

# Executive Summary Backgrounder

No. 2200  
October 21, 2008



Published by The Heritage Foundation

## U.S.–China Economic Dialogue: In Need of Tough Love

*Derek Scissors, Ph.D.*

The end of 2008 could be a momentous time for Sino-American commercial relations. A new U.S. President will take the reins just after the 30th anniversary of China's market reforms. Natural attention is being given to what the new President plans for the Strategic Economic Dialogue (SED) and other elements of the economic relationship.

But the 30th anniversary marks a more important development to the future of these negotiations. Reform began 30 years ago—about three years ago, it stopped.

Since the present Chinese leadership took power in late 2002, market-oriented reform has been minor, resting on a legacy of earlier decisions. As market-oriented policies wind down, they are increasingly supplanted by state-run development. The last few years have been characterized by price intervention, absence of privatization, rollback of competition, and fresh investment barriers.

By most economic standards, however, the state has done very well. Success has created a constituency, moving Beijing dangerously close to an obsession with growth at the expense of all else. It presently does not see a strategy of further genuine market-oriented reform as in its long-term interest. Whatever the objectives of the new U.S. Administration, it must surmount this frame of mind. While true broad-based market-oriented reform should remain as a goal and context for American economic policy toward the People's Republic of China,

the next Administration's economic diplomacy would do best to focus negotiating objectives on an evaluation of actual Chinese development strategy of rapid and state-led growth. American policies that presume ongoing market reform will be flawed from the start.

One response is to dismiss the whole endeavor of economic engagement with China. That would be a high-stakes gamble. The U.S. and China combined accounted for more than 30 percent of gross domestic product (GDP) worldwide last year. Bilateral trade volume between the two countries stood at \$387 billion, dwarfing the \$208 billion between America and Japan. Chinese exports to the U.S. were the equivalent of approximately 9.5 percent of Chinese GDP in 2007 while its holdings of U.S. treasuries were more than \$500 billion at the end of June 2008. This is the most important bilateral economic relationship in the world. Even incremental improvement in its structure would have a large economic payoff.

With this in mind, the question is *how* to engage China. The answer depends first on the new President's viewpoint on trade. The advantages of free

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trade are apparent both in the abstract and tangibly. At its core, free trade offers opportunity and choices to businesses and consumers, while protectionism limits both. It would be especially difficult in the current economic environment for a President to move sharply away from open trade: Surprisingly vigorous second-quarter GDP growth this year was driven almost entirely by trade. It is thus quite unlikely that the new President will simply abandon economic dialogue with the People's Republic.

Fortunately, while the substantive ground has shifted, the existing institutional framework for Sino-American economic relations, topped by the SED, is generally sound. Retaining the SED or an equivalent arrangement offers a superior path to progress in bilateral talks, though the location of U.S. negotiating authority should be changed from the Secretary of the Treasury to the Vice President. This makes changes in U.S. policy relatively easy to implement.

Under the circumstances, the best action that the U.S. can take is to encourage the Chinese to move in the right direction by focusing on a narrow range of reform that is feasible in the present context. The changes proposed here feature steps toward long-term price liberalization, curbing state dominance at the corporate level, shielding American companies from mercantilist "reforms," and restarting the process of opening the capital account to allow money to move freely in and out of the country.

**Conclusion.** Economic dialogue with China may be even more complicated than the next President anticipates. The importance and multifaceted nature of the relationship call for an overarching institutional mechanism like the SED. But some present American objectives fly in the face of a state-dominated development model that has yielded rapid growth and is thus deemed very successful by the Chinese government. The recommendations

made in this paper take into account Chinese reaction and are WTO-compliant. The lead negotiating authority in the SED can thus be assertive in terms of legal or other actions in pursuing these outcomes.

Though only modest progress can reasonably be expected until the flaws of China's model become more apparent, true market-oriented reform must remain the ultimate goal. The next American Administration should, therefore, continue to state the case for deeper liberalization of China's economy. This will emphasize that long-term U.S. objectives have not changed and prepare the ground for the time when China is again open to market-oriented reform.

Elements of the new Administration will surely offer alternate views to the one argued here. An obvious alternative is to pursue much more fundamental change on the Chinese side. With President Hu Jintao and Premier Wen Jibao committed to a path that has brought at least 10 percent annual GDP growth since they assumed power, some will maintain that sharp protectionist threats are required to move them toward fundamental change. The problem with such protectionist threats is not that they are not credible, but that they are not effective, and in fact, counterproductive. Protectionism will harm the U.S.—even if it harms China more. Threatening to cut off one U.S. finger while cutting off two of China's fingers amounts to damaging political posturing instead of viable, effective policy. American leadership is demonstrated by the confidence and ability to thrive in competitive environments at home, in global markets, and in the People's Republic of China itself. Protectionism is a retreat from that leadership.

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# Background

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By most economic standards, however, the state has done very well. Success has created a constituency, moving Beijing dangerously close to an obsession with growth at the expense of all else. It presently does not see a strategy of further genuine market-oriented reform as in its long-term interest. Whatever the objectives of the new U.S. Administration, it must surmount this frame of mind. While true broad-based market-oriented reform should remain as a goal and context for American economic policy toward the People’s Republic of China (PRC), the next Administration’s economic diplomacy would do best to focus negotiating objectives on an evaluation of actual Chinese devel-

### Talking Points

- China’s market reforms stopped about three years ago.
- The state has been successful in spurring rapid growth, but the last few years of China’s economy have been characterized by price intervention, absence of privatization, rollback of competition, and fresh investment barriers.
- American engagement that presumes ongoing market reform in China is flawed. It must, instead, focus on a narrow range of meaningful reform that is feasible in the current context.
- The importance and multifaceted nature of the U.S.–China economic relationship call for an overarching institutional mechanism, such as the Strategic Economic Dialogue (SED).
- The next American Administration should continue to state the broader case for deeper long-term liberalization of China’s economy, but harbor no illusions about its prospects.

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With this in mind, the question is *how* to engage China. The answer depends first on the new President's viewpoint on trade. The advantages of free trade are apparent both in the abstract and tangibly. At its core, free trade offers opportunities and choices to businesses and consumers, while protectionism limits both. It would be especially difficult in the current economic environment for a President to move sharply away from open trade: Surprisingly vigorous second-quarter GDP growth this year was driven almost entirely by trade.<sup>2</sup> It is thus quite unlikely that the new President will simply abandon economic dialogue with the PRC.

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Under the circumstances, the best action that the U.S. can take is to encourage the Chinese to move in the right direction by focusing on a narrow range of reform that is feasible in the present context. The changes proposed here feature steps toward long-term price liberalization, curbing state dominance at the corporate level, shielding American companies from mercantilist "reforms," and restarting the process of opening the capital account to allow money to move freely in and out of the country.

### The End of Reform

The June 2008 meetings of the SED in Annapolis, Maryland, emphasized energy, environmental cooperation, and the start of challenging talks on a bilateral investment accord.<sup>3</sup> According to Secretary of the Treasury Henry Paulson, the December 2008 meetings will focus on the same topics.<sup>4</sup> One issue is whether the next President should retain, modify, or drop the SED as the executive branch's negotiating framework. The more important subject, of course, is what the SED or its replacement is intended to accomplish. Here, a significant shift in American policy is required.

