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Chinese–US Economic Relations After the Global Financial Crisis

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Introduction

The global financial crisis has had three profound effects on Sino–American relations. First, China and the United States have become a *de facto* Group of Two (G2), largely by default, as Europe and Japan have fallen on even harder times than the United States and because India’s development path is at least 15 years behind China’s. Second, the speed with which China is catching up to the United States has increased, with the mid-2020s projected as when China will pass the United States to become the world’s largest economy—though it will then still be a much poorer and less powerful country than the United States. Third, the global financial crisis (GFC) did not—as some projected—reduce the enormous economic imbalances between China and the United States even as both countries reduced their imbalances with the rest of the world.

The first half of the Asia-Pacific century will thus likely be dominated by a waxing China and a waning United States, both standing head and shoulders above the other major powers, with profound differences in values and interests between the two countries, and tied together in a profoundly imbalanced but deeply co-dependent economic relationship. What China and the United States do—alone, together, in regional and multilateral forums or in conflict with each other—will increasingly define the global bounds of the possible not only in economic and security terms but also for new challenges such as sustainability.

What is the likely course of Sino–American relations: geopolitical conflict, economic competition or uneasy coexistence? Contra the heated punditry surrounding Chinese–US relations, uneasy coexistence built on economic co-dependence seems the most likely outcome.

There is one clear similarity and one important difference between Chinese–US relations today and USSR–US relations in the second half of the past century. The similarity is that there is a likely enduring gulf in core principles and world views between China and the United States—certainly making possible another intense and lasting geopolitical rivalry. The difference, however, is that China is deeply integrated into the global economy and joined at the economic hip with the United States, whereas the USSR was not part of the global capitalist economy and its economic ties with the United States were close to nonexistent. The smart money today says that this economic difference with the Cold War is likely to remain more important than the political similarity with the second half of the twentieth century.

There is a long tradition suggesting that Sino–American economic integration will be a powerful force for stability in Chinese–US relations. From Kant and Cobden on, liberals have believed that economic entanglements reduce the probability of armed conflict. This was a guiding principle of the open-economy vision of the United States after World War II, notwithstanding the absence of the communist world from it. Bill Clinton and George H. W. Bush seemed also to believe in the geopolitical power of economic entanglements, strongly supporting the integration of China into the global economy after the collapse of the Soviet Union.

Nonetheless, many today believe that Chinese–US economic relations are so imbalanced that, rather than acting as an inhibitor of geopolitical conflict, they will be a source of such conflict between the world’s two most powerful countries. This is why Niall Ferguson (2009) argues that we are today living in a time that bears strong parallels with the years immediately before World War I.

Until now, the nearly constant flare-ups and ongoing aggravations in Chinese–US economic relations have acted more as a pressure-release valve to ease tensions than as wildfires threatening to rage out of control—at worst into another world war. There seems every reason to suspect that after more than two decades of savvy management of their difficult relationship, the leaders of both China and the United States will be up to the task of continuing to keep a lid on their frictions simply because the stakes are so transparently high.

There is no denying that the post-GFC challenges facing Sino–American relations are large. But they are dwarfed by the potential costs of conflict. As Henry Kissinger (2011) argued, the China–United States relationship will never look like a second Cold War because ‘the overriding reality is that neither country will ever be able to dominate the other and that conflict between them would exhaust their societies’. Ultimately, the massive stakes in Chinese–US relations—the upside to their economic ties and the downside to armed conflict—are what should make us confident that both countries will continue to be able to manage their relations.

The remainder of this chapter unfolds as follows. The next section assesses the economic trajectories of China and the United States before and after the GFC, pointing both to the dramatic successes of China’s massive crisis-fighting measures and to the spottier record of the United States despite comparable fiscal and monetary stimuli. The third section analyses the enduring economic imbalances between the two countries even in the post-GFC period when they have begun to unwind their imbalances with the rest of the world. The fourth section argues that these imbalances are less important to Sino–American economic relations than is commonly thought because they mask profound private sector interdependencies between the two countries. The final section examines the strong record of managing economic tensions by both sides, particularly in the immediate post-GFC period, which should give us confidence that stability rather than conflict will continue to be the watchword in relations between the world’s two most powerful countries.

The *de facto* G2, by default

The GFC was born in the United States of too loose money and too lax regulation, aided and abetted by Asia's willingness to provide credit to America apparently without limit, and instantly transmitted to Europe through integrated global capital markets and then the rest of the world through plummeting global trade. Post GFC, buccaneering capitalism has lost its sheen, debt and deficits haunt the Western world, and emerging economies are rethinking their reliance on exports and funding Western debt to pay for them.

But *plus ça change, plus c'est la même chose*. The fundamental big-picture trajectory of the post-financial crisis era is the same as it was before—towards a world dominated by interactions between the United States, which is still the most powerful country, and China, which is the biggest and fastest-growing rising power. A *de facto* G2 is emerging, almost by default, even though neither China nor the United States will give their relationship this grandiose title.

