Lower Yangtze, and the Pearl River urban center – to contribute 65 percent of China's GDP by 2020, up from 38 percent at present. While all three of these mega-urban centers will inject China even more vigorously into the world economy, all three could be seen as particularly vulnerable to security threats.

With regard to environmental amelioration as a key driver of China's economic progress, the speaker focused on the critical problem of China's water resources, both their depletion and their degradation. The majority of China's cities are now classified as water-scarce. Forty percent of urban water is untreated. Water rationing is likely throughout Northern China. Waterborne diseases are spreading, while acid rain is damaging cultivable land.

China's dependence on coal raises huge problems. Water for coal-washing is insufficient, so coal is transported unwashed (burdening the transport system and wasting still more energy), and burned unwashed, with attendant exacerbation of China's notorious air-pollution problems.

With these and other challenges as immediate background, China's next economic plan envisions massive expansion of expenditures on environmental projects – to RMB 1.3 trillion. Yet, except for very large projects like the North-South water transfer project, China remains environmentally very weak. Environmental constraints on growth are going to be serious in the next decade, and trends will worsen later in the period.

Discussion

A participant noted that one of the presenters had predicted continued high rates of Chinese savings, while the other had predicted massive increases in PRC government expenditures on urbanization and environmental amelioration. Would the latter trend cut into China's savings so that the PRC might be less able to continue to purchase U.S. government securities, as it has done in such great volumes in recent years?

The first presenter replied that the answer to that question was not clear. The National Development and Reform Commission's much-discussed concentration on improving the quality (i.e., the efficiency) of Chinese investment might go some way toward increasing the "bang for the buck" of Chinese investment. To date, no signs of an early decline in the savings rate below the investment rate have become evident.

Another commenter pointed out that the source of PRC investment growth is *not*, as is often maintained, China's global trade surplus. U.S. securities purchases have thus far been financed mainly from capital inflows. The presenter and the commenter discussed whether henceforth very large trade surpluses were likely to be "structural" and continue indefinitely, but they did not reach consensus.

Another participant noted that, even though China laid off more than 50 million workers from collapsing state-owned-enterprises in recent years, the overall employment picture has shown improvement. He pointed out that the size of the labor force is likely to peak in about ten years, after which overall economic growth may not need to be as high in order to maintain adequate employment levels. The same commenter noted that consumption as a percentage of GDP has actually declined over the past decade. Household savings have risen, not declined, as urbanization has increased. He pointed out that in regard to consumption trends in China, the government can only control its own behavior, and that it should be spending more on services, infrastructure.

As the discussion proceeded, one of the presenters observed that, previously, China had constituted a foreign and security policy issue for the United States, but under current economic trends, China is becoming an issue of increasing significance to fundamental U.S. domestic policy decisions as well.

A participant extended that observation beyond China, referring to Clyde Prestowitz's recent book analyzing the significance of the entry of three billion new participants into the mainstream of global economic affairs. He pointed out, against that background, one of China's real vulnerabilities lies in the possibility that the developed economies of the United States and Europe might act to limit China's ability to sell into their markets.

An earlier presenter, picking up on this theme, noted that Chinese enterprises are now highly focused on selling to China's domestic market. He questioned whether a possible closing of the U.S. market to Chinese goods would, in fact, "hurt that much." Another presenter replied that a precipitous drop in external demand would be very bad for China's economy. However, he added that it was difficult to conceive of a radical closure of the U.S. and European markets to China's exports and observed that if the United States did attempt to strike a damaging blow at China in that way, China would be more likely to reach accommodating arrangements with its European and other trade partners.

A participant in the workshop observed that China is *not*, contrary to popular image, an export-led economy. Domestic demand in China is not solely, or even heavily, dependent on the United States. This comment occasioned a lively exchange. The participant noted further that, until this year, the contribution of China's trade surplus to GDP growth was minuscule; 2005 will be the first year of a significant contribution to such growth from China's global trade surplus. Yet, he argued, for a continental economy, the total volume of Chinese foreign trade is very high. Any forcible constriction of such trade would most likely have severe effects on the overall Chinese economy.

Session V: China as a Global and Regional Player

Presenter I: Kenneth Lieberthal– China as a Global Player

Kenneth Lieberthal, the principal presenter in the first session, offered remarks around three issues: a) To what extent will China be able to leverage its economic power for global influence? b) What will China's role be as an international economic competitor? and c) How far will interdependence constrain China's international behavior?

China's Leverage

The presenter made clear at the outset certain assumptions:

- Over the coming decade, chances of strong economic growth in the PRC are very good. At the end of the coming decade, though, China will face very difficult issues and could be in "deep trouble."
- China currently continues, and will continue, along the path to global integration, and as seen in its conduct following WTO accession, the continuation and extension of core reform policies.
- Assuming continued rapid economic growth, China has a huge stake in the global "rules of the road."

From these three assumptions flow certain consequences:

- While China has not thus far stepped to the forefront in most global economic negotiations, it will continue to voice its national interests, and those interests will include continued global trade liberalization and reduction of barriers to international economic relations.
- As China's already astute diplomacy becomes even more adept, its impact on global economic regimes is likely to increase, because it is likely to develop further its ability to mobilize international support for its positions in multilateral and bilateral fora.
- China's relationship with the United States is so dense that it will need to remain very prudent, even in situations of bilateral disagreement or friction. Economic steps that could cause damage to the U.S. economy, such as a diminution of China's substantial holdings of U.S. government financial instruments, would also affect the economic health of China's crucial market. It is likely, however, that China will broaden its dollar investments to include, for example, U.S. corporate bonds. Any alteration of China's established mix of dollar investments could raise diplomatic issues, but it should not be expected that China will use its foreign exchange holdings as a pressure device with which to influence the United States on other issues.

China as an International Competitor

The presenter took a measured view of China's likely competitive prowess over the next decade. He noted that Chinese firms (those without foreign investment or foreign participation in enterprise leadership) are for the most part far from global competitive dominance at present, except when low labor costs are the determining concern, and that they still, as a whole, display serious systemic weaknesses. Research and development remains small; middle management ranks remain thin; design capabilities remain modest; and, importantly, he suggested that as a whole, Chinese firms demonstrate very limited capacity to optimize choices across a wide spectrum of alternatives. Chinese firms, he also suggested, remain deficient in their knowledge of foreign markets and business environments.

Chinese firms, he estimated, will require ten to twenty years to ameliorate these weaknesses. For that reason, the speaker argued, the key international competitive impact for China over the coming decade will continue to lie in multinational corporations' growing use of China as a production platform.

The speaker touched briefly on "The Chinese Model," i.e., the degree to which China's approach to economic growth, social change, and political organization will prove influential elsewhere. He noted that the notion of a "Beijing consensus" – a putative formula for rapid economic growth within a non-liberal political system that retains very substantial government interference in the operation of the economy – is increasingly prominent. He predicted that while China will not proselytize its "model," but its attractiveness as an example to other countries will strengthen if its economic performance continues to be very strong.

The speaker also mentioned briefly China's current internal discussion as to the desirability of a standard-setting role for the PRC in global manufacturing; much world attention has of late been focused on whether China will seek to establish technical standards in such fields as information technology. The speaker noted considerable opposition within China to the continued paying of technology licensing fees to other countries' companies, when China's current and future market is so significant to world commerce. While discussion of China's potential standard-setting role flourishes within the PRC, no decisive outcomes are yet evident.

Global Interdependence as a Constraint on PRC behavior

The speaker noted that China's increasingly dense integration with the world economy is likely to place heavy constraints on its behavior. Stability and diminished perceptions of China as a threat are two important elements in the country's global economic strength. Despite this, the restraining influence of global interdependence is not unlimited: the speaker pointed to an uncontrolled crisis over Taiwan and to the possibility of a rapid downgrading of relations with Japan, as examples of those limits.

