China: Challenges for US Commerce

A Hearing Before the

Senate Committee on Commerce, Science and Transportation
Subcommittee on Security

March 7, 2019

Is China's System A Concern for the US Economy and Manufacturing?

Testimony of

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Chairman Sullivan, Ranking Member Markey and Members of the Subcommittee, I appreciate the opportunity to offer my views at this hearing on challenges for US commerce presented by China's marketplace practices. I approach this question based on 26 years of professional work evaluating the nature of China's economy, the prospects for US-China economic relations, and the interests of American firms pursuing commercial opportunities. Following eight years in the think tank sector and time in government, I established what is today Rhodium Group – a private research partnership – to conduct this analysis, where 16 researchers are presently involved in the effort.

Today I wish to offer a high-level picture of the arc of China's economic practices and priorities leading up to the present concerns. Each of the broad characterizations I offer is underpinned by a body of research which I would be pleased to elaborate in discussion, or in follow-up with you or your staff.

Background

After the start of its self-described "reform and opening" era in 1978, China generally converged – though with fits, starts and exceptions – with the liberal economic approaches championed by the United States. It did so not due to foreign pressure, but because market economics was more productive. Support for this evolution was in the United States' strategic and commercial interest. In recent years, however, this convergence has slowed and in some areas reversed. With its size and global footprint, a China pursuing a non-market oriented path – regardless of motive – will be a concern for US economic welfare, and for other market economies. While the right American policy response to these trends is not yet clear, there is a consensus that status-quo approaches must evolve.

Structural Divergence

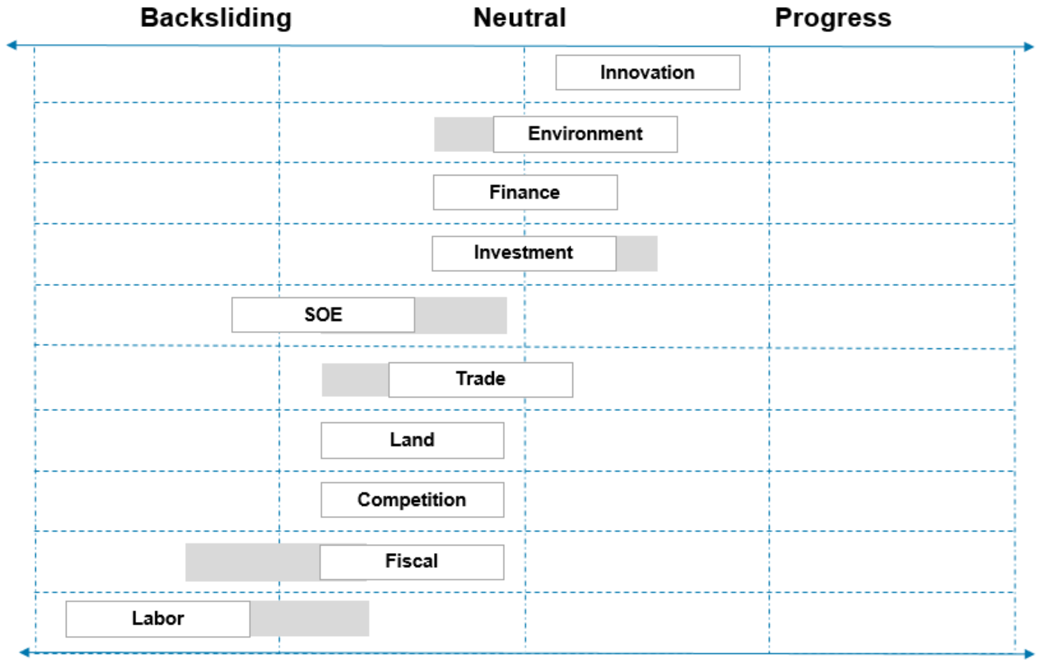
As China recovered from a state of epic impoverishment in 1978 to a normal level of development, it was bound to present a trial to the United States and the world. Since Nixon went to China the nation's population has risen by 60% to 1.4 billion, and per capita incomes rose 75-fold in nominal terms: accommodating the demand and supply consequences of that was naturally a challenge. Not all challenges are malign, and the United States should welcome those that accompany the betterment of one-fifth of humanity, and the related commercial competition that was bound to bring. The real concern arises not from competition per se, but from the implications if a $13 trillion China decides to revert to non-market solutions to managing its economy. And because China now seeks to project economic presence around the world as a trader, financial investor, commercial director investor and development finance purveyor, the non-market incentives China uses to shape its economy at home will spill over and affect economic conditions around the world.

