

## The Troubled Sino-American Politico-Economic Relationship in Historical Perspective

An Exercise in Anecdote at a Seminar on Contemporary China

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### *Takeaways:*

- § *From the beginning of "opening and reform," unstated and unexamined presuppositions and biases have deformed U.S. understanding of the Chinese economy, the sources of its dynamism, and its potential to undergird much greater Chinese power.*
- § *China has left the Soviet system, autarky, and socialist sloth far behind it.*
- § *The Chinese political economy now effectively combines the invisible hand of the market with that of the Communist Party to guide enterprise decisions. It is about to add big data and artificial intelligence to the mix.*
- § *In some respects, the Chinese economy is already more formidable than America's. It promises to become more so.*
- § *China's economic performance challenges the core dogmas of contemporary American capitalism. America needs to reconsider these dogmas to be able to compete.*

I am not an economist. I only do economics when I have to. Decades ago, I had a lot to do with the policies that opened the Chinese economy to our own. For the past quarter century, I've done business all over the world, some of it with Chinese companies.

I am here, of course, as a living fossil. Allow me to present my credentials for this role. In 1971, I became – among other things – the officer-in-charge of economic relations with China at the Department of State. State was then the only government department to have such a pretentious position, given the total U.S. embargo on trade and investment with what we called Red China. The job was not arduous. Bilateral trade that year was about \$5 million.

I drafted and then verified the translation of the portions of the Shanghai Communiqué that opened trade and cultural relations with the China mainland in February 1972. The 862 million people there then had a GDP of only \$113 billion, one-third that of the 15 million people on Taiwan. But I was soon besieged by hustlers in the U.S. trying to sell all sorts of things to China, including coffins, which American undertakers who had read Pearl Buck and didn't know about China's turn to cremation erroneously assumed so large a population must need in abundance.

In 1972, nobody thought there was much to buy from China other than curios, though I helped some businesspeople go to the Canton Trade Fair and went there myself. (My only significant personal accomplishment at the Fair, other than to help two Orthodox Jews from Brooklyn who were bent on cornering the world hog bristle market, was to buy the Hollywood actress, Shirley Maclaine – then at the height of her beauty – a gin and tonic or two at the roof garden bar of the Dong Fang Hotel [东方宾馆], known to foreign attendees as “the Top of the Fang.”)

China was then completely outside the global financial system. After the Chinese signed their

first contract to buy Boeing aircraft, they asked the company's representatives how they would like to be paid. When the puzzled Boeing people asked what their counterparts meant, the Chinese purchasers rolled open a curtain, revealing \$42 million in stacked \$100 bills.

But, the Chinese learned fast, and by 1978, bilateral trade had risen to a bit over \$1.14 billion, amidst escalating complaints from Chinese officials about their country's mounting trade deficit with the United States. I and others became practiced in telling them that their overall trade was in balance and that bilateral trade imbalances are meaningless. (Now that we Americans have gone mercantilist, I am about to put my old talking points up for sale on one of the Chinese versions of eBay.)

After Deng Xiaoping's adoption of policies of "reform and opening" and his establishment of diplomatic relations with the United States at the end of 1978, trade began to double each year. This was facilitated by the rapid establishment of a legal framework for bilateral interaction. From 1979 through the end of 1984, first as Country Director for China in Washington and then as Deputy Chief of Mission or Chargé in Beijing, I personally negotiated or participated in negotiating three-dozen framework-setting treaties and agreements.

By the time I left Beijing in November 1984, the two countries had put in place a formal relationship equivalent to what they might have had if they had not squandered twenty-three years in non-intercourse. Bilateral trade in 1984 came to about \$6 billion, pretty much equally balanced between the two economies according to American figures. To Chinese distress, U.S. statistics did not then and do not now count U.S. exports to China through Hong Kong. Such investment as there was (very little) flowed from America to China, which had no thought of investing anywhere beyond its borders. China's GDP had by then risen to about \$316 billion and was growing at an annual rate of 15 percent.