The heart of the matter is that the new President must re-orient U.S.–China trade policy in light of Chinese disinterest in meaningful talks on issues such as subsidization of state enterprises. That dis-

1. World Bank, "World Development Indicators Database: Gross Domestic Product 2007," September 10, 2008, at <http://siteresources.worldbank.org/DATASTATISTICS/Resources/GDP.pdf> (October 9, 2008); U.S. Census Bureau, "U.S. International Trade Statistics," at <http://censtats.census.gov/sitc/sitc.shtml> (September 11, 2008); and U.S. Department of the Treasury and Federal Reserve Board, "Major Foreign Holders of Treasury Securities," August 15, 2008, at <http://www.ustreas.gov/tic/mfh.txt> (September 11, 2008).
2. Cindy Perman, "Dow Gains 200 Points on GDP, Oil," *CNBC*, August 28, 2008, at <http://www.cnbc.com/id/26440792> (October 8, 2008).
3. Press Release, "U.S. Fact Sheet: Fourth Cabinet-Level Meeting of the U.S.–China Strategic Economic Dialogue," U.S. Treasury Department Office of Public Affairs, June 18, 2008, at <http://www.ustreas.gov/press/releases/reports/sedusfactsheet.pdf> (October 8, 2008).
4. Maya Jackson, "Paulson: China Moving in Right Direction on Currency," *Market Watch*, August 19, 2008, at <http://www.marketwatch.com/news/story/paulson-china-moving-right-direction/story.aspx?guid=%7BE205257A-13E1-4641-BDFF-95DB09F9B06E%7D> (October 14, 2008).



interest stems from an apparent decision by President Hu Jintao and Premier Wen Jiabao to halt market-oriented reform. As for the substance of the negotiations, energy, environment, and bilateral investment are fine topics, but the agenda should be restructured to emphasize a series of meaningful market reforms.

In 1998, then-President Jiang Zemin and then-Premier Zhu Rongji ordered that investment by state entities be pushed much higher. This was in response to a genuine slump induced by the 1997 Asian financial crisis and emerged while China was offering important market reforms during World Trade Organization (WTO) talks. There has been no equivalent slump since, yet the Hu–Wen administration has relentlessly advanced the public role in the economy. With WTO concessions largely implemented by 2005, the state’s advance has been forcing the market’s retreat.

Though he is a devout optimist, Secretary Paulson acknowledges that “China’s leaders today are committed to reform, at least so long as it improves the country’s political and economic stability.”<sup>5</sup> In fact, even this is not true, unless a very dubious definition of “reform” is accepted (discussed below).

Arguing that reform is frozen or worse may be controversial among those who assume that China has been moving forward all the while, but overwhelming evidence that reform has stopped is being ignored. There have been setbacks in price liberalization, the core of market reform. Privatization was first stalled, and then explicitly rolled back. Corporate competition is also being rolled back. Even the relatively open external sector is not immune to an increasing state role. Ignoring these developments will leave any U.S. dialogue with China an exercise in futility.

## Status of Prices After Liberalization

### Significant Liberalization

- Wages
- Retail goods
- Property
- Food

### Minor Liberalization

- Interest rates
- Exchange rates
- Services
- Energy

Table I • B 2200  heritage.org

## State Price-Setting

There was outstanding progress in liberalizing prices during the first two decades of reform, perhaps its crucial feature. This has been halted and, recently, reversed by the central government. The price of labor—wages—is largely free from government interference. But that is manifestly not true of the price of capital—the interest rate.<sup>6</sup> All interest rates are confined within ranges set by the People’s Bank. Prices for basic assets, such as land, are constantly distorted by government intervention.<sup>7</sup> The price of foreign currency—the exchange rate—has been loosened in the past three years, but the daily setting of parity by the People’s Bank still dictates its direction. There are stark limits on the extent of movement. Daily movement of the yuan against the dollar, for example, can be no more than 0.5 percent.<sup>8</sup>

There is also bad news elsewhere. Prices for all key services are managed by the State Council. This includes not only utility bills and the cost of health care, but also education and transportation fees.<sup>9</sup>

Finally, it is commonly understood that sales prices of ordinary goods are set by the market. This has never been entirely true, and the tendency over the past few years has been to extend, not retract,

5. Henry M. Paulson, Jr., “A Strategic Economic Engagement: Strengthening U.S.–Chinese Ties,” *Foreign Affairs*, Vol. 87, No. 5 (September/October 2008), p. 1, at <http://www.foreignaffairs.org/20080901faessay87504/henry-m-paulson-jr/a-strategic-economic-engagement.html> (October 9, 2008).

6. “China Raises Interest Rate, Slashes Interest Income Tax,” *Guangdong News*, July 23, 2007, at [http://www.newsgd.com/business/prospective/content/2007-07/23/content\\_4212368.htm](http://www.newsgd.com/business/prospective/content/2007-07/23/content_4212368.htm) (October 9, 2008).

7. For example, “China Tightens Credit Control on Property Rights,” *China View*, August 28, 2008, at [http://news.Xinhuanet.com/english/2008-08/28/content\\_9728847.htm](http://news.Xinhuanet.com/english/2008-08/28/content_9728847.htm) (October 9, 2008).

8. “Exchange Rate Could Float in a Wider Band,” *China Daily*, May 26, 2007, at <http://us2.mofcom.gov.cn/aarticle/chinanews/200705/20070504725854.html> (October 9, 2008).

the reach of price controls for goods. Complete state control of grain distribution has always distorted wholesale grain prices; the recent bout of inflation has prompted retail food price restrictions as well.<sup>10</sup> Energy has also always been tightly held. New price levels mandated this year are merely business as usual in coal and oil products, such as gasoline.<sup>11</sup>

### Privatization Is Dead

There certainly has been privatization of Chinese state assets during the reform era. But it has never been extensive and, in the third decade of reform, it has faded. The number of individuals who own businesses fell 15 percent to 26 million from the end of 2005 to the end of 2006, a pittance in such a large population.<sup>12</sup> Official data show that truly private companies contributed less than 10 percent of tax revenue in the first nine months of 2007 and that the private sector's proportional contribution is actually beginning to drop.<sup>13</sup>

The “truly private” aspect is important because privatization has become confused with the spread of a shareholding structure and sales of minority

stakes. In such cases, 100 percent state ownership is diluted by dividing ownership into shares and making some available to non-state actors such as foreign companies or retail stock investors. Nearly two-thirds of state-owned enterprises and subsidiaries have undertaken such changes.<sup>14</sup> Some foreign observers reclassify these firms as “non-state” or even “private.” This reclassification is incorrect, conceptually and practically.

