Strategy Research Project

The Implications of China's Economic Statecraft

by

Lieutenant Colonel Omuso D. George
United States Army

United States Army War College
Class of 2012

DISTRIBUTION STATEMENT: A
Approved for Public Release
Distribution is Unlimited

REPORT DOCUMENTATION PAGE

Form Approved
OMB No. 0704-0188

1. REPORT DATE *(DD-MM-YYYY)*
19-03-2012

2. REPORT TYPE
Strategy Research Project

3. DATES COVERED *(From - To)*

4. TITLE AND SUBTITLE

The Implications of China's Economic Statecraft

5a. CONTRACT NUMBER

5b. GRANT NUMBER

5c. PROGRAM ELEMENT NUMBER

6. AUTHOR(S)

Lieutenant Colonel Omuso D. George

5d. PROJECT NUMBER

5e. TASK NUMBER

5f. WORK UNIT NUMBER

7. PERFORMING ORGANIZATION NAME(S) AND ADDRESS(ES)

Dr. David Lai
Strategic Studies Institute

8. PERFORMING ORGANIZATION REPORT NUMBER

9. SPONSORING / MONITORING AGENCY NAME(S) AND ADDRESS(ES)
U.S. Army War College
122 Forbes Avenue
Carlisle, PA 17013

10. SPONSOR/MONITOR'S ACRONYM(S)

11. SPONSOR/MONITOR'S REPORT NUMBER(S)

12. DISTRIBUTION / AVAILABILITY STATEMENT

Distribution A: Unlimited

13. SUPPLEMENTARY NOTES

14. ABSTRACT
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15. SUBJECT TERMS
Finance, Trade, Manufacturing, Fiscal, Treasury

16. SECURITY CLASSIFICATION OF:			17. LIMITATION OF ABSTRACT	18. NUMBER OF PAGES	19a. NAME OF RESPONSIBLE PERSON
a. REPORT UNCLASSIFED	**b. ABSTRACT** UNCLASSIFED	**c. THIS PAGE** UNCLASSIFED	UNLIMITED	30	**19b. TELEPHONE NUMBER** *(include area code)*

Standard Form 298 (Rev. 8-98)
Prescribed by ANSI Std. Z39.18

USAWC STRATEGY RESEARCH PROJECT

THE IMPLICATIONS OF CHINA'S ECONOMIC STATECRAFT

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Lieutenant Colonel Omuso D. George
United States Army

Dr. David Lai
Project Adviser

This SRP is submitted in partial fulfillment of the requirements of the Master of Strategic Studies Degree. The U.S. Army War College is accredited by the Commission on Higher Education of the Middle States Association of Colleges and Schools, 3624 Market Street, Philadelphia, PA 19104, (215) 662-5606. The Commission on Higher Education is an institutional accrediting agency recognized by the U.S. Secretary of Education and the Council for Higher Education Accreditation.

U.S. Army War College
CARLISLE BARRACKS, PENNSYLVANIA 17013

ABSTRACT

AUTHOR: Lieutenant Colonel Omuso D. George

TITLE: The Implications of China's Economic Statecraft

FORMAT: Strategy Research Project

DATE: 19 March 2012 WORD COUNT: 6,285 PAGES: 30

KEY TERMS: Finance, Trade, Manufacturing, Fiscal, Treasury

CLASSIFICATION: Unclassified

Twenty years after the end of the Cold War and the rise of the U.S. as the world's sole great power, many now view the emergence of China as the most likely contender or threat to balance U.S. power or surpass it. In the midst of an increasingly globalized international environment and as the U.S. and other western nations currently face serious financial crises, China, among several other nations (including India and Brazil), has one of the fastest growing economies in the world, and holds a significant amount of U.S. public debt. Meanwhile, the U.S. economy appears to have stalled with no clear end in sight out of its current economic recession. For some observers, these factors point to an impending decline in U.S. influence in the Asia-Pacific region and around the globe. However, China's rapid economic growth does not automatically signal the coming decline of the U.S. as a great economic power. Since their economies are so interconnected, the economic fortunes of both may rise and fall together. Therefore, China's economic rise does not necessarily spell the demise of the U.S. This paper will examine the strategic implications for the U.S. of China as a rising economic power.

