

# Background

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## 10 China Myths for the New Decade

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**Abstract:** *China's economic growth has been accompanied by growing misinformation about its economy. Contrary to conventional wisdom, China is not leading the world out of a recession, is no longer moving toward a market economy, is not America's banker, and may never surpass the U.S. Heritage Foundation Asia expert Derek Scissors debunks 10 leading myths about the Chinese economy and replaces them with the accurate picture necessary to guide American policy.*

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The Chinese economy may still be growing rapidly despite the financial crisis. One thing that has been growing even faster is misinformation about the Chinese economy.

This is partly a function of unreliable economic numbers put out by China's government, but it is also partly a function of mistaken American and other perceptions. Hidden within the sweeping pronouncements of "China's decade" and "China's century" are important, specific points—some of which turn out to be demonstrably wrong.

The foundation of good policy is good information. If the U.S. is to respond wisely to the rise of the People's Republic of China (PRC), the actual speed and nature of that rise must be correctly understood. Exaggerating Chinese prowess and emphasizing the wrong issues leads to general mistakes in U.S. economic and foreign policy, and to an incoherent China strategy.

### Talking Points

- The U.S. continues to be the engine for global growth. China does not generally contribute to GDP growth in the rest of the world as a whole because it exports far more than it imports.
- The U.S. has important fundamental advantages over China and may remain the world's largest economy indefinitely.
- China is not "America's Banker." Rising levels of U.S. government debt are a critical problem, but Chinese purchases of American debt are much less important than commonly perceived and should not be a factor in foreign policy.
- The American economy depends far less on China than the Chinese economy depends on the U.S. To work well, China's investment-driven economy relies on the open global system created by the U.S.
- China has turned away from the market and toward the state. As a result, the controlled Chinese exchange rate is less important than other interventions into the market.
- American's greenhouse emissions are now considerably smaller than China's. China's emissions target is almost meaningless.

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It turns out that China is not leading the world out of recession, is not nipping at America's economic heels, is not America's banker, is not becoming more consumption-driven, and is not controlling its carbon emissions. Instead, Chinese growth for the moment comes at the expense of global growth, the U.S. has stronger long-term economic fundamentals than China, Chinese bond purchases appear unimportant, China is more investment-dependent than ever, and is by far the world's largest greenhouse emitter.

The American position is thus considerably stronger relative to China than commonly believed. However, it is also the case that the policy challenges, such as inducing genuine economic reform in the PRC, are more daunting. It will be more difficult for the U.S. to avoid the pitfalls of superficial changes, such as in exchange rates and carbon intensities, to make progress toward a Chinese economy that genuinely does boost world growth.

### Myth or Truth?

**Myth #1: China is now the leading engine for global growth.**

**Truth: China detracts from the rest of the world's growth in gross domestic product (GDP).**

The standard procedure employed by those convinced of Chinese economic leadership is to take every country's GDP growth, add it all up, and check which economy contributed most to the global pile.<sup>1</sup> But that is not the way GDP works.

If a country successfully dictates trade terms and extracts a great deal of wealth from its partners, its GDP would grow very quickly while that of its partners would shrink or grow much more slowly. It would then seem this country is leading global growth higher while it is actually enriching itself at the rest of the world's expense.

Behind this confusion is that GDP includes trade. A trade surplus adds to GDP and a trade deficit takes away from it. China runs the largest trade surplus in the world, which means the rest of the world runs a large trade deficit with the PRC.

From this perspective, China is not adding anything to global GDP growth. Using trade, China adds the most to its own GDP and takes away the most from the rest of the globe's.

The distinction is between performance and welfare. China is outperforming the world but it is not contributing to global GDP. Just the opposite: Some of its gains are mirrored in offsetting GDP losses in the rest of the world.

China *has* contributed a great deal to the world economy. Competition is the life-blood of long-term growth, and competition from Chinese goods has arguably been the largest contributor to competition in the global economy over the past decade. In terms of policy, Chinese production kept consumer prices down worldwide, helping to keep inflation low despite high levels of government stimulus around the world.

The financial crisis has changed this. Previously, Chinese supply was helping to meet strong global demand. Now, Chinese supply is threatening to overwhelm weak global demand. Rather than leading, China is using the world to boost itself higher.

It need not be so. The PRC could encourage the development of its domestic economy for the sake of its own people. This would increase demand for goods produced in the rest of the world. Then, and only then, China might be an engine for the global economy.