Conceptually, the sale of stock does nothing by itself to alter state control: For instance, dozens of centrally directed enterprises are no less state-owned simply by being listed on foreign stock exchanges (e.g., Guodian Power, an electric company which has a Hong Kong-listed subsidiary). As a practical matter, three-quarters of roughly 1,500 companies listed as domestic stocks are still state-owned. It is also true that state enterprises and the government share the same pool of officials. It is routine for Chinese officials to repeatedly bounce back and forth from corporate to government posts, each time at the behest of the Party.<sup>15</sup>

9. “China Orders Utility Price Freeze,” *BBC News*, May 10, 2004, at <http://news.bbc.co.uk/1/hi/business/3699477.stm> (October 9, 2008); Qingyue Meng, Gang Cheng, Lynn Silver, Xiaojie Sun, Clas Rehnberg, and Göran Tomson, “The Impact of China’s Retail Drug Price Control Policy on Hospital Expenditures: A Case Study in Two Shandong Hospitals,” *Health Policy and Planning*, Vol. 20, No. 3 (2005), pp. 185–196, at <http://heapol.oxfordjournals.org/cgi/content/abstract/20/3/185?etoc> (October 9, 2008); “Urban Compulsory Education Fees to Be Exempted,” *China Daily*, November 10, 2007, at [http://www.chinadaily.com.cn/china/2007-11/10/content\\_6245300.htm](http://www.chinadaily.com.cn/china/2007-11/10/content_6245300.htm) (October 9, 2008); Xinhua, “Railway Ticket Prices to be Increased During Spring Festival,” *China Daily*, January 10, 2006, at [http://www.chinadaily.com.cn/english/doc/2006-01/10/content\\_511054.htm](http://www.chinadaily.com.cn/english/doc/2006-01/10/content_511054.htm) (October 9, 2008); and “China Hikes Oil and Gas Prices by 18 Per Cent,” Associated Press, June 20, 2008, at [http://www.ctv.ca/servlet/ArticleNews/story/CTVNews/20080620/china\\_fuel\\_080620/20080620?hub=World](http://www.ctv.ca/servlet/ArticleNews/story/CTVNews/20080620/china_fuel_080620/20080620?hub=World) (October 9, 2008).
10. Shu-Ching Jean Chen, “Price Controls Again in Vogue Among China’s Planners,” *Forbes*, January 17, 2008, at [http://www.forbes.com/2008/01/17/china-price-update-markets-econ-cx\\_jc\\_0117markets08.html](http://www.forbes.com/2008/01/17/china-price-update-markets-econ-cx_jc_0117markets08.html) (October 9, 2008).
11. Rujun Shen and Jim Bai, “Update 2—China Tightens Coal Price Controls, Shortages Stay,” Reuters, July 24, 2008, at <http://www.Reuters.com/article/governmentFilingsNews/idUSPEK1598020080724> (October 9, 2008), and Dominic Meagher, “Understanding China’s Oil Prices,” *East Asia Forum*, at <http://eastasiaforum.org/2008/06/25/understanding-chinas-oil-prices/> (October 9, 2008).
12. Bi Mingxin, “China to Scrap Administrative Fees for Individual-Owned Businesses,” Xinhua news agency, August 23, 2008, at [http://english.gov.cn/2008-08/23/content\\_1077936.htm](http://english.gov.cn/2008-08/23/content_1077936.htm) (October 9, 2008).
13. “Over 5.5 Mln Private Enterprises Now Operating in China,” *People’s Daily Online*, November 19, 2007, at <http://english.people.com.cn/90001/90776/6304800.html> (October 9, 2008), and “Heavy Taxes, Hamper Chinese Private Business,” *China Daily*, December 18, 2007, at [http://chinadaily.com.cn/china/2007-12/18/content\\_6330249.htm](http://chinadaily.com.cn/china/2007-12/18/content_6330249.htm) (October 9, 2008).
14. “Two-Thirds of SOE Giants Become Shareholding Companies,” *China Daily*, August 26, 2008, at [http://www.chinadaily.com.cn/bizchina/2008-08/26/content\\_6972475.htm](http://www.chinadaily.com.cn/bizchina/2008-08/26/content_6972475.htm) (October 9, 2008).
15. Jonathan R. Woetzel, “Reassessing China’s State-Owned Enterprises,” *The McKinsey Quarterly*, July 2008, at <http://www.mckinsey.it/storage/first/uploadfile/attach/140418/file/reth08.pdf> (October 9, 2008).

No matter their shareholding structure, all large corporations in sectors that make up the core of the economy are required to be state-owned. The list of sectors that must by law be state-controlled is impressive:

[T]he State should solely own, or have a majority share in, enterprises engaged in power generation and distribution, oil, petrochemicals and natural gas, telecommunications and armaments. The State must also have a controlling stake in the coal, aviation and shipping industries.... Central SOEs [State-Owned Enterprises] should also become heavyweights in sectors including machinery, automobiles, IT, construction, iron and steel, and non-ferrous metals.<sup>16</sup>

Remarkably, that is not exhaustive. Rail, grain distribution, and insurance are dominated by the state, for example, even if no edict was issued to that effect.

Moreover, the state exercises control over most of the rest of the economy through the financial system, especially its banks. The outstanding stock of loans was more than \$4 trillion and annual growth more than 14 percent in the first half of 2008, making lending perhaps the principal economic force. All large financial institutions are state-owned, the People's Bank assigns them loan quotas every year, and, within these quotas, lending is directed according to the state's priorities.<sup>17</sup>

The central bank's loan quotas frustrate non-state borrowers. They might try to raise funds through bond or stock sales, but these are also dominated by the state. The volume of government bond issuance

is more than a dozen times that of corporate bonds and is growing relentlessly, crowding out private firms. In stocks, a purported solution to the huge quantity of non-traded state shares launched domestic stocks on a wild bull run in 2006 and 2007.<sup>18</sup> That solution relied on keeping non-traded state shares locked up for three years. With the lock-ups starting to expire, state shares again loom large over the market and share prices have come crashing back to earth.<sup>19</sup>

### What Belongs to the State

- Autos, aviation, rail, and shipping
- Banking, insurance, and securities
- Construction and machinery
- Coal, gas, oil, and petrochemicals
- Information technology
- Power
- Steel and other metals

Table 2 • B 2200  heritage.org

### Competition Is Wounded

One reason the dearth of reform has been overlooked is that China is engaged in a process of "restructuring." Unfortunately, "restructuring" has none of the characteristics of market reform. It is aimed at shrinking the number of participants in many industries, expanding the size of the remainder, and thus reducing competition on both counts.<sup>20</sup>

Japan and Korea have previously developed a model of national champions—large corporate groups consciously created with the idea that size is neces-

16. Zhao Huanxin, "China Names Key Industries for Absolute State Control," *China Daily*, December 19, 2006, at [http://www.chinadaily.com.cn/china/2006-12/19/content\\_762056.htm](http://www.chinadaily.com.cn/china/2006-12/19/content_762056.htm) (October 9, 2008).