Well, you know the rest. (If you've forgotten it, there is a sort of kinescope of China's economic evolution in the form of six-month snapshot analyses by me. It's in a digital addendum to my 2013 book, *Interesting Times: China, America, and the Shifting Balance of Prestige*.<sup>1</sup> Full disclosure: when I retired from the Foreign Service of the United States at the very end of 1994, I decided, on principle, not to read anything classified if I could avoid it. So my analyses are deliberately based solely on publicly available information or my own sources.)

Someone once said that "accountability is the measure of a leader's height." I'm about 2 ½ inches shorter than I once was, and it's been quite a while since I aspired to lead much of anything but a quiet life with the woman I love. I can accept neither credit nor blame for the course of US-China economic relations after 1984.

But I have kept as sharp an eye on the interactions between the two countries as I could. So I can confirm what you all know: bilateral trade in goods this year will be about \$600 billion, with a huge imbalance in favor of China. Investment now flows in both directions, with cumulative Chinese direct investment in the U.S. now about \$120 billion and growing fast despite obstacles imposed by the denizens of the miasmatic "swamp" here in Washington.

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<sup>1</sup> <http://chasfreeman.net/books-and-publications/supplementary-texts-interesting-times/how-china-transformed-itself/>

At nominal exchange rates, China's GDP is currently a bit short of \$12 trillion. (By this measure, at \$18.5 trillion, U.S. GDP is greater by half. But, in purchasing power terms, China has a GDP of about \$25 trillion, one-third larger than the United States.) The Chinese economy is growing at twice the speed of the global economy (of which, depending on how it is counted, it now comprises 15.1 - 18.3 percent) and three times as fast as the United States. In some very important respects, China's economy is already considerably larger than America's. The United States has banking, insurance, real estate, health, marketing, and entertainment sectors of unparalleled size, but China's industrial production is now about half again bigger than America's. It accounts for one-fourth of all industrial output in the world.

China is also now a technology exporter as well as an importer. One in three of the world's 262 "unicorns" (start-ups that are valued at more than \$1 billion) is Chinese. China accounts for more than 40 percent of the world's e-commerce. By 2025, it is expected to have a larger science, technology, engineering, and math workforce than all the countries of the Organization for Economic Co-operation and Development (OECD) put together. The size of China's population and the scale of its people's digital interactions make it uniquely suited to cybernetic, marketing, medical, social control, and telecommunication innovation.

If I had to summarize the analytical problems underlying ineffective American policy responses to China's rapid economic evolution over the past forty years, I would cite ideologically induced delusions, deduction from politically appealing narratives rather than from emerging realities, unwillingness to engage in self-examination, and a persistent reluctance to contemplate the implications for America's wealth and power of the contrast between China's dynamism and our own politico-economic sclerosis. Bad models of real world phenomena produce bad conclusions, like the apocryphal assertion that "bumbees can't possibly fly."

In terms of American politico-economic dogma, China is a bumblebee. It flies very well in practice, despite all sorts of meretricious explanations for why it cannot. Our surprise at China's socioeconomic successes should lead us to question our presuppositions. But these have the status of ideological axioms. So we continue to hope that the bumblebee will at some point vindicate our biases by crashing to the ground. The field is crowded, but anyone here who cares to do so can earn a good living by periodically predicting China's coming collapse, as some celebrity Sinophobes have been doing for decades.

Analytical inertia has seldom been more apparent than in the unwillingness of most Americans -- including, notably, those in our intelligence community (IC) -- to accept that Deng Xiaoping's policies were likely to prove transformative. As our IC saw it, Deng had inherited a Soviet-style planned economy with Chinese characteristics. Despite mad experiments like the Great Leap Forward, China was stuck with the inherent sloth of this so-called "socialist" system. So, like the Soviet Union, it would forever stumble rather than race ahead.