THE IMPLICATIONS OF CHINA'S ECONOMIC STATECRAFT

> The fact is that a thriving America is good for China and a thriving China is good for America.
>
> —Hilary Clinton[1]

When the Vice President of the United States, Joseph Biden, returned from his August 2011 visit to China, he provided some candid observations and opinions in a *New York Tim*es op-ed piece:

> I FIRST visited China in 1979, a few months after our countries normalized relations. China was just beginning to remake its economy, and I was in the first Senate delegation to witness this evolution. Traveling through the country last month, I could see how much China had changed in 32 years—and yet the debate about its remarkable rise remains familiar. Then, as now, there were concerns about what a growing China meant to America and the rest of the world. As I told China's leaders and people, America is a Pacific power and will remain one. But, I remain convinced that a successful China can make our country more prosperous, not less.[2]

Vice President Biden's comments after his state visit to China capture the heart of an ongoing discussion that has taken root in the center of current discussions regarding the state of U.S. economic and political dominance in comparison to China. Twenty years after the end of the Cold War and the rise of the U.S. as the world's sole great power, many now view the emergence of China as the most likely contender or threat to balance U.S. power or surpass it. In the midst of an increasingly globalized international environment, and as the U.S. and other western nations currently face serious financial crises, China, among several other nations (including India and Brazil), has one of the fastest growing economies in the world, and holds a significant amount of U.S. public debt. Meanwhile, the U.S. economy appears to have stalled with no clear end in sight out of its current economic recession. For some observers, these factors point to an impending decline in U.S. influence in the Asia-Pacific region and around the globe.

However, as the previous statement by U.S. Secretary of State Hillary Clinton suggests, China's rapid economic growth does not automatically signal the coming decline of the U.S. as a great economic power. Rather, since their economies are so interconnected, the economic fortunes of both may rise and fall together. Therefore, China's economic rise does not necessarily spell the demise of the U.S. This paper will examine the strategic and political implications for the U.S. of China as a rising economic power. It will examine economic factors to include growth (as measured in GDP), manufacturing, trade policy, fiscal and monetary policy, finance, and investment to determine China's true economic strength relative to that of the U.S. With a particular focus on the financial and trade dilemmas between the United States and China, can either use the debt and trade issues as leverage against the other? What are the potential pitfalls or benefits? What is the way out? It will also examine current economic forecasts for China in these areas, and provide recommendations for U.S. economic policy toward China for the future.

To begin, what are the current conditions in the global economic environment that have led to so much recent discussion, highlighted by Vice President Biden's comments, about American decline in the midst of Chinese rise to prominence? For the purpose of this discussion, it is most useful to examine the dramatic changes in the global economic environment primarily starting in 2008 when the American financial crisis began. Just prior to that in 2006 and early 2007, as Fareed Zakaria describes in *The Post American World: Release 2.0*, "America was at the center of the world."[8]

Although it was heavily mired in war in Iraq, U.S. military power stood unmatched across the world, American culture reigned supreme around the world, and America represented the world's most advanced form of capitalism.[4] However, in 2008, the global financial crisis began to take hold and the U.S. economy began to collapse. In the fall of 2008, the U.S. economy contracted by 6 percent and shed almost four million jobs in six months, the largest such decline since the 1930s.[5]

Suffice it to say, the specific details, events, and actions taken by the U.S. federal government, private industry, and federal and commercial financial institutions to address the contraction of the U.S. economy from 2008–2010 is fairly well documented in the public information domain and is outside the primary scope of this project. However, it is worth noting that the recent events of the American financial crisis and the greater global financial crisis have propelled debate of alleged American decline and China's rise to prominence to the forefront of contemporary discussion. Specifically, the recent U.S. recession appears to have contributed to a growing view that China's economy is economically superior to the U.S. According to a recent Gallup poll, 53 percent of Americans consider China to be economically superior to the U.S., while only 33 percent view the U.S. as the top economic power.[6] The Gallup poll says that the idea of Chinese economic dominance has taken hold in the United States only since the start of the U.S. recession in 2008 and that opinions could change when the U.S. starts to recover.[7] Clearly, the recent U.S. economic troubles combined with China's recent rapid economic expansion have influenced perceptions. However, these influences need to be put in perspective.