**Myth #2: China could surpass the U.S. as the largest economy in 10 years.**

**Truth: There is a reasonable chance that China will never surpass the U.S.**

One element in this forecast is the last 30 years of reported Chinese growth, the second is the last three years of American growth. The second element is far more important: If American growth remains at the 2007–2009 level, GDP rankings will hardly matter. The U.S. must focus first, second, and third on fixing its own policies—deeply cutting the budget deficit, steadying interest rates, expanding trade, and reducing government regulation, especially taxes.

1. Keith Bradsher, "Recession Elsewhere, but It's Booming in China," *The New York Times*, December 9, 2009, at <http://www.nytimes.com/2009/12/10/business/economy/10consume.html> (January 21, 2010).

If the U.S. takes these actions, China may not pass the U.S. at all, much less in the next 10 or 15 years. It is a fundamental mistake to graft the previous 30-year trend onto the next 30. The China of 1949 to 1978 looked nothing like the China of 1979 to 2009, and there are powerful reasons to believe that 2010 to 2040 will be very different again.

The most important and most certain aspect is an aging Chinese population. The last 30 years were characterized by demographic expansion very favorable to growth in the PRC. The next 30 will be generally characterized by demographics unfavorable to growth. The transition from growth-conducive to growth-hostile demographics will begin about the middle of this decade and continue indefinitely.

In 1985, 15-year-olds to 29-year-olds made up 47 percent of the working-age population in China. In 2030, they will make up only 26 percent. By 2035, a daunting 280 million people are projected to be 65 or older.<sup>2</sup> Far fewer people will be working to support far more retirees.

The previous economic challenger to the U.S., Japan, has faced the same problem. Over the past 15 years, the Japanese economy has not grown at all. Over the next 15 years and beyond, China's population structure will become more and more similar to Japan's today.

Before Japan's economic ascent, the Soviet Union was thought to challenge American economic supremacy. An unsustainable emphasis on heavy industry contributed greatly to the Soviet collapse. Among other things, it led to horrific pollution and a decline in life expectancy, where life expectancy is strongly correlated with wealth.<sup>3</sup>

China has the same emphasis on heavy industry and grave pollution problems. The PRC suppresses research into the effect of pollution on life expectancy, but reported birth defects have been rising for at least the past 10 years, including in wealthy provinces.<sup>4</sup>

**Myth #3: China will surpass Japan as the world's second-largest economy in 2010.**

**Truth: China probably surpassed Japan several years ago.**

As soon as February, the media could report that China has finally surpassed Japan. If not in February, then certainly over the course of 2010.

Every discussion of the Chinese economy, including this one, should be taken with a truck's worth of salt. The officially stated unemployment rate is acknowledged to have little to do with true unemployment, announced sales volumes include millions of items never sold, and much announced foreign direct investment (FDI) is not foreign. The central government does not agree with the provinces and the provinces do not agree with their counties concerning GDP, FDI, and many other indicators.<sup>5</sup>

Evidence for many economic statements is weak; but what there is suggests the PRC surpassed Japan several years ago.

In 2004, China conducted a nationwide census and discovered its economy was almost 17 percent larger than previously stated. The service sector was found to be larger than previously thought, as was also the case in the 1993 census. In fact, the 2004 census discovered an even larger gap than found in 1993. At the end of 2009, China revised its 2008 GDP upward by 4.5 percent, again citing a larger

2. Nicholas Eberstadt, "China's Family Planning Goes Awry," *Far Eastern Economic Review* (December 2009), at <http://www.feer.com/essays/2009/december51/chinas-family-planning-goes-awry> (January 21, 2010).
3. Matteo Cervellati and Uwe Sunde, "Life Expectancy and Economic Growth: The Role of the Demographic Transition," Social Science Research Network, May 19, 2009, at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1405928##](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1405928##) (January 21, 2010).
4. "Birth Defects on the Rise in China," CNN, September 15, 2009, at <http://www.cnn.com/2009/HEALTH/09/15/china.birth.defects/index.html> (January 21, 2010), and "China Birth Defects Soar Due to Pollution: Report," Reuters, October 29, 2007, at <http://www.reuters.com/article/idUSPEK15525020071029> (January 22, 2010).
5. Derek Scissors, "The Truth About China's Growth," Heritage Foundation *WebMemo* No. 2238, January 22, 2009, at <http://www.heritage.org/Research/AsiaandthePacific/wm2238.cfm>.

service sector, and indicated GDP growth from earlier in 2009 would also be revised upward.<sup>6</sup>

There is little reason to believe the PRC has its numbers right now. More likely, it is still undercounting—services are especially hard to measure due to pervasive state activity that elevates some economic exchange and drives some into the shadows. A proper census would show that China's economy has been larger than announced at the time for every single year in the reform period. That suggests the PRC passed Japan no later than 2007.