17. "CBRC: Total Banking Assets Reached RMB 57.5 Trillion," China Banking Regulatory Commission (CBRC), at <http://www.cbrc.gov.cn/english/home/jsp/docView.jsp?docID=20080801DD09D887C99F6380FFE9ED3D9A37EF00> (October 9, 2008); Simon Rabinovitch, "Update 1—China Fixes 2008 New Loan Quotas for Big Banks—Source," Reuters, December 26, 2007, at <http://www.Reuters.com/article/rbssFinancialServicesAndRealEstateNews/idUSPEK20725020071226> (October 9, 2008); and Jane Cai, "Banks Urged to Meet Loan Quotas for Small Firms," *South China Morning Post*, August 29, 2008.

18. For example, Lan Xinzheng, "How Healthy is China's Stock Market?" *Beijing Review*, No. 5, February 1, 2007, at [http://www.bjreview.com.cn/quotes/txt/2007-01/30/content\\_53892.htm](http://www.bjreview.com.cn/quotes/txt/2007-01/30/content_53892.htm) (October 9, 2008).

19. Zhao Yidi, "China May Turn to Bonds to Lift Stocks, Official Says (Update 3)," August 26, 2008, Bloomberg News, at <http://www.bloomberg.com/apps/news?pid=20601087&sid=aOID212mAHdM&refer=home> (October 9, 2008).

20. Jamil Anderlini, "China to Speed State Groups' Shakeup," *The Financial Times*, August 20, 2008.

sary to compete globally. An unspoken corollary is often that neither domestic nor foreign competition with these champions can be tolerated. China has been enamored of the champions concept for at least a decade, but the restructuring process was accelerated in 2002 with the ascent of Hu and Wen.<sup>21</sup>

Results are striking. A plan for central state enterprises to pay dividends to the Ministry of Finance has been tentatively adopted. The dividend requirement was imposed on the oil and petrochemicals, gas, coal, power, telecom, and tobacco industries. There were only 18 firms involved in the six sectors in the beginning.<sup>22</sup> Now there are 17, as the number of national telecom entities was shrunk from four to three, reversing the break-up of China Telecom under the previous administration.

It is hardly just the telecom industry that is affected. First Aviation Industry and Second Aviation Industry are merging—apparently two firms are too many.<sup>23</sup> Managed consolidation is occurring from cement to retail.<sup>24</sup>

Where market concentration is already very high, the National Development and Reform Commission (NDRC) seeks to guard against any relapse. Rather than permitting competition to drive down

windfall crude profits and drive out inefficient oil product suppliers, the NDRC hiked taxes for crude on the three state oil giants—which constitute the entire crude industry—and subsidized the three companies in oil refining, where they face small competitors.<sup>25</sup> This had the extra benefit of ensuring that state involvement is central to all oil-related activity, so that the suppression of competition fits perfectly with suppression of privatization.

## Trade and Investment

More trade and inward investment would be a step toward domestic economic freedom, but foreign investment has faced mounting barriers since economic nationalism began to intensify in late 2005.<sup>26</sup> This seems to fly in the face of strong inward direct investment this year but the gains are a mirage. In the first five months of 2008, while official foreign direct investment (FDI) leaped 55 percent, investment in fixed assets, where the spending is tangible, declined by 4 percent. The Chinese press is well aware that increasing FDI is largely for purposes of financial speculation rather than developing new technology or creating high-quality jobs.<sup>27</sup>

True multinational corporations interested in investing in the PRC have seen WTO-inspired

21. Margaret M. Pearson, "Governing the Chinese Economy: Regulatory Reform in the Service of the State," *Public Administration Review*, Vol. 67, No. 4 (2007), pp. 718–730, at <http://dx.doi.org/10.1111/j.1540-6210.2007.00755.x> (October 10, 2008).
22. "Government to Get 10% of SOE Profits, December 18, 2007," *Shanghai Daily*, at [http://www.china.org.cn/business/news/2007-12/18/content\\_1236074.htm](http://www.china.org.cn/business/news/2007-12/18/content_1236074.htm) (October 10, 2008).
23. "AVIC I, II Integration to Reinforce China's Lumbo Aircraft Program," May 29, 2008, *Avbuyer*, at <http://www.avbuyer.com.cn/e/2008/24697.html> (October 10, 2008).
24. "Gov't to Consolidate Cement Industry," China Business Council for Sustainable Development, at <http://english.cbcsd.org.cn/activities/develop/4914.shtml> (October 10, 2008), and "Chinese Retailers Merge in Consolidation Drive," March 19, 2007, Reuters, at <http://www.flex-news-food.com/pages/7812/China/Retail/chinese-retailers-merge-consolidation-drive.html> (October 10, 2008).
25. "China Slaps Windfall Tax on Oil, Gives No Size," Reuters, March 27, 2006 at <http://asia.news.yahoo.com/060327/3/2i1df.html> (October 10, 2008), and Zhu Qiwen, "Time to Take a Fresh Look at Oil Subsidies," *China Daily*, March 21, 2008, at [http://www.chinadaily.com.cn/opinion/2008-03/21/content\\_6554797.htm](http://www.chinadaily.com.cn/opinion/2008-03/21/content_6554797.htm) (October 10, 2008).
26. Zia K. Cromer, "China's WAPI Policy: Security Measure or Trade Protectionism?" *Duke Law & Technology Review*, No. 18 (2005), at <http://www.law.duke.edu/journals/dltr/articles/2005dltr0018.html> (October 10, 2008).
27. "China Focus: Unprecedented Capital Inflows Test Chinese Regulators," *People's Daily Online*, July 1, 2008, at <http://english.people.com.cn/90001/90776/6440136.html> (October 10, 2008). Also, more FDI is coming from off-shore tax havens such as Samoa. In the first half of 2008, Hong Kong accounted for most spending growth and 45 percent of total FDI in China. The British Virgin Islands accounted for another 18 percent. Japan, Korea, and the U.S. combined constituted less than 11 percent. See National Bureau of Statistics, *China Monthly Statistics*, Beijing, Vol. 7, 2008. Explosive growth in outward investment by Chinese firms has led to the establishment of more overseas subsidiaries, beginning in Hong Kong. Money returned to the mainland from subsidiaries is counted toward FDI, though it has few of the qualities that make FDI desirable.



hopes dashed. The greater market access required by a proposed U.S.–China bilateral investment treaty is undercut by the regression in market access over the past three years. The curtailing of access dates back to the Carlyle Group’s original attempt to acquire Xugong Construction Machinery.<sup>28</sup> Barriers against foreign investment in real estate followed shortly thereafter.<sup>29</sup> In 2007, Beijing announced national security restrictions on FDI, including restrictions on acquiring any “famous” domestic brand, whereby the Chinese government decides what is famous.<sup>30</sup> When stocks were soaring, foreign bids were said by regulators to undervalue domestic companies.<sup>31</sup> Now that share prices have collapsed, deals are blocked nonetheless.<sup>32</sup>

Two new significant laws enacted in 2008, touted as “reforms,” appear principally to be weapons against foreign companies. Implementation of

one, the Labor Law, is in the hands of a xenophobic Party organ, the All-China Federation of Trade Unions (ACFTU).<sup>33</sup>

Despite its name, the other, the Anti-Monopoly Law will not promote competition. It is designed to protect “public interest and...the healthy development of the socialist market economy.” It forbids dominant firms from buying or selling at “unreasonable” prices, yet offers no method to identify what is unreasonable. It fails to define a market.<sup>34</sup>

Most telling, the Anti-Monopoly Law contains an exception for all industries controlled by the state, as well as any industries deemed important to national security. It also provides for a national security review of foreign acquisitions in addition to the antitrust probe.<sup>35</sup> The notion of screening proposed acquisitions on national security grounds is not unusual—many countries do so—but the Commu-

28. “Carlyle Abandons Xugong Dream,” *China Daily*, July 24, 2008, at [http://news.Xinhuanet.com/english/2008-07/24/content\\_8760203.htm](http://news.Xinhuanet.com/english/2008-07/24/content_8760203.htm) (October 10, 2008).