Figure 10.1 US GDP Growth 2007-2010

Source: US Bureau of Economic Analysis

There are two faces to the United States' economic recovery from the GFC. On the one hand, the real economy is doing quite well. From the depths of a precipitous 6 per cent decline in the fourth quarter of 2008, US gross domestic product (GDP) growth has returned to its historical norm of about 3 per cent (Figure 10.1). Similarly, the share market has recovered most of the value it lost during the crisis (Figure 10.2). Indeed, both recoveries, and especially growth, have the basic V-shape that has characterised previous American bounce-backs from recession.

Figure 10.2 US Stock Market (DJIA)

Source: Dow Jones

The US rebound, however, has been anaemic on the two most politically salient economic statistics: unemployment and housing prices. Wall Street might have recovered; Main Street is still reeling. The unemployment rate doubled to 10 per cent from the beginning of 2008 to the end of 2009 and has subsequently come down only slowly to slightly less than 9 per cent (Figure 10.3). After doubling between 2000 and 2006, US house prices fell by 30 per cent over the next two and a half years. Housing has essentially flat-lined since (Figure 10.4).

Figure 10.3 US Unemployment Rate

Source: US Bureau of Labor Statistics

Figure 10.4 US Housing Prices (Case Shiller Index)

Source: S&P Case Shiller Home Price Index (20 city)

There are at least two ways to interpret these data. Optimists say that housing prices and unemployment were always going to be lagging indicators in America's recovery, and hence that they too will soon start to bounce back—even if not in any way approximating a V-shaped recovery. Pessimists instead say that the trajectory for jobs and housing prices is more likely L-shaped, with the poor outcomes of the recent past continuing for an extended period. The reality is likely to be somewhere in between.

The rising post-GFC debt and deficit mountain is more worrying to the United States' economic future (Figure 10.5). The massive US fiscal stimulus during the crisis resulted in a budget deficit of more than 10 per cent for the 2009–10 financial year. But short-term stimulus only adds to the fiscal unsustainability of the two biggest parts of the American welfare state—social security pension benefits for retirees and Medicare health care for the aged—which are under siege from the demographic time bomb of ageing, post–World War II baby boomers.

The Obama administration's budget projections will reduce the annual deficit to 4 per cent by 2014 (according to the independent Congressional Budget Office), with deficits rising back above 5 per cent by the end of the decade. Barack Obama, like other presidents before him, is unwilling to think the unthinkable of performing radical surgery on Medicare and social security—and the voting public remains squarely behind this inaction. But the consequence of massive GFC fighting and do-little on the welfare state is that US public debt is projected to nearly double from a little more than 50 per cent of GDP in 2009 to 90 per cent of GDP in 2020.

Figure 10.5 US Budget Deficits and Public Debt (%GDP), 2009-2020

Source: Congressional Budget Office estimates of Obama 2011 budget

The global financial markets can see the United States’ fiscal future all too clearly. Before, during and after the financial crisis, the markets thought that the path of least resistance for the United States would be to inflate its way out of its fiscal obligations. The decade-long descent of the greenback is their reaction. The US dollar actually appreciated in trade-weighted terms from 2000 to 2002—first when Y2K problems did not materialise and then in a flight to safety after the 9/11 terrorist attacks (Figure 10.6).

But over the next six years, the dollar lost 30 per cent of its value. There was another flight into the dollar during the financial crisis—perhaps as much because assets were repatriated into the United States as because the dollar is the global currency. But since then the dollar has gone back onto what looks like another extended slide. The US dollar today is only two-thirds the currency it was a decade ago.

In sum, the US economic picture is very much a mixed bag. Growth has rebounded since the depths of the financial crisis and there are literally trillions of dollars on corporate balance sheets waiting for the right time to invest. But the United States’ fiscal problems are very real and some worry that the innovation and flexible labour markets that have helped the United States grow out of its debts in the past are no longer up to the job. Nonetheless, it would be highly imprudent to predict that the US economy will soon fall off the global cliff. An extended period of relative decline—caused as much by emerging Asia’s rise as by America’s slowing down—seems much more likely. Couple this with the United States’ military hegemony and the fact that its cultural and political reach will continue to dwarf that of other countries, and the old Mark Twain saying seems apposite: talk of America’s demise has been grossly exaggerated.

Figure 10.6 Trade Weighted US dollar

Source: Federal Reserve Bank of St Louis

The arc of the Chinese economy is obviously very different. The 30 years of average double-digit growth from the late 1970s are an economic miracle without precedent. China is surely plagued by great challenges, such as mass urbanisation, interior development, pollution, energy security, rapid ageing, and a mushrooming middle class that will inevitably seek political change. But the immense capacity of the Chinese state, coupled with the insatiable drive among its people for a better life and their innate business acumen, has proved time and again a sufficiently powerful combination to overcome these challenges.

Many worried, however, that the GFC would finally put paid to the Chinese miracle. The country had long lived by the sword of export-led growth, a sword that hung menacingly over its head when world trade plummeted during the crisis. But the history books will say that the GFC was not the death knell of the Chinese economic miracle. In fact, China's ability to ward off the potentially devastating effects of the slump in world trade is one of the more stunning features of a crisis replete with the extraordinary.