The speaker summed up by noting that China's interdependence with the global economy is "becoming strategic;" China will go far, he predicted, to ensure that global events do not derail its growth strategy. While seeking to restrain U.S. influence, China will continue to strive for stable and positive diplomatic relations with the United States. It will, however, be vigilant for indications that the U.S. is attempting to contain or damage China's economy, and might well adjust its posture if it perceives the United States to be doing that.

***Presenter II*: Ed Lincoln– China as a Regional Player**

The principal speaker in the second portion of Session V, addressing China's role in the Asia-Pacific region, joined the first speaker in the expectation that the next ten years will see continued rapid economic growth in China. He noted, interestingly, that while economists over many years have come to understand the crucial importance of an infrastructure of effective rules on which economic growth must rely, analytical understanding of how a country can grow robustly even while "getting things wrong" was less fully developed.

The speaker noted that the region he called "East Asia Other than Japan" does not share Washington's concerns over trade imbalances, currency maladjustment, or even intellectual property rights abuse for several reasons.

First, China is in fact an open economy, with more than 30 percent of its GDP accounted for by imports. This is in stark contrast to Japan's import ratio, which rose during its economic development; Japan simply did not become a more open economy. Thus, China looks good to the region, and there is a pervasive sense that China represents opportunity. Furthermore, China is "rather open" to inflows of foreign direct investment (FDI). FDI currently runs between ten and twenty percent of total fixed capital formation; in Japan, FDI accounts for *one* percent of fixed capital formation.

In addition, the fear in the region that China would up FDI to the detriment of other economies' ability to recruit foreign investment has receded. FDI is in fact returning to ASEAN (except for Indonesia), in part because multinational corporations (MNCs) appear interested in hedging their bets by placing investments simultaneously in China and in Southeast Asia. Another factor in Southeast Asia's increasingly tranquil view of China is that, collectively, ASEAN can wield considerable economic clout, given the size of the region's overall population.

Finally, the speaker noted that China's trade in 2004 with East Asia (not including Japan) was actually $80 billion in deficit, in contrast to its enormous merchandise trade surplus with the United States. This statistic also accounts for the contrasting visions of China in the region and in the United States.

He then turned to a discussion of China and Japan, noting that, for the most part, the same observations pertain. Japan's exports to China are rising rapidly. Japanese investment in China has remained low but is now rising quickly to a current level of about US$5 billion per year. Japan's worries about "hollowing out" in the face of China's economic rise have also receded; and, Japan enjoys a substantial trade surplus with the PRC.

In spite of these positive economic views, the bilateral political relationship has seriously darkened. Japanese anxiety over the international power implications of China's rapid economic growth is now acute, and the speaker noted, Japan had suffered a "bruised ego" as the center of economic leadership in Asia has shifted in China's direction. The speaker pointed to a series of provocations and irritants mostly originating in Japan, including repeated visits to the Yasukuni Shrine by the Japanese Prime Minister and a number of stridently nationalistic statements by the Japanese Foreign Minister. Other irritants include

Education Ministry approval of school text books containing interpretations of history highly offensive to China; persistent comments by right-wing activists in Japan; the recently-disclosed suicide of a Japanese consular diplomat in Shanghai; and the public disclosure by the Japanese government of Chinese submarine entries into an oil-drilling zone claimed by Japan. In the latter two cases, the discretionary decision by Japanese authorities to make public these sensitive events appeared as a form of Japanese provocation.

In the speaker's view, economics will ultimately triumph. The Japanese business community, long torpid on bilateral problems, has begun to make its voice heard for example, the chairman of Keidanren (the Federation of Economic Organizations, Japan's largest and most influential business group) recently called for an end to prime ministerial visits to the Yasukuni Shrine. The speaker expects that Japan's most highly placed and highly visible figures will discontinue their Yasukuni visits. In the end, the speaker predicted that China and Japan will "muddle through."

Finally, the presenter provided to brief observations on regional integration between China and the rest of the Asia-Pacific region. His expectation is that integration will proceed slowly. There have been few substantive developments so far, the most prominent of which – the so-called Chiang Mai Agreement – was mostly symbolic. Within the region, there is still broad disagreement as to who makes up "the region", as can be seen in the proliferation of plurilateral meetings in the area.

Still, the speaker suggested, "something *is* happening," and the United States should remain watchful. Evolution of the Asia-Pacific region along lines of the European Union, he suggested, would be highly undesirable.

He admitted to some ignorance as to PRC perceptions of East Asian regional integration. The PRC, he did note, recognizes the centrality of the United States, and is unlikely to move in an exclusionary direction. Any regional free trade agreement with ASEAN, he argued, would be more of a political than an economic device. All in all, he predicted that China's enthusiasm over regional integration would remain muted.

With regard to Sino-Indian economic relations, the speaker pointed out that meaningful economic cooperation remains for the future. Synergies will not come easily. At present, less than one percent of China's exports are destined for India.

In conclusion, the speaker returned to his first observation, i.e., that East Asia does not react to China with the combination of anxiety and fear sometimes demonstrated by the United States. He suggested that a more vigorous use of APEC – the Asia-Pacific Economic Cooperation entity – might offer the United States a means of addressing its concerns about China's future regional role.

Discussion

The first discussant noted that World War I had proved the fallacy of the shibboleth that nations who trade with one another do not go to war. China, he noted, is "prickly," even with its best trading partners: why is this so? Many countries suffered at the hands of Japan in the 1930s and 1940s: why do only the Chinese remain so sensitive? What harm would come to anyone, he asked rhetorically, if China were simply to forget about such issues as the Yasukuni Shrine visits by Japanese leaders or the circulation of school textbooks?

One of the principal speakers responded that, *vis à vis* the United States, China had in fact become much less "prickly" of late, and similarly had become much less bumptious in multilateral institutional fora. "Prickliness" with Japan, he suggested, was now the exception to the rule in China's behavior. And even there, China currently seems reasonably receptive to some notion of a Northeast Asia Security Community that would involve China, the United States., Japan, and possibly South Korea. The speaker noted that South Korea is as "prickly" toward Japan as China. Southeast Asia, on the other hand, experienced Japanese wartime occupation and domination in a somewhat different manner than China and Korea.

The other principal speaker joined in the response. In 1990, he asserted, Japan was still going out of its way to "be nice" to China, rapidly increasing foreign aid to China, minimizing its hostile response to the events at Tiananmen in 1989, and so on.

A participant added that China formerly saw benefits to itself in a high degree of U.S.-Japan cooperation, because such cooperation helped to limit Japan's independent military development. Currently, however, the United States is working to reconfigure Japan as a "normal country," with subsequent implications for Japan's military development.

Another participant, continuing the response to the original question, also pointed out that some Chinese concerns over Japan's behavior appear to be based on bad information. For example, an unbalanced use of far-right-wing sources as definitive statements of Japanese attitudes toward China.

Another participant weighed in with the comment that the real danger in the current Sino-Japanese tension is that the common people in both countries are beginning to hate each other. China's visceral feelings about Japan and the Japanese are genuine; most Chinese families have had a direct encounter with tragedy at the hands of Japan. Chinese feelings go deeper than that, back to the "Century of Humiliation" which included the "loss of Taiwan". Thus, the matter transcends the issue of Yasukuni Shrine visits.

