

# WebMemo



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## U.S.–China Strategic and Economic Dialogue: America Must Lead by Example

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On May 24, the United States and People's Republic of China will start the annual Strategic and Economic Dialogue (S&ED) in Beijing. In the economic track, the U.S. Department of the Treasury indicates that the American side will focus primarily on three areas, probably in this order of priority:

1. President Obama's goal of doubling U.S. exports and the role of the RMB's value against the dollar;
2. Policies that harm foreign business in China, now described as "indigenous innovation"; and
3. Greater balance in the bilateral economic relationship and the global economy.

The S&ED will make little progress on these issues and less still to bring China into the international economic order. Instead, the U.S. is heading in China's policy direction.

**The S&ED's Limitations.** The S&ED serves as a useful way for America and China to exchange information, which helps avoid economic disputes before they materialize. But it has produced modest cooperation even where the two sides have shared interests, such as energy. It has not, and will not, address severe problems in the American, Chinese, or world economies.

At first glance, it appears an RMB appreciation against the dollar would support the President's goal of doubling exports. An appreciation, though, will have little effect. The connection between the RMB and the bilateral trade imbalance is uncertain at best, and the coming shift in Chinese currency policy will again be very tentative, not enough to affect much of anything.<sup>1</sup>

Worse, the drive to double exports clashes with what should be the American goal for the RMB. The Obama Administration seeks to promote exports largely through government support, while the U.S. should be pressing China for less government control of its exchange rate. This is only one example of America warping its own policy due in part to its relationship with the PRC.

There are also reasons to expect that nothing material will come from discussing "indigenous innovation." Putting aside the overly broad use of the term, indigenous innovation is part of a concerted effort by the central government to promote state enterprises. Recently discovered by the press, the effort is at least seven years old.<sup>2</sup> It is part of a much broader and well-established mercantilist Chinese approach to commerce. Modifications of a few recent regulations will do nothing to alter China's course.

The U.S. continues to shy from an even more important issue: global rebalancing. Washington is right to exhort Beijing to move toward an economy led by consumption, not investment. However, discussing the issue yet further will accomplish nothing new—the State Council itself endorsed rebalancing in 2004, but the gap between invest-

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ment and consumption then widened dramatically.<sup>3</sup> The change China must ultimately make will be painful, hardly one to be accomplished by another year of chatter.

Nonetheless, the U.S. can contribute to this change and help its own economy immensely at the same time by going forward instead of backward with American rebalancing. Rather than talking, the Obama Administration and the U.S. Congress can take the biggest single action to actually rebalance by quickly slashing the gigantic federal budget deficit.

**Who's Changing Whom?** Part of the original reason for the S&ED and other bilateral dialogues was to encourage Chinese economic and security policies to fit better with American ones. It appears, though, the U.S. is becoming more like the PRC instead of the reverse.

That the U.S. could help transform China gained credence during the first Clinton Administration. It was argued that there was political value in economic engagement: engagement and resultant prosperity would facilitate greater freedom in the PRC. The process, however, has yet to begin. Despite greater economic opportunities for most Chinese citizens, the grip of the Communist Party has not loosened. To be fair, realistic advocates of engagement acknowledged that the process would take time; 15 years may not be enough to alter the way 1.3 billion Chinese live.

Apparently, however, 15 years is enough to alter the way 300 million Americans live. The U.S.

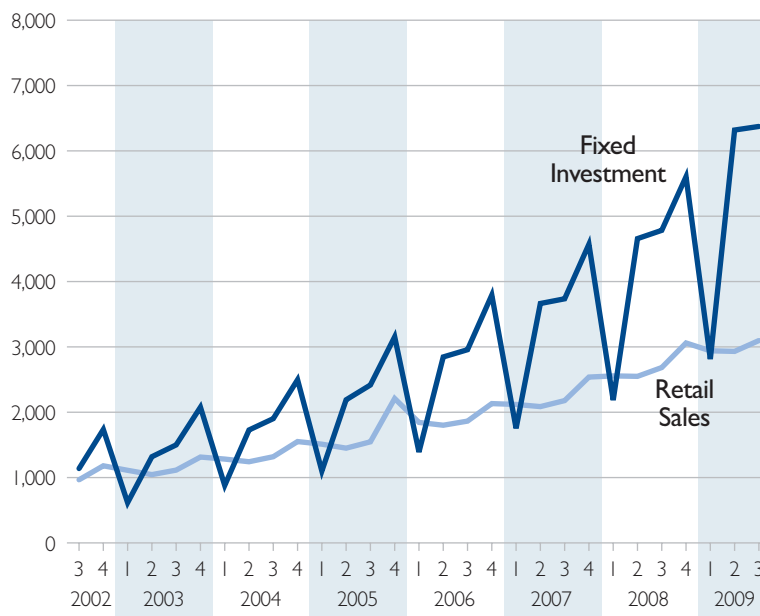
seems to be the country that is changing—following the Chinese example in extending the reach of government.