I did not question this myself until a bowl of noodles I bought from a street vendor at the corner of Nanchizi [南池子] and Chang'an Dajie [长安大街] in September 1979 unexpectedly led to *satori* [悟] instead of indigestion. (I tell that story and recount my subsequent struggles with Washington and Hong Kong China-watchers in another digital addendum to my book that you

might find interesting.<sup>2</sup> )

Now to some of the unspoken “ideologically induced delusions” and other implicit assumptions that impede understanding of the evolution of China’s political economy.

The only really damaging thing about the demise of the Soviet system a quarter century ago I can think of is that our Soviet specialists no longer had it to study. This led them to turn their talents to China on the assumption that they understood communists and would therefore have a leg up on understanding China. But, for the most part, this was nonsense. If you’ve seen one “communist,” you have not seen them all. Yet many Americans subconsciously continue to assume that “communism” means something universal in systemic terms. This mostly unstated belief continues to distort the dominant view of China in our country.

Beijing’s attempt to import and impose the Soviet system failed. China never was and is not now much like the USSR. It is a civilizational state that is returning to wealth, power, and self-confidence. It is doing so under a model that mixes eclectic borrowing from overseas Chinese and foreigners (including Americans, Germans and other Europeans, Japanese, Koreans, and Russians) with native entrepreneurship (some bureaucratic and some private) to stand up a system that is *sui generis*. China has a highly successful economy, not a constipated or failing one. It is unburdened by the gigantic defense spending that helped bring down the USSR. It is ruled by a meritocratic mandarin state that calls itself “the Chinese Communist Party.” It is quasi-Leninist but ideologically flexible in ways the Soviet Union never was.

State ownership of core elements of Chinese heavy industry and telecommunications does not mean that the Chinese economy mirrors the Soviet economy’s statism and inefficiency under Gosplan. The Chinese private sector accounts for 60 percent of GDP, over 60 percent of new investment, and 80 percent of jobs. It is growing faster than the state-owned component of the economy. In any event, in Chinese corporations, whether state or privately owned, business decisions are driven by a search for profit and are made by corporate managers, not by the nominal owners or according to a rigid state plan.

China pursues its stated national economic development objectives with financial and other incentives to companies. These influence their investment decisions. It rewards Party members who work in these companies and in local governments with career advancement in proportion to their promotion of the Party's program including its economic objectives. In effect, China has joined the invisible hand of the market to that of the ruling Communist Party. This dual guidance system, already effective, is about to be significantly strengthened through the "Social Credit System," which is to be in full effect by 2020. China proposes to use big data and artificial intelligence to measure both attitudes and performance on the individual and corporate level. Rather than abandoning market economics, the Social Credit system aims to exploit and harness markets to serve state objectives. Beijing is on the verge of producing a degree of social control and a form of *dirigisme* that will be unprecedentedly responsive to its ambitions.

Despite recent efforts to consolidate key Chinese industries by merging companies into huge

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<sup>2</sup> <http://chasfreeman.net/books-and-publications/supplementary-texts-interesting-times/forecasting-change-in-china/>

central government-owned corporations, China has yet to find its Andrew Carnegie or John D. Rockefeller. The Chinese economy is made up of highly competitive markets, subject to far fewer national monopolies and oligopolies than in the United States. Ironically, China is now in most respects closer to the capitalist ideal of the “perfect market” in which prices are set solely by interplay between supply and demand than the contemporary West, where markets have typically come to be dominated by a few major firms or to have rates of return guaranteed by government regulation. In some ways, "socialism with Chinese characteristics" has realized the chronic overproduction that Karl Marx predicted would afflict capitalist economies. The rapidly increasing competitiveness of Chinese companies abroad reflects the fiercely competitive environment from which they are emerging.

Meanwhile, China’s economic performance continues to challenge some of the core dogmas of contemporary American capitalism in ways that highlight the massive contradictions in our thinking about the Chinese “bumblebee.” This is a topic that deserves much more time than that allotted to me. Let me just cite a few examples of the disconnects between American expectations and Chinese performance.

