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SPECIAL REPORT

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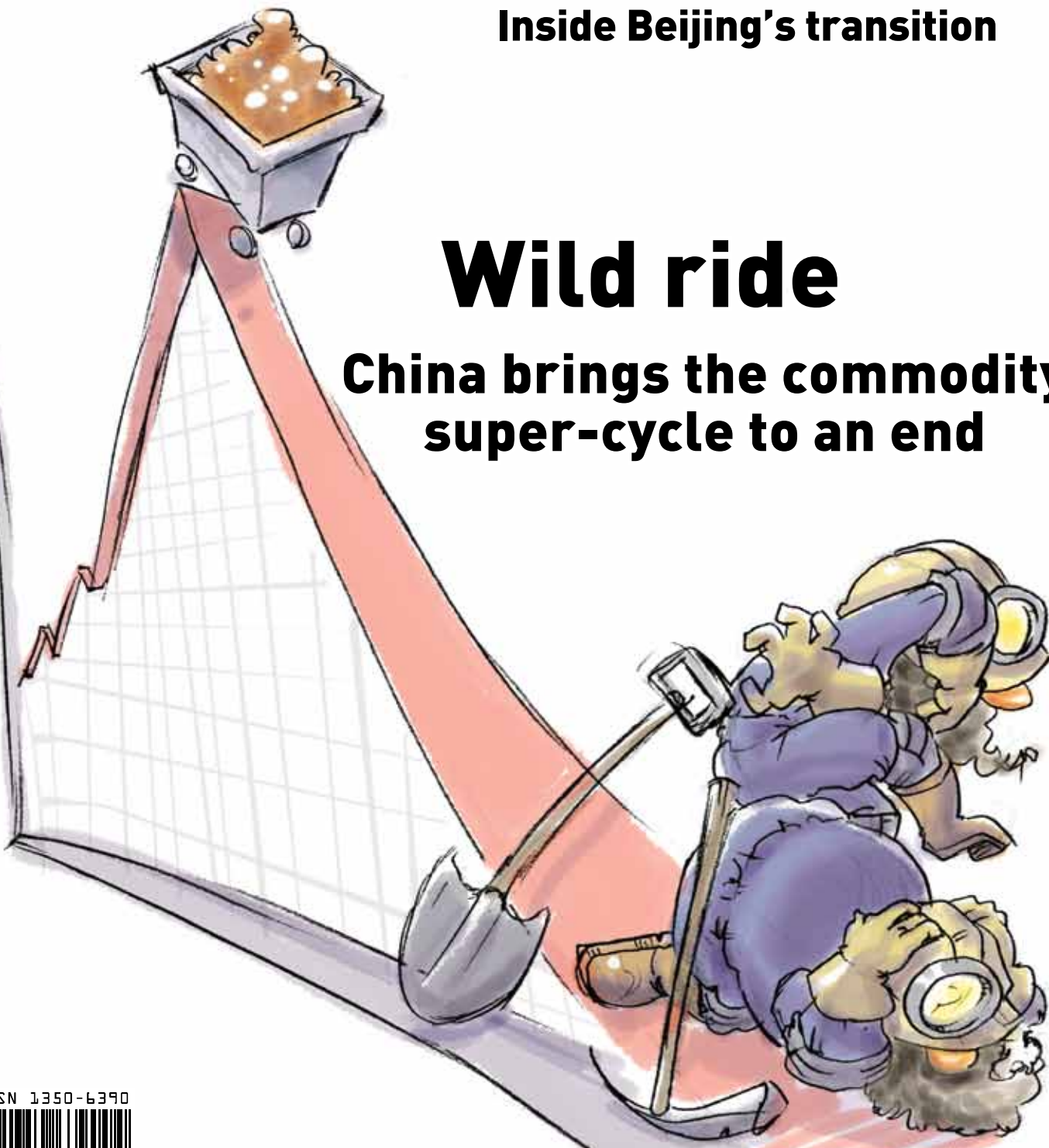
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SPECIAL REPORT:

CHINA IN THE US ELECTION



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Tough on China

Obama and Romney are pledging to crack down on China's purported economic crimes. Will that really benefit the US?