As the global economy came under real stress in 2008, Chinese economic growth dropped precipitously from a heady and no doubt unsustainable 13 per cent in early 2007 to reach a low point of just more than 6 per cent in the first quarter of 2009 (Figure 10.7). But only 12 months later, growth was back up to 12 per cent, before dropping back to a more sustainable 10 per cent.

China was not immune to the collapse of global trade, but the effects were muted in China: a drop of 15 per cent from 2008 to 2009 rather than the 30 per cent for the world as a whole (Figure 10.8). At least as impressive, the effect of the global downturn lasted only 12 months, with trade in 2010 returning to the same rapid growth trajectory of earlier in the decade.

Figure 10.7 China GDP growth rates, 2007-2011

Source: Trading Economics

Figure 10.8 China Trade (Billions of \$US), 2001-2010

Source: PRC National Bureau of Statistics

The secret to China’s success in warding off the crisis was the one-two punch of a massive fiscal stimulus coupled with a dramatic increase in bank lending. According to the best estimates of the International Monetary Fund (IMF) for the crisis-fighting year of 2009, China’s discretionary fiscal stimulus made up a bigger portion of GDP than the United States’ stimulus: 5.8 per cent of GDP for China compared with 3.8 per cent for the United States (IMF 2009). Even more improbably, China also injected as much money into the financial

system as did the United States (both 21 per cent of their respective GDPs), even though none of China's banks failed or even threatened to fail. If one sums the two statistics to measure the size of a country's GFC fight (relative to its economic size), China came third among the major Group of Twenty (G20) economies, behind only two countries ravaged by the crisis—Japan and the United Kingdom—and ahead of the United States, its epicentre.

Perhaps not surprisingly, China's principal economic challenge in the wake of the financial crisis has been inflation (Figure 10.9). China's inflation rate rose from zero to 6 per cent from 2002 to 2008, before dropping below zero in 2009 as the full force of the GFC hit. But one negative consequence of all the money injected into the Chinese economy was that inflation turned quickly positive—above 3 per cent in 2010 and projected at 5 per cent for 2011.

Nonetheless, the best Chinese epitaph for the GFC is that the country came through the greatest challenge to its post-1978 economic miracle with flying colours—and it did so largely because of domestic policy responses, not the help of the international community.

Figure 10.9 China Inflation Rate (% growth in CPI), 2000-2011

Source: IMF

As a result, China is continuing its heady climb up the global economic rankings. In 2010, it passed Japan to take second place in total economic size measured in terms of GDP at market exchange rates. The best estimate of Goldman Sachs' BRICS (Brazil, Russia, India, China and South Africa) country team is that China will finally overtake the United States on this measure in the middle of the 2020s. The IMF now predicts China's economy will pass the United States when GDP is measured in purchasing power parity (PPP) terms in 2016 (IMF 2011). Goldman Sachs is unwilling as yet to say when or if the United States will fall into third place; but it will presumably be overtaken by India, though not until well into the second half of this century.

Since the GFC, China and the United States are clearly the world’s two most important powers and the gap between them has narrowed. The global ramifications of Sino–American relations have long been extensive. Today, they are greater than ever before.

Chinese–US economic imbalances

Putting together all we know about the economics of the crisis, the world does appear to be moving towards a *de facto* G2, almost by default. The Chinese–US economic relationship is very big. But it is also very imbalanced.

The headline statistics concerning the two key indicators of Sino–American imbalances pre-GFC are by now well known: the mushrooming of Chinese Government purchases of American Treasury bonds (T-bills) and American consumption of Chinese goods. China increased its holding of T-bills more than fivefold to well more than US\$500 billion from 2000 to 2008. Over the same period, America’s trade deficit with China more than trebled to more than US\$250 billion (Figure 10.10).

Figure 10.10 China-US Trade and Treasuries (\$US billions), 2001-2010

Sources: US Trade Statistics, US Federal Reserve

The co-dependence inherent in these imbalances is equally well understood. China kept its currency from appreciating rapidly against the dollar by buying dollars and dollar-denominated paper, keeping US interest rates low and American debt-financed consumption booming. This kept Chinese goods flying off American shelves and made possible year after year double-digit growth in China.

Economists long decried these imbalances as ‘unsustainable’. But neither China nor the United States wanted to stop the party while the music was still playing—their economies benefited too much from them, in the short term at least. Then the music stopped with the onset of the GFC, and leading commentators such as the *Financial Times*’ Martin Wolf (2008) pointed to Chinese–US imbalances as one of the major causal factors behind the crisis.

There was, however, supposed to be a silver lining to the financial crisis: it would naturally reduce Sino–American imbalances by forcing China to rely more on domestic growth and less on export-led growth and by reining in the voracious appetite of the American consumer. China would become more American in behaviour by consuming more and saving and investing less. The United States would become more Chinese by saving and investing more and consuming less. American imports from China would shrink and American exports to China would grow. China would buy fewer US dollars and Treasury securities. The renminbi (RMB) would appreciate against the dollar. The Chinese–US economic relationship would go from unsustainable co-dependence to more balanced and sustainable interdependence.