Finally, using a concept known as purchasing power parity, which tries to even out price differences in different economies, China passed Japan in the 1990s. As media headlines reflect, China has been number two for a while.

**Myth #4: China is America's banker.**

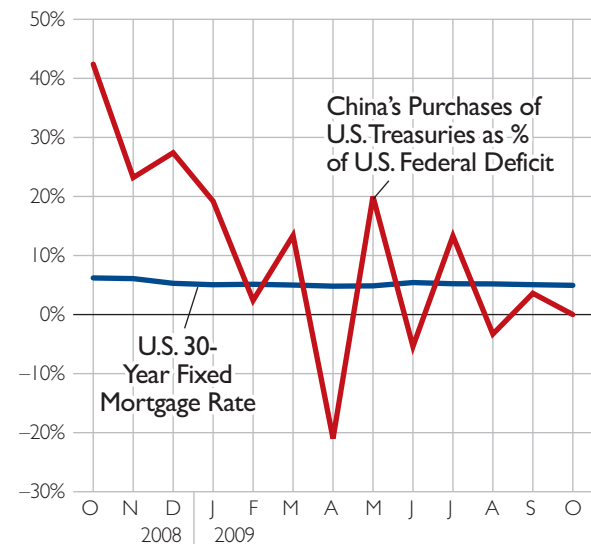
**Truth: If there was ever any Chinese financial influence, it is not there now.**

The U.S. federal government is running, and is expected to continue running, a gigantic budget deficit, which will hurt the economy for the next decade. China buys some of the bonds to finance that deficit and has about \$800 billion in official holdings of U.S. treasuries, plus perhaps that much in other types of holdings.

Even so, the conventional wisdom—that America needs Chinese financing to continue its wild spending—turns out to be wrong. Partly because of the damaging jump in the size of the deficit, Chinese bond purchases have become irrelevant.

Official Chinese purchases of U.S. Treasury bonds are on pace to fall well below \$100 billion for 2009 (the full-year total is published in Febru-

### U.S. Interest Rates and Chinese Purchases of Treasury Bonds



Sources: FreddieMac, 30-Year Fixed-Rate Mortgages Since 1971, 1971–2005, at <http://www.freddiemac.com/pmms/pmms30.htm> (January 11, 2010); U.S. Department of the Treasury, Financial Management Service, Monthly Treasury Statement, Monthly Receipts, Outlays, and Deficit or Surplus, Fiscal Years 1981–2009, at <http://www.fms.treas.gov/mts/MTS.xls> (January 11, 2010); U.S. Department of the Treasury, Treasury International Capital System, Major Foreign Holders of Treasury Securities, at <http://www.treas.gov/tic/mfh.txt> (January 11, 2010).

Chart 1 • B 2366  [heritage.org](http://heritage.org)

ary), while the federal government deficit soared to \$1.4 trillion. Yet U.S. commercial interest rates are lower than at the end of 2008, when official Chinese purchases were equivalent in size to nearly half the federal deficit.<sup>7</sup> Official Chinese holdings of treasuries equal less than 7 percent of U.S. gov-

- Carsten A. Holz, "China's 2004 Economic Census and 2006 Benchmark Revision of GDP Statistics: More Questions than Answers?" *The China Quarterly*, No. 193 (March 2008), pp. 150–163, at <http://ihome.ust.hk/~socholz/CQ-Holz-EconomicCensus04-13July07.pdf> (January 22, 2010), and National Bureau of Statistics of China, "Announcement of the National Bureau of Statistics of China on Revision of the 2008 GDP Data," December 25, 2009, at [http://www.stats.gov.cn/english/newsandcomingevents/t20091225\\_402610196.htm](http://www.stats.gov.cn/english/newsandcomingevents/t20091225_402610196.htm) (January 22, 2010).
- U.S. Department of Treasury, Treasury International Capital System, "Major Foreign Holders of Treasury Securities," 2009, at <http://www.treas.gov/tic/mfh.txt> (January 22, 2010); U.S. Department of Treasury, Financial Management Service, "Monthly Treasury Statement, Monthly Receipts, Outlays, and Deficit or Surplus, Fiscal Years 1981–2009," at <http://www.fms.treas.gov/mts/mts.pdf> (January 26, 2010); and FreddieMac, "30-Year Fixed-Rate Mortgages Since 1971," 2005, at <http://www.freddiemac.com/pmms/pmms30.htm> (January 22, 2010).



ernment debt.<sup>8</sup> Chinese bond purchases no longer seem to matter, if they ever did.