“Fewer Americans are working today than when President Obama took office. It doesn't have to be this way if Obama would stand up to China,” a man's voice says as the camera pans past broken warehouse windows.

With vague language and stark imagery, the 30-second campaign ad for Republican presidential candidate Mitt Romney conflates America's economic stagnation with Obama's failure to “stand

up” to devious Chinese practices. “Seven times Obama could have taken action,” the ad says, referring to the US Treasury Department's semi-annual review of currency practices. “Seven times he has said no. His policies cost us 2 million jobs.”

Obama has fired back with his own campaign ads charging that private equity firm Bain Capital shipped jobs off to China under Romney's direction. Both candidates claim that China's unfair tac-

tics have damaged US businesses, lifted unemployment and helped to boost the US trade gap with China to a record US\$295.5 billion in goods in 2011.

Listening to this rhetoric, it seems that the continued fallout from the financial crisis has rung in a new era of economic conflict. China's currency continues to be a subject of debate. The Obama Administration has brought more major trade actions against China in the WTO

than any previous administration, launching complaints over auto parts, solar cells, credit cards, chickens, rare earths and even kitchen sinks.

However, a closer look shows that punitive actions by the US against China are not nearly as wide-ranging or as beneficial as the candidates purport them to be. Furthermore, their bombastic claims may be putting the world's most important bilateral relationship at risk.

"US-China relations are very troubled, for reasons that partly have to do with the economy and partly have to do with security," said Tom Wales, deputy director of analysis for Oxford Analytica, a global advisory firm. "As long as things remain economically tough in both countries, you're going to have this kind of friction."

Tit-for-tat

The flurry of trade complaints the Obama Administration has launched against China are not without merit. "It rather depends on the company and the industry, but in general, Chinese companies do get much more significant subsidies, direct and indirect, than US companies receive," Wales said.

The US also subsidizes its businesses, of course, but it does so mostly in line with WTO rules – for example, offering income tax breaks for people or companies that buy domestic solar products, rather than offering its solar companies direct subsidies like soft loans and grants.

Lower-income countries like China have more difficulty following WTO regulations, since the rules were written by and for high-income countries, said Yukon Huang, a senior associate at the Carnegie Asia Program and a former World Bank country director for China. For example, China has trouble subsidizing its solar industry through tax breaks because many Chinese underreport or do not pay income tax. Of course, as a WTO member, China must still follow the rules or pay the penalty, Huang added.

But while trade cases against China may be valid, they are unlikely to do much to revive the US economy. Take the Obama Administration's latest measure: Obama announced in late September in Ohio, a swing state and a major auto parts producer, that the US would bring a WTO case against China for providing US\$1 billion in illegal subsidies to auto parts exporters between 2009 and 2011.

The US auto parts sector has suffered

in recent years; employment in the sector fell roughly 50% between 2001 and 2010. But that's more likely due to massive increases in productivity in the industry than foreign competition, said Wales of Oxford Analytica.

China is not even the major source of competition for the US auto parts industry. China's share of the US import market rose from 1.6% to 9.3% between 2001 and 2010, according to Oxford Analytica, but the country continues to lag behind Japan, Canada, Mexico and Germany as a supplier of auto parts to the US. And rapidly rising wages within China mean that its auto parts factories are becoming less competitive.

By some measures, the US-China relationship is not even America's most embattled

"[Obama's] action, particularly its timing, is 100% politically motivated, [and] it's just a very small gesture," said Ian Fletcher, senior economist at the non-partisan Coalition for a Prosperous America. "The US has been firing more complaints recently, but the thing that people tend not to understand is that these specific complaints are a very small part of the overall trading relationships."

By some measures, the US-China relationship is not even America's most embattled. As a proportion of total trade volume, disputed cases between the US and China are much smaller than those between Canada and the US or India and the US, said Li Chunding, an assistant researcher at the Chinese Academy of Social Science's Institute of World Economics and Politics.

