The Great China Challenge

America's G7 deputy makes the case that when China succeeds, America succeeds.

BY DAVID H. MCCORMICK

The United States and China are global economic leaders: they have accounted for over 40 percent of total global economic growth in the past five years, and each is an important market for the other. For example, U.S. exports of services to China support some 37,000 jobs in high-paying, high-productivity sectors of the U.S. economy. And imports from China provide U.S. consumers and companies with greater consumer choices and access to more efficient global supply chains. For China, access to the U.S. and international markets—and openness to international investment—has helped to create a world-class export sector and to drive the spectacular rates of economic growth that have turned this country into the global economic leader it is today.

But China's economy has changed fundamentally over the past thirty, and even ten years, and the Chinese now face a set of new and different challenges in sustaining future economic growth. The growth model that has transformed China from a largely homogeneous, agricultural economy into a dynamic, increasingly technologically sophisticated economy has been hugely successful to this point. But some of the policies developed for a far

---

David H. McCormick is Under Secretary for International Affairs at the U.S. Treasury Department. This article is based on a speech he gave at Beijing University on September 20, 2007.

THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
888 16th Street, N.W.
Suite 740
Washington, D.C. 20006
Phone: 202-861-0791
Fax: 202-861-0790
www.international-economy.com

different China are now responsible for the buildup of large and rising imbalances.

China's most senior leaders have clearly identified these imbalances. They include imbalances in growth between rural and urban areas, between the coast and the interior, between economic and social advancement, between reliance on internal and external demand, between rich and poor households, and between economic development and environmental protection.

Based on China's current growth model, these challenges are likely to grow. China's growth model for the past several decades has featured high levels of investment in physical inputs to production, such as plants for producing manufacturing exports, but has done comparatively less to foster innovation, and the development of deep and competitive markets. The current growth model has served China well to this point, but it is now exacerbating some of the challenges in achieving balanced growth.

First, growth has been increasingly energy-intensive and environmentally unfriendly despite Chinese leaders' efforts to strengthen and enforce environmental regulations. Since 2001, the ratio of growth in energy demand to GDP growth in China—a good measure of the energy-intensity of growth—has tripled relative to levels of the previous two decades, putting more pressure on energy supply and increasing the environmental damage from growth.

Second, growth has been highly capital-intensive, reducing the rate at which incremental growth creates new employment opportunities for the Chinese people. Capital and labor are substitutes in economic production, and in an environment of cheap money, Chinese firms have had strong incentives to use more capital and less labor despite China's need to provide jobs for many workers who are now seeking to move from the state and agricultural sectors to the private manufacturing and services sectors.

Growth has been increasingly energy-intensive and environmentally unfriendly despite Chinese leaders' efforts to strengthen and enforce environmental regulations.

The Role of Human Capital

Chinese economic growth has been highly capital-intensive, reducing the rate at which incremental growth creates new employment opportunities for the Chinese people. Capital and labor are substitutes in economic production, and in an environment of cheap money, Chinese firms have had strong incentives to use more capital and less labor despite China's need to provide jobs for many workers who are now seeking to move from the state and agricultural sectors to the private manufacturing and services sectors.

—D. McCormick

Third, recent growth has gone hand-in-hand with a decline in both consumption as a share of GDP and household income as a share of GDP. National saving has risen to its highest rate since the beginning of market reforms, and the share of wages in GDP has fallen more than 10 percentage points in less than ten years. This is not unrelated to the increasing capital share of economic output, as much of the increase in savings has come from the corporate sector. As a result, the Chinese people are capturing an increasingly smaller share of the benefits of growth.

These features of the current growth model are mutually reinforcing. The capital-intensive nature of China's economic growth has been fueled by high national saving, which has both provided the resources for capital investment and encouraged the use of capital-intensive techniques. The pattern of prices—maintained by an inflexible exchange rate—has encouraged production in export industries, many of which are highly resource-intensive. At the same time, as Chinese production has increasingly targeted foreign consumers, domestic consumption has remained low, and the resulting high saving has been channeled back into investment in export sectors, perpetuating the cycle.

High and increasing national saving—and its counterpart, the slow growth of domestic demand—has led to increasing trade surpluses and made Chinese growth increasingly dependent on external demand.

China's leaders understand these issues well and are right to be turning their attention now, rather than later, to reforms aimed at achieving economic growth that stems more from domestic demand, innovation, and high quality investment. These reforms include efforts to rebuild the social safety net and address the causes of precautionary household saving, efforts to make education less costly and more widely available, efforts to improve environmental safeguards, and efforts to build a more robust services sector.