The American bet on engagement with China never rested on China becoming a market economy overnight, but on evidence that China believed its interests were served by marketization in the long-term, and, thus, that with patience (and transitional mechanisms) we would naturally converge. This depended on China endeavoring to liberalize its economy, not on pressure from American trade negotiators. Two hundred years of American foreign policy experience had taught that only China would change China. Twenty years of observation from the start of rapprochement to Deng Xiaoping's recommitment to market reform in 1992 made clear that China, and the Communist Party, was serious about change.

Concern for US economic interests today stems from indications that China's drive to converge with the liberal international economic order has stalled. Xi Jinping began his tenure with a broad economic reform plan – the *Sixty Decisions* – and he endorsed a series of reform initiatives in his first term. From 2012 to 2018 Beijing attempted to deleverage the interbank credit markets (twice), open the equity markets, empower independent boards of directors at state enterprises, achieve currency internationalization, and open the capital account. All of these economic reform moves led to mini-crises and were reversed (arguably the second credit deleveraging is still underway). The shadow over US-China economic engagement comes not so much because China refused to reform but because it couldn't manage it.

Regardless of etiology, China's non-convergence with market approaches to resource allocation and regulating competition (see Figure 1) has consequences for others, including the United States. We depend for our vitality on structural conditions that China's current policy choices will disrupt. There are myriad pieces of a liberal market foundation, but three that are paramount are the financial system, rules-based pro-competitive regimes, and the sanctity of private intellectual property protection. Nations that do not share the same fealty to these elements cannot be as engaged or interoperable as nations that do.

Figure 1. Net Assessment: Winter 2019 China Dashboard
Quarterly movement in 10 areas



Source: Asia Society Policy Institute, Rhodium Group.

First, China's financial system serves the interests of borrowing firms with favored access to credit more than consumers or savers. While Chinese authorities assert that they can be neutral in regulating capital market access for state and non-state firms alike, the reality so far is that this separate but equal approach is inherently unequal. The mushrooming volume and cost of capital have insulated many Chinese firms from the same diligence demanded of their private foreign competitors, giving them an advantage. This is true even when Chinese rates for credit are higher than foreign rates, as debt service ratios don't matter if new money to pay off old loans is always made available. In addition to capital market conditions, local government fiscal outlays and abundant national and sub-national subsidies also distort capital allocation conditions.

Second, for a market-oriented system to function, even-handed rule of law is essential. For commercial interests competition policy is a crucial aspect of this. China is today mixing political guidance with commercial considerations in corporate governance, in ways prone to change market outcomes at home and abroad. The Rhodium Group-Asia Society China Dashboard shows, for instance, that foreign firms pursuing a merger in China are about five times as likely to face Chinese government review than solely Chinese merger are. Asymmetries in trade and investment market access for foreign firms in China relative to Chinese firms abroad are an important part of uneven legal conditions. This distorts market outcomes and generally serves the interests of firms in China at the expense of Chinese consumers and foreign producers including those from the United States. China is not the only nation with border barriers to commerce higher than those maintained by the United States, and American consumers benefit from imports regardless of trade barrier differences. But at China's scale and weight in marginal global growth these distortions, like financial subsidies, can quickly put firms in other nations out of business, and thus present predatory outcomes or otherwise harm efficiency. China's international initiatives including the Belt and Road program are extending the consequences of the Chinese model worldwide.

Third, innovation drives modern economies, especially at higher income levels. In their 2013 reform program, China's leaders pledged to improve the innovation environment in China through greater emphasis on market forces. They called for "market-based technology innovation mechanisms" and said "the market is to play a key part in determining innovation programs and allocation of funds and assessing results, and administrative dominance is to be abolished." But eighteen months later *Made in China 2025* was launched, a 10-year strategic plan for achieving new levels of innovation in emerging sectors. The plan emphasized central planning, setting performance targets for domestic content and domestic control of intellectual property in critical industries. A related implementation plan set benchmarks for global market share for Chinese firms. This industrial policy approach to innovation, infused with hundreds of billions of dollars in support, will distort conditions in the innovation ecosystems of other nations, including the United States, and precipitated the aggressive 2018 US Section 301 Investigation, which concluded that China's technology push was unreasonable, discriminatory and a burden on U.S. commerce.