In addition, when Chinese purchases were large, it was because Beijing had no choice but to buy American bonds. The PRC can take in a great deal of money from the world through its trade surplus and other activities. The same rules that keep the Chinese currency undervalued keep Beijing from spending the world's money at home. Most foreign money disbursed in China ends up right back with the central government, by law.<sup>9</sup>

That can leave the PRC sitting on a huge pile of dollars and the U.S. economy as the only place big and solid enough to absorb it back. China has not been lending; they have been investing the only way they can.

Finally, the bulk of China's pile of foreign money can be traced back to the Sino-American trade gap. On exactly the same lines, the PRC ties its currency to the dollar. Linking itself closely to the American economy that way is also the PRC's best choice. In contrast, any American financial dependence on China has almost vanished.

**Myth #5: The U.S. and China are intensely interdependent—"Chimerica" has emerged.**

**Truth: China depends far more heavily on the U.S. than the U.S. depends on China.**

China's reliance on the U.S. is real, but takes a somewhat different form than commonly believed. It is true that China exports a great deal to the U.S.

In 2008, American demand accounted for 7.4 percent of Chinese GDP.<sup>10</sup>

That number has been falling, however, and will fall again for 2009. In terms of GDP, the PRC has substituted domestic investment for exports since 1998 and more substantially since global demand peaked in 2006.

The fundamental Chinese dependence is on the American-built and American-led international economic system. Because it invests so much, China produces far more than it consumes across a wide range of sectors. It has done so since the Asian financial crisis of 1997.<sup>11</sup>

Without an export outlet, constant oversupply would generate crushing deflation and cripple genuine Chinese growth. Open global trade fomented by the U.S. enables China's investment-led model to work, while serious American protectionism would ultimately make that model unviable.

The same is true in finance. Without the U.S. dollar as the world's reserve currency and the American bond market as safe haven, China's exchange rate and balance of payments regime could not function. The PRC gains considerably from the American consumer, but relies utterly on the American-led system.

On the American side, China is the cheapest supplier of many consumer goods, but other low-cost suppliers—such as Vietnam—could emerge to replace it and would be happy to do so. Without

8. "Major Foreign Holders of Treasury Securities," 2009, and "The Debt to the Penny and Who Holds It," Treasury Direct, January 22, 2010, at <http://www.treasurydirect.gov/NP/BPDLogin?application=np> (January 26, 2010). This understates PRC debt holdings, probably by about half, making it closer to 13 percent of the total. This is due to the large amount of debt purchased outside official Chinese purchases of treasuries. A variety of figures can be given based on unofficial Chinese holdings and different measurements of American debt. However, all measures of the proportion of American debt held by China show a decline.
9. Derek Scissors, "China is a Banker Over a Barrel," Heritage Foundation *Commentary*, March 16, 2009, at <http://www.heritage.org/Press/Commentary/ed031609b.cfm>.
10. National Bureau of Statistics of China, "Announcement of the National Bureau of Statistics of China on Revision of the 2008 GDP Data," and U.S. Census Bureau, "Foreign Trade Statistics: Trade in Goods (Imports, Exports and Trade Balance) with China," at <http://www.census.gov/foreign-trade/balance/c5700.html#2009> (January 22, 2010).
11. Li & Fung Research Centre, "A Review on [sic] China's Consumer Prices from Late 2001 to Early 2003," *China Update*, April 1, 2003, at [http://www.idsgroup.com/profile/pdf/china\\_update/030401\\_consumer\\_price.pdf](http://www.idsgroup.com/profile/pdf/china_update/030401_consumer_price.pdf) (January 22, 2010), and Zhang Xiangdong, Liu Weixun, and Wan Xiaoxiao, "China Moves to Rein in Overcapacity," *Economic Observer*, September 10, 2009, at <http://www.eeo.com.cn/ens/Industry/2009/09/10/150693.shtml> (January 22, 2010).

China, consumer prices in the U.S. would be higher, but not much.

The notion that the U.S. needs China to finance its budget deficit is flawed in a number of ways. One is logical: The deficit is much too large, so Chinese financing merely makes it easier for the U.S. to perpetuate bad policy. The other is factual: Chinese bond purchases do not seem to be affecting American interest rates.

This leaves China effectively relying on the U.S. to keep its very development model viable, and the U.S. collaborating with China as a matter of convenience.