Another participant noted that in his government agency, China is viewed with a sense of danger. He perceived that U.S.-China policy is conflicted, with both a desire for greater Chinese openness and trade and a vision of China as a threat. He pointed to a pervasive sense that "China wants to push us out of Asia." When speaking with Americans in Beijing, he noted, the optimistic vision seems to prevail; outside of China, though the sense of worry and fear tends to dominate.

How, he asked the principal speakers, do the Chinese see themselves in relation to the United States? He added a second observation on the matter of nationalism in China. Noting the expressed view of former Prime Minister Lee Kwan Yew of Singapore that future generations of Chinese leadership may be far less cautious in global affairs than the present generation, the participant observed that even now, the younger generation in China is far more nationalistic in its world outlook than are those currently running the country.

To this, one of the principal speakers replied that China does not have a short term plan to "drive the U.S. out of Asia," but that it does want to be highly respected throughout the region. This may produce unanticipated behaviors. The speaker cautioned against expectations for China to "act like us." The Chinese themselves remind the United States that their analytical processes are not necessarily our own. On North Korea, for example, the speaker predicted that China will not agree to a sanctions-focused approach; they remain more concerned than the United States with preservation of the other party's "face" and tend to be averse to hardball tactics.

To the expressed concern over the global outlook of later generations of Chinese leaders, the speaker pointed out that China's domestic problems will be bigger and more intractable, by the time that such younger leaders come to power. The assumption that a future Chinese Leviathan, having solved its domestic difficulties, will take on the world is likely to be mistaken. China will not try to "drive the United States out", bur rather will try to fill in holes or vacancies left open by the United States.

The other principal speaker at this point spoke of a sense of *déjà vu*, remembering the wave of American insecurities focused on Japan two decades ago. What, he asked rhetorically, would "pushing the U.S. out of Asia" actually mean in practice? China has embraced the notion that it lives in a global economy and that its domestic development is critically dependent on global engagement.

Another participant noted growing interest among Chinese firms in investing in the United States "to create jobs in the United States" and pointed to several recent examples of Chinese efforts to stimulate e-commerce with the United States; fifty thousand Chinese firms have indicated a desire to participate in one such endeavor.

Another participant spoke critically of the phrase "drive the U.S. out of Asia." While in its military dimension, the term might be interpreted to mean the quest to eliminate U.S. bases in the region, economically, the term "makes no sense at all," noting the continued increase of MNC participation in the PRC economy.

Another participant pointed out the tendency within the Pentagon to espouse realist views of international affairs and of China. These include familiar historical analogies to the rise of Germany in the late 19th century and Japan in the early 20th century in a perceived "zero-sum" environment; He noted this is a different era. Global interdependence is massively different from the international economy of the pre-World War I period, to say nothing of the limits of feasibility of future conflicts in which thermonuclear weapons lie at the end of the alley. This speaker sees the leaders of the United States, China, and Japan as focused on maintaining the rules of the game and the structures of global interaction. In his view, the military community does not widely grasp, let alone embrace, this perception.

A question arose regarding the future of major Chinese companies in global competition. Will they develop globally powerful brands? And separately, what might be the implications for China's international relations of the massive migration from China's rural sector to non-agricultural communities, a development anticipated in the near future?

In response, one presenter noted China's intention to concentrate on the development of three major coastal regions, the Bohai region encompassing Beijing, Tianjin and the Bohai coastal zone; the Lower Yangtze Delta, and the Pearl River zone in the southeast. All three of these development-focused regions are already a key focus of China's interaction with the global economy. All three, by virtue of their placement along the Chinese coast, are also particularly vulnerable militarily. He concluded that China has chosen to "place its eggs" in a basket whose preservation is predicated on the avoidance of military conflict. This could, he speculated, reinforce China's support for global economic changes conducive to China's integration and growth. Indeed, he noted, China's recent rhetorical emphasis on its so-called "peaceful rise" is misplaced: the "threat" of China is not to world peace, but rather arises from the disruptions attendant on China's massive economic development itself.

The same participant temporized on the matter of Chinese companies' future ability to develop globally prominent brands. A few are already recognized internationally, but they are not achieving dominant global dominance. The deep-seated PRC tendency toward government intervention to mitigate the stresses of a truly competitive commercial environment ultimately discourages, rather than encourages, competitiveness of Chinese firms. The other principal speaker noted in a supplementary comment that the Japanese experience had begun with Japanese firms' development of prowess in original equipment manufacturing (OEM) for other companies' brands – even in the automotive sector.

A presenter on the program offered views on the differences between Chinese and U.S. modes of thinking about economic development. He cautioned not to expect China to use the "zero-sum and deductive mindset" in its approach to economic development that characterized U.S. policy thinking during the Cold War. China, in his view, is more likely to ask, "What works?" and act on the answer. As early as the 1980s, this participant discovered what he termed "Chinese calculus." In sum, he counseled that analysts must regard the Chinese economy with an eye to the variety of ways in which an economy can develop, not to a single formula deemed by the observer to be the only one feasible option.

The same presenter did not accept the implication, raised earlier, that the citizens of China and Japan maintain a visceral hatred of each other. Both groups, however, think that their governments have not learned the lessons of history. The trigger, in China in recent years has been the growing appearance of Japan as a U.S. military proxy, in a manner seen as adverse to China's interests. This presenter offered the subjective perception that a kind of "China furor-generation" is underway in Japan with the aim of generating popular support for the Two-Plus-Two Agreement with the United States on the defense of Taiwan.

Another participant asked what it would take to induce China to take formal economic sanctions against Japan. There seem to be few examples that offer an indication of what it would take. One participant noted that China and its Asian trade partners have engaged in some tariff-increase maneuvers in the course of commercial disputes, but that there has been nothing of an overarching economic/political nature.

Another participant put several questions to the session's presenters:

- To the first presenter's suggestion that China will be reluctant to use its growing economic power, including holding large quantities of U.S. government securities as leverage against the United States, the questioner asked whether the speaker's optimism extended as far as five to ten years ahead. The questioner noted recent examples of Russian heavy-handedness in this regard (presumably this was a reference to, among other things, Russia's then-fresh attempt to coerce Ukraine in a gas pricing dispute by cutting the supply of gas to Ukraine and thus to Western Europe – *Rapporteur*).
- To the second presenter, the questioner commented on "driving the U.S. out of Asia." He noted that China appeared committed to Asia multilateralism, but that China sees APEC as a weak reed and may be willing to look toward other Asian vehicles, with or without U.S. participation.
- To the second presenter, the same questioner asked if the perception that most of Asia sees China in terms of opportunity and not threat will continue or will a greater sense of threat emerge over time? The questioner expects that Asian views of China will become more complex, or ambivalent, in coming years.

The participant added his own observation that China had played hardball with its economic leverage against, for example, North Korea, the guessed that China would not be above attempting to coerce a U.S. company like Boeing to support U.S. policy positions amenable to China's preferences. The first speaker replied that his sense of likely Chinese restraint in the use of its economic power related to multilateral settings, rather than to bilateral ones, and he agreed that China has on occasion played hardball in bilateral venues.

He also noted that, generally speaking, it is not China's style to take the lead in multilateral economic settings, but that it will act more subtly, and without Russia-style heavy-handedness. He reiterated that China's freedom of action is constrained by the fact that the key international players with whom China must deal are all significant players in the Chinese economy itself, a situation that makes China very different from either Japan or Russia.

The other presenter, responding to the questions above, offered the view that as long as China's trade balances with Asia remained favorable to other Asian states, the benefits of China's engagement within Asia will continue to be firmly understood.

Session VI: China as Inflator and Deflator

Presenter I: David Hale– China as an Inflator

The principal presenter in this session chose to concentrate primarily on China's role in global commodity markets.

