View from the Beltway

Will China's Economy Fall Short?

By Owen Ullmann

Predictions of global supremacy may be premature.

During the late 1980s, an economic consensus among the brightest thinkers and writers had formed around the conviction that the United States' days as the world's preeminent economic power were about to end. The new superpower inevitably would be Japan, a manufacturing and exporting juggernaut that could not be stopped. The country seemed to have found a secret sauce of cooperation between industry and government to produce high-quality, low-cost products that would dominate global markets, from cars and televisions to bicycles and portable audio players like the Walkman—the ancestor to today's smart phones.

The belief in Japanese supremacy-in-waiting was best captured in the 1988 book, *Trading Places: How We Are Giving Our Future To Japan & How To Reclaim It,* by former Reagan administration trade guru Clyde Prestowitz. He predicted that the American Century was giving way to an era of Japanese success that would dominate the world in the twenty-first century. "Japan has created a kind of automatic wealth machine, perhaps the first since King Midas," he wrote. Other influential thinkers such as economist Lester Thurow agreed, citing Japan's low levels of unemployment and poverty and high rates of life expectancy and education. Many saw a strengthening yen becoming the world's main reserve currency, replacing a dollar often crippled by inflation and trade deficits. Some even predicted the two World War II adversaries would engage in another conflict to determine who would be the economic top dog.

China is viewed with suspicion about its opaque government and true intentions.

Well, we know now how spectacularly wrong those predictions were. After a buying spree that snapped up American companies and real estate during the 1980s, fueled by skyrocketing stock and real estate prices, Japan's bubble burst in 1991. Thirty years later, its economy still hasn't recovered. In the wake of a "lost decade" of stagnant growth, it continues to struggle with a shrinking and aging population, massive debt, slow growth, and the risk of deflation. So much for the Japanese Century.

Today, a similar consensus is emerging about the end of American economic dominance in the world. The predictions are similar to those of three decades ago if you substitute China for Japan. The thinking is remarkably similar in many respects: China is a manufacturing juggernaut, it has an efficient, state-controlled economy, and it has accumulated trillions of dollars in reserves from predatory trade practices with the rest of the world that allow it to invest in companies, iconic real estate, and joint projects everywhere. Rhetoric among American policymakers across the political spectrum has become more belligerent toward China, as many see a new cold war emerging between the two nations—and a few even warn of a future shooting war.

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There also are significant differences, of course, that make China appear to be even more of a threat than Japan had been to supplant the United States as the world's most powerful economy. China's population is more than ten times that of Japan at the latter's peak, it has a powerful military in contrast to largely pacifist Japan, and the country is run by a communist dictatorship in Beijing that has its sights set on dominating the world this decade. President Xi Jinping outlined the country's ambitious "Made in China 2025" agenda in 2015. Its goal is to transform the country from a low-end manufacturer to the global leader in technology and innovation.

Many countries that signed up to be part of the Belt and Road Initiative are now having second thoughts.

It certainly appears likely that China will overtake the United States as the world's largest economy when valued in nominal GDP dollars, if for no other reason than its population is four times that of the United States and the Beijing government is still investing in raising living standards for hundreds of millions of Chinese yet to enjoy middle-class status. That is projected to occur sometime in the 2030s, ending the U.S. reign at the top after more than one hundred years.

Even so, having the largest overall economy does not alone confer global supremacy. China would still lag badly in per capita GDP—currently just one-sixth that of the United States. In addition, the Chinese renminbi, while designated one of the world's elite currencies in 2015 by the International Monetary Fund, accounts for only about 2 percent of central banks' foreign reserves, compared to more than 60 percent for the U.S. dollar, still the most coveted currency in global finance by far.

As China continues under Xi to pursue its ambitious goal of becoming the world's number one economy in all respects, it's worth asking: What are the prospects for that to occur? It's already a source of growing debate and worth examining the arguments on both sides, with the caveat that a lack of transparency makes it difficult to determine just how sound China's economy really is, and keeping close to mind how wrong economic predictions about the future often prove to be.

THE CASE FOR CHINESE DOMINANCE

No one can deny the economic miracle unleashed by China under Deng Xiaoping in the late 1970s, when he opened up his country's economy to foreign trade and investment. By keeping central control over the economy, the government has seemed able to maximize efficiency and avoid the boom-bust cycles common in Western capitalist democracies.

When the Chinese stock market crashed in 2015, the government banned trades of certain stocks until the market righted itself in 2016. This past September, China's central bank declared all cryptocurrency transactions illegal, a surprise announcement that had the effect of banning Bitcoin and other digital tokens. By contrast, U.S. regulators, who see potential dangers from the $2 trillion—and rapidly growing—digital currency exchanges, are still in the early stages of figuring out oversight rules to prevent market disruptions. Top U.S. Federal Reserve and Treasury officials who have met with their Chinese counterparts over the years have marveled at how well the country's bureaucrats have managed the Covid-19 pandemic and steered their economy along a path of steady growth and stability—at least from all outward appearances, since no one really knows for certain how stable China's murky financial system is.