The development of the financial services sector—including increased access to consumer finance for Chinese households—will be particularly important to ensuring that strong Chinese growth continues. Access to capital is key to ensuring that Chinese entrepreneurs are able to take full advantage of their capacity for innovation. And access to a wider range of higher-yielding savings instruments would provide all Chinese households with the tools they need to build assets more rapidly, allowing for higher consumption and living standards both today and in retirement. Developing a modern financial sector is not an easy thing, but investment by foreign firms—and the advanced risk management skills and market expertise that comes with it—can play an important role in expediting the process.

As a result, the Chinese people are capturing an increasingly smaller share of the benefits of growth.

While rebalancing growth will require a number of major structural changes, price measures, including exchange rate adjustment, must also play a role. Flexible prices play a critical function of allocating resources on the basis of accurately matched costs and benefits, and they fulfill this function with great effectiveness and at very low cost. The exchange rate has become a highly charged issue in U.S.-China economic relations. This is unfortunate, because as many non-official and non-American observers have argued, exchange rate flexibility is extremely important to China. But it is important to understand what increased currency flexibility in China will, and will not, do for the United States and China.

For the United States, what it will not do is significantly reduce the overall U.S. trade deficit, nor will it provide a magic bullet for solving the problems of American industries facing overseas competition. What increased currency flexibility will do is remove a major cause of the perceived unfairness in our bilateral relationship, allowing us to move on to the important long-term challenges the United States and China jointly face.

For China, more currency flexibility will not restrain growth. Nor will it lead to deflation. We have already seen the resilience of China's exporters to currency appreciation, with many enjoying higher profit margins today than they did two years ago. East Asia, South Korea, Indonesia, and Australia have all had currency appreciations far larger than China's, while maintaining strong growth and price stability.

What currency flexibility will do for China is support—and in fact be a necessary component of—a growth

Continued on page 85

The Yuan and the U.S. Trade Deficit

It is important to understand what increased currency flexibility in China will, and will not, do for the United States and China.

For the United States, what it will not do is significantly reduce the overall U.S. trade deficit, nor will it provide a magic bullet for solving the problems of American industries facing overseas competition. What increased currency flexibility will do is remove a major cause of the perceived unfairness in our bilateral relationship, allowing us to move on to the important long-term challenges the United States and China jointly face.

For China, more currency flexibility will not restrain growth. Nor will it lead to deflation. We have already seen the resilience of China's exporters to currency appreciation, with many enjoying higher profit margins today than they did two years ago. East Asia, South Korea, Indonesia, and Australia have all had currency appreciations far larger than China's, while maintaining strong growth and price stability.

—D. McCormick

Continued from page 76

strategy that brings higher consumption to Chinese households and more balanced, sustainable growth. This transition will occur through a decrease in the price of imports and the introduction of stronger incentives for Chinese companies to produce for Chinese consumers. What currency reform will also do is provide Chinese policymakers with greater freedom to use monetary policy to maintain price stability and avoid asset bubbles. This is of particular significance given China's recent acceleration of inflation. All of this will lead to growth that is more stable, more China-centered, and more effective in raising the living standards of the Chinese people than China's current growth model now is.

There are many in China who have expressed concern that more rapid currency appreciation will hurt low-income workers in some sectors. To the contrary, by encouraging employment growth in less capital-intensive domestic-oriented industries, exchange rate appreciation will open up new opportunities for low- and unskilled workers. Even more important for the poor is that industries serving domestic consumption demand will create new jobs at a much faster rate. According to a recent study by economist Robert Feenstra from the University of California at Davis, growth in domestic demand has proven three times more effective in generating employment in China than growth in exports.

The U.S. trade deficit and China's trade surplus are outcomes that are not only driven by international economic factors, but also by domestic economic factors. For the United States, our trade deficit can only be reduced through decisive measures to increase both private and public saving—the opposite problem China faces in its efforts to reduce a large trade surplus. To meet this challenge, we are committed to continuing to improve our fiscal outlook, particularly through measures to address the challenge of entitlement spending reform.

The United States must also avoid the siren song of protectionism. We must not sacrifice the long-term gains of openness by pursuing short-term and misguided responses to the challenges presented by global international markets. President Bush and U.S. Treasury Secretary Henry Paulson are committed to maintaining America's open trade and investment climate.

It is vital that the U.S. and Chinese economies continue to grow strongly and in ways that do not worsen global or domestic imbalances. Yet in today's dynamic global economy, recipes for past success do not guarantee success in the future. In the end, to ensure vibrant economies that provide prosperity for their peoples, China and the United States need to adapt their policies to the realities of today's globalizing world—and tomorrow's. ◆