The world has passed a landmark. China has displaced the United States as the leading consumer of industrial raw materials such as copper, aluminum, iron ore, and steel. China's production of steel is now double that of the United States and Japan combined. China has also replaced Japan as the second largest consumer of oil. At the same time, per capita consumption still remains modest at only 25 percent of U.S. copper consumption per capita and ten percent of Germany's per capita aluminum consumption.

The "China factor" in global commodity markets will grow, he asserted, and the Chinese business cycle will become the dominant factor in the setting of global commodity prices. Fifteen years ago, China was a net exporter of commodities. The situation today is reversed. For China, its present role is unprecedented. The huge Chinese manufacturing sector drives commodity demand. Even after the recent revision of China's national economic statistics to reflect a much larger role for the service sector, manufacturing still accounts for 45 percent of GNP. China's current annual rate of manufacturing growth is 16 percent; that of the United States is five percent. China's manufacturing sector is destined to be the largest in the world.

The manufacturing sector is driven by China's large and growing domestic market and by exports, particularly exports linked to foreign direct investment. Foreign-invested firms currently produce 55 percent by value of total PRC exports. This secular trend will continue for at least the next ten years, and perhaps indefinitely.

After laying out these findings, the speaker discussed their implications:

1. China is attempting to develop Free Trade Agreements (FTAs) with commodity-producing countries such as: Chile, Australia, Saudi Arabia, New Zealand, and South Africa. South Africa is of mixed minds about the prospect: its mining sector favors it, but its textile sector does not, as South Africa currently maintains high textile tariffs.

2. China is also using infrastructure investments to promote commodity relationships. Hu Jintao's recent Latin American swing brought pledges of Chinese investment – $10 billion for Brazil, $15 billion for Argentina. In Cuba, Hu "bought a nickel mine." On the other hand, Brazil has lately displayed some dissatisfaction with this, as PRC investment has not materialized. Brazilian textile firms, moreover, now object to the Brazilian government's earlier declaration that, China was a market economy (a politically significant declaration much sought by China, as China continues to face stiffer treatment within the WTO framework as long as it remains designated a "non-market economy.") China has even applied to join the Inter-American Development Bank, since membership would give Chinese construction companies access to IADB country markets.

As U.S.-Venezuela relations have chilled, Washington has begun to be concerned over the warming of Venezuela-China relations. President Chavez of Venezuela has traveled to China to encourage increased Chinese FDI and has expressed an interest in selling the oil company CITGO to China.

3. China plans to expand foreign trade with Africa from $18 billion to $30 billion. It has made refinery purchases in Algeria and Egypt. It has active interests in Angola, Gabon, and Nigeria, as well as small investments in Sierra Leone, the Central African Republic, Congo, and Zimbabwe. Its first overseas military deployment, of 4000 MPs, was to Sudan to protect an oil pipeline transporting oil acquired by Chinese companies.

4. China is also active in North America, notably in Canada. It bid on Noranda, but the bid ultimately fell through over currency valuation and other issues. In April 2005, Chinese entities made small investments in Canada's tar sands industry. There have been rumors of the possibility of a Chinese takeover of a Canadian oil company. In October, a Chinese company bid on the Ecuador gas services business of another Canadian gas producer. In the view of the presenter, there are good reasons for U.S.-China collaboration in the energy sector in such areas as energy technology, conservation, response to OPEC power, etc.

5. In Central Asia, a Chinese entity made a bid to take over PetroKazakhstan (headquartered in Canada); and, the takeover is underway. The PRC has sought to enhance and stabilize its relations with Central Asian states through the Shanghai Cooperation Organization. There have been some Chinese investments as well in Turkmenistan. A new pipeline now connects Kazakhstan and China. Russia has shown a cooperative attitude in regard to the routing of that pipeline.

6. Russia is also a focus of Chinese interest. In January 2005, President Putin indicated Russia's willingness to consider the sale of some assets of Yukos, the Russian petroleum firm, to China or India. China currently brings in Russian oil by rail, but there is a strong likelihood in the future of a Russian pipeline into China, as well as to a Russian oil port dedicated to shipment of oil exports to Japan.

The presenter noted that China now exerts upward pressure on global prices of many commodities. China, for its part, is making efforts to reduce waste and increase efficiency, especially in petroleum consumption, as it remains very aware of its energy vulnerability.

The PRC has not signed the Kyoto Protocol, for reasons well known to participants. A 2005 agreement with the United States on technology sharing has yet to produce any concrete programs or results.

The presenter concluded by noting that coping with new challenges and new rivalries in global commodity economics will be a major task for the United States.

***Presenter II*: Sandra Polaski– China as a Deflator**

The presenter on "China as a Deflator" concentrated on China's impact on labor markets. While China may constitute an inflationary force in commodity markets and certain agricultural markets, on the labor side, China's influence is deflationary. The Chinese labor supply is the central factor in this deflationary impact, and it is in labor-intensive economic sectors that the phenomenon is clearest.

The speaker organized her presentation around four issues:

- Labor supply and the global labor market structure;
- China as a low-wage labor center over the past twenty and next ten years;

- The role of trade liberalization as related to China's impact on global labor markets;
- The future of the Chinese labor market.

The central observation of this presentation is that, with the end of the Cold War, two hitherto separate production systems melded into one: the Western and the Socialist. Now, the world displays a single global production system.

The U.S. labor market is approximately 150 million. All developed economies together account for approximately 450 million workers. China possesses 700 million and India another 400 million. The former Soviet bloc adds 250 million, and all other developing economies bring in another 900 million workers. Thus, suddenly, the global labor force has doubled. The presenter then considered China as a reservoir of low-wage labor since the 1980s.

Much of China's achievement in poverty alleviation over the past 25 years took place in the 1980s in the rural sector. That trend has now slowed. The greatest achievement was at the "extreme poverty" level; populations living on less than US$1 per day are now confined to a relatively small number of super-poor areas. The number of those living on two dollars a day, however, dropped far less. This is the "high end" of the peasantry that flows into China's manufacturing work force, thus providing continuing downward pressure on wages in China.

Although the labor supply in China will grow more slowly in coming years, somewhere between 100 million and 150 million people, from the rural sector and from the ranks of the laid-off from state-owned enterprises still require absorption into the work force.

China's accession to the World Trade Organization contributed to the country's heightened impact on global labor markets. Prior to accession, the PRC anticipated losses of 6 million jobs in agriculture, but gains of 6 million in the apparel sector. U.S. and EU market-closing measures against Chinese apparel imports will exacerbate PRC employment difficulties.

The Carnegie Endowment has developed a model to project the impact of the Doha Round on global prices. Under this model, most agricultural prices would rise. There would be marginal impacts on manufactured products, no impact on oil and gas, and price reductions on metal products, cars, parts, and apparel. China will be a heavy beneficiary of the Doha Round, if the Round concludes with agreements assumed by the Carnegie model as low-labor-cost products will move more easily into other markets.

With regard to demographic trends in China, the presenter suggested that the picture will change significantly. The Chinese population is aging. The leading edge of a smaller work force is just now arriving in the workplace. This "supply push" will moderate in the future. Regardless of future changes in fertility rates, the Chinese labor force will grow at a lower pace in the next thirty years.

This gradual alteration of the PRC labor force, in the direction of smaller, older and more experienced could profoundly alter China's comparative advantage in the global economy twenty years from now. By that time, China may be searching for comparative advantage, not in the lowest-wage and unskilled/semi-skilled categories of recent decades, but in sectors requiring the kind of labor that will be found in the future PRC labor pool.