29. “China: Foreign Investment Restrictions in Real Estate Market,” Deacons, January 7, 2007, at [http://www.hg.org/articles/article\\_1696.html](http://www.hg.org/articles/article_1696.html) (October 10, 2008).

30. Tom Holland, “Coke-Huiyuan Deal Poses a Thorny Problem for Beijing Friday,” *South China Morning Post*, September 5, 2008.

31. Zhang Hong, “Goldman Gored by Chinese bull,” *China Business International*, February 3, 2008, at [http://www.cibmagazine.com.cn/Features/Obizuary.asp?id=313&goldman\\_gored\\_by\\_chinese\\_bull.html](http://www.cibmagazine.com.cn/Features/Obizuary.asp?id=313&goldman_gored_by_chinese_bull.html) (October 10, 2008).

32. “Arcelor Mittal Bid to Buy Laiwu Nixed,” *China Daily*, March, 13, 2007, at <http://www.investchina.org.cn/english/BAT/202685.htm> (October 10, 2008).

33. The most feared provision of the Labor Law requires that a permanent contract be offered after two fixed-term contracts. The terms under which employees with permanent contracts can be fired make doing so prohibitively costly. Another provision requires management to consult with the ACFTU before adjusting hours or wages. “Labour Law of the People’s Republic of China,” Standing Committee of the Eighth National People’s Congress, July 5, 1994, at <http://www.usmra.com/china/Labour%20Law.htm> (October 10, 2008). The ACFTU has uniformly ignored abusive behavior by state firms while periodically assailing foreign firms on comparatively minor grounds. “ACFTU: GE Seriously Violated China’s Labor Law,” *China CSR*, April 18, 2008, at <http://www.chinacsr.com/en/2008/04/18/2269-acftu-ge-seriously-violated-chinas-labor-law/> (October 10, 2008). For example, an unauthorized labor action against China Eastern Airlines revealed contract restrictions, ignored by the ACFTU, far harsher than practices attacked by the ACFTU at McDonald’s. Edmund Klamann, “China Eastern Grounds Pilots After Strike Action,” *Reuters*, April 7, 2008, at <http://www.Reuters.com/article/rbssIndustryMaterialsUtilitiesNews/idUSSHA12724720080407> (October 10, 2008), and “ACFTU: Fast Food Restaurants Must Pay Workers in Line with Law,” *China CSR*, April 5, 2007, at <http://www.chinacsr.com/en/2007/04/05/1202-acftu-fast-food-restaurants-must-pay-workers-in-line-with-law> (October 10, 2008). Unsurprisingly, the first clash over the Labor Law involved a multinational corporation. Kraft was accused of inadequate consultation before moving its headquarters. There is no standard for adequate consultation and the case was brought against Kraft even though it involved job relocation, not job loss. “Kraft China Accused of Violating Labor Law for Headquarters Moving Plan,” March 12, 2008, *China Daily*, at [http://www.chinadaily.com.cn/bizchina/2008-03/12/content\\_6529988.htm](http://www.chinadaily.com.cn/bizchina/2008-03/12/content_6529988.htm) (October 10, 2008).

34. “Anti-Monopoly Law of the People’s Republic of China,” Standing Committee of the 10th National People’s Congress of the People’s Republic of China, August 30, 2007, at <http://english.peopledaily.com.cn/90001/90776/90785/6466798.html> (October 10, 2008).

35. For example, Robert Doyle, “China’s Anti-Monopoly Law,” July 31, 2008, at [http://www.antitrustlawyerblog.com/2008/07/chinas\\_antimonopoly\\_law.html](http://www.antitrustlawyerblog.com/2008/07/chinas_antimonopoly_law.html) (October 10, 2008).

nist Party's definition of "security" is exceptionally broad. In light of the long list of industries that must be controlled by the state, these provisions can include essentially everything. State monopolies will remain untouched.

Multinational corporations face multiple threats. The first monopoly claim with the Ministry of Commerce was filed against Microsoft.<sup>36</sup> Perhaps most distressing, intellectual property rights (IPR) can be terminated if they are deemed abused in connection with a monopoly. China has long considered many patents unfair and now has legal means to act. The law could be wielded to retaliate against IPR enforcement attempts such as the case brought by the U.S. to the WTO against China. It could be used as a new way of undermining IPR if the WTO rules against China.

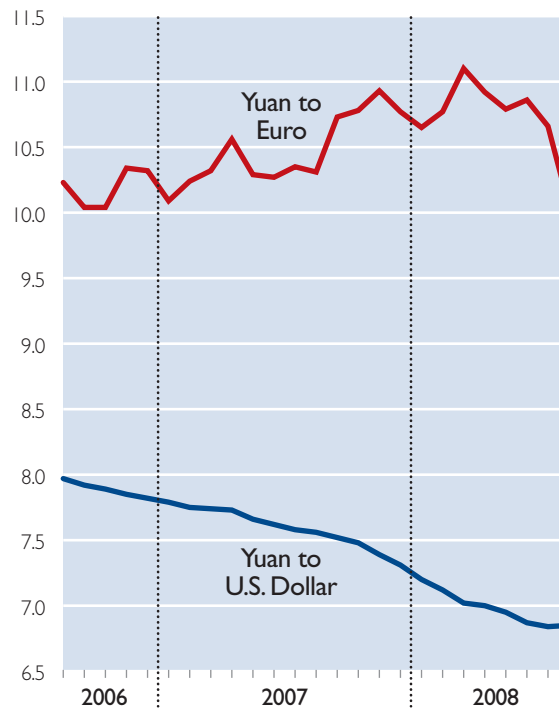
Trade is largely open and competitive on the export side. Imports still face some non-tariff barriers for the sake of protecting state prerogatives. As usual, vital industries such as energy and agriculture are sheltered.<sup>37</sup>

The main point of contention, of course, has been the exchange rate. As mentioned, the exchange rate is controlled as part of all financial prices set by the State Council. A push for exchange-rate liberalization, however, will present America's new President with a clear trade-off: Curbing Chinese state control may not favor the U.S.