The initial evidence gave some reason to think that this rosy scenario might play out. In particular, America’s trade deficit with China dropped for the first time in a decade in 2009, and by more than US\$40 billion. But despite worrying out loud about the long-run viability of the greenback as the global currency, the Chinese Government increased its purchases of T-bills in 2009, overtaking Japan as the largest foreign holder of US Government debt.

Then in 2010, notions of a rapid and substantial unwinding of Chinese–US imbalances came back to reality with a thud. The bilateral trade deficit between the two countries increased by more than US\$50 billion while China’s holdings of T-bills increased by more than US\$100 billion. Today, the Sino–American economic relationship is both bigger and more imbalanced than ever.

One key question concerning these bilateral imbalances is whether their trajectory mirrors or departs from China’s and the United States’ relationships with the rest of the world—that is, is there something different about the China–United States relationship, or is it a bilateral manifestation of the broader trajectories of each economy? If the latter were true, there would be less reason to concentrate on Sino–American imbalances, *per se*, and more reason to focus on each national economy writ large.

While the evidence is somewhat mixed, the data are certainly open to the interpretation that there is something unique about Sino–American economic relations.

The United States’ trade deficit with the rest of the world (that is, excluding China) peaked in 2006 at US\$600 billion—almost three times the United States’ China deficit that year (Figure 10.11). By the depths of the GFC in 2009, the United States’ deficit with the rest of the world had halved, whereas its deficit with China was more or less where it had been in 2006. The result was that in 2009, the United States’ trade deficit with China, at US\$266 billion, was only \$50 billion less than its deficit with the rest of the world combined.

Put differently, in 2009 almost half of the United States' trade deficit with the world was with China. In 2010, the United States' trade deficit grew by more than US\$150 billion as the American economy began to recover. But despite the fact that about two-thirds of this increased deficit was outside the relationship with China, the United States' bilateral deficit with China was still about three-quarters as large as its deficit with the rest of the world.

Figure 10.11 US Trade Deficits (\$US billions), 2000-2010

Source: US Census Bureau – Foreign Trade

The United States stands out even more clearly in the Chinese trade statistics (Figure 10.12). China actually ran trade deficits with the world excluding the United States from 2001 to 2006 and again in 2009 and 2010. China's trade deficit with the rest of the world in 2010 was US\$90 billion—up from US\$61 billion in 2001. Taking the decade as a whole, China's trade stance with the rest of the world has been to run relatively small deficits—far from the common perception of China as a country amassing ever-greater surpluses with the world.

But over the same period, China always ran a trade surplus with the United States—more than trebling from US\$83 billion in 2001 to US\$273 billion in 2010. It is only when the United States is included that the conventional view of China as a big-surplus nation is born out in the statistics.

Figure 10.12 China Trade Surplus (\$US billions), 2001-2010

Source: US-China Business Council

Over the past decade, foreign holdings of US T-bills more than quadrupled to almost US\$4.5 trillion dollars—equivalent to about 30 per cent of US GDP (Figure 10.13). In 2001, Chinese T-bill holdings of US\$78 billion were less than one-tenth the holdings of other countries around the world. By 2007, China's holdings had grown considerably to almost US\$500 billion, then roughly one-quarter as large as the holdings of all other countries.

Figure 10.13 Foreign Holdings of US Treasury Bills (\$US billions, 2001-2010)

Source: US Treasury

Foreign holdings of T-bills skyrocketed as the US Government pumped close to US\$2 trillion dollars into the staggering domestic economy during the financial crisis. Despite near-zero interest rates and a dollar under siege in global markets in the United States, foreign countries were willing to underwrite US public debt to an unprecedented extent.

China's holdings of T-bills more than doubled between 2007 and 2010, reaching US\$1.16 trillion by the end of last year. Over the same three-year period, holdings by all the other countries in the world grew by 75 per cent to almost US\$3.3 trillion. Today, China holds a little more than one-quarter of all the T-bills held outside the United States—a smaller portion than the media hype would suggest, but very large given the enormous gap in development between America and the largest foreign holder of its debt. And China is now by far the foreign country with the largest US T-bill holdings.

Putting together the data in Figures 11–13 suggests three things about the United States and China. First, as everyone knows, the United States runs large trade deficits with and borrows a lot of money from the world. Second, China's overall trade position is more balanced than many people might think.

But third, the imbalances between China and the United States have increased greatly in the past decade, both in absolute terms and compared with each country's relations with the rest of the world. The scale of and imbalance in Sino–American economic relations are something the world has never before seen. As a result, it is important to analyse the Chinese and American economies as such and to then focus on what is unique about their bilateral relationship.

Private domestic demand in the United States has cooled markedly since the onset of the GFC. But this has been offset by the enormous public sector one-two punch of fiscal stimulus and bank bailouts. The fiscal challenges facing the United States are well understood. It remains unclear if the country has the political will to meet these challenges, both because average Americans are clinging desperately to their welfare-state programs in the wake of the crisis and because the partisan divides in Washington have made the political system close to ungovernable. How and whether the United States rises to these challenges will have enormous implications for the United States' global economic position—its trade balances, foreign borrowing and the strength of the dollar.