GDP and Growth

An understanding of the implications of China as a rising economic power cannot begin without first examining key economic factors, foremost among them being the size and growth rate of the U.S. and China's economies as measured by Gross Domestic Product (GDP). GDP represents the total value of all goods and services produced in a country for a specific time period. Although commonly misperceived that China's GDP is larger than that of the U.S., it is not, in fact, the case. As of 2010, the GDP for China is approximately, $5.9T, the second largest in the world, behind that of the U.S., leading at approximately 14.6T, almost two and a half times the size of China's GDP.[8] Despite its recent economic woes, the U.S. distinctly continues to lead as the world's largest economy and has begun a slow and tentative turnaround.

In considering GDP per capita, the U.S. far exceeds China, with per capita equaling $47K, compared to China's GDP per capita of $4.4K.[9] However, GDP growth represents an entirely different matter. China's GDP growth rate was 10.4 percent for 2010, while the U.S. GDP growth rate climbed to three percent after negative growth over the preceding two years.[10] In fact, China has sustained an average annual GDP growth rate over nine percent a year for almost thirty years, the fastest growth rate for any major economy in recorded history.[11] Consistent with this phenomenon and based on current projections, Goldman Sachs has forecasted that China will overtake the U.S. as the world's largest economy in 2026, just 14 years away.[12] If China's unprecedented economic growth over the last thirty years is to serve as a blueprint for the next thirty years, it is hard to argue that China's economy won't eventually surpass that of the U.S. in size and possibly scope. However, one must ask the question whether there are certain social, political, or other economic factors that could hamper or slow this unprecedented growth in China's future, and some of these factors will be discussed later.

Manufacturing

While China may not yet have the world's largest economy, its manufacturing potential is nearly unrivaled. Supported by a population of over 1.3 billion, China is the world's largest producer of coal, steel, and cement, and it manufactures two-thirds of the world's photocopiers, microwave ovens, DVD players, and shoes.[13] Additionally, many analysts now agree that the sharp increase in U.S. imports from China (and the resultant growing bilateral trade imbalance) is largely the result of the movement in production facilities from other (primarily Asian) countries to China.[14] Essentially, various products that used to be made in other Asian countries like Japan, Taiwan, and Hong Kong, and then exported to the United States, are now being made in China (often by foreign firms in China) and exported to the United States.[15]

Few locations around the world can marshal the requisite labor pool to meet large scale production requirements on short notice for a sustained period. As an example, prior to the debut of its iPhone, when Apple searched for a location that would meet the large scale production requirements to respond to the debut of the iPhone, it found what it was looking for in China at a large industrial facility known as Foxconn City.[16] With 230,000 employees working six days a week in 12 hour shifts, the employees live in company barracks. To prepare for the iPhone's launch, Apple estimated that 8,700 industrial engineers would be needed to oversee and guide 200,000 assembly line works in manufacturing iPhones for nine months. In China, it took 15 days.[17] No facility exists of this scale in the U.S., and this anecdote clearly speaks to China's manufacturing capacity potential. It continues to contribute to China's rapid economic rise.

While China's growth as a manufacturing engine represents China's economic rise, it does not, by itself, signal the end of U.S. economic dominance and it should not be considered a zero-sum game for the U.S. As previously mentioned, the sharp increase in U.S. imports from China is largely the result of the movement in production facilities from other primarily Asian countries to China. This means that companies with a global supply chain that includes production outside of the U.S. are shifting product manufacturing from one location outside of China to locations in China. It does not translate to lost American jobs, because the manufacturing was not occurring in the U.S. anyway. Therefore, the argument by some that China's increase in economic power, as a result of its manufacturing strength, will directly result in the loss of American jobs is a questionable argument. The U.S. lost those jobs long ago. The strategic implication for the U.S. is not how to lure manufacturing jobs from China to the U.S.; with an economy that is no longer dominated by manufacturing, the U.S. instead needs to determine what place it wants to hold with regard to manufacturing in the global economy. For the U.S., the real competition in manufacturing is not with China, but with all global manufacturing competitors that possess factors that support manufacturing as an economic strength.

Trade Issues

With the U.S. and China comprising the world's two largest economies and dominant manufacturing capacities, it would only follow that these two countries share a complex trade relationship. Of all economic factors between both countries, trade is this is among the top issues with the greatest implications, due to the complexity of the relationship.

