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Getting China Right: Cutting Through the Myths of Economic Growth

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China's trade surplus with the United States ($202 billion in 2005), its rapid overall economic expansion, and its growing appetite for energy have made China's growth a salient issue for average Americans. While the facts of Chinese growth are indisputable, the causes and ramifications of that growth story are anything but. For many Americans, though, the story is straightforward—China is winning the game of globalization because it is playing by a different set of rules from us, and its gains are coming at our expense. From this perspective, the only real question is whether we should do anything about it. Do we stand up to China—whether with regard to trade issues, foreign exchange valuation, intellectual property rights protection, etc.—or do we let the situation ride while we deal with other international problems? The problem is that while this sort of framing has a certain gut appeal, it is based on faulty assumptions—faulty assumptions about not only the Chinese economy, but also our own. Such assumptions, if left uncorrected, will lead to policies that over the long run will prove detrimental to American geopolitical and economic interests.

THE GLOBALIZATION REVOLUTION

China's economic rise, unlike Japan's a generation ago, is taking place amidst revolutionary changes in the way production takes place. The physical products we consume on a daily basis are being made in ways they were never being made before—through international production chains involving myriad corporate actors, firms bearing a wide variety of national flags of origin, and firms operating across a host of geographic locales. Geographically, China has become a key node in these chains, a shop floor for manufacturing activities. Yet, who actually benefits—which countries, which companies, and which stakeholders—is a much trickier question, one arguably as perplexing to Chinese policy makers as to our own. It is certainly worth noting that just as Americans feel that we are losing the globalization game (i.e., jobs in manufacturing are disappearing, high value economic activities seem to be moving abroad, foreign firms seem to be encroaching on our daily lives, etc.), many Chinese too feel that they are losing, and often for the same reasons. The sections below will explain why.

THE COMPLEXITY OF CHINA'S TRADE RELATIONS

China today is running substantial trade surpluses with two main global markets: North America and Western Europe. Simultaneously, China (unlike Japan in the 1980s) is running substantial trade deficits with other key parts of the world, most notably East and Southeast Asia. China currently runs trade deficits with Taiwan, Japan, South Korea, and virtually every Southeast Asian nation, a fact that says a great deal about internationalized production chains. Many products that we in the United States view as "made in China" are only assembled in China, but are composed of parts—often high value parts—that are manufactured outside China and imported into the country for final assembly. In personal computer production, for example, the product gets booked as a Chinese export, but 60–85% of the profits go to American firms (software, integrated circuit design, branding), 10–35% to Taiwanese, Singaporean, or Korean component and ODM (original design manufacturer) firms, and 5% to Chinese assemblers. When Americans see a "made in China" computer, they rue their nation's economic demise. When Chinese see a "made in China" computer, they see Intel inside (processors), Samsung inside (screens), and Microsoft inside (operating software), and rue their nation's inability to compete globally.

This partly explains why despite its "global shop floor" status, China, relative to the United States, accounts for such a small portion of global production in terms of value. In 1990, Japan accounted for 22.5 percent of global production, the U.S. 20.7 percent, and China 2.2 percent. By 2003, the United States had grown to 23.3 percent (the world leader), Japan was at 18.1 percent, and China at 6.6 percent.

Globalized production chains make for complicated issues of national economic interest. Japan, South Korea, Taiwan, and Australia—all net exporters to China—hardly sympathize when major net importers from China, namely the United States, complain about Chinese trade practices. Similarly at the corporate level, firms producing the high-value guts of Chinese-assembled products (the software, the processors, the software, etc.) or the capital-intensive machines driving Chinese industrialization (the construction equipment, the high-end looms and textile production equipment, the semiconductor assembly equipment) are also unreceptive to concerns about China's rise. Even on such issues as intellectual property rights protection, despite repeated and justifiable U.S. Department of Commerce complaints about IPR violations in China, major victims of such piracy—firms like Microsoft, IBM, and Hewlett Packard—have been unwilling to bring cases to the WTO.

THE COMPLEXITY OF FOREIGN DIRECT INVESTMENT, OWNERSHIP, AND CONTROL IN CHINA

The situation is made more complex by ownership patterns within China-based industry. Again unlike Japan in the previous generation, China has been open to foreign direct investment (whether through foreign equity investment in Chinese companies or wholly-foreign owned companies/subsidiaries based in China). Today, the bulk of export-oriented manufacturing in China, particularly at the higher end, is performed by foreign-invested or wholly foreign-owned entities (be they Taiwanese, Japanese, American, German, etc.). In 2004, 57 percent of all Chinese exports were produced by foreign-invested firms. In 2003, 85 percent of all high-tech exports from China were booked by such firms.