After the inauguration of more rapid exchange-rate movement with the 2.1 percent revaluation in July 2005, the yuan climbed an additional 16 percent against the dollar by the end of August 2008. Over the same period, the yuan fell 2 percent against the euro. While it is probably still overvalued against the dollar, the yuan is far more overvalued against other currencies. A wider daily band in which the value for the yuan can move in an authentic, trade-weighted basket of currencies

### The Yuan's Trade-off

Value of the Euro and the U.S. Dollar to the Chinese Yuan, Aug. 2006–Aug. 2008



Source: "FXHistory: Historical Currency Exchange Rates," Oanda.com, at <http://www.oanda.com/convert/fxhistory> (September 11, 2008).

Chart 1 • B 2200 heritage.org

could very well lead to short-term depreciation against the dollar. In the long term, a freer exchange rate is in American interests, but the next Administration should be careful what it wishes for.

There is another avenue to pursue on the trade side, though. During WTO accession, it was believed that the difficult process of liberalizing the capital account—letting money move freely in and

36. Jeff Pao, Ng Tze-wei, and Bien Perez, "Support Builds for Probe into Microsoft," *South China Morning Post*, August 26, 2008.

37. "The Quantity, the Application Conditions and the Principle of the Distribution of the Import Tariff Quotas of Grain and Cotton of 2005," National Development and Reform Commission of the People's Republic of China, No. 58, September 30, 2004, at [http://www.fdi.gov.cn/pub/FDI\\_EN/Laws/ImportExport/ImportAdministration/P020060620382395006823.pdf](http://www.fdi.gov.cn/pub/FDI_EN/Laws/ImportExport/ImportAdministration/P020060620382395006823.pdf) (October 10, 2008), and David Winning, "China Non-State Cos 2009 Oil Product Import Quota 11.25 Million Tons," Dow Jones Newswires, August 26, 2008, at [http://resources.alibaba.com/topic/342626/China\\_Non\\_State\\_Cos\\_2009\\_Oil\\_Product\\_Import\\_Quota\\_11\\_25\\_Million\\_Tons.htm](http://resources.alibaba.com/topic/342626/China_Non_State_Cos_2009_Oil_Product_Import_Quota_11_25_Million_Tons.htm) (October 14, 2008).

out of the country—would move in tandem with implementation of WTO concessions. An open capital account was to be ratified not later than the 2007 Communist Party Congress. Instead, under the Hu–Wen regime, there has been little progress, and perhaps regression.<sup>38</sup> Part of this is understandable: The State Administration of Foreign Exchange has been plagued the past three years by funds pouring into the country. Even before that, however, Beijing showed little interest in allowing multinationals, and certainly not its own citizens, to send earnings or savings freely out of the country.

The obvious benefit of capital-account liberalization is unfettered repatriation of profits by foreign investors. As such, the U.S. business community has long been an advocate. There is also a more subtle, more important gain for the offering. The state intervention in the economy documented above would be considerably reduced if financial policy had to account for a market reaction. An open capital account would permit capital to exit, constraining bank behavior. This would, in turn, inhibit the state-directed lending that has effectively blocked privatization and subverted competition. An open capital account is still far in the future, unfortunately, but it is a prize worth pursuing.

### The Growth Obsession

Contributing directly to the death of reform is the pursuit of GDP growth at the expense of all else. In recent years, the Communist Party has used rhetoric suggesting growth was no longer the primary objective.<sup>39</sup> The words were followed by yet faster growth. As the economy returns to its previous speed, growth has once again been formally elevated above all other objectives.<sup>40</sup> The apparent

mandate that the economy expand by at least 10 percent annually sharply limits, among other things, the potential for bilateral cooperation in ecology and energy.

There would be little discussion of commercial negotiations with China were it not for its brilliant economic performance over the past three decades. The last six years, in particular, have brought gravity-defying growth and the emergence of China as a truly global economic actor.

These six years coincide with the arrival of the Hu–Wen administration. It is routine for a new Chinese regime to buy the affections of provincial leaders by initially boosting growth. Hu and Wen, however, have extended the standard of one to two years to an extreme six.

China's GDP has more than tripled in dollar terms over the past six years and nearly tripled in yuan terms. The 10.4 percent gain in the first half of 2008 is considered slow. More telling, the purpose of rapid GDP growth has been to create jobs and it has been successful. The registered urban unemployment rate was stable at 4 percent by the end of June, excelling an already ambitious target of 4.5 percent. (That figure greatly understates true joblessness, but may be accurate with respect to trend.)<sup>41</sup> This has allowed millions of migrating rural workers to be absorbed into the urban labor force.

At the same time, urban wages have managed to climb significantly. On official data, urban salaries were said to increase by 18 percent from the first half of 2007 to the first half of 2008, considerable even after inflation.<sup>42</sup> The payoff is demonstrated in retail sales growth of 21 percent (again unadjusted for inflation).<sup>43</sup> Exports have been the subject of

38. For example, Tom Miller, "Regulators Tighten Curbs to Block Hot Money," *South China Morning Post*, September 5, 2008.

39. "CPC Central Committee Concludes Plenum, Elevating Social Harmony," *Guangdong News*, October 12, 2006, at <http://www.newsgd.com/news/chinakeyword/6thsessionof16thcpc/200610130018.htm> (October 10, 2008).

40. "China Shifting Focus from Inflation to Growth: Analysts," *Sino Daily*, July 28, 2008, at [http://www.sinodaily.com/reports/China\\_shifting\\_focus\\_from\\_inflation\\_to\\_growth\\_analysts\\_999.html](http://www.sinodaily.com/reports/China_shifting_focus_from_inflation_to_growth_analysts_999.html) (October 10, 2008).

41. Zachary Wei, "China End-June Urban Registered Unemployment 4.0 Pct," *FXStreet.com*, July 31, 2008, at <http://www.fxstreet.com/news/forex-news/article.aspx?StoryId=edf14189-03d1-4352-b3e6-a0e36fa48204> (September 11, 2008).

42. "Chinese Urban Workers' Per Capita Salary Up 18 Percent in H1," *Xinhua*, July 28, 2008, at [http://news.Xinhuanet.com/english/2008-07/28/content\\_8786414.htm](http://news.Xinhuanet.com/english/2008-07/28/content_8786414.htm) (October 10, 2008).

43. "China's Retail Sales Up 23% in June, a 10-Year High," *Xinhua*, July 30, 2008, at [http://news.Xinhuanet.com/english/2008-07/30/content\\_8850867.htm](http://news.Xinhuanet.com/english/2008-07/30/content_8850867.htm) (October 10, 2008).

much gnashing of teeth, but expanded by more than 20 percent in dollar terms in the first half. The trade surplus declined, but this is due to global oil prices. The non-oil trade surplus rose.

There are drawbacks to six years of furious expansion, of course. The most pointed one at present is that soaring food prices for consumers have been replaced by soaring energy prices for producers.<sup>44</sup> And official results understate inflationary pressure because energy price controls have always been in place and were recently extended to food. Producer price inflation will be felt by consumers over at least the next year, though this may not be evident in a poorly constructed consumer price index.

GDP growth has exceeded double digits, job creation has surpassed its target, and inflation has spiked. All the while, fiscal and monetary policies have remained intensely expansionist, despite loud pronouncements to the contrary. At the growth peak in 2007, monetary policy actually became increasingly loose. When the pace of GDP moderated in 2008, there was a rush to fiscal stimulus.