On the diplomatic front, China has sought to forge closer economic relations with countries around the world through its Belt and Road Initiative. A March 2021 Council on Foreign Relations report on the massive project by Jennifer Hillman and David Sacks noted that Xi proposed in 2013

The Chinese Bond and Democracy

"If there's a crisis, what do you do with a Chinese bond? It's not an open system. You're not sure that if you sell your bond, you only get RMB currency. The dollar's role in the world is tied to democracy in the United States. Without democracy, it's hard to have checks and balances and protection of property rights. If you're holding Chinese government bonds as your reserves, you'd have no confidence that they couldn't somehow be expropriated and you would have no recourse. The Chinese legal system is basically managed by the Communist Party. There definitely is a school of thought that it would be difficult to be an important world reserve currency without a democratic political system backing it."

David Dollar,
senior fellow at Brookings Institution.

building a land-based "Silk Road Economic Belt" from China to Central and South Asia, the Middle East, and Europe, and a sea-based "21st Century Maritime Silk Road," connecting China to Southeast Asia, the Middle East, Africa, and Europe via major sea lanes.

The authors described the project as Xi's "signature foreign policy undertaking." It is China's version of the United States' post-World War II Marshall Plan that provided $150 billion in today's dollars to help sixteen European countries rebuild, resist communism, and restore economic growth and trade. China's program is far more ambitious, as Chinese banks and companies have financed new roads, power plants, ports, railways, and 5G networks. In all, 139 countries have joined BRI. Those that haven't tend to be "more democratic, politically stable, and economically developed than those that have endorsed the initiative," according to the Council's report.

To help finance BRI projects, China launched the Asian Infrastructure Investment Bank in 2015 to challenge the Bretton Woods global financial system set up under U.S. leadership in 1944 to stabilize currencies and promote economic growth through the International Monetary Fund, World Bank, and in later years, the Asian Development Bank. More recently, China has tried to take advantage of the United States' withdrawal from global leadership during the Trump administration.

For example, it has applied to join the Comprehensive and Progressive Agreement for Trans-Pacific Partnership following Trump's decision to withdraw from the trade pact, which had excluded China because of its restrictions on foreign investment, lax enforcement of intellectual property protections, weak labor standards, and proliferation of state-owned enterprises. President Joe Biden is now on the spot and must decide whether to rejoin the trade accord or let China wield even more influence in the Pacific region.

All of these economic moves have come as China continues to build up its military forces, much as the U.S. has done, to be able to base troops and ships around the world. China's defense budget is second only to that of the United States. Though only about one-third the size of the Pentagon's budget in nominal dollars, it is closer to American spending in purchasing power.

Rush Doshi, a China expert at the Brookings Institution, sees a pattern to China's initiatives that has been decades in the making, as he explains in his new book, *The Long Game: China's Grand Strategy to Displace American Order.* The book argues that China has been following a long-term strategy to displace America as the world's preeminent military, political, and economic power based on the growing belief that American strength is waning. Based on this perspective, the only unsettled question is not if China will become the new number one, but when.

Tight control over every aspect of the economy is hardly the kind of free-wheeling environment needed to spark creativity and innovation, essential building blocks for future prosperity.

THE CASE AGAINST CHINESE DOMINANCE

While there is no doubt about China's growing economic, military, and political clout, the country does not enjoy the goodwill the United States has fostered within the world community as an example of a prosperous free-market democracy. Even the countries it fought in World War II quickly became close friends and economic allies. China, by contrast, is viewed with suspicion about its opaque government and true intentions. Those concerns have grown under the leadership of Xi, who is running China with ever tighter control as he emerges as the most powerful leader since Mao Zedong. That attitude has been underscored by China's rebuff of international efforts to determine the source of the Covid virus.

The list of issues pitting an ever-more aggressive China against other countries keeps growing. There's its crackdown on democracy advocates in Hong Kong and Muslim Uyghurs in the northwestern region of Xinjiang that has provoked international condemnation. There are menacing threats against Japan over its recent pledge to help separatist Taiwan to defend itself from a Chinese attack, as well as Beijing's condemnation of a small U.S. training force on the island. There's the ongoing territorial and maritime dispute in the South China Sea with other nations in the region, including Vietnam and the Philippines. Border disputes with India and Pakistan persist, trade relations with Australia have been worsening much as they have with the United States, as tariffs imposed by President Trump remain in place under Biden.