**Myth #6: China's controlled exchange rate is a central factor in the global economy.**

**Truth: The controlled exchange rate is merely one symptom of a larger problem.**

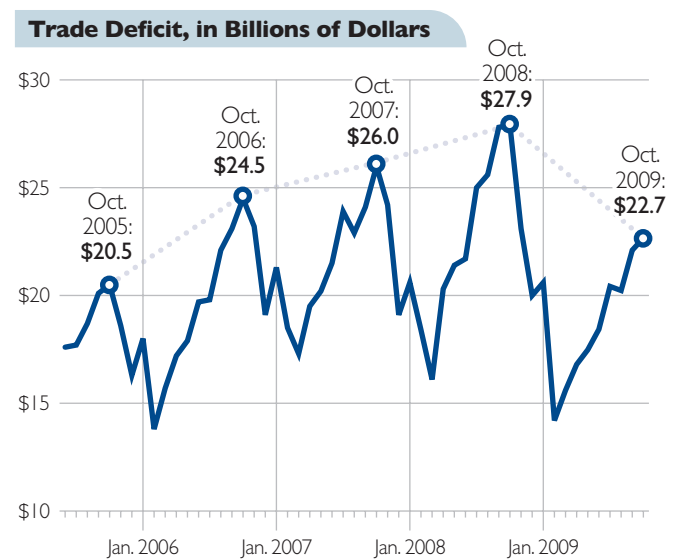
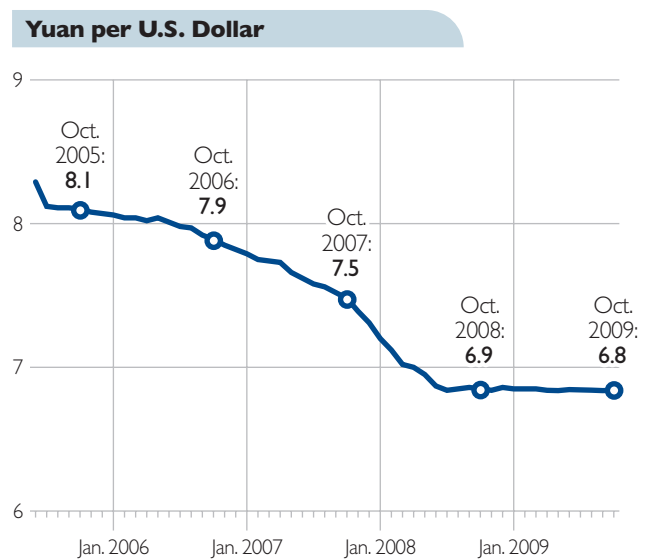
Exchange rates matter. They are the price of one currency in terms of another and, like the price of

anything, when exchange rates change, supply and demand changes. In this case, the supply and demand are exports and imports.

There are many times, however, when exchange rates do not matter that much. An example is the yuan and the dollar. From July 2005 to June 2008, the yuan rose 20 percent in value against the dollar. Yet China's annualized trade surplus with the U.S. still increased in size by nearly 50 percent.<sup>12</sup> This is because the effect of the exchange rate appreciation was overwhelmed by other factors on both the American and Chinese side.

On the American side, the federal government, including the Federal Reserve, effectively boosted U.S. demand for Chinese goods. The historically low interest rates and unjustifiable budget deficits involved were far more harmful to the American economy than the undervalued yuan.

## The Yuan and the U.S.–China Trade Deficit



Sources: OANDA, FXHistory: Historical Currency Exchange Rates, at <http://www.oanda.com/convert/fxhistory> (January 5, 2010), and U.S. Census Bureau, Foreign Trade Division, Data Dissemination Branch, "Trade with China: 1995," at <http://www.census.gov/foreign-trade/balance/c5700.html#1995> (January 10, 2010).

Chart 2 • B 2366 heritage.org

12. This occurred despite the effect of the financial crisis. Comparison is the 12-month rolling surplus from July 2004 to June 2005, before the appreciation began, to July 2008 through June 2009, after it was halted. U.S. Census Bureau, "Foreign Trade Statistics: Trade in Goods (Imports, Exports and Trade Balance) with China."

The forces at work on the Chinese side affect all their trade partners, not just the U.S. The impact of the artificially undervalued yuan is easily outweighed by other, pervasive state intervention in the economy. On behalf of state firms, China blocks competition through regulation, gives away land, offers effectively free capital in the form of bank loans, and subsidizes energy prices.<sup>13</sup> State firms lag in exports as compared to non-state firms but their exports might disappear entirely without government assistance.

More pointedly, state firms are made exceptionally competitive against foreign imports because so many of their costs are channeled away by central and local governments. This protection on behalf of state enterprises utterly dwarfs the recent unfortunate duties imposed by the U.S. on Chinese steel and other products.