In 2007, inflation-adjusted “real” interest rates began to turn negative, the ultimate sign of perverse monetary policy. Interest rates turned more starkly negative in the first quarter of this year. The benchmark one-year interest rates set by the People’s Bank for borrowing and saving remained fixed despite considerable inflation. At the end of June 2008, official consumer and producer price inflation were

### The Recent Economic Expansion

*The economy has shown remarkable growth since 2002, featuring a tripling of GDP. The pace was still blistering through mid-2008.*

Economic Indicator	June 2002	June 2008	2008 to 2002 Ratio	Percent Change, 2007–2008
GDP (in billions)	\$550	\$1,901	3.46	+33
Fixed investment, (in billions)	\$174	\$995	5.72	+40
Retail sales (in billions)	\$235	\$743	3.16	+38
Exports (in billions)	\$142	\$666	4.69	+22
Foreign reserves (in billions)	\$243	\$1,809	7.44	+36
Urban disposable income	\$476	\$1,174	2.47	+27
Rural cash income	\$136	\$368	2.71	+33
Exchange rate per \$1 US	8.287	6.872	1.21	+9.9

Source: National Bureau of Statistics, China Monthly Statistics, Beijing: Vol. 6, 2002 and Vol. 7, 2008.

Table 3 • B 2200  heritage.org

both close to 8 percent while the return on a one-year deposit was barely 4 percent. The inter-bank market hosts the lion’s share of financial transactions, though it is overrun by government bonds with fixed prices. The January 2008 inter-bank bond yield was 2.81 percent. After six months of purported monetary contraction, the July inter-bank bond yield was 2.76 percent.<sup>45</sup>

With consumer inflation beginning to ebb, real interest rates will become less distorted than before. But this coincides with additional loosening of the fiscal taps. China’s urban fixed investment jumped nearly 27 percent in the first half of this year and accelerated further in July.<sup>46</sup> “We need to actively boost domestic demand, to maintain steady economic growth,” said [the Chinese Academy of Social Sciences’] Wang Tongshan. “Investment is an indispensable part of boosting domestic demand.”<sup>47</sup>

44. “China Reports 6.3% Rise in CPI in July,” *China Daily*, August 12, 2008, at [http://www.chinadaily.com.cn/china/2008-08/12/content\\_6928254.htm](http://www.chinadaily.com.cn/china/2008-08/12/content_6928254.htm) (October 10, 2008).

45. “Financial Performance Remained Stable in July,” The People’s Bank of China, August 13, 2008, at <http://www.pbc.gov.cn/english/detail.asp?col=6400&ID=1131> (October 10, 2008), and “Financial Market Performance in January 2008,” The People’s Bank of China, February 26, 2008, at <http://www.pbc.gov.cn/english/detail.asp?col=6400&ID=1029> (October 10, 2008).

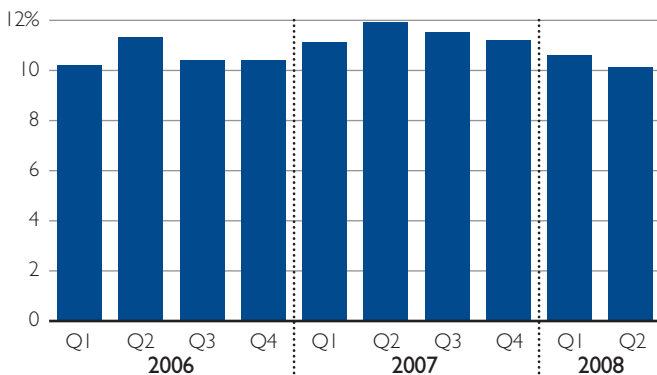
46. Urban investment is dominated by locally-controlled state entities and is three times larger than central budgetary expenditure. “China’s Fiscal Surplus Hit 1.19 Trillion First Half of 2008,” *CriEnglish.com*, August 8, 2008, at <http://english.cri.cn/4026/2008/08/08/1241s391218.htm> (October 10, 2008).



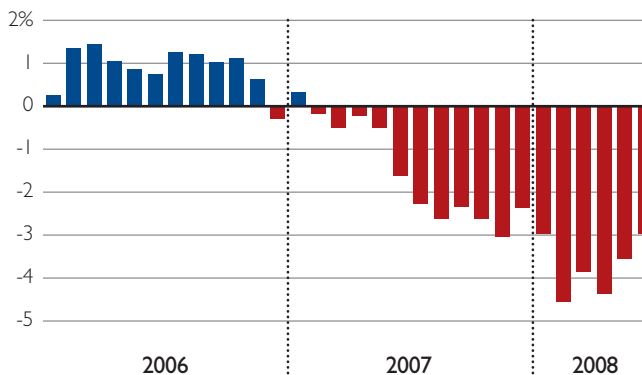
## Monetary Policy

The economy has enjoyed double-digit growth since 2006, yet already low real interest rates have been slashed.

Gross Domestic Product (Percent Change)



One-Year Savings Deposits, Real Return (Percent Change)



**Note:** Unrevised GDP growth is used because the State Statistical Bureau has been incomplete, inconsistent, and seemingly biased in its revisions.

**Sources:** National Bureau of Statistics, China Monthly Statistics, Beijing, Vol. 1, 2006 to Vol. 7, 2008; State Statistical Bureau Quarterly Communiqué, for example, Li Xiaochao, "National Economy: Steady Performance in the First Half of 2008," National Bureau of Statistics of China, July 17, 2008, at [http://www.stats.gov.cn/english/newsandcommingevents/t20080717\\_402492920.htm](http://www.stats.gov.cn/english/newsandcommingevents/t20080717_402492920.htm) (September 11, 2008); People's Bank of China monthly report, for example, "Financial Performance Remained Stable in July," People's Bank of China, August 13, 2008, at <http://www.pbc.gov.cn/english/detail.asp?col=6400&id=1131> (September 11, 2008).

Chart 2 • B 2200 heritage.org

This sounds reasonable, except that the baseline from which "domestic demand" must be boosted features 10 percent GDP growth and the means of doing the boosting is urban investment growth which already exceeds 25 percent.

This is the correct light in which to view cooperation with Beijing on energy and ecological concerns. China certainly needs to protect its environment and thus wants to diversify its energy sources. Neither of these bars the terrible distortion of the financial system and 27 percent investment gains—which finance the very production that drains energy and other resources and depletes the environment, but are deemed necessary because GDP growth is "only" 10.4 percent.