China has gone to great lengths to focus more of its economic attention on the domestic economy—in particular, with its own enormous fiscal stimulus and bank lending boom to inoculate the country from the GFC. Despite the strength of its own banks during the crisis, the Chinese Government led a lending spree by state-controlled banks, with new loans in the first quarter of 2009 alone in excess of the entire government fiscal stimulus plan for three years and greater than total bank loans for all of 2008, which were already the largest in Chinese history (Leow 2009).

Chinese domestic consumption has been rising rapidly in recent years, but not as quickly as investment, which now sits at 45 per cent of GDP—an extraordinarily high number by global standards. Chinese investment during the GFC was even more concentrated in infrastructure development and state-owned enterprises than ever before.

The Chinese Government continues to say it wants to rebalance the domestic economy away from investment and towards consumption. But as its response to the GFC showed, the Government will always look to investment to keep growth humming and employment full. And the kinds of reforms needed to promote consumption by average Chinese—including a more open and useful retail financial system and a stronger system of welfare-state supports for the sick and the old—seem to remain far off. Whether China can pass the baton on economic growth from exports to domestic demand will have a major impact on its position in the global economy over the next several decades.

Private sector interdependencies

How well China and the United States tackle their own problems will affect their economic relations with the rest of the global economy, not just with each other. But the unique features of Sino–American imbalances are what stand out as much as the overall trajectories of the two national economies. The trade statistics are particularly troublesome. The United States has already been able to reduce its trade deficit with the rest of the world considerably, but not with China. China continues to run a small trade deficit with the rest of the world, but the growth in its large surplus with the United States seems to have no upper bound.

Why is the China–United States relationship so different? The conventional view is to blame China—and in particular its management of the RMB exchange rate against the dollar—for unfair competition with the United States, and therefore for taking jobs away from Americans. This view was already common in Middle America before the GFC and has become even more pronounced since as the unemployment rate has stayed stubbornly close to double digits.

The United States shed about four million manufacturing jobs over the past decade—the same decade in which the US trade deficit with China mushroomed and vaulted into the news headlines. The temptation to draw a causal connection is clear. Here is how US Senator Sherrod Brown painted the picture for his part of Middle America in March 2009:

The Ohio manufacturer has a minimum wage to pay his workers. He has clean air and workplace and product safety standards by which to abide, helping to keep his workers healthy and productive and his customers safe. The Chinese manufacturer has no minimum wage to maintain and is allowed to pollute the local water sources and let workers use dangerous and faulty machinery. The Ohio manufacturer pays taxes, health benefits, and social security. He typically allows family leave and gives WARN notices when there is a plant closing. The Chinese manufacturer often allows child labor. The Ohio manufacturer receives no government subsidies, and the Chinese manufacturer often receives subsidies for the development of new technologies, or for export assistance. The Chinese manufacturer benefits from China's manipulation of its currency, which gives up to a 40 per cent cost advantage. (<http://brown.senate.gov/newsroom/press_releases/release/?id=83a8362f-5b7f-4901-9659-37957ac77798>)

There is more than an element of truth to the ‘unfair competition’ critique of China, certainly with respect to Chinese restrictions on foreign access to its domestic market and to Chinese infringement on American intellectual property rights. But the notion of a fixed and undervalued Chinese exchange rate cannot be the whole story behind Sino–American imbalances.

Since 2005, the RMB has appreciated more than 25 per cent in nominal terms, and about 50 per cent in real terms, according to *The Economist* (‘Nominally cheap or really dear?’, *The Economist*, 4 November 2010), due to higher inflation in tradables in China than in the United States (Figure 10.14). In response to the growing imbalances between the two countries in the first half of the 2000s, Chinese authorities allowed the RMB to appreciate steadily against the dollar from the middle of 2005 until mid-2008. Amid the chaos and pervasive uncertainty of the crisis, China then decided to re-peg the RMB to the dollar. But when the Government was confident the worst of the crisis was over, it again started a gradual appreciation against the dollar that has added another 5 per cent to the value of the Chinese currency.

Figure 10.14 Chinese–US exchange rates, 2005–10

The fact that the US–Chinese trade imbalance has continued to grow despite the strong appreciation of the RMB says that exchange rate manipulation is not the whole story, and may not even be much of the story, in Chinese–US trade. So what is behind the gaping trade imbalance? One answer that not only many in China but also many American businesspeople believe, but rarely say in public, is that the headline trade statistics are grossly misleading and undervalue how the United States benefits—for two reasons.

First, the bulk of Chinese exports involve multinational firms operating in China. According to a recent systematic study based on 2005 data, foreign affiliates of multinationals send half of the exports out of China, with joint ventures between multinational corporations

(MNCs) and Chinese companies accounting for another 25 per cent of all Chinese exports (Manova 2011). Put differently, only one-quarter of what are booked as exports from China are wholly ‘Chinese’.

Second, most of the MNCs operating in China are engaged in global supply chains in which parts made in other countries, particularly throughout Asia, are assembled into final products in China. In 2010, for example, China ran trade deficits of well more than US\$50 billion with both Japan and South Korea, and even more with Taiwan—all producers of high value-added goods that are then assembled into finished products in China for export to the rest of the world (US–China Business Council 2011).