The speaker touched briefly on a series of issues facing China and its global trade partners in areas related to employment:

- First, is the challenge of absorbing surplus labor from the agricultural sector and from the reorganized state-owned-enterprise sector.
- The downward pressure developing countries on wages and on product prices until China have absorbed its massive labor surpluses.
- Policies, such as market-closing restrictions in the United States or other importers of Chinese products, which delay the crucial absorption of surplus labor into the Chinese workforce, will actually *prolong* global deflationary pressures, pushing Chinese product prices downward and perpetuating the existence of extra-low wage labor.
- Meanwhile, China faces the challenge of preparing itself for a post-labor-surplus economy. It needs to plan long-term for skills training and other measures to the ultimate reduction and disappearance of the surplus of unemployed workers that now is the dominant feature of the labor economy.
- As China moves beyond today's labor surplus, its deflationary effects will move up the value chain to affect more heavily products of medium- and high-skilled labor.
- To restate a point made earlier, the more wealthy economies do to constrain China's absorption of the current labor bulge, the more they push their problems off to the future without addressing them.

Discussion

One participant noted the importance of recognizing China's impressive gains in productivity over the past twenty-five years, first in agriculture, then in the urban economy following Deng Xiaoping's 1992 "Southern Tour," and the reinvigoration of market-oriented reforms, and most recently in China's growing emphasis on technological improvements. This last gain distinguishes China from other "Asian Model" countries and poses a distinctive challenge to the United States. Those who have suffered most from PRC productivity gains, he noted, were other poor developing countries that have not achieved China's gains in infrastructure and other productivity-enhancing arenas.

Turning to the implications for the United States of China's growing economic prowess, including its rising productivity, this speaker noted that economic theory stipulates that no economy can be the dominant competitor in everything at once. The challenge facing the United States, he argued, is to find America's future competitive advantages. One must not assume that competition with China is futile. The United States must develop an economic flexibility to permit it to adapt successfully to constantly changing circumstances.

The participant acknowledged that rising productivity further exacerbates the impact of labor oversupply on prices. She also noted that, as China's economy grows and domestic demand rises, China can itself moderate the deflationary effects on the world economy that had been one of the foci of her presentation.

Another participant noted that, in the past year, widely-noticed labor shortages had appeared, particularly in Guangdong Province, a key center of Chinese export production. The principal presenter noted, however, that available information indicates that such spot shortages are not indicative and that short labor supplies will not drive labor prices upward for many years to come.

A question about the current average hourly wage in China led to various demurrers and qualifications, but two general observations emerged. First, Chinese wages in absolute terms are not the lowest in the world by any means; and, second, that while Chinese wages are higher than many other low wage economies', productivity in China is also much higher.

Discussion then refocused on the first of the session's two presentations, dealing with China's effect on global commodity markets.

One participant cautioned that Chinese consumption figures are not automatically indicators of China's impact on global demand. In the cement industry, for example, China consumes 40 percent of world cement, but it produces domestically most of what it consumes. In such cases, blaming China for shortages that appear is simplistic and inaccurate. A similar point could be made with regard to oil: increases in U.S. consumption have far exceeded increases in Chinese consumption, and it is facile to assign responsibility for short supplies and higher prices solely to rising Chinese consumption.

These observations drew a qualifier from another participant, who pointed out that since 2003 the very rapid rise in Chinese demand has in fact become a causative factor in driving global prices higher. That observation, in turn, drew a rejoinder that the very heavy increases in Chinese demand in 2004 gave way to much slower demand growth in 2005.

In response to a related question as to how much of China's imported oil comes from such sources, i.e. overseas production owned by or dedicated solely to Chinese importers, the first principal presenter indicated that the major source of "captive oil" for China is Sudan and that less than ten percent of China's total oil imports are from "captive" sources. By way of illustration, he noted that after five years of expanding its controlling access to overseas petroleum sources, China's total global reserves amount to less than ten percent of the global reserves of one U.S. company – Exxon.

Discussion then returned to the presentation on labor. One participant observed that it is not the poorest of China's rural population who leave the villages for urban work opportunities: it is the "best educated, best endowed" rural inhabitants. He noted as well that in spite of the massive movement of population from rural to urban locations, natural increase has kept the size of the rural population unchanged. What is shrinking, though, is the amount of cultivable land, at the rate of one to two percent per annum. For this reason, pressure on land, and pressure to migrate off the land, is likely to increase. Demographic trends in China mean, he continued, that by 2015 the current favorable ratio of working adults to citizens not in the active work force will deteriorate sharply.

A continued analytical distinction between urban and rural demographics, however, remains important to understanding. The urban demographic trend is improving, thanks to in-migration.

In regard to labor rates, he pointed out, geography must also inform analysis. As coastal areas begin to move toward competitiveness in higher-wage production, there has been a widespread effort to move manufacturing that depends on low-skill/low-wage labor inland to poorer provinces with greater labor resources at the low end of the scale.

Another discussant took issue with the presenter's interpretation of the direct impact of the PRC labor supply on certain goods sectors. He noted others' predictions of a peaking of the size of the PRC labor pool by 2015 and emphasized that Chinese wage levels are among the most rapidly rising in the world. Once out of the entry level, Chinese wages are rising at ten to 15 times the rate of increase in the United States. The discussant associated himself with the earlier observation that productivity increases, more than the sheer numbers of available workers, are significantly responsible for the impact of China's production on global wage levels. In response, however, the principal presenter noted that the key index of measure is unit-labor costs which include both wages and productivity.

The presenter, returning to her prediction that, in the future, China will have a deflationary impact on higher-wage and skilled-labor manufacturing globally, qualified her comment to note that China will not be the only origin of such an impact, and that isolating China's sole impact will be difficult.

A participant asked how long it would take to absorb the "China labor bulge" and what would happen to the U.S. in the meantime, mentioning the difficulties facing the U.S. manufacturing sector, rising levels of United States indebtedness to Chinese holders of U.S. government securities, etc. The presenter responded that a prediction of ten years (from 2004) was optimistic. *If* China continues to grow vigorously; and, *if* the government's current emerging focus on rural incomes succeeds in raising rural consumption levels; and *if* external shocks (such as trade restrictions and sanctions) can be held to a minimum, one might "hope for a better equilibrium" in about ten years.

Responding to the previous list of "ifs," a participant noted that in 2005, PRC corporate profits actually had dropped sharply, and that many foresaw a near-term slowdown in the Chinese economy.

A few miscellaneous observations ended this session:

- China's infrastructure improvements, far more extensive than India's, have had a major effect on China's global export competitiveness (the implication being that such competitiveness entails more than simply a labor component).
- The Chinese government, which had briefly turned away from the traditional policy of compelling farmers to raise grain in the interests of food self-sufficiency at the end of 2003 returned to that policy. Now, authorities are warning that grain prices are dropping again. The "grain cycle" is an important factor in the overall analysis of rural economics, rural-to-urban migration, and their global impacts as discussed in this session.

- Finally, one participant asked if there was "something about the Chinese worker" that made Chinese labor more productive. The principal presenter acknowledged the difficulty of finding clear answers to that question across sectors and over time.

Session VII: Keynote Presentation

The luncheon presenter, noting that a number of his intended comments had been touched upon during the morning sessions, spoke informally.

On the question of productivity, he emphasized that the concept of Total Factor Productivity was important to proper analysis. This concept includes, for example, elements of education and training, but also includes government reform policies that are conducive to increased labor productivity, such as the many structural reforms China agreed to as conditions of its entry into the WTO.

Beyond that, he noted the sharp decrease in the share of total manufacturing accounted for by state owned enterprises (SOE). SOEs now account for approximately 20 percent of total manufacturing production. Privately-owned manufacturing enterprises account for a rapidly rising share of the total. At the same time, even in SOEs, productivity has increased. Thanks to the greater and more reliable information required of SOEs as they seek to be listed on equity exchanges, SOE appear to return on equity, at 3.4 percent in 1998, has risen to over ten percent in 2005.