Americans deride state-owned enterprises as inherently inefficient and extol the virtues of laissez-faire (except when it works against us). But, at the same time, we complain that Chinese companies, both publicly and privately owned, out-compete our own, tax-subsidized corporations, most of which are publicly rather than privately owned bureaucracies. Meanwhile, we have forgotten the extent to which industrial policy spurred our own economic development and now assert both that industrial policy can’t work and that, if it nonetheless does (in places like China and Germany), it is a perversion of nature that must be slain.

At least rhetorically, we attribute the growth of China’s high tech industries to their purloining of American patents. There is something to this as an explanation for China’s amazingly rapid catch-up with developed economies. But China has inevitably discovered the merits of an effective intellectual property protection system, just as we did when we became a net producer rather than consumer of innovation. Western companies now increasingly take their complaints about patent infringement inside and outside China to Chinese courts. They find the Chinese legal system more expeditious, effective, and economical in providing relief than elsewhere.

Americans bemoan Chinese policies directed at encouraging technology transfer even as we refuse to revise tax and labor-management policies here that encourage such “offshoring.” We condemn Chinese telecommunications firms for their presumed allegiance to the Chinese state but quite reasonably expect our own telecommunications companies to cooperate fully with our military and intelligence services on demand.

It is an article of faith for Americans that innovation requires freedom of political expression. We pay no attention to the many examples of politically repressive societies (like Nazi Germany or the USSR) in which freedom of scientific and commercial communication proved sufficient to produce notable new technologies. Neither our government nor our companies have organized themselves to detect, match, or adopt the ever-more numerous examples of industrial innovation in China. (After all, isn’t it obvious that it can’t possibly be taking place?) This is the sort of complacency that risks our losing our edge.

The United States demands Chinese openness to American investment in areas of China's economy that are central to its prosperity, domestic tranquility, and security, even as we increasingly restrict Chinese investment in our own economy on national security grounds. China has become competitive through participation in global supply chains. The latest American answer to this competition is to attempt to sever or disrupt supply chains by imposing tariff walls to protect our companies from it. We are unlikely to enjoy the effects of this approach on American consumers, let alone American competitiveness.

As a final example, China has shown the gains that can accrue from government investment in physical and human infrastructure. Our government is instead disinvesting in both as well as in basic scientific research and technology projects. This leaves us with decreasing economic efficiency at home, no answer to China's use of infrastructure investment to build connectivity in Eurasia that will sideline us, and less reason to expect to lead future phase change in the global economy.

To sum up: It is now a commonplace that things are not going well for us in our economic rivalry with China. But this has less to do with China than with deep-seated American misperception of Chinese realities and a chronic unwillingness to examine and address problems in our own economy. Americans find it easier to charge the Chinese with failing to conform to our practices and to demand that they do so than to consider how we might alter those practices to match or outdo their successes. (In my view, with the right policies, the extraordinary human and physical endowments of the United States make doing so entirely feasible).

More than any other factor, the federal tax code determines where and how investment flows in the U.S. economy. Over the course of a century, American politicians and the special interests and lobbyists who openly suborn them have structured taxes to protect established practices, vested interests, and sectors of our economy that invite propping up because their productivity has ceased to grow. The overall aim of our economic planning is to boost consumption, not savings or investment. We give no thought to revising our approach to incentivize investment in productivity or sectors of the economy in which emerging technologies promise the greatest and most beneficial economic growth.

The United States is now making no significant effort to study and adopt best practices from other economies, not just China. Our politicians routinely dismiss foreign experience as irrelevant and confidently assert that systems with a long history of working well abroad (for example, single-payer national health programs) are unimaginable. The U.S. economy performs less than optimally at present in large measure because the U.S. government encourages stale thinking, perpetuates sub-optimal practices, and leaves shibboleths unchallenged.

China has learned from the United States. We Americans must now consider what its performance can teach us about how to improve our own. Appalling as current political trends in China may be, it is a more formidable economic competitor than any we have previously faced. We cannot dwell on our past role as the global leader or rest on our laurels if we are to hold our own in relation to it.