This notion that goods are ‘assembled in China’ for foreign firms rather than ‘made in China’ by China is nowhere clearer than in the iconic Apple iPhone. In 2009, the official trade statistics show that more than 11 million iPhones were shipped from China to the United States at a total value of just more than US\$2 billion. There were only about US\$100 million in American parts in these iPhones. So iPhones added about US\$1.9 billion to the official US trade deficit with China.

But a new study by researchers from the Asian Development Bank uncovers the economic reality written on the back of every iPhone: ‘Designed in California, assembled in China’ from parts made elsewhere, and with all the profits going back to Apple headquarters and Silicon Valley and its mostly American shareholders (Xing and Detert 2010). According to this study, components from Germany, Japan and Korea made up about two-thirds of the US\$200 wholesale price of an iPhone. Chinese assembly of them—by a Taiwanese firm, Foxconn, operating on the mainland—was worth about only US\$6 per iPhone, which was less than half the cost of the American parts shipped to China to make the phone (Figure 10.15).

As a result, iPhones were actually a net export of about US\$50 million from the United States to China, not the US\$2 billion deficit in the trade statistics. Germany, Japan and Korea were net exporters to China. And none of this takes into account the massive 50 per cent or so profit Apple made on all its iPhone retail sales, driving its spectacular performance on the Nasdaq.

Americans should be celebrating the iPhone not only because of the value they get from it personally but also because of the value they generate for the US economy through the Apple powerhouse. If Americans want to complain about the evils of iPhone globalisation, they should be worrying more about why the disk drives, memory and screens come from Germany, Japan and Korea rather than the United States. In the most important economic sense, the fact that iPhones are assembled in China is only a small part of the story—even though it is the only thing the US–Chinese trade statistics pick up.

Figure 10.15 The iPhone supply and distribution chain

The first two responses to the normal critique of Chinese–US trade imbalances are thus that the Chinese currency has appreciated significantly against the US dollar in recent years and that multinational firms such as Apple are the principle beneficiaries of China as an assembly platform. The final rejoinder to the conventional imbalances critique is American multinational firms are benefiting enormously from China’s rise not only by using China as an export platform, but also by making products in China to sell directly into the Chinese market.

Here the General Motors (GM) story is exemplary. Venerable GM—the icon of American manufacturing in the twentieth century—was bailed out by the Obama administration in the dark days of the financial crisis. Now it has returned to profitability and repaid the Government for its bailout. But the backslapping between Detroit and Washington does not tell the real story behind GM’s recovery: its joint venture with SAIC to build and sell cars and trucks in China.

When the GM–SAIC plant started producing its first cars in Pudong in 2003, its initial sales in China were about 200 000 units. In the same year, GM’s sales in the United States were almost 5 million units (Figure 10.16). Over the next seven years, GM’s American sales plummeted while its Chinese sales skyrocketed. In 2010, GM sold more cars and trucks—2.5 million—in China than it did in the United States. And, according to most estimates, the profit margin on GM’s Chinese operations was much higher than that in the United States given the much lower labour costs and much newer production facilities and an upper middle-class market big enough to support global automobile prices.

There are, of course, limits to what GM can do in China. It cannot have a majority stake in its Chinese operations. It knows that by building cars in China it is affording indigenous Chinese firms the chance to learn from its technology and know-how. It also knows that the

Chinese Government is looking to create its own global champion auto-maker. But the size and likely growth of the Chinese market are nonetheless irresistible to GM and will remain that way unless and until home-grown Chinese companies push it out of the way.

Figure 10.16 General Motors sales, 2003-2010

Source: General Motors

Apple and GM arguably are closer to the reality of Chinese–US economic relations than the official trade statistics. But neither firm nor the US Government has much incentive to tell their story—because it would only lead to a loud ‘where are the jobs?’ critique from inside America. The Chinese Government has more incentive to tell Americans of the new realities of the global economy. But publicising the successes of American firms on Chinese soil is unlikely to persuade Chinese citizens that the Government is pursuing a development strategy that is in their interests—in contrast with the Government’s indigenous innovation push.

To be sure, there are real problems for American firms trying to do business in China—most importantly, concerning limited market access and weak enforcement of intellectual property rights. The Chinese Government’s desire to create literally hundreds of world-beating firms has led to an emerging pattern of industrial policies that favours domestic companies at the expense of their foreign counterparts. Foreign companies remain partly or completely barred from participating in major industries such as banking, securities, telecommunications, legal services, and insurance (Ahrens 2010).

But American multinationals know they cannot stay out of China, with its rapidly growing consuming middle class as well as its highly cost-competitive production processes. They are trying to make it easier for themselves to do business in China, but not in ways that push their hosts too hard (American Chamber of Commerce in China 2011).

The US Government is listening, and its high-level economic diplomacy with China is today focused at least as much on increasing market access for American MNCs as it is on prosecuting the case for Americans at home adversely affected by Sino–American economic imbalances.