A second element in rising productivity is the intensely competitive nature of the Chinese domestic economy. Overinvestment in many sectors, often fed by cheap or subsidized capital, has produced such heavy competition that it is difficult to raise prices within China. Excess capacity has thus sought overseas outlets. This factor must be added to the labor factor discussed earlier in any analysis of China's export behavior and its impact on global markets, and is likely to continue to play a serious role as long as overabundant capital is not efficiently allocated in China (i.e., as long as the banking system and other intermediary structures remain incomplete or irrationally operated).

The speaker turned to the notion of rebalancing the Chinese economy, with its current emphasis on "people-oriented growth," "harmony," in the face of rising rural labor unrest and other social destabilizations. Violent incidents, factory closures, social incidents arising from land alienation, and environmental degradation, have joined long-standing destabilizers such as floods and official corruption to breed increased rural resentments.

Thus, the CCP has turned to "rebalancing": higher wages in the river basin/coastal regions, plans for industrial migration to inland provinces, and heavier infrastructure construction in the central and western provinces. Rural agricultural taxes are now eliminated. Eleven provinces have extended urban "hukou" – residence status – to rural migrants to cities, including so called rural cities. Experiments with this continue in different provinces and localities. The aim is to keep people in their original locations, rather than encouraging migration to the East Coast cities, and to reduce rural discontent and potential social disorder in the interior provinces.

The speaker observed that, thus far, the PRC regime had "atomized" widespread social demonstrations and prevented their coalescence into something far more menacing, but that the government was strongly concerned over the future worsening of the problem. He contrasted China's situation with India's, pointing out that the vast majority of Indians had benefited not at all from the "India Shining" movement. On the other hand, China lacks the safety valve of popular elections. Thus, he interpreted widespread social demonstrations in the PRC rural sector as a kind of functional equivalent, a manner of expressing discontent that, in India, might find expression through the ballot box.

Looking ahead, the speaker warned that if the regime fails to deliver on the expectations now engendered by the rhetoric of Hu Jintao and the CCP leadership, the sense of disappointment will be heavy and the situation much more complicated.

The speaker then moved to another subject, the issue of the RMB exchange rate in the context of the foregoing discussion of rural society. He argued that the exchange rate issue is badly understood in the United States. Given the already very low level of corporate profits in China, a significant change in the value of the RMB would cripple or destroy many Chinese companies. When the People's Bank of China discusses the RMB with the State Council, the speaker suggested, the key question is always, "What are the employment impacts?" China may be concerned about protectionist measures by the United States, but it is more concerned about social stability in China and sees RMB revaluation in that context. Thus, even if good financial reasoning suggests revaluation, the employment consideration takes precedence.

In conclusion, the luncheon presenter spoke to the now-pervasive U.S. fear that China will prove competitive in *every* manufacturing dimension at once. Theoretically, as he had noted in the morning discussion, the answer is "no." But China is in fact different given its large pool both of low-skill/low wage labor and of higher-skill/higher wage workers.

Thus, the question facing the United States is whether it will be able to change its own allocation of capital and human resources with enough agility to stay ahead of China. This depends partly on the U.S. educational system, partly on the highest possible efficiency of capital markets in the United States, and partly on a frank recognition of the China challenge; while the China challenge may be broader than that presented by Japan in the 1980s, the current furor over China is reminiscent of that over Japan two decades ago.

Unlike the debate over the Japan challenge, however, or even an earlier wave of uneasiness over the economic challenge of uniting Europe, the current debate over China's economic challenge is accompanied by a serious discussion over China's implications for U.S. national security. The frequent assertions, for example, from the so-called U.S.-China Economic and Security Review Commission that the benefits China derives from its global economic activity are directly transformed into military threats against the United States complicate the discourse and heighten the possibility of an irrational American response to the economic challenge presented by China.

Discussion

One participant discussed in some detail the anatomy of U.S. concerns about China:

- Whereas traditionally the United States treated China as a problem within the domain of foreign policy and national security policy, China's presence today poses challenges in the realm of U.S. domestic economic policy formulation.
- There is considerable uncertainty regarding the long-term future of United States-China relations. One group of policy advocates holds that China must inevitably be an enemy of the United States. Another group argues that China is potentially such an enemy, but that this depends on how the United States manages its relations with China. Overall, though, the center point of this debate has shifted toward a more pessimistic vision over the past twenty years.
- No one can say with confidence what Chinese domestic affairs will be like in fifteen years. Some see a state in which an illiberal or even repressive regime holds power in concert with giant affiliated non-government economic interests. Some even envision political or economic disorder.
- Uncertainty over the respective roles of the United States and China in Asia is acute. How will the United States perform economically? Will the United States succeed in making the domestic adjustments necessary for continued economic success in Asia? The first term of the current administration focused exclusively on the "war on terror;" Asia was at best an afterthought. While in its second term the administration has re-focused to some extent on engagement with Asia, it now faces greater "push-back" from China itself.
- As China's economic success gains it respect around the world, the rise of an alternative model of political and economic conduct, the so-called "Beijing Consensus" – a model of economic development linked to an illiberal political order – has begun to coexist with the "Washington Consensus" model of political liberalization, market economics, and economic growth, thus adding to tensions in the United States-China relationship in its global context.

A workshop participant asked given all the fissures and failings discussed throughout the day's sessions, how long can these discrepancies persist? Or can they persist longer than we tend to assume? Metaphorically speaking, who needs to care about the banking system's ills, as long as the economy is continuing to steam ahead so vigorously even with an apparently sick banking sector?

The luncheon presenter picked up this theme and added complexity to it. China's First World economy is moving up the technological ladder. The old socialist economy is diminished but still very significant. The rural economy is struggling. The service sector has recently been acknowledged to be much larger and more rapidly growing than previously understood. Corruption, though, is "bad" because it leads to the inefficient allocation of resources. The banking sector issue is even larger, and causes an even more serious misallocation of resources. The "banking sector," even now, is not really a "banking sector" at all; the banks remain policy-lending windows for the state or for sub-national authorities.

Such problems, he noted, might not catch up with China immediately, in part because the government has so much hard currency in reserve for use in recapitalizing or bailing out faltering banks. But over time, it *will* catch up with China. For one thing, especially because of the sector-opening requirements embodied in China's WTO accession commitments, the banking system will very soon have to respond to competitive pressure from foreign banks expanding their operations in China.

Another participant asked: since the regime has now identified so many major problems demanding amelioration, can it deliver solutions? In response, the presenter proposed the example of the social security problem. Everyone understands that the population is aging rapidly and that the need for a social security system is urgent. SOEs, which were once the "social security system" for hundreds of millions, are no longer; eager to bear the burden of "contingent liabilities."

Thus, the government is trying to develop a two-part system. 1.) a pool system comparable to the U.S. Social Security Trust Fund to pay off looming "legacy benefits" in the coming several years, and 2.) a "defined contribution system" for new entrants into the labor force, with the funds to be invested by the government with the aim of growing the resources and providing for later payout.

However, the pool today is under-funded. Companies, moreover, are reluctant to join in the second-track system until the pool *is* fully funded, for fear that their contributions under the second track could be diverted to meet the more urgent requirements of the pool. The government's attempt to fund the pool by selling shares in SOEs failed badly. Efforts to fund the pool from other sources relating to equity share trades have not worked well. The focus of greatest concern is the Northeast, which has the biggest and most immediate burden of "legacy costs" from failed or declining SOEs.