Trade relations increased significantly after the U.S. and China re-established diplomatic relations in 1979, signed a bilateral trade agreement and granted mutual most favored nation (MFN) to one another in 1980.[18] China began economic reforms in 1979; at that time, total U.S.-China trade was $2 billion. China ranked as the 23rd-largest U.S. export market and its 45th-largest source of U.S. imports.[19] Those economic reforms that began in 1979 have been a primary contributor to China's incredible economic growth. In 2001, China also joined the World Trade Organization (WTO), which also led to a marked expansion in commercial ties between the U.S. and China.[20] By 2010, bilateral merchandise trade between the U.S. and China was $457 billion; China was the second-largest U.S. trading partner after Canada, the third-largest U.S. export market after Canada and Mexico, and the largest source of U.S. imports.[21] In recent years, China has been one of the fastest-growing U.S. export markets, and the importance of this market is expected to grow even further, given the pace of China's economic growth, and as Chinese living standards continue to improve.[22]

Despite the recent growth of U.S. exports to China, the imbalance between what the U.S. exports to China, and what the U.S. imports from China, has become a significant trade deficit for the U.S. U.S. imports from China have grown much faster than U.S. exports to China. That deficit rose from $10 billion in 1990 to $266 billion in 2008, fell to $227 billion in 2009, and then rose to $273 billion in 2010, and was significantly larger than that with any other U.S. trading partner and several trading groups.[23] This growing trade imbalance is obviously not without implications and challenges. As an example most recently, the Chinese government increased trade tensions with the U.S. by unexpectedly imposing tariffs on imports of sports utility vehicles, and midsize and large cars from the U.S.[24] The new tariffs added almost 22 percent to the import prices, and along with other tariffs and taxes already in place, serve to severely limit sales of the American imports by raising the retail price to approximately three times what the same cars and sports utility vehicles would sell for in the U.S.[25] For its part, China asserted that the tariff is an "antidumping" and "antisubsidy" tariff, because the U.S. car companies like Chrysler and General Motors received government aid several years ago during the financial crisis. However, this assertion is not strongly supported because the retail price in China for these vehicles is already higher than what it would be in the U.S., and the tariffs that China applied are much higher than the norm that would be applied on these vehicles in other countries.[26] Interestingly, some argue that it is these types of unfair trade practices that have contributed to China's economic rise and since China joined the WTO in 2001, the U.S. has brought complaints to the WTO to open trade cases to be investigated. As in previous complaints, the Obama administration indicated that it would open a WTO case for this incident.

Part of the explanation of the aforementioned trade issue and what some consider similar other protectionist issues is due in part to the history of China's entrance into the WTO (formerly the General Agreement on Tariffs and Trade, or GATT) that began in 1986, culminating in 2001. When China was accepted in the WTO in 2001, it agreed to accept the organizations broad free trade rules. However, China also negotiated an accession agreement that articulated a plethora of details tailored to the specifics of the economy of China, which at that time was still very much a developing country.[27] The agreement required China to lower its tariffs to lower its tariffs to levels below those of many other developing countries, but compared to most industrialized countries, China was allowed to impose considerably higher tariffs that China still retains even as its economy has risen to the second largest in the world.[28]

U.S. policymakers at the time actively supported China's WTO membership. They maintained that China's WTO membership would encourage the Chinese government to deepen market reforms, promote the rule of law, reduce the government's role in the economy, further integrate China into the world economy, and enable the U.S. to use the WTO's dispute resolution mechanism to address major trade issues. As a result, it was hoped, China would become a more reliable and stable U.S. trading partner.[29] According to U.S. trade officials, China made noteworthy progress in adopting economic reforms in the first few years after it joined the WTO. However, beginning in 2006, progress toward further market liberalization appeared to slow.[30] By 2008, U.S. government and business officials noted evidence of trends toward a more restrictive trade regime.[31] As of April 2011, the United States has brought eleven trade complaints against China to the WTO's Dispute Resolution Board (DSB), several of which have been resolved or ruled upon. China has brought WTO cases against the United States as well.[32]

Few trade officials expected all of the terms of China's accession agreement to last as long as they have, and conditions will inevitably change, in some cases in China's favor and in some cases against China's favor, when China is automatically relabeled as a market economy in 2016.[33] Regardless, there are clear implications for the U.S. as the current President Obama's administration will invariably decide very soon how it chooses to respond to allegations of China's unfair trade practices. The U.S. response should be synchronized with its overall policy for continued strategic and economic engagement of China. Given that this is a presidential election year, it is fair to say that this response will undoubtedly be informed by the perception of whether China's trade practices negatively impact American jobs now and in the future.