Managing Sino–American relations

The biggest challenges facing the American and Chinese economies are more domestic than they are concerned with relations between the two. Hillary Clinton and Tim Geithner made this clear on the eve of the first Strategic and Economic Dialogue meeting with their Chinese counterparts in July 2009 as both countries turned from crisis management to recovery:

As we move toward recovery, we must take additional steps to lay the foundation for balanced and sustainable growth in the years to come. That will involve Americans rebuilding our savings, strengthening our financial system and investing in energy, education and health care to make our nation more productive and prosperous. For China it involves continuing financial sector reform and development. It also involves spurring domestic demand growth and making the Chinese economy less reliant on exports. Raising personal incomes and strengthening the social safety net to address the reasons why Chinese feel compelled to save so much would provide a powerful boost to Chinese domestic demand and global growth. (Clinton and Geithner 2009)

But the challenges laid out by Clinton and Geithner amount to nothing less than changing the economic DNA of both countries. For the foreseeable future, the biggest domestic economic problem facing the United States will be what President Obama calls ‘fiscal sustainability’. But just stabilising US public debt after the full effects of the Obama administration’s crisis-fighting measures are felt will require tax cuts or spending increases of nearly one-third of central government spending, or 7–9 per cent of US GDP (Auerbach and Gale 2009).

President Obama’s 2011 budget projects deficits of roughly 5 per cent of GDP until 2020—increasing public debt from about 50 per cent to 90 per cent of GDP by the end of the decade. The most important fiscal reform he has proposed is ending the Bush tax cuts for the wealthiest Americans—not enough substantially to bend the curve on fiscal unsustainability. The newly empowered Republicans in Congress have come up with a plan that would come closer to balancing the budget without ending the tax cuts based on massive spending cuts. But they found out that mainstream America is in no mood for the kind of radical surgery that would be required to balance the budget the Republican way—most notably, the *de facto* privatisation of the Medicare program of health care for the aged. The path of least resistance in the United States—perhaps best reflected in the dollar’s slide—is on more red-ink bleeding from the American budget into the foreseeable future.

China’s challenge is the mirror image of that facing the United States. Unlike spendthrift Americans, Chinese citizens save for a rainy day. Members of close-knit extended families save because family rather than the state will look after them when they get sick, old or lose their jobs. Even if Chinese citizens wanted to spend and borrow more, the retail financial sector needed to service a consumer society is at best rudimentary in China.

The Chinese Government has the capacity to build an effective social safety net and to change the regulatory environment to favour the growth of retail banks, credit cards and insurance targeted at consumers. But the Government has preferred to invest in infrastructure, state-owned enterprises (SOEs) and state-controlled companies, with state-owned banks a preferred intermediary.

This strategy makes political as well as economic sense for the Chinese Government. Focusing on driving productive capacity ever higher allows the Chinese Government to deliver on its implicit guarantees of full employment and higher living standards for all its citizens. The Government also knows that the history of democracy runs through the development of a large consumerist middle class. Chinese leaders learned well the lessons of Mikhail Gorbachev's *glasnost* and *perestroika*, and they will not lightly walk down what might be considered the former Soviet Union's naive path to openness.

Given these difficulties in fundamentally restructuring the Chinese and American economies, the temptations are great for each side to blame its imbalances with the other as the cause of its economic challenges. This certainly seemed to be the case in the immediate aftermath of the GFC once the initial panic of the post-Lehman collapse somewhat abated.

It is not surprising that after the first half of 2009 witnessed a rising tide of public mud-slinging between China and the United States, America took the lead, but China was quick to follow.

On the US side, Geithner let slip in his confirmation hearings in early 2009 that China indeed 'manipulates' its currency. Understanding that this could trigger a legislative process requiring US retaliation against China, President Obama quickly sought to recover the situation by saying his Treasury Secretary had misspoken.

Chinese reaction to Geithner's diplomatic *faux pas* was sharp and swift. Premier, Wen Jiabao, worried out loud about China's dollar-based holdings, saying that in light of the GFC 'of course we are concerned about the safety of our assets'. A week later, the Governor of the Bank of China, Zhou Xiaochuan, proposed a new global reserve currency 'that is disconnected from individual nations and is able to remain stable in the long run, thus removing the inherent deficiencies caused by using credit-based national currencies' (Anderlini 2009). He did not mention the US dollar by name, but the focus of his worries was clear to all.

The public duelling over the dollar's weakness and control of the RMB soon died down because both sides knew they were playing with fire. But sniping over protectionism soon replaced jibes over currencies.

The United States fired the first shot when Obama chose to do what George W. Bush had been unwilling to do—use Section 421 of US trade law and an obscure element of China's World Trade Organisation (WTO) accession agreement to impose heavy tariffs on Chinese imports into the United States for the mere reason that they were adversely affecting American production and American jobs. In this case, the product was tyres, the tariffs were up to 35 per cent, and the lobby pushing the action was the United Auto Workers' union.

But more important was the precedent the action set. China and the world had been anxiously waiting to see if Obama in office would resist the protectionist temptations and back down from his sometimes quite protectionist rhetoric on the campaign trail. In the tyres case, Obama blinked. This apparently has emboldened American textile and steel producers and workers to consider similar appeals to Obama.