The minor increases in energy efficiency and slower rates of environmental degradation over the last few years will, therefore, continue to be over-

come by economic growth. This is evident most clearly in coal use. Beijing has spent lavishly on nuclear, gas, and wind power in an attempt to diversify energy sources. The government has tried to close small coal mines for environmental and safety reasons. Yet coal production went from 525 million tons in the first half of 2002 to a staggering 1.26 billion tons in the first half of 2008.<sup>48</sup> Now, the State Council has switched back to emphasizing greater coal output.<sup>49</sup>

### The Best Institutions

Chinese economic performance is largely beyond the control of the next U.S. President. What he and his senior staff can control is how to engage the Chinese government. The existing institutional frame is the SED, created by order of President Bush and President Hu in September 2006. The SED houses an increasingly ungainly series of

47. "Fast China Investment Suggests Firm Domestic Demand," *Business Spectator*, August 15, 2008, at <http://www.businessspectator.com.au/bs.nsf/Article/UPDATE-1-Fast-China-investment-suggests-firm-domes-HJ6SP?OpenDocument&src=is> (October 10, 2008).

48. National Bureau of Statistics, China Monthly Statistics, Beijing, Vol. 6, 2002 to Vol. 7, 2008.

49. "China to Reward Coal Companies that Increase Output," *Dow Jones News*, August 29, 2008.

high-level interactions between U.S. and Chinese institutions.<sup>50</sup>

- The Joint Commission on Commerce and Trade (JCCT) between the U.S. Department of Commerce, the U.S. Trade Representative, and China's Vice Premier responsible for trade;
- The Joint Economic Committee between the U.S. Department of the Treasury and the Chinese Ministry of Finance;
- The Joint Commission on Science and Technology between the U.S. Director of the Office of Science and Technology Policy and the Chinese Ministry of Science and Technology;
- The Economic Development and Reform Dialogue between the U.S. Department of State and China's National Development and Reform Commission;
- The Energy Policy Dialogue between the U.S. Department of Energy and China's National Development and Reform Commission;
- The Global Issues Forum led by the U.S. Department of State and China's Ministry of Foreign Affairs; and
- The Healthcare Forum between the U.S. Department of Health and Human Services and the Chinese Ministry of Health.

This clutter is a natural by-product of the world's two largest economies coming to grips with each other. There are so many issues and sectors to be covered, the clutter alone suggests the need for an overarching mechanism like the SED. There is also the more concrete problem of harmonizing objectives among Cabinet departments. China and the U.S. have both common and clashing interests in trade, investment, energy, ecology, health, and scientific research, suggesting exchanges between such disparate agencies as America's Health and Human Services and China's new Ministry of Environmental Protection.

Even limiting the discussion to traditional economics still entails the JCCT, the Joint Economic Committee, and the Economic Development and

Reform Dialogue, involving the U.S. Departments of Commerce, State, and Treasury and the USTR on one side, and a Chinese delegation headed by a vice premier and including the Ministries of Commerce and Finance and NDRC on the other. Single issues also run across department lines. American desires for Chinese capital-account liberalization, for example, would see Commerce, Treasury, and USTR in talks with the Ministry of Commerce, People's Bank, and NDRC.

Economic dialogue with China will continue to be difficult. Opportunities might be missed if there is no framework in which to coordinate the objectives of different departments and no higher authority to offer trades across issues that, when taken individually, appear to be intractable. Even if the new President decides on a more direct, aggressive approach, it would be an advantage to be able to raise the stakes from the energy policy dialogue, for example, to the SED or something similar.

The SED or an equivalent should, and probably will, survive the transition to a new Administration. Treasury's leading role may not survive, though, as this can undercut the principal benefits of the SED.

First, a higher vantage point than that of a Cabinet secretary is needed to discern where progress can be made.

Second, a Cabinet secretary's obvious counterpart is a Chinese Cabinet minister, relatively low in the Communist Party hierarchy. U.S. efforts have led to the routine inclusion of a vice premier on the Chinese side, but it would be ideal if the premier, as head of the State Council and thus of all bureaucracies involved, would take the lead. The American side would then need to be represented by the Vice President, but only if he or she has real authority to negotiate. Otherwise, an especially powerful and trusted Cabinet secretary—from the Treasury, Commerce, or State Departments—should be given an additional title pertaining to economic policy or China in order to encourage the permanent assignment of a vice premier with sufficient authority to make difficult concessions.

50. Fact Sheet, "Creation of the U.S.–China Strategic Economic Dialogue," U.S. Department of the Treasury, September 20, 2006, <http://www.treasury.gov/press/releases/hp107.htm> (October 10, 2008).

## What the U.S. Should Do

- The lead American negotiator should ask his counterpart for a long-term, explicit, commitment to broad price liberalization, including interest and exchange rates. This will be valuable when a future slump leaves Beijing more willing to listen.
- The next U.S. Administration should press for partial energy price liberalization in China when the latter's energy inflation calms. There is a domestic constituency favoring price liberalization, and it would serve to check energy consumption and preserve the environment.
- Rather than waste calls for privatization on this particular unwilling audience, the Administration should emphasize the possibility of WTO complaints over state involvement unless the central government's support for state-controlled "shareholding" firms is made transparent.
- The Administration should seek a formal, long-term commitment that each consolidated, state-dominated sector be opened to foreign participants, even if the Chinese side insists on some limits to the latter.
- The Administration should emphasize that discriminatory application of the Labor Law is not acceptable. It also should demand modification of the Anti-Monopoly Law to eliminate the threat to intellectual property. A WTO complaint on the extent of state exclusions from the Anti-Monopoly Law can serve as leverage. A comprehensive bilateral investment accord should be placed on hold as unfeasible.
- The Administration should switch emphasis from exchange-rate to capital-account liberalization, asking for a long-term schedule of steps the Chinese government will commit to in opening the capital account.
- The Administration should downgrade priority of environmental agreements that threaten China's economic growth. From the U.S. side, such agreements are considered clear mutual interests. From the Chinese point of view, they are non-starters.
- The SED or an equivalent should be adopted by the new President—to be led by the Vice President, not the Secretary of the Treasury.

## Conclusion

Economic dialogue with China may be even more complicated than the next President anticipates. The importance and multifaceted nature of the relationship call for an overarching institutional mechanism like the SED. But some present American objectives fly in the face of a state-dominated development model that has yielded rapid growth and is thus deemed very successful by the Chinese government. The recommendations made in this paper take into account Chinese reaction and are WTO-compliant. The lead negotiating authority in the SED can thus be assertive in terms of legal or other actions in pursuing these outcomes.

Though only modest progress can reasonably be expected until the flaws of China's model become more apparent, true market-oriented reform must remain the ultimate goal. The next American Administration should, therefore, continue to state the case for deeper liberalization of China's economy. This will emphasize that long-term U.S. objectives have not changed and prepare the ground for the time when China is again open to market-oriented reform.

Elements of the new Administration will surely offer alternate views to the one argued here. An obvious alternative is to pursue much more fundamental change on the Chinese side. With Hu and Wen committed to a path that has brought at least 10 percent annual GDP growth since they assumed power, some will maintain that sharp protectionist threats are required to move them toward fundamental change. The problem with such protectionist threats is not that they are not credible, but that they are not effective, and in fact, counterproductive.

Protectionism will harm the U.S.—even if it harms China more. It should not be credible to threaten to cut off one U.S. finger while cutting off two of China's fingers. American leadership is demonstrated by the confidence and ability to thrive in competitive environments, at home, in global markets, and in the People's Republic of China itself. Protectionism is a retreat from that leadership.

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