Worth noting is the complexity (and degree of foreign participation) in the stakeholder relationships surrounding "made in China" products or Chinese corporate strategy. Such cross-border, multi-faceted relationships now extend even into China's strategic industries, including areas like oil and gas. When the Chinese National Offshore Oil Corporation (CNOOC) attempted to acquire UNOCAL in the summer of 2005 (for $18.5 billion), more than two-thirds of the financing for that bid was provided not by the Chinese government, but by Goldman Sachs and JP Morgan, firms that also happened to provide substantial overall guidance, advisory support, and encouragement to the Chinese client. Meanwhile, legal counsel was provided by Davis Polk, and lobbying support by Aiken

Gump. The point is not there is anything nefarious about these interactions (indeed, one might argue it is a good thing that formerly closed-off Chinese firms are being infiltrated and influenced by practitioners of global best-practice). Instead, the point is that one should be skeptical about arguments attaching clear-cut "flags of origin" on commercial interactions, whether in terms of "made in China" products or "Chinese" efforts to secure "American" assets. Similarly, one should be skeptical about assertions that the actions of ostensibly Chinese firms—like CNOOC—are either dictated by the Chinese government or part and parcel of Chinese state geostrategy.

THE SOCIO-POLITICAL STORY IN CHINA

Globalized production also makes for complicated, often ambiguous societal outcomes, whether in the U.S. or China. Americans today express concerns about the decline of manufacturing jobs (and the benefits traditionally attached to such jobs), a decline that has been going on for five decades (manufacturing employment in the U.S. stood at 35 percent of the total in 1950, and 13 percent in 2004).

The interesting thing is that comparable phenomena are observable in China, albeit at China's substantially lower level of per capita income (according to World Bank estimates, China's per capita income in 2004 was $1500, compared to $6790 for Mexico, and $41,440 for the United States). During the first fifteen years of China's economic reforms, manufacturing jobs rose absolutely and also as a percent of total employment. By 1995, however, manufacturing jobs, which then stood at 98 million, began to decline, both absolutely and relatively. By 2001, they were down to 80.8 million. Several things were happening. First, the bulk of new job creation in the Chinese economy shifted to the service sector, namely construction and transportation. These are generally temporary jobs, devoid of benefits and performed by migrants moving from the countryside into cities. Second, the manufacturing jobs that remain have been stripped of the extensive benefits traditionally associated with socialism. Lifetime employment, guaranteed housing, free healthcare, and extensive pension programs are all for the most part gone.

This makes for tough life prospects for many Chinese citizens. Per capita income is undoubtedly up, in large part because the nation is undergoing a basic industrial revolution. For large parts of the population, extreme poverty associated with agrarian life has been replaced by a somewhat wealthier, albeit highly tenuous semi-urbanized existence. Meanwhile, along the coast, clusters of real wealth can be found in cities like Shanghai, a municipality whose local per capita income is now on par with Portugal's. Across the country, we witness rapidly growing disparities of wealth, levels—though notoriously difficult to measure—far outstripping the United States, and now approaching those of Ethiopia and India.

Key to remember is that such disparities have developed in the context of a massive shift nationally, by default, to fee-for-service provision of basic public goods like healthcare and education. In China today, if you want healthcare, you generally have to pay cash for it. The same is true for education. In both cases, Chinese law guarantees free provision, but actual provision in practice is an entirely different story.

THE GOVERNANCE STORY IN CHINA

That the reality of public goods provision diverges so far from stipulated legal requirements has a great deal to do with the way China is governed.

Governance in China has several characteristics. First, while the state bureaucracy is extensive, it is also highly decentralized and fragmented. National policies emerge through a highly informal process. Vague policy "directions" emanate from the center, but those policies get both defined and implemented by local-level (provincial, county, municipal) officials. Indeed, reform has moved forward through frequent instances of local "experimentation," localized practices that often directly contravene formal central rules. When experiments prove successful, they may get propagated regionally and even nationally, all the while remaining technically in contravention of existing law. If success continues, only then does the experiment become legitimized as official policy and the existing laws amended to reflect reality. In practice, this means that within a single national system of rules and regulations, multiple—and often contradictory—local institutional systems operate simultaneously.