In general, the transfer of resources to state firms via various subsidies suppresses Chinese consumption, in particular Chinese consumption of foreign goods. A more valuable yuan would be entirely out-matched by this phenomenon.

**Myth #7: China continues to reform its economy, with perhaps an understandable pause due to the financial crisis.**

**Truth: China's market reform slowed sharply in 2002 and effectively stopped in 2005.**

The 1980s saw path-breaking market reform in the PRC. The 1990s saw a mix of reform and, after the Asian financial crisis, greater state intervention. The 2000s saw early implementation of World Trade Organization concessions pushed aside by a dominant state. In prices, privatization, and even foreign investment, China was heading

away from the market long before Lehman Brothers collapsed.<sup>14</sup>

Privatization of the corporate sector was first stalled, and then explicitly reversed by the Chinese government. All national corporations in sectors that make up the core of the economy are required by law to be state-controlled.<sup>15</sup> Their executives are routinely shuttled back and forth by the Communist Party to government positions.

The state exercises control over most of the rest of the economy through the financial system. It owns all large financial institutions, which lend according to state priorities, topped by favoritism for large state enterprises.

The People's Bank sets very narrow ranges for the price of both domestic money (the interest rate) and foreign money (the exchange rate). Liberalization of the price of goods has been stalled by constant state intervention in the areas of food, health care, and energy.

The end result is that competition has been warped into a largely political battle among sibling state firms. For oil and petrochemicals, gas, coal, power, telecom, and tobacco industries combined, there are a total of 17 firms operating nationally, all state-owned. Consolidation is being pushed by the state from aviation to retail, reducing competition and further concentrating assets in the hands of the state.<sup>16</sup>

Inward foreign investment has seen increasing restriction. For example, the anti-monopoly law explicitly excludes the state giants and appears to apply only to foreign companies, while being touted as "reform." Against that, domestic investment on non-market terms is pushed by the state ever higher.

13. Eswar S. Prasad, "Is the Chinese Growth Miracle Built to Last?" Institute for the Study of Labor, August 2007, at <ftp://repec.iza.org/RePEc/Discussionpaper/dp2995.pdf> (January 23, 2010).

14. Derek Scissors, "Deng Undone," *Foreign Affairs*, Vol. 88, No. 3 (May/June 2009).

15. 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) (January 22, 2010).

16. The auto industry is perhaps the best known example—"China: Government Continuing to Push Consolidation of Auto Industry," February 26, 2009, at <http://www.insideline.com/car-news/china-government-continuing-to-push-consolidation-of-auto-industry.html> (January 22, 2010)—but the reduction extends to coal, chemicals, and many other areas.

**Myth #8: China is rebalancing toward more domestic consumption.**

**Truth: The dominance of investment over consumption in driving China's economy is intensifying.**

The PRC's official trade surplus fell by \$100 billion in 2009. The U.S. reports the bilateral trade deficit will also decline for 2009, though by a smaller proportion.<sup>17</sup> This will be hailed, correctly, as a welcome event and, incorrectly, as a sign that the Chinese economy is changing.

The trade surplus shrank because Chinese exports fell faster than imports. In other words, Chinese demand for foreign goods weakened, but global demand for Chinese goods weakened more. The major change occurred outside the PRC, as global demand faltered. In fact, Chinese market share is rising and China has passed or will soon pass Germany as the world's top exporter.<sup>18</sup>