China's retaliation was again swift. The Chinese Government took the United States to the WTO, claiming that it was dumping chicken and auto parts on the Chinese market—taking aim at two sectors of the American economy benefiting from US Government subsidies in the wake of the financial crisis. A month later, they added nylon to American products potentially dumped on the Chinese market.

But what is most interesting about these 2009 skirmishes over currencies and protectionism is that they did not flare out of control into the trade and currency wars many expected. Instead, cooler heads prevailed in both China and the United States, returning to the behind-closed-doors, softly-softly economic diplomacy that characterised most of the decade before the GFC.

In 2010, the arena for Sino–American tensions in fact moved from economics to geopolitics as China—emboldened by its remarkable escape from the GFC compared with the United States' navel-gazing swoon—became much more confident about asserting its interests in East Asia, engaging partly in head-bumping and partly in chest-thumping in its relations with Japan, Korea and Taiwan. The United States responded with more military exercises in the Western Pacific and by emphasising the values and interests it shares with a wide range of market-oriented democracies in the region—not only Australia, Japan and Korea, but also India and Indonesia—but pointedly not China.

But again predictions that geopolitical tensions between China and the United States would boil over proved unfounded—just as they have in the past.

Looking into the future, it would seem reasonable to expect that Sino–American economic frictions over time will move away from trade and towards investment issues between the two countries.

China's sovereign wealth funds and its large para-statal companies wanted to buy American firms before the crisis. But the backlash in America was intense—most vividly in the congressional firestorm in the summer of 2005 that led CNOOC to withdraw its bid for the small American oil and gas company Unocal. Since then, China has kept a low profile in the market for corporate control in the United States, opting for minority stakes in shadow banks such as the private equity firm Blackstone over more visible acquisitions of manufacturing firms and their quintessentially American middle-class jobs.

With American asset prices battered by the GFC, China worried about the security of its T-bill holdings because of American public debt, and, with the Chinese currency likely to continue appreciating against the dollar, the economic incentives are high for China to go on a foreign direct investment buying spree in the United States. But it is hard to imagine that the reception in the United States would be favourable.

In China, tight governmental control of its domestic market has always created high hurdles for American firms wanting to establish footholds in China—with the ability to void potential foreign investments if they threaten what the Chinese Government calls ‘national economic security’. American firms salivate at the prospect of satisfying the needs of China’s growing middle class, and they have been willing to go to great lengths to get inside the Chinese market. Wal-Mart is now China’s biggest retailer, but the infamously anti-organised-labour firm was willing not only to let its Chinese workers unionise but also to hold meetings of the Chinese Communist Party on Wal-Mart premises. GM is China’s biggest car maker, but its joint venture is still controlled by its Chinese partner, SAIC. American banks continue to expend immense effort trying to open branches in China, but getting anything more than a small minority stake has proved impossible.

The geopolitical rivalry between China and the United States is also bound to intensify in the future. The good news, however, is that potential flash points that could trigger military confrontation between the United States and China are apparently receding. Taiwan’s economic integration with China continues to build stronger linkages between the island and the mainland. Japan and China might lock horns on disputed islands, but everyone knows how tightly Japan’s economic future is tied to China. The United States and China have cooperated more closely over curtailing North Korea’s nuclear ambitions in recent years than many predicted. Tibet seems unlikely to assume the significance of Taiwan. China might not always cooperate with the United States in the struggle against Islamic extremism, including the vexed issue of sanctioning Iran, but this is about diplomatic cooperation rather than a head-to-head security struggle.

Conclusion

There seem to be two bottom lines in relations between China and the United States. On the one hand, frictions are inevitable between the two countries. China is a rapidly rising power; the United States is a waning one, even if much more slowly than is often suggested. The differences in values and interests between the two countries are deep and enduring. The economic imbalances between them are enormous and likely long lasting. The fact that Chinese defence spending is growing even more rapidly than its world-beating economy will always leave American hawks unwilling to trust Chinese protestations that their military intentions are solely defensive.

On the other hand, time and again, both countries have managed tensions in their relationship that threatened to spiral out of control—and this has been at no time more the case than following the GFC. There seems to be a shared understanding on both sides that signalling their real differences in values and interests—often with an eye to domestic audiences—is to be tolerated as a necessary cost of doing business with each other. As a result, it seems reasonable to interpret the inevitable and frequent spats between the two countries more as pressure-release valves than as brushfires that could ignite into a bushfire.

Both sides understand that the benefits from their economic relationship are immense. For the United States, China is not only a cheap assembler of American innovations. It is also the world’s fastest-growing middle-class consumer market. For China, the United States

is not only its consumer of last resort but also the repository of technology and know-how that can help China's economy remain productive and efficient even as its labour-cost advantages are eroded by its prosperity. Both sides also know that the costs of real conflict and ultimately war between them would be catastrophic.

This highly pragmatic approach to Sino–American relations requires real leadership on both sides. Both sides—under a variety of leaders over recent decades—have been up to the challenge. The GFC raised the stakes higher than ever before and increased the points of potential friction between China and the United States. But cool heads in both countries have been able to keep their eyes firmly on the bigger prize of the benefits of economic integration and on avoiding the cataclysmic costs of military conflict.

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