Second, complicating this pattern is the blurring of boundaries between the commercial and governmental sectors. Over the past two decades, the basic governance norm throughout the system—the glue holding the system together, and the clearest signal flowing downward to local officials—is that virtually any action is permissible so long as it results in economic growth. Many local officials have interpreted this not just as a mandate to foster business, but also as a mandate to go into business. Examples abound, but the point is that Chinese entrepreneurs—capitalists, in essence—simultaneously wear a variety of "hats," a commercial one, an investor one, and a governmental/regulatory one. When private entrepreneurs, for example, choose to locate in a particular city, they frequently do so because land is given to them for free by the municipal government. The municipality often acquires that land by forcibly removing and relocating (in violation of national rules) farming households. The municipality grows economically, local officials take a shadow equity position in the firm (receiving compensation accordingly), the entrepreneur thrives, the peasant suffers, and the central government scrambles to address the socio-political dislocation that results.

What we witness in China now is not so much "China, Inc."—a national business system adroitly managed by a clear governmental hierarchy with a clear strategy—but instead a type of "government in business, government as business" model. Local governments are making the rules at the same time they are deeply involved in commercial affairs. Meanwhile, they end up doing very little of what government is supposed to do (and what the central government wished they would do), which is to provide public goods (whether in form of tangibles like healthcare or education, or intangibles like fair enforcement of rules).

Even in something as strategic as the energy sector, we can see the results. In the electricity sector, China's total national generating capacity amounts today to approximately 500 gigawatts (GW). Yet, central officials estimate that approximately 110 GW of that capacity is "illegal," pertaining to power plants that have been built (often with local governmental investment) but that never received required central approvals. The point is not that these plants are hidden, but instead that they do not generally comply with centrally-mandated engineering standards, environmental controls, or technical requirements. In such a rapidly growing environment, it is the Chinese corporate entities (often with foreign advisory partners and investors) and Chinese local governmental investors who end up making de facto policy through fait accompli infrastructure projects. Central officials, meanwhile, continually play catch up, scrambling not just to regulate, but also simply to access information about what actually is happening on the ground. Many of us in the United States find China's growth—and the ramifications of such growth for the global commons—headspinning. More interesting, so too do many of the Chinese central officials as they try to govern this highly diversified, fragmented, and wildly commercialized system.

SO WHAT? RAMIFICATIONS FOR AMERICAN POLITICS AND NATIONAL POLICY

Two main "take away" points emerge from this analysis of China. First, on the American electoral front, politicians should be cautious about playing the "China economic threat" card. Decrying "Chinese" currency manipulations, "Chinese" lobbying, "Chinese" IPR violations, and "Chinese" asset grabs may seem viscerally appealing for rallying voter support. The problem, however, is that many of the actions described as "Chinese" often involve substantial American stakeholders: investors, corporate partners, suppliers, etc. Their support for China bashing will prove tepid at best. More broadly, increasingly large portions of the American population are benefiting indirectly from "made in China" production (through cheap products, low interest rates fostered by Chinese investment in the U.S., or service-sector jobs related to the production of "made in China" products). Given these complicated groupings of interests, bashing China is no longer a low-risk, low-cost political strategy.

Second, and far more important, political leaders should be wary of the risks to American national interest of miscasting China's economic rise. Managing China's emergence is arguably the most challenging imperative of the 21st century. The rapidity of China's growth and the sheer size of the Chinese economy mean that China's economic activities now impact global sustainability across many dimensions: economic, geopolitical, technological, and environmental. Actions that alleviate pressures along one dimension often exacerbate pressures along another (for example, shifts in China from the burning of domestically-plentiful coal to domestically-scarce natural gas are good for the global environment, but problematic for international geopolitics and resource competition). The point is that by miscasting China as overly unified, coherent, mercantilist, and geostrategic—in effect, by interpreting economic outcomes we do not like as products of Chinese strategic intent—we risk failing to identify areas in which our respective interests actually overlap (for example, as major energy-consuming nations), or where Chinese officials are as eager as we are to address the Chinese outcomes we find objectionable (for example, in the environmental area, or even in the area of currency valuation). In short, we risk missing opportunities to cooperate while at the same time creating conflict where none is foreordained.

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