Money talks

Another source of popular misconceptions is the rhetoric surrounding China's currency. While many Chinese now argue the renminbi is close to its real value, critics (many in the US) charge that China still undervalues its currency by as much as 20-30% to subsidize its exports and raise the cost of imports.

Romney criticizes Obama for failing to right this perceived wrong, and he has pledged to label China a currency manipulator "on day one" of his presidency. He is not alone: Democrat Chuck Schumer

led the Senate in passing a bill that would impose an across-the-board tariff on any country that is labeled a currency manipulator, though the bill was later voted down in the House of Representatives.

But it's far from clear that China deserves to be singled out as a currency manipulator. The country does control the value of its currency, allowing it to fluctuate within a narrowly set band, but analysts say China is by no means the only offender, and perhaps not even the most egregious.

Most countries manage their exchange rates, often by tying their currency to the value of the US dollar as China has, said Huang of Carnegie. "The Hong Kong dollar has been HK\$7.80 to the US dollar for a hundred years. They've never changed their exchange rate, but has anyone ever labeled them a currency manipulator? No."

Kenneth Lieberthal, the director of the John L. Thornton China Center at the Brookings Institution, calls the currency manipulator label "gratuitous" (see full interview on page 31). The label would primarily trigger a series of negotiations with China, and "we've done that every day with China for years. So this is a distinction without a difference." The main purpose of labeling China a currency manipulator would be to take a humiliating swipe at the country, Lieberthal said.

Some, like He Weibao, a researcher at the Chinese Academy of Social Sciences' Institute of American Studies, worry that this would invite Chinese retaliation in the form of a trade war.

Because the US business community – including many Romney backers – is wary of that prospect, some speculate that Romney would be unlikely to follow through on labeling China a currency manipulator if he is elected. The US-China Business Council has registered its opposition to the plan, and Bloomberg cited one unnamed Romney advisor as saying that all of the candidate's top advisers also disagreed with Romney's decision.

"Basically every US political challenger since 1992 has accused the incumbent party of being soft on China on trade and in more recent years the currency valuation issue," said Wales of Oxford Analytica.

"And yet every party when they get into office soon realizes the size of the US-China trade relationship, [and] >>



Imaginedchina

>> that they can't afford an all-out trade war with China."

Bigger fish to fry

Furthermore, these "tough on China" policies are unlikely to bring jobs back to the US or have much effect on the looming US trade deficit. While the deficit with China is by far America's largest, the US imported more than it exported with 11 of its 15 largest trading partners in 2011.

The most likely effect of tougher policies on China would be to displace trade from China to other developing countries, increasing the cost of some goods for US consumers in the process, Wales said. "The major beneficiaries wouldn't be workers in the US; they'd be workers in Vietnam, Mexico and other developing economies."

Besides, much of the US-China trade deficit results from higher-value components from countries like Japan, South Korea and Taiwan passing through China for assembly on their way to Western markets, argues Huang of Carnegie.

Huang illustrates this with the example of the Apple iPad, which retails for roughly US\$650 in the US. Of that sticker price, Apple takes in about US\$300 in revenue, while about US\$250-300 of the total value goes to manufacturers of the iPad's high-tech components in countries like South Korea, Japan and Taiwan. Only about US\$15 is absorbed by China to pay for the labor that is used in assembly. Yet the total value of the product is recorded in the US-China trade deficit.

The result is that the US-China trade deficit balloons, and the US-South Korea

and US-Japan trade accounts appear more balanced. If US politicians really want to reclaim jobs, they would be much better off focusing on the higher-tech manufacturing jobs of their closer Asian allies than on the low-wage assembly jobs of the Chinese, Huang said.

"Those workers in Taiwan, South Korea and Japan are being paid US\$30,000, US\$40,000 per year," Huang said. "Those are the kinds of jobs that you could reasonably ask, why aren't Americans producing these things?"