China's Currency Policy and Issues

An integral issue closely tied to the complex trade relationship between the U.S. and China is China's valuation policy for its monetary currency, the renminbi (RMB). China's policy of intervention to limit the appreciation of the renminbi against the dollar and other currencies has become a major source of tension with many of its trading partners, especially the United States.[34] Some analysts contend that China deliberately "manipulates" its currency in order to gain unfair trade advantages over its trading partners. They further argue that China's undervalued currency has been a major factor in the large annual U.S. trade deficits with China and has contributed to widespread job losses in the United States, especially in manufacturing.[35]

As an example, every month, the U.S. buys approximately $35 billion in goods and services from China and sells $11 billion back, leaving a $24 billion trade deficit. According to NPR writer Adam Davidson, this should generate an increased demand for renminbi, with China demanding few U.S. dollars, and the natural result should be for U.S. dollar to get weaker as the renminbi gets stronger.[36] However, China's government prevents the adjustment by spending much of the $24 billion surplus on U.S. Treasury bonds, thus artificially increasing the demand for dollars and effectively making all Chinese exports approximately 25 percent cheaper and all U.S. imports to China about

25 percent more expensive.[37] This obviously allows Chinese goods in the U.S. to be cheaper for consumers in the U.S. and also impacts U.S. Treasury bond interest rates to keep them low (thereby keeping interest rates for things like credit cards and mortgages low), but some economists estimate it has cost the U.S. between 200,000 and 3 million jobs.[38]

While China contends that its currency policy is not intended to benefit Chinese exporters and is intended to promote overall financial stability in China, U.S. legislators have seized on this currency issue by introducing legislation to punish China for allegedly keeping its currency depressed. Five currency bills have been introduced in the 112th Congress thus far.[39] Most recently, the Senate introduced a bill that would require the Treasury Department to determine whether China is manipulating its currency, and then order the Commerce Department to impose retaliatory tariffs on certain Chinese goods.[40] While China's currency valuation discussion has been ongoing for several years, and members of Congress have introduced legislation in the past to address concerns over China's currency policy, the recent emphasis on the issues has taken on a greater sense of urgency with the recent U.S. economic crisis, increased unemployment, and upcoming elections this year.

Although there is an increased sense of urgency for some on this issue, the jury is still out with regard to whether the currency issue is of as great strategic and national importance as some claim, as some economists, policy makers, legislators, and business leaders contend that it is not as impactful on jobs and the economy as some believe. Some legislators are concerned about increases in consumer prices that might occur from the likes of legislation recently introduced by the Senate, while business leaders argue that it would not create more jobs in the U.S. and distracts attention from more urgent issues, such as market access.[41] The U.S.-China Business Council, a private, nonpartisan, nonprofit organization of roughly 240 American companies that do business with China, does not even identify the currency exchange rate issue in its top-ten list of economic concerns with China.[42] Also, some analysts contend that, although an appreciation of China's currency could help boost U.S. exports to China, it could also lessen China's need to buy U.S. Treasury securities, which could push up U.S. interest rates at a critical time when the U.S. economy is attempting to recover.[43] In fact, in the medium run, an undervalued RMB neither increases nor decreases aggregate demand in the U.S.; instead, it leads to a compositional shift in U.S. production, away from U.S. exporters and import-competing firms toward the firms that benefit from Chinese capital flows. Thus, it is expected to have no medium- or long-run effect on aggregate U.S. employment or unemployment.[44] Therefore, the urgency of increasing China's currency exchange rate in order to improve U.S. economic success is not as compelling as some have presented, upon further analysis, and it does not signal U.S. economic decline. In fact, the U.S. government must engage carefully with China in this area to ensure that any significant and sudden appreciation in China's currency exchange rate does not produce negative unintended consequences for the U.S.

Monetary Policy, Finance and U.S. Treasury Securities

Closely tied to the previously discussed issue of the renminbi exchange rate is the equally complex issue of China's large scale purchase of U.S. Treasury securities, and its accompanying finance of the U.S. public debt. Since this issue intimately binds the economies of both countries together, what are the implications?