There have been protests in Cambodia over China's military presence, and many countries that signed up to be part of the Belt and Road Initiative are now having second thoughts because of concerns that China is wielding too much political and economic control. Recent public opinion polls among China's neighbors, including South Korea and India, show Beijing viewed increasingly as an economic and military threat. All of these negative developments recently prompted Kurt Campbell, a top China hand on the National Security Council, to blame Xi's more assertive foreign diplomacy for sparking a global backlash.

Evidence of that backlash was on display in September, when Biden hosted a meeting of leaders of the "Quad"—Australia, India, Japan, and the United States—at the White House. The *Washington Post* noted they met "to cement an emerging partnership … united in their misgivings about China."

Even China's vaunted economic management has been cast in a bad light by the growing debt problems in the property development sector led by China Evergrande Group, which is saddled with more than $300 billion in liabilities. It missed payments to lenders in September and the prospect of its collapse has prompted growing fears of a crash throughout the property sector that even the Beijing government's masterful central planners may be unable to avert. Shades of Japan in the 1990s.

Also troubling was the government's abrupt decision to ban cryptocurrency trading. Similarly, it stunned the tech industry with its surprise move in September to limit how much time Chinese children can spend playing video games. Crackdowns announced against billionaires, such as Alibaba founder Jack Ma, to redistribute income as a way to reduce economic inequality, can be seen as another heavy-handed move by the Xi's Communist Party to intervene in the economy whenever and however it wants without consequence. As much as the huge and lucrative Chinese market beckons foreign business, investors know the rules could change at any time. Tight control over every aspect of the economy is hardly the kind of free-wheeling environment needed to spark creativity and innovation, essential building blocks for future prosperity.

China faces another huge challenge in confronting climate change, as more developed nations make it a key focus of financial regulation. The U.S. Treasury Department under Secretary Janet Yellen has added a Climate Hub for the first time to ensure that department policy is consistent with efforts to combat global warming. As the world's largest emitter of greenhouse gases, China lags behind other nations in tackling the problem and will surely face increased pressure to accelerate efforts to curb harmful emissions.

David Dollar, a senior fellow at the Brookings Institution and an expert on China's economy, isn't ready to write off future U.S. economic dominance. He notes that China's labor force is starting to decline, while the U.S. labor force is still growing. And he doesn't see the dollar losing its dominance as a reserve currency.

"If there's a crisis, what do you do with a Chinese bond? It's not an open system," he said. "You're not sure that if you sell your bond, you only get RMB currency. The dollar's role in the world is tied to democracy in the United States. Without democracy, it's hard to have checks and balances and protection of property rights. If you're holding Chinese government bonds as your reserves, you'd have no confidence that they couldn't somehow be expropriated and you would have no recourse. The Chinese legal system is basically managed by the Communist Party. There definitely is a school of thought that it would be difficult to be an important world reserve currency without a democratic political system backing it."

Dollar added that he believes the world is headed for a multi-polar system in which several major economies compete in a complicated global system—but one with the United States back on top: "If you're looking out towards the middle of the century, I'm optimistic about the United States. We're the only one among the top five economies with labor force growth that would continue at a healthy, consistent rate with a sensible immigration policy. That's a big advantage. So while China may surpass the United States in terms of nominal GDP in a decade, don't be surprised if later in the century, the United States returns as the biggest economy."

Eswar Prasad, a professor of international trade policy at Cornell University, is similarly doubtful that China will supplant the United States as the world's geopolitical and economic leader, even if its nominal GDP rises to first place. "I think there is increasing pushback against China from a variety of quarters, even from many of its Asian neighbors, who are somewhat suspicious of its geopolitical and expansionist tendencies," he said. "Likewise, many of its trading partners feel economic ties with China come with too many strings attached." He observed that Trump's isolationist policies created a vacuum for China to fill but it failed to take advantage of that.

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Prasad, who wrote the 2016 book, *Gaining Currency: The Rise of the Renminbi,* sees the RMB gaining traction as a form of payment for trade and financial transactions, but not as a reserve or safe haven currency, where it may chip away at the euro or pound sterling, but not the dollar. "Elements of the institutional framework that are really crucial to maintain the trust of foreign investors are the rule of law, an independent central bank, and a system of checks and balances," he explained. "China does not have good institutions in any of these dimensions relative to the United States. The chances that the renminbi will pose a serious threat to the dollar's dominance are minimal."

Indeed, it seems premature to declare the end of American economic rule. It's worth remembering that the United States rose to the top with a system far from perfect but one that other countries admired and emulated to varying degrees. That's the secret sauce Xi Jinping is still missing: the ability to lead by example, not merely through strength and buying power. ◆