This situation is slowly changing as Chinese wages increase and low-wage assembly jobs move across the border to Southeast Asia. Just as US politicians previously censured Japan and the "four Asian tigers" (South Korea, Hong Kong, Taiwan and Singapore) in past decades, the US may shift its focus in the future to criticizing Vietnam or Cambodia as they generate larger trade surpluses, said Li of CASS.

Talk isn't cheap

US political rhetoric may not be well grounded in facts, but it can still have practical consequences. Analysts worry that the contentious political process could add to already widespread mistrust between the countries.

Due to the rapid spread of the internet, Chinese are more exposed to the US political process now than in any election in the past. Chinese official newspapers regularly take the candidates, especially Romney, to task over their "irresponsible" and "foolish" comments. "It is advisable that politicians, including Romney, should abandon ... short-sighted China-bashing tricks and adopt at least a little bit of statesmanship on China-US ties," state-run Xinhua News Agency wrote in an editorial in mid-September.

Chinese also worry that US posturing will damage the image they are trying so hard to improve abroad. Anti-China rhetoric in the election will undoubtedly influence people's views towards China, potentially harming relations, said He of CASS. Perhaps most importantly, China-bashing gives leaders in both the US and China less scope to concentrate on important international and domestic issues, such as reviving their economies.

Admittedly, the real nature of the US-China economic relationship is difficult to capture in a 30-second sound bite. But if US politicians want to revive their economy, they need to try. ♦

Diplomacy in action

The US will fare far better with Chinese success than failure, says Kenneth Lieberthal of the Brookings Institution

By some accounts, the world's most important bilateral relationship is becoming increasingly uneasy. Trade disputes between the US and China have multiplied, the US presidential campaigns are rife with complaints about China stealing jobs and manipulating its currency and China is disparaging the US for opposing its claim to the disputed Diaoyu/Senkaku Islands.

The average observer could be forgiven for seeing the relationship as a zero-sum game. But Kenneth Lieberthal, the director of the John L. Thornton China Center of the Brookings Institution, argues for more nuance. While the US does have legitimate complaints about China, Chinese success is ultimately good for the US, and vice versa, Lieberthal told CHINA ECONOMIC REVIEW.

Lieberthal has a distinguished career in foreign policy, serving as a special assistant to the president for national security affairs and senior director for Asia at the US National Security Council during the Clinton Administration. He is also a former professor of political science at the University of Michigan and the author of several books, including the recent "Bending History: Barack Obama's Foreign Policy."

What are your thoughts on the role that China has played in the US election? Is it different than previous campaigns?

It's significantly different from 2008, but that's because Obama made a very conscious decision in 2008 not to campaign on China. That's partly because he recognized that a constructive relationship was in our interest, and he didn't want to campaign on the basis of suggesting that it wasn't. George W. Bush, for all his idiosyncrasies in how he approached friends and enemies, built a very strong relationship with Hu Jintao and the Chinese leadership. While Obama had a lot of differences with Bush, he was not going to argue that Bush fundamentally made a mistake by building

constructive relations. If you go back before that, it's fair to say that in most of the campaigns since the