To answer that question, an initial understanding of U.S. monetary policy is helpful. The U.S. Federal Reserve, the central bank of the U.S which is responsible for conducting monetary policy, buys and sells marketable Treasury securities in the secondary market to promote maximum employment, stable prices, and moderate long-term interest rates.[45] By adding to reserves or draining reserves through the purchase or sale of securities in open market operations, the Federal Reserve can influence short-term interest rates (e.g., the federal funds rate–the rate at which banks lend to one another on an overnight basis).[46] However, during the recent financial crisis, the Federal Reserve also purchased longer-term Treasury securities in an effort to spur economic growth.[47]

For foreign investors, U.S. Treasury securities offer are an attractive investment because the U.S. has a stable political system, possible favorable returns, and the dollar is considered to be the world's dominant reserve currency.[48] Because of its internal low savings rate, the U.S. depends on countries with high savings rates like China to invest some of its capital in the U.S. market, which has helped to keep the U.S. interest rates low and enabled the U.S. to consume more than it produces.[49] As discussed in the previous section, China's central bank is a major purchaser of U.S. financial assets, largely because of its exchange rate policy. In order to limit the appreciation of the renminbi against the dollar, China must purchase U.S. dollars. This has led China to amass a huge level of foreign exchange reserves, which totaled $3.2 trillion as of June 2011.[50] Rather than hold dollars (and other foreign currencies), which earn no interest, the Chinese central government has converted some level of its foreign exchange reserve holdings into U.S. financial securities, including U.S. Treasury securities, U.S. agency debt, U.S. corporate debt, and U.S. equities.[51] U.S. Treasury securities, which are used to finance the federal budget deficit, constitute the largest category of U.S. securities held by China, and as of December 2011, these totaled $1.1 trillion and accounted for 23.3% of total foreign holdings of U.S. Treasury securities.[52] Since total U.S. federal debt stands at almost $15 trillion ($14.781T as of September 30, 2011), this means that China holds just over 7 percent of total U.S. federal debt.[53]

Despite holding this small percentage of U.S. federal debt, some U.S. policymakers have great concern about the growing U.S. dependency on China to purchase U.S. Treasury securities to help fund the U.S. budget deficit. These include concerns that China's large holdings may give it leverage over the U.S. on economic and noneconomic issues, or that China might lose faith in the ability of the U.S. to meet its debt obligations, and, thus, might seek to liquidate its assets or significantly cut back on purchases of new securities, a move some contend could damage the U.S. economy.[54] Meanwhile, Chinese officials have expressed concerns over the safety of their large holdings of U.S. debt, and some have argued that China should either diversify away from U.S. Treasury securities or implement policies that slow the accumulation of foreign exchange reserves, which would lessen the need to buy U.S. securities.[55] Apparently, China's concern is driven by the Federal Reserve's use of a policy called quantitative easing (QE), which ultimately devalues the U.S. dollar and increases the value of the yuan (renminbi) faster than the Chinese government is comfortable with, leaving China no choice but to eventually stop buying U.S. debt and to reduce its holdings of U.S. securities.[56]

So, what are the real implications of China's holdings of U.S. public debt? Does the percentage held really give China some leverage over U.S. policy? Can China's holdings of U.S. public debt really be used as an economic and political weapon against the U.S.? Although it is difficult to determine whether China's holdings of U.S. debt give it any leverage over the U.S., based on the previous discussion thus far that illuminates the complexity of the U.S.-China economic relationship, it does become clear that it is unlikely that China would suddenly reduce its holdings of U.S. securities because it would have a sharp negative impact on the Chinese economy. Again, based on the previous discussion on monetary policy, a decision to suddenly sell off a significant portion of its U.S. financial holdings in the open market would cause the dollar to suddenly drop in value, resulting in an immediate appreciation in the value of the renminbi, which would of course result in immediate increases in Chinese manufactured products. With an economy mostly dependent on exports, this clearly would not be in China's best economic interests. This assertion is validated by many economists, who agree that a large sell-off of China's U.S. holdings could diminish the value of these securities in international markets, which would lead to large losses on the sale, and would subsequently decrease the value of China's remaining dollar-denominated assets.[57] This would also occur if the value of the dollar were greatly diminished in international currency markets due to China's sell-off. Also, such a move would diminish U.S. demand for Chinese imports, either through a rise in the value of the renminbi against the dollar or a reduction in U.S. economic growth.[58] A sharp reduction of U.S. imports from China could have a significant impact on China's economy, which heavily depends on exports for its economic growth and is viewed by its government as a vital source of political stability.[59] Accordingly, the Chinese government has an interest in helping the U.S. get back on its economic feet, as the government estimates that it needs to grow at least eight percent annually to avoid excess unemployment and social unrest.[60] Thus, it is clear that while a long-term gradual reduction of U.S. securities would not necessarily hurt the U.S. and China, a sudden decision to reduce its holdings of U.S. securities would have potentially harmful implications for China's, and by extension, the U.S. economy.

