

## **CHINA Town Hall: Local Connections, National Reflections**

NYU, Silver/Main Classroom Building, Room

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PROFESSOR BARRY NAUGHTON: I guess what I'd like to do is just start by responding a little bit to what Norm Ornstein was talking about. If we start by accepting very much something that he said, which is that the role that China plays in the American political campaign is as an emblem of the anxiety the United States feels about its own future and specifically about its own economic future. And of course that's always been true, but what's especially peculiar about the present is that the United States right now is in this very complex financial economic crisis. And this crisis is unusual because nobody saw it coming in exactly the form that it did, it involves an enormous amount of miscalculation on the part of many different actors, but if there's one thing that's absolutely unambiguous it's that the crisis is domestically generated within the United States' financial institutions and financial processes, and that that's what's gone wrong. It is called the sub-prime mortgage crisis for a clear reason, which is this is where a whole series of problems that initiated within the U.S. financial system first emerged and first exploded. So there's something very peculiar going on right now, which is that China is an emblem for our economic anxieties even though we know very clearly that China's not responsible for any of our economic problems.

Another part of this is peculiar. So 8 percent of the people feel that the U.S. is on the wrong track and we have a lot of economic problems. This is true. And if we look back at the world economy over the last five years, what's your impression about how the world economy has done in the last five years? It's