Chinese authorities, the presenter noted, know these issues very well. They know their needs: a well-functioning corporate bond market, a well regulated stock market, the ability to place some funds abroad, etc. But at present, finding to cover short-term social security demands is critical; people simply will not dedicate money to the longer-term program if they fear that their contributions will be siphoned off to fund the short-term needs.

A participant continued the discussion by commenting further on the banking system and its inefficiencies and resource misallocations. While China's banks are not banks in the true sense, they *are* nonetheless efficient instruments of growth. They are, in fact, highly productive devices for the funding of infrastructure projects that private investors might not otherwise invest in, given the long payback periods involved, and they have facilitated massive growth in the real estate sector. In other words, he argued, the system *is* productive from the standpoint of economic growth goals.

The presenter disagreed. The banks, he argued, still fund many projects in sectors already burdened by excessive capacity or supply, simply to meet the wishes and expectations of provincial or local officials.

The participant argued that excess capacity itself will pull economic growth along, in the manner of the familiar, "If you build it, they will come." The presenter, however, argued that the operations of the present banking sector result in both supply bottlenecks and vast waste of resources. Thus, for example, the government, unable to control the banks' excessive lending, had to resort to strictures on the alienation of land in an effort to cool the current cycle of overheating. The participant observed, tenaciously, that as per capita income continues to grow, so will demand for resources, manufacturers.

A few miscellaneous observations concluded the luncheon session:

- Other than regime change, asked one person, what can the United States do to avert the ultimate conclusion that conflict with China is simply inevitable?
- A second person offered the personal view that, in regard to "regime change," even if China tomorrow possessed a two-party democracy, American anxieties with regard to China would be little changed.
- A third person argued that Taiwan remains the tripwire for United States-China conflict and that if the Taiwan issue could be resolved the likelihood of United States-China confrontation would be significantly diminished.

Session VIII: China as a Surprise

***Presenter I*: Harry Harding– China as Unexpected Falterer**

The workshop's final session focused on two ways in which China could prove to be a surprise – by faltering in ways not widely anticipated or by exceeding the optimistic projections of most analysts.

The first presenter focused on the negative perspective, noting that thinking about political risk in China requires analyzing a country's observable vulnerabilities and the potential shocks that could cause a crisis. In some cases, a stable society might suffer more acutely from an unanticipated shock than an unstable one might.

The speaker delineated four types of potential crises:

- economic crises, perhaps inflationary or deflationary;
- humanitarian crises;
- political crises that force changes in policy, personnel, institutions, or possibly even the viability of the entire system;
- international crises, including those in which China is victim and those in which China is victimizer.

To the speaker, the highest dangers lie in the area of threats to human security – environmental or epidemiological catastrophe, including crises in air quality or potable water supply. The probability of such crises is extremely high and some are likely to overwhelm the capacities of the regime and the administrative system. Avian flu is an example. Political outcomes from such emergencies could include both policy changes and leadership changes.

Political crises are potentially significant, but, in the view of the speaker, locally derived solutions to locally perceived dysfunctions will generally suffice.

Some extant situations are volatile and could impinge on the leadership's ability to respond maturely to emergent crisis. Such potential inhibitors of effective management of other crises include the enormous sensitivity of anything linked to China's handling of Taiwan, the volatility of popular nationalist sentiments, and conceivably the emergence of difficult issues involving civilian-military relations within the regime.

The speaker found that some situations are, in fact, unlikely to become crises. These include international crises originating with China and overwhelming economic crises, either inflationary or deflationary. However, situations like these do not normally occur in a vacuum, and if they concatenate, as was seen in the Asian financial crisis of the late 1990s, the cumulative effect of their eruption could be much more serious.

The impact of potential China crises on the international system merit review; by definition, any Chinese international crisis would have broader ramifications. The world's perception of China, and concern over China's long-term intentions, would be affected by the outbreak of even a small international crisis involving China, e.g., a conflict with a border state. Of the two alternatives, inflationary crisis or economic dissolution, the latter would have the more serious international implications. A major medical crisis, such as SARS or avian flu, would surely become an international crisis. Domestic political turmoil would have fewer impacts on the external world, unless the crisis led China to more assertive or bellicose international behavior as a means of promoting domestic political tranquility.

The speaker reflected briefly on trend lines in relation to the above discussion:

- Some serious problems may resolve themselves gradually over time – for example, according to current demographic trends, the likely lessening of the oversupply of labor within twenty years. But other crises, such as those affecting the environment, will worsen with time if effective remediation is not achieved.

- The probability of some sort of shock increases with time. Moreover, "compound probability" suggests that over time the chance of a major disaster must increase.

- China has just established an emergency management program, but to date the emphasis has been on "leveling bumps in the road," or "stabilizing the cargo," rather than "fixing the shock absorbers" (the latter implies development of a more responsive political system.)

***Presenter II*: Albert Keidel– China as Succeeding Beyond Expectations**

The session's second speaker addressed ways in which China might surprise the world by exceeding expectations, particularly in regard to its economic performance. In the next five-year period covered by the 11th Five Year Plan, China needs to grow only at a 5.5 percent rate to achieve stated 2010 targets; growth rate of only 3.5 percent would yield attainment of goals thus far articulated for 2020. The speaker, however, preferred to look much farther into the future: 40 to 50 years.

His overall theme was one less often heard in the analytical community: The United States must revise its thinking now to grapple with the challenge of how it can reach a military and economic relationship with a China that, economically at least, is going to be much larger than the United States.

The speaker's ultimate point was in reality a question: if China continues to grow at nine percent through 2020, how is the United States to think about the "new world" that results? The United States has a brief window of opportunity, at the beginning of the 21st century to "re-do who we are." But by the middle of the century, it will be too late.

Can China achieve such growth? What happens to China domestically? The country appears reasonably well prepared to manage high growth for decades. Ongoing reforms, for example in the banking sector, are increasingly successful: an improved "directed credit system" augurs better for the economy than the abandonment of "directed credit" altogether. The critical task is improvement of the old "directed credit" system.

As for social unrest, the speaker found that rapid economic change can be summed up as "privilege meets productivity," where "privilege" stands for the traditionally advantaged segments of the Chinese political system. Privileged groups, he asserted, are no longer isolated from competitive challenges to their standards of living. He views China optimistically in this regard: even on the vexing problem of defining land rights, China's evolving solution may look like corruption, but it is economically rational, in that those who use the land more productively are gaining ownership rights.

On the other hand, China is not yet handling the rural economy well. Japan, in fact, did not significantly alter income distribution in the rural sector until after World War II. China's re-emphasis on grain production in the next Five-Year-Plan is a step backward: what is needed is diversification, which would engender higher levels of rural income and consumption, and even promote increased manufacturing. The regime's re-emphasis on grain production is actually a way of squeezing the rural economy for other economic ends.

Problems persist as well in what might be termed (by the rapporteur) "system responsiveness," i.e. control over sub-national and local government behavior. Even the collection of reliable statistics is compromised when local statistical workers, for example, are paid off by local officials. Similar examples are legion.

The presenter concluded by noting that ideological issues have been left in the dust: Mao-era egalitarianism is not a meaningful factor, laissez-faire liberalism has not been adopted either. Today's "ideology" is the "pragmatics of what works." China is *not* a one-person autocracy; a voting process prevails among the most senior leadership.

The global implications of this depend heavily on how the United States behaves. If the United States becomes a predatory power, bent on preventing China from taking what is "ours," big trouble lies ahead. The presenter continued by noting that the force projection profile that the United States assumed following World War II cannot last indefinitely. The alternative, he suggested, was a change of U.S. approach to an assumption that problems arising with China are faced by all and must be managed and solved jointly.