This transformation starts with ever-expanding federal spending assisted by Chinese financing. President Clinton's engagement policy was laid out in May 1994. That year the deficit was 2.9 percent of GDP and falling toward zero; this year it will be 10.6 percent of GDP. In the interim, Chinese holdings of American bonds soared from barely \$100 billion in March 2000 to more than \$1.5 trillion now.<sup>4</sup>

1. See Derek Scissors, "Deadlines and Delays: Chinese Revaluation Will Not Bring American Jobs," Heritage Foundation *WebMemo* No. 2855, April 6, 2010, at <http://www.heritage.org/Research/Reports/2010/04/Deadlines-and-Delays-Chinese-Revaluation-Will-Still-Not-Bring-American-Jobs>.
2. China Watch, "The Emergent Industrial Policy," Vol. 6, No. 9 (September 19, 2003).
3. Xinhua, "China Tackles Underlying Economic Problems," August 3, 2004, at [http://www.chinadaily.com.cn/english/doc/2004-08/03/content\\_357329.htm](http://www.chinadaily.com.cn/english/doc/2004-08/03/content_357329.htm) (May 21, 2010).
4. U.S. Department of Treasury, Treasury International Capital System, "Foreign Portfolio Holdings of U.S. Securities," at <http://www.ustreas.gov/tic/shlhistdat.html> (May 21, 2010).

## Chinese Investment and Consumption

Figures in Billions of Yuan, by Fiscal Quarter



Source: People's Republic of China, National Bureau of Statistics, China Monthly Statistics, Vols. 6, 2002–Vol. 12, 2009.

Chart 1 • WM 2912  heritage.org

More and more economic resources are controlled by Washington, with federal spending surpassing 25 percent of GDP, the highest since World War II. That level is projected to skyrocket due to the impending tsunami of entitlement spending.<sup>5</sup> Unsatisfied with a federal budget near its historical levels of 20 percent of GDP, the President and Congress continue to seek foreign money, especially from the PRC. Rather than encouraging Chinese society to change for the better, the economic interaction has given rein to the U.S. to change for the worse.

Part of the federal expansion is the demand that someone else's money must fund another new program. This old game has a new flavor: taxpayers should fork over more so America can keep pace with China. Billions should be spent on wind turbines that generate relatively little energy, because China is doing the same. Massive high speed rail lines that few will use must be built, because China is doing so.<sup>6</sup>

The PRC is not making these comparisons—they are made in the U.S. by those seeking a share of the flood of government spending. And they are almost always deeply flawed.

Thankfully, many secrets of China's success are not transportable, such as the ability to forcibly clear people from land desired by the state. There are largely unnoticed fault lines in the Chinese model, such as children of Party members making up 90 percent of the wealthiest Chinese, though Party membership is less than 5 percent of the population.<sup>7</sup> There is no dictatorial Party to enrich in the U.S., but the hungry acquisition of resources by

the federal government is a long step in the wrong direction.

**Recommendations: Start Here.** The PRC is not moving toward more political freedom. Instead, many American politicians have taken engagement with China as a prod to move this country toward less economic freedom. Prior to discussions with China, America should reverse economic course.

Starting with the FY 2011 budget, the Administration and Congress should cut federal spending more decisively than implied by the targeted 3 percent of GDP by FY 2015. Even more pressing, they should wrench the major entitlements—Social Security, Medicare, and Medicaid—back to a sustainable course.

As a byproduct of fixing its own house, America's relationship with China can be much more effectively addressed. By recommitting to the market, the U.S. can more credibly press the PRC on statist policies that harm American companies and the world economy.

The dialogue aspect of the S&ED should give way in part to focused negotiations on one or two economic issues (only) for each round. The exchange rate has proven a minor factor and should not be the focus. Instead, the spotlight should be on the full set of policies, not just indigenous innovation, that support Chinese state enterprises at everyone else's expense.

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5. See The Heritage Foundation, "The Federal Budget in Pictures: Budget Chart Book," at <http://www.heritage.org/budgetchartbook>.
6. David Kreuzer, Karen Campbell, William Beach, Ben Lieberman, and Nicolas Loris, "A Renewable Electricity Standard—What It Will Really Cost Americans," Heritage Foundation *Center for Data Analysis Report* No. CDA 10-03, May 5, 2010, at <http://www.heritage.org/Research/Reports/2010/05/A-Renewable-Electricity-Standard-What-It-Will-Really-Cost-Americans>; Paul Midler, "The Cost of Driving in China," *Forbes*, April 20, 2010, at <http://www.forbes.com/2010/04/19/china-tolls-car-travel-markets-economy-infrastructure.html> (May 21, 2010).
7. Carsten A. Holz, "Have China Scholars All Been Bought?," *Far Eastern Economic Review*, April 2007, p. 38, at <http://ihome.ust.hk/~socholz/HaveChinaScholarsAllBeenBought-FEER30April07.pdf> (May 21, 2010).