Internal Challenges to China's Continued Economic Rise

As initially discussed, China's economy has shown unprecedented growth since its government initiated market reforms in recent decades. However, China's continued meteoric economic rise is not guaranteed. As the previous discussion up to this point provides a view into just how integrally intertwined the economies of the U.S. and China are, it is also important to examine a few key issues that may potentially challenge China's continued rise as an economic power. These are issues that the Chinese government will have to address if it is to sustain China's continued economic growth, and any hopes of becoming the world's leading economy anytime soon in the 21st century.

Uneven Economic Growth. As economic modeling has predicted China's continued growth based on current conditions, it become more difficult to predict future economic performance based on future economic inputs. As China's economy evolves from subsistence agriculture to smokestack industries to the latest electronics for consumer devices, it is possible that China's economic growth rates will level out and slow down, returning to rates more like those experienced by comparable countries.[61] The rationale behind this states that as countries grow, growth gets harder; as economies progress up the global value chains from production of simple manufactured goods to increased reliance on the creativity of their citizens to develop new industries, they rise less rapidly.[62] As a comparison, it took South Korea 30 years, from 1960 to 1990, to raise its GDP per capita from one-thirtieth to one-third of U.S. GDP per capita, but it took an additional 20 years to inch from one-third to one-half.[63]

Over-reliance on Foreign Trade. Closely related to its currency exchange policy issues, the global economic crisis has demonstrated to the Chinese government the dangers of relying too heavily on exports and fixed investments for economic growth, thus promoting easy credit policies among banks.[64] That dependency made China's economy particularly vulnerable to the effects of the global economic downturn. In the future, these policies might undermine long-term economic stability by causing overproduction in various sectors, increasing the level of non-performing loans held by the banks and boosting inflationary pressures.[65]

Population and Demographics. It appears that China will eventually have to deal with the effects of a declining birth rate and to a lesser degree, its one-child policy that it implemented in 1979. Population scientist are predicting that, by the mid-21st century more than one-third of China's population will be aged 60 or over and one-quarter of China's population will be aged 65 or over, with more than 100 million people aged 80 or over.[66] This means that less than two young adults will have to support one old person and shows that in a few decades, China's population structure will turn from a pyramid to a pillar shape.[67] The challenge will be in how the Chinese government adapts to this change in demographics, as there are serious implications and costs for providing health care to such a large aged population. The other less visible implication is that

China's abundant labor supply will begin to shrink, and that labor pool has been a driving force behind China's economic growth up to this point.[68] Thus, if China's economic growth does not progress beyond reliance on a large labor pool to feed simple manufacturing processes, its government will have significant problems in sustaining its future economic growth.

Social Unrest. Although China's authoritarian political system has harnessed the country's growing economic potential, it has not yet found a way to solve the problem of demands for political participation that tend to accompany rising per capita income, with an expanding urban middle class, regional inequality, rural poverty, and resentment among ethnic minorities.[69] Every year numerous protests occur in China over a number of issues, including pollution, government corruption, and land seizures. A number of protests in China have stemmed from frustrations among many Chinese that they are not benefitting from China's economic reforms and rapid growth, and perceptions that those who are getting rich are doing so because they have connections with government officials.[70] It remains to be seen how China will address these issues in order to sustain its continued economic growth. As Salvatore Babones reflects, it is difficult to imagine a dynamic knowledge economy emerging in a politically repressive one-party state, as not one ever has.[71]

Government Control of State Owned Enterprises (SOEs). As a relic of its authoritative communist government, SOEs, which account for a significant amount of Chinese industrial production, put a heavy strain on China's economy. By some estimates, over half lose money and must be supported by subsidies, mainly through state banks.[72] Government support of unprofitable SOEs diverts resources away from potentially more efficient and profitable enterprises, and the poor financial condition of many SOEs makes it difficult for the government to reduce trade barriers out of fear that doing so would lead to widespread bankruptcies among many SOEs and unemployment.[73] This is yet another area where a full conversion to a free market would improve economic efficiency and innovation in China's economy.