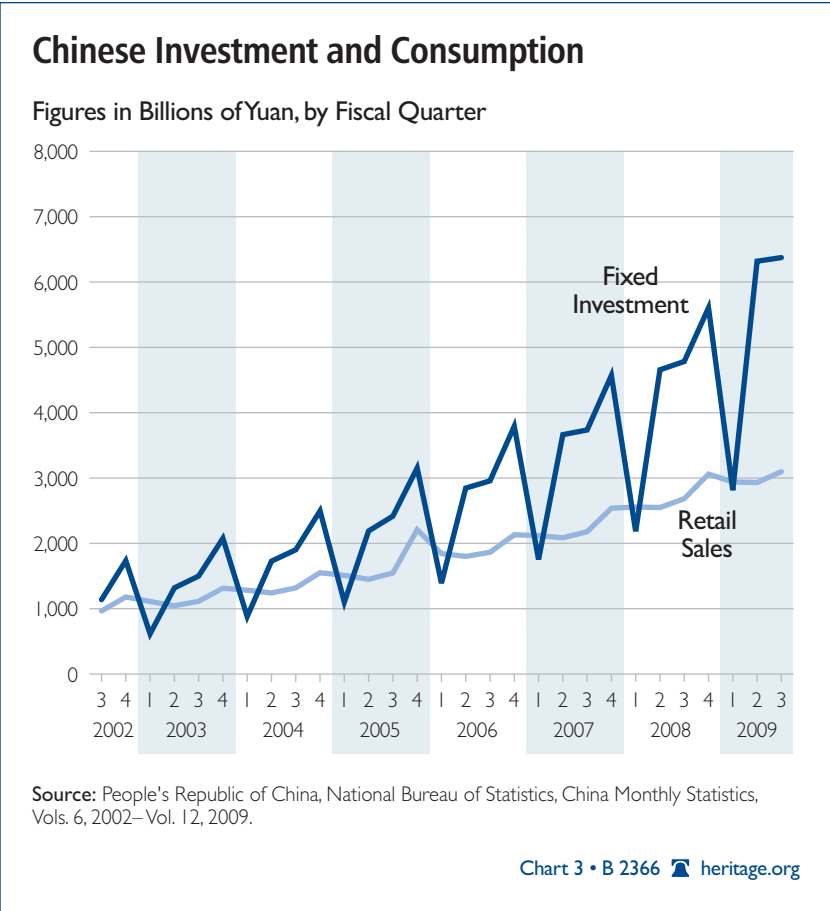
Inside the PRC, strong Chinese consumption has received much praise. Some is deserved: Chinese consumption has held up better than the rest of the world's. Still, there are multiple reasons to dismiss this as a meaningful change.

Chinese consumption before the global crisis also looked robust. But from 2003 to 2007—when the expansion induced under General Secretary Hu Jintao took place—consumption fell as a proportion of GDP every year. This is because investment was much larger and grew far faster in those easy times.

This is still the case in the tough times of 2008 and 2009: The role of consumption keeps diminishing

compared to investment. Over the course of the last decade, nominal fixed investment expanded by a factor of 12. By 2009, fixed investment was close to twice as large as retail sales by volume, and still growing almost twice as fast.<sup>19</sup> By itself, fixed investment stood at no less than 67 percent of GDP last year and is still rising.

The view ahead is no more encouraging. It is widely hoped that internal Chinese demand will eventually drive imports higher. But demand has been as strong as could be reasonably hoped for throughout the crisis, and imports have dropped noticeably. Imports are tied tightly to exports via the PRC's role as an assembly center in global manufacturing.



17. U.S. Census Bureau, "Foreign Trade Statistics: Trade in Goods (Imports, Exports and Trade Balance) with China."

18. Ministry of Commerce, The People's Republic of China, "Zhong Shan: Put Great Store by Sustainable Development of Foreign Trade," December 31, 2009, at <http://english1.mofcom.gov.cn/aarticle/speech/200912/20091206716321.html> (January 22, 2010).

19. National Bureau of Statistics, China Monthly Statistics, Beijing, Vol. 10, 1999 to Vol. 11, 2009.



Worse, the extreme growth of investment during the financial crisis has added to the problem of oversupply. As total global demand has weakened, Chinese production capacity, driven by investment, has (perversely) expanded. That excess capacity will create even greater pressure to export in 2010 and beyond.

**Myth #9: China's greenhouse gas emissions are about the same as America's.**

**Truth: China's emissions are as much as 25 percent larger, and the gap is widening every day.**

The effort to limit greenhouse-gas emissions is not usually thought of as a topic when discussing the Chinese economy, but it should be. By itself, the PRC is set to generate the majority of the world's carbon emissions over the next decade.<sup>20</sup> In contrast, China's population will fall below 20 percent of the world total. The emissions story is about China's development model, not size.

In 2006, most monitoring agencies put American and Chinese emissions at roughly equal levels. Three years, however, is a great deal in Chinese industry time. A very conservative estimate puts Chinese emissions growing by 10 percent more than America's in 2007 and the first half of 2008, before the financial shock hit.

In the nearly 18 months since, the PRC's extremely aggressive stimulus and orientation toward heavy industry almost surely mean its emissions growth has remained rapid. Coal production is still expanding between 12 percent and 13 percent annually. The industries most cited by the central government as overinvested and expanding too fast—steel, cement, and aluminum—are major greenhouse-gas emitters.<sup>21</sup> As a result, it is entirely possible that 2009 Chinese emissions were 25 percent larger than U.S. emissions.

All the unanswered questions about Chinese economic data apply to the environment as well.