Impacts and Options

It is impossible to confidently project the economic cost of China choosing to pursue a non-market model for the United States or US manufacturing, let alone for qualitative variables such as national security or resilience. This is turn impedes cost-benefit assessment of policy options for our response. Do tariffs work? In some ways, but by depriving us of cost-efficient intermediate inputs they also diminish our export competitiveness. What is the price of disengagement? It depends on how much erosion in the value of American intellectual property if we do not respond to technology policies abroad, not on a steady-state projection of US conditions. And meanwhile, if China continues to put political guidance above efficiency in the economy a financial crisis is almost inevitable, changing our China concerns from those associated with a strengthening competitor to those wrapped up in a flailing one.

The concerning features of the Chinese system described above would be present and require our attention even if China were staying the course on reform. If that were the case, the questions would be *what degree* of statism would China keep, what would it slough off, and how long would it take. Most nations, including the United States, employ some state involvement in the economy, including in the allocation of finance (Fannie Mae), tipping the competitive playing field in some industries (electric power – Tennessee Valley Authority) and promoting innovation (Sematech). The question of degree and ground rules – whether there is an overarching commitment to the primacy of market and consumer orientation – is key. And the mix is not eternal, as present debates over the role of industrial policy in the United States and other advanced economies shows. But if instead of convergence with advanced economy norms where the state plays a limited economic role Beijing claims to have an alternative, state-guided model that requires other nations to accommodate its non-market preferences, then past assumptions about the course of engagement with China will be outdated. China has the sovereign right to choose the system it thinks best for itself, but to draw on an old saying, its freedom to swing its fist stops where our nose begins.

What to Do: Provisional, Partial, Peaceful

We are at the beginning of a national conversation – better still, an international conversation among like-minded liberal colleagues – about policy responses to new directions in China's evolution, not at the end. There are not yet refined answers. However principles to guide policy thinking are emerging.

First, our responses should be provisional. Unless everything we think we know about the relative efficiency and dynamism of free markets over state-controlled markets is wrong, the present Chinese policy turn will be a dead-end, and we will see either a diminishing threat or a reversion to market orientation in the future. Indeed, one can argue that China is already showing signs of an economic stall. Anticipating this, American policy should be built for adaptability. Any disengagement we pursue should be reversible, and our ability to reengage should be protected.

Second, our response should be partial and selective, whether in the short-term or the long-term. Where there are national security risks from commerce, or interaction threatens to disrupt the healthy functioning of our market ecosystem, we must be prepared to stand apart; but in much of our economic exchange these concerns are not present or can be mitigated. *The United States can say yes to Chinese manufactured goods and direct investment most of the time*. Blocking these flows would be gratuitous and serve no strategic purpose. Rather than plan only for all or nothing scenarios, we should build a sliding scale of engagement that fits with the likely mixed-bag that China will present – a nation somewhere in the middle between advanced economy norms and statism.

A third normative principle is for our stance on commercial interaction with China, even if emphasizing disengagement, to be *peaceful*, not just on liberal moral grounds, but for realpolitik reasons. Putting politics above economic efficiency will not work in China today, just as it failed to work in the past. When a reckoning occurs, the Chinese people will either blame bad ideas at home or hostile foreign forces abroad. It is the American interest that they correctly make the domestic diagnosis, and that when the time comes to engage in convergence again there is a foundation of goodwill between us not a sour recollection of bellicosity. If China chooses to pursue a non-market solution to its problems we can be self-protective and counsel caution to others, while at the same time avoiding malice.

Concluding Thought: Danger of Overprotection

Openness is a wellspring of American national security. In responding to concerns about China it is imperative that we preserve that asset as much as possible. Our welfare will take a hit from sliding our engagement scale in the direction of caution, at least in the short-term. Our ability to offset that cost is uncertain. We will need to enact domestic policies to replace inputs from China, adjust our trade to embrace replacement imports from other nations, and write-off many investments made in the past. There are real centers of innovation leadership in China too, and disengagement will deprive us of those. The quicker and more extensively we choose to part ways with China in areas of high-tech concern, the more urgently we need to return to responsible leadership of the advanced economy caucus. Economic protectionism has often been disguised as national security through history, and when firms reduce competition with fear-mongering our security is diminished. As we consider strategies to mitigate consequences of China's economy for our interests, we must take care to do no harm to what makes us strong in the first place.