Pollution. According to the World Health Organization, it is estimated that air pollution in China kills 656,000 people annually and water pollution kills 95,600 annually; China's own Ministry of Water Resources estimates that about 300 million people rely on water that contains harmful substances.[74] Although growing environmental degradation has been recognized as a serious problem by China's central government, it has found it difficult to induce local governments to comply with environmental laws, especially when such officials feel doing so will come at the expense of economic growth.[75] This kind of environmental peril could seriously hamper China's sustained economic growth if the government does not work proactively to address environmental issues in the future.

U.S. Policy Approach to China's Economic Rise

The discussion thus far has highlighted China's emergence as an economic power, the key economic areas that encompass China's burgeoning economic strength along with how any potential actions by China in those areas could ultimately impact both China and the U.S. positively or negatively, and several important challenges that China will have to address in order to sustain continued strong economic growth. Consequently, with such highly connected economic prospects, what is and what should the U.S. strategic approach be to China's economic rise?

The long-term strategic approach has been and should continue to be one of strategic engagement because of the high economic stakes and opportunities. Most recently this approach of strategic engagement was begun in September 2006 when President George W. Bush and Chinese President Hu Jintao agreed to establish a Strategic Economic Dialogue (SED) in order to have discussions on major economic issues at the "highest official level."[76] Then, in 2009 President Barack Obama and President Hu Jintao agreed to continue the dialogue and revised it to be the U.S.-China Strategic and Economic Dialogue (S&ED), with it being organized under two tracks, the Strategic Track and the Economic Track.[77] The Dialogue represents the highest-level bilateral forum between the two countries annually to discuss a broad range of issues between the two nations and is an essential step in advancing a positive, constructive, and comprehensive relationship between the two countries.[78] For the U.S., Secretary of State Clinton represents President Obama for the Strategic Track and Treasury Secretary Geithner represents the Economic Track, while Vice Premier Wang Qishan and State Councilor Dai Bingguo, as special representatives of President Hu, co-chair the Dialogue for China.[79] It is in this forum where the larger issues previously addressed in this paper are discussed by both sides.

While the long-term strategic approach of engagement continues, the current administration has shown willingness in the short-term to file trade cases with the WTO to address current disputes, as highlighted previously in this paper. President Obama spoke to this approach in his State of the Union Address in January 2012, mentioning that the current administration had brought opened trade cases against China at nearly twice the rate as the last administration, and that a new Trade Enforcement Unit would be created to investigate unfair trade practices in "countries like China."[80] His comments may be more illustrative of political rhetoric in a presidential election year, but they do capture recent U.S. actions to hold China accountable for current trade disputes. The long-term strategic engagement approach in tandem with this short-term approach both form a framework akin to a "carrot and stick" approach, albeit a larger carrot and smaller stick, to support U.S. national interests and objectives.

Conclusion

Does China's economic rise spell the demise of the economic strength of the U.S.? Based on a review of the complex economic relationship between these two great countries, this notion couldn't be farther from the truth. As the preceding discussion has illustrated, the U.S. and Chinese economies are inextricably linked across multiple facets of trade, fiscal, monetary and financial policy. As the world struggles to emerge from the recent global financial crisis, both countries need each other now more than ever, and both have a vested interest in the other's economic success. Economic prosperity based on free market economies has long proven not to be a zero-sum game, where the rising wealth of one nation equates to a corresponding decline of another. If anything, China's economic rise validates once again that the liberal free market approach long championed by the U.S. works best. As Secretary of State Clinton asserted, "the stakes are much too high for us to fail. As we proceed, we will continue to embed our relationship with China in a broader regional framework of security alliances, economic networks, and social connections."[81]

The economic prospects of China and the U.S. rise and fall together. Accordingly, as the leading free market economy, the strategic implications for the U.S. are that the U.S. should actively continue its long-term strategic approach of engagement to successfully work through its complex economic relationship with China. The U.S. recognizes that China has a stake in maintaining the international trading system, which is largely responsible for its economic rise, and China should take a more active leadership role in maintaining that system; and further economic and trade reforms are the surest way for China to grow and modernize its economy.[82]

Does China's economic rise equal U.S. demise? No–it represents opportunities for engagement, partnership and economic growth for both.

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