Chinese GDP is likely underestimated; so is energy use and pollution. Government monitoring is skewed by limited funding and political motives. There have been repeated failures to keep unsafe coal mines and outdated steel plants closed, and their output is often ignored because they should have been shut down. The true quantity of Chinese greenhouse emissions is uncertain.

**Myth #10: China has an official program to substantially cut its carbon emissions.**

**Truth: The goal is to cut carbon emissions intensity. Actual emissions will soar in the next decade.**

China has not vowed to cut emissions but rather emissions intensity, in this case measured in emissions per unit of GDP. That is, the commitment is to reduce emissions only relative to the size of the economy; if China's economy continues to grow, so will total emissions. And GDP comes in multiple flavors, with different kinds of inflation adjustments plus adjustments for the currency being used. This leaves a great deal of room to maneuver.

China's 2005 carbon dioxide emissions, for instance, were approximately 5.43 billion tons, or approximately 2.95 tons of carbon dioxide for every 10,000 yuan of GDP.<sup>22</sup> The pledge is to cut carbon emissions intensity by 40 percent to 45 percent from the 2005 level, which would put emissions intensity near 1.75 tons carbon dioxide per 10,000 yuan of GDP.

From 2000 to 2009, simple GDP in yuan increased about 3.7 times. If that rate of nominal growth continues for the next decade, simple GDP will approach 135 trillion yuan in 2019. Using the target emissions intensity, carbon emissions in 2019 would more than quadruple over 2005, past 23 billion tons.

This is a numerical worst case and it is far more likely that China's pledge refers to some adjusted version, not simple GDP. But which adjustment?

20. Dinakar Sethuraman, "China Under More Pressure to Cut Emission Than India, CLSA Says," Bloomberg, September 2, 2009, at [http://www.bloomberg.com/apps/news?pid=conewsstory&tkr=601991%3ACH&sid=adXYWzP\\_UP8Q](http://www.bloomberg.com/apps/news?pid=conewsstory&tkr=601991%3ACH&sid=adXYWzP_UP8Q) (January 22, 2010).

21. "Excess Capacity, 'Spread' to New Industry," *China Financial Daily*, August 27, 2009, at <http://www.chinafinancialdaily.com/financial/news/2009/08/27/11167/excess-capacity-spread-to-new-industry.html> (January 22, 2010).

22. Energy Information Agency, *International Energy Annual 2006*, December 8, 2008, Table H1CO2, at <http://www.eia.doe.gov/pub/international/iealf/tableh1co2.xls> (January 22, 2010), and calculations using revised GDP.

The difference between the arithmetic change of GDP from year to year and real GDP growth is called the deflator. It is all but impossible to make sense of China's GDP deflator over time. With 10 years to play with, the Communist Party can announce whatever adjusted GDP it wants. Carbon dioxide emissions are unlikely to quadruple, but they very possibly will double, and Beijing will still be able to claim success in its intensity program.

Amid all the uncertainty, the best bet for the next decade is that the PRC rejects international estimates of its emissions the way it rejects international monitoring now. Beijing will substitute its own measurements, which will have some familiar magical properties.

### What the U.S. Should Do

- The foundation of the American economy is more conducive to sustained growth than is the foundation of the Chinese economy. To maintain U.S. international leadership, policy must focus on fundamental human, natural, and technological advantages, not supposed benefits of government intervention.<sup>23</sup>
- The Obama Administration has dramatically failed to adopt clear, comprehensive, and open bilateral and multilateral trade policies. These are the best way to help the U.S. economy and secure American influence, especially influence over China.

- Negotiations for market-oriented reform will be extremely difficult with present Chinese leadership. Such negotiations should not focus principally on the exchange rate, which is a secondary concern. The most pressing matter at the moment is cutting into growing Chinese overcapacity.
- Chinese bond purchases are forced by Beijing's own system and now almost irrelevant to U.S. interest rates. The level of bond purchases should not restrict American policy choices in the slightest.
- Without enforced limits on Chinese emissions, costly American action to limit greenhouse-gas emission will accomplish nothing. To the extent that a policy response to climate change is desirable, Chinese emissions are by a large margin the first priority.

### Conclusion

Myths concerning China encourage bad U.S. policy. Exaggerating Chinese prowess and focusing on secondary issues leads to mistakes in general American economic and foreign policy and an incoherent strategy with respect to the PRC. A better-informed view is only the first step in meeting the real challenges, but it is a necessary first step.

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23. Derek Scissors, "World GDP: A Story of American Leadership and Asian Partnerships," *The Foundry*, Heritage Foundation blog, November 25, 2009, at <http://blog.heritage.org/2009/11/25/world-gdp-a-story-of-american-leadership-and-asian-partnerships>.