Thus in trade in goods and services, the United States must change rapidly and massively. The speaker spoke to familiar concerns over education, training, portability of pensions, and other factors widely identified as critical to long-term U.S. competitiveness in the global economy. The speaker observed that deeply held "small government" fixations will not serve the United States well in the face of the 21st century world economy's challenges.

The speaker suggested that U.S. naval superiority in the Western Pacific cannot be indefinitely sustained. Now, he said, is the time to prepare. On Taiwan, he asserted that Taiwan's bargaining position with regard to a permanent relationship with the PRC will never be stronger, and that Taiwan needs to reach an understanding with Beijing now; waiting will only weaken Taiwan's hand further.

He noted that the future will see a much larger Chinese role in international institutions in which the United States has long been accustomed to leadership and predominance. If the PRC economy is 50 percent larger than the American economy, China will want to see the World Bank headquartered in Beijing and will want to be its principal shareholder. Similarly, in the future, the WTO will pose stiffer challenges to longstanding U.S. agricultural trade barriers. The United States, he argued, had better get used to the implications of nine percent PRC economic growth for the next five years, and indeed the next 50.

In conclusion the speaker predicted that China's continued growth at a rate of nine percent or better for the next five years will offer proof to others that the Chinese system of economic growth is effective, that others will seek to emulate China, and that the United States will have to grapple with the implications of a Chinese economy much larger than its own.

Discussion

A participant opened by asking the first presenter to elaborate on prospects for democracy in China. The presenter replied that, in the longer run, further evolution toward a form of greater democracy might well occur but that the expectations, found in some quarters in the United States that in the shorter term a political crisis would force China to democratize, are misplaced.

The second presenter weighed in by noting his lack of patience with Winston Churchill's famous formulation to the effect that democracy was the worst of all political systems, except for all the others. Every country, he argued, will have an "inherited, traditional authority." If that authority wishes not to be destroyed, it must gradually develop means of mediating between central authority and society itself. But this evolution can only take place if economic growth is sufficient to prevent a national growth crisis capable of destroying the possibility of evolutionary change.

The first presenter added that the international political system itself for example the World Bank and the UN is not traditionally "democratic" either. Their diversity and scale are so gigantic that few people regard the international order as merely a "small nation state" writ large.

Another participant questioned the enduring dilemma of the Chinese political system, the problem of self-regulation. Can the ruling elites be expected effectively to regulate their own conduct? Where will the self-regulatory power of the Party come from?

The second presenter responded briefly that this problem called for a "federalist" solution, in which other levels of government, with their own adequate financial resources separate from central government largess, could exert the limiting and regulating function necessary to prevent misconduct by the nation's highest elites.

The first presenter agreed that some sort of federalism would be important, but noted that the notion is barely noticed in China, where whatever sprouts of democratic innovation are likely to be viable at much lower, more local levels of political organization.

Returning to the second presenter's stress on the need for American reassessment of the world around it, now that China has emerged as a large presence, a participant noted, perhaps with concern, that American interest in crafting the major international institutions was greater at a time after World War II, when the United States was at the apex of its global strength and that as the relative strength of the United States diminishes, regrettably, the United States is politically less likely to address the challenge of new architecture of global institutions.

Another participant returned to the discussion of vulnerabilities and potential shocks awaiting China: how real are they? Could any of them seriously derail Chinese economic growth over the next one to two decades? Would, for example 20 million deaths in a flu pandemic do catastrophic damage? The commenter suggested that the unraveling of the Taiwan situation was clearly the biggest single potential disrupter of continued Chinese progress.

The presenter's response was that much would depend on others' adaptive reactions. Clearly, a huge pandemic would affect the entire world economy, not just China's. All growth components would be crippled. The world would not face a global recession; it would face a closing-down of the world trading system as quarantines were imposed worldwide. The duration of such a system-wide collapse cannot be foreseen, but such a crisis would likely set off a cascade of crises, including perhaps a political crisis over governments' perceived culpabilities in failing to preserve public health, economic stability, employment, and so forth.

The presenter expressed great concern over the Taiwan situation. So far, the bad news has been the reinvigoration of Chen Shui-bian's intransigence toward the PRC following his party's defeat at the polls. The good news has been that the PRC has remained quiescent, perhaps assuming that Chen is digging his own political grave.

On the possibility of political crisis in China, one participant noted that popular satisfaction with the national government in China is high. Food is abundant, as are consumer goods, including cutting-edge consumer products. A high tolerance for government faults persists, in his view, and even an avian flu pandemic would not destroy the regime.

Another participant inquired as to the possibility that U.S. protectionism would lurch out of control. The "pessimistic scenario" presenter agreed that it could and that it could unleash a tit-for-tat trade war that could lead to a more serious international crisis. He noted, however, that much of the Washington political drama over perceived trade grievances consisted of elaborate "signaling" and "sending of messages," in ways that left escape doors or otherwise stopped short of unleashing trade armageddon.

The second presenter weighed in with similar concerns. After World War I, he noted, Japan's economy strengthened with the assumption of some of the international economic advantages formerly held by the defeated Germany. Yet the Kanto Earthquake of 1923, far from stimulating further Japanese revival and recovery, presaged the world economic collapse of the Depression, in which each major power protected its own economic hinterland and shut all others out. Today, he argued, even if the United States chose harsh protectionism, the rest of the world probably would not, thanks to a much greater degree of international economic sophistication and integration. Further, China's economy today offers a far stronger foundation for China's economic self-sufficiency than did Japan's in the 1920s. In addition, if the United States did opt for heavy market closure directed at China, the ensuing steep rise in prices within the United States would prove politically unsustainable.

A participant criticized a presenter's assertion that China's continuing economic success would inevitably lead Taiwan to adopt more accommodating positions *vis à vis* the PRC. He also pointed out that if China's political system were to become democratic, U.S. anxieties over China's future identity would be reduced. What form will China take in fifty years? If the country continues to be run by an unelected elite, the United States would be justified in wondering about its future intentions and trajectory.

A presenter noted that it is "objectively correct" that the United States perceives the relevance of China as a "communist" system and that this makes China seem even more important and more eligible for criticism. The key analytic question, however, is: What would cause China to act in a more assertive and aggressive way in international affairs? To this presenter, the most likely answer would be greater popular pressure on the government to behave more assertively. In that sense, a decline in the regime's authoritarian control is likely to conduce to heightened nationalist emanations more difficult to contain. The PRC government is thus very cautious now about cultivating international crises that might raise popular expectations and engender popular pressures on the regime.

A participant noted, from earlier in the discussion, that the term "democracy" is by now so loaded and so fragmented as to lose analytical salience. In his view, the term "good governance" might prove more analytically useful. It is necessary to identify and analyze the elements of such "good governance." A free press, for example, is certainly a major factor. Internationally, behavior as a "responsible stakeholder" is also important. Historical analogies are to be approached very cautiously. Strategic interdependence now and in the future is qualitatively and quantitatively different from any previous models. In particular, any assessment of what the world might be like in 20 or 50 years must take account of

China, and how it will evolve over such a period, in a manner that prognosticators until very recently never had to do.

Finally, a participant raised a question on the volatility of political issues involving China's significant Muslim minority populations in its farthest western regions: how significant are the periodic incidents that come to public attention in Xinjiang? A presenter responded that the United States and China have identified a common issue in Islamic terrorism, but differ over the labeling of different Muslim groups. The presenter, returning to a theme of his opening remarks, expressed greater concern that, as China "arrives" as a global power and success story, it might join the United States and other major states as a target of global terrorist assault. If China is the poster child of globalization, he asked rhetorically, will it become a target of terrorist activities?