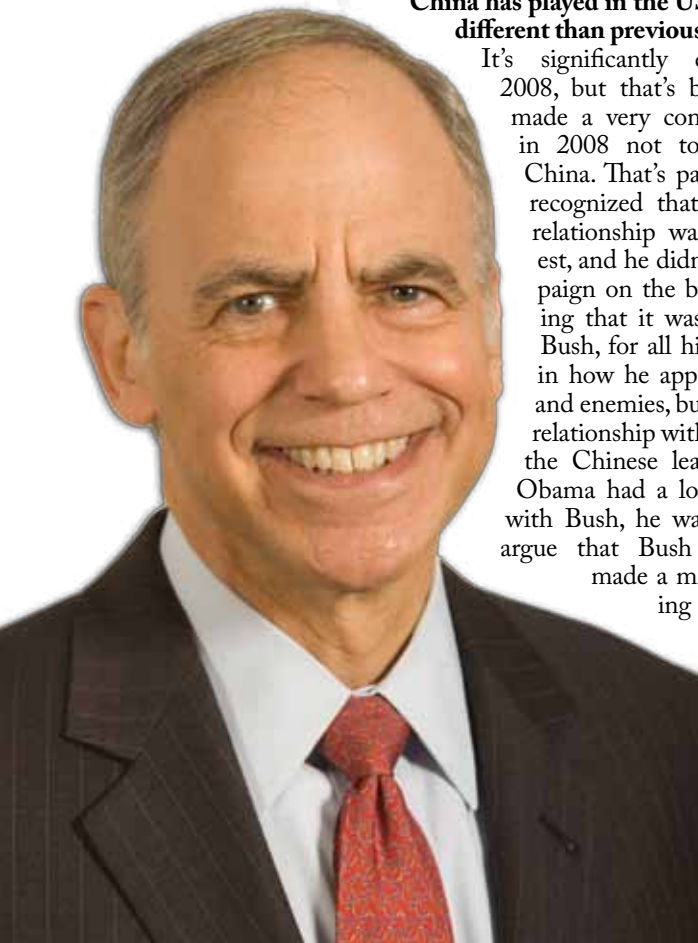
normalization of relations with China, this tough-on-China rhetoric has been a part of the campaign. But I don't think it's swayed any electoral outcome for the White House or even for the House or Senate. This is part of posturing in a campaign. It can have real consequences if the challenger is elected and has made specific commitments, but it doesn't shape elections.

What has been the practical effect of Obama's more aggressive stance on trade? Is a tough stance on China good or bad for the US economy?

Obama has no big strategic theory that leads him to feel that we have to compete with China across the board. He does not, like some people, believe that US-China conflict is inevitable. He is a pragmatic problem solver. But the one area where he is livid – I think that's the right term to use – is on China's economic and trade policies. I'm not quoting him directly, but I think it's fair to say that he sees China following a highly mercantilist set of policies that disadvantage the US. What he has done, and I think this is exactly right, is to take economic issues that need to be addressed to the WTO. I was in the White House when we negotiated the bilateral trade agreement with China to join the WTO in the second Clinton Administration, and the major reason behind that strategy was that we could anticipate all kinds of future economic problems with China, especially on the trade side. It is a big emerging economy and it operates very differently than we do. If you don't want to make all disputes into bilateral issues, you get China into the WTO where they agree to a set of rules and dispute adjudication procedures. It may be clumsy at times, but it tends to prevent trade wars. Obama has basically followed that. I know in his gut he thinks that the US needs to take strong action to protect its own legitimate interests. He's not someone who thinks we have to sit back and wait for the Chinese to become liberal democrats and true believers in the free market. He thinks you've got to use the tools you've got, but don't use them in a way that makes it much more difficult to get Chinese cooperation on other issues, for example, Iranian nuclear development.

What are your expectations from China's new leadership?

My own view is that the Xi Jinping leadership is likely to be enormously focused on domestic problems, to the extent that they will, if given the option, seek to tamp down international tensions so they have more capacity to focus on domestic issues. If we have a president in office who sets out to challenge China to teach it a lesson, declare >>





WORD TRAVELS: A Chinese man shops next to biographies of US President Barack Obama at a Hangzhou bookstore

Imaginechina

>> it a currency manipulator, apply new tariffs, execute a variety of unilateral actions to show the Chinese there's a new sheriff in town, Xi Jinping will react very strongly. And he'll do so for two reasons. One is the Chinese have experience with this before when the US has changed presidents, and their reaction always is that you have to show the new guy this is the wrong way to elicit cooperation from China. But secondly, Xi recognizes that he needs to build tremendous domestic political capital in order to carry out the reforms that are so necessary during his first five years in office. If in his early months he is seen as caving to the US, it will deeply damage his efforts to garner sufficient political capital to undertake the domestic reforms that are likely to be at the core of his agenda. But bottom line, I think the Chinese will want a much-improved relationship with the US. On the US side, if Obama is elected, I think he would be responsive and our policies would remain pretty much as they are now. With Romney, there's more of an unknown quantity. He's talking extremely tough on China, but then again he has no responsibility now but to get elected. Once elected, when he knows he has to cope with the consequences of

The problems that Chinese success creates are more likely ones we know how to deal with

whatever he does, he may choose to recalibrate significantly. We'll have to see.

We're seeing increasing uncertainty in China now, with the economy slowing and the leadership transition approaching. Are there scenarios with China you lose sleep over?

Sure there are. Let me be very candid. From a US interest point of view, we do better with Chinese success than we do with Chinese disappointment or failure. Having wrestled with these issues for many years, fundamentally I come down on that side. The problems that Chinese success creates are more likely ones we know how to deal with. China now faces one of the most difficult challenges it's had since the 1970s: the challenge of significantly restructuring its economy at a time when the political system is structured in a way not to allow that to happen. The incentives for the top party

and government leaders in each locality from the provincial level down to the township level – even if this is only the top two people [in each location] we're talking about, it's more than 70,000 officials – are very much built around the model that has produced all the growth of the last 30 years. That model has been the basis for rewarding and promoting these officials, so not surprisingly they are comfortable with that model and have learned how to milk it for satisfaction. The economic development model of the 12th Five-Year Plan, which is a model that suits both Chinese and American interests very well, requires restructuring those incentives in a major way. It's going to be extremely difficult for the top leadership in China to develop the political will power and capacity. You also now have enormous SOEs that are extremely powerful and that would be disadvantaged by the 12th Five Year Plan, and many of them are linked to elite families. So while they formally adopted the 12th Five-Year Plan in March of 2011, I see very little evidence at this point that we're going to have rigorous implementation of it. Without rigorous implementation of the 12th Five-Year Plan, China within 10 years is going to be in deep trouble.

What are the major problems China could face?

The current model is based on assumptions that are largely exhausted at this point, assumptions about a very large cohort of workers in the 18- to 35-year-old bracket, assumptions about the capacity of the international system to keep absorbing very large increases in Chinese exports, assumptions about the capacity of the eco-system to permit China to develop now and clean up later, and assumptions about popular tolerance of corruption, inequality of wealth, and environmental degradation. All those assumptions were accurate ten years ago, but they're now largely exhausted. The major problem with the current model is that it's increasingly inefficient. It's a very resource intensive model in a country that has a real shortage of resources. But even beyond that, the big Achilles heel is that it generates social tension. And especially if there's an economic slowdown, so incomes aren't rising rapidly, then all the other downsides – cancer villages, corruption, inequality of wealth and so on – become increasingly worrisome. The Standing Committee and the Politburo

At the end of the day, the link between the domestic situation and foreign policy is profound, but it's also not completely predictable

can make some changes and implement them in Beijing, such as changing interest rates at state-owned banks, required bank reserve ratios and the Qualified Foreign Institutional Investor quotas, and that all has an impact. But that doesn't change the outcomes of the system as a whole. If structural reform fails, we're going to be dealing with a country where extremism from both the left and the right is more likely to play a larger role, where repression of civil liberties is likely to grow as instability grows, where the consequences in terms of global climate change are likely to be exacerbated, because China will not have shifted away from an

extraordinary stress on energy-intensive manufacturing.

Does US policy have any sway in that outcome?

If the US adopts a highly adversarial posture toward China, that's more likely to lead China in the wrong direction. Nevertheless, at the end of the day the link between the domestic situation and foreign policy is profound, but it's also not completely predictable. You can always have someone take a foreign crisis and use it to say we must carry out major domestic reform to be set for the future. Or you can have someone take a foreign crisis and say we have to mobilize the military and repress dissent, and we can't afford to diddle around with the economy. As that "great sage" [former American baseball player] Yogi Berra said, "Predictions are always difficult, especially when they're about the future." But if we have to place a bet, we should be betting that Chinese success is good for the US, that deep domestic failure is much more problematic for US interests, and that we have a greater ability to tip the balance to the downside than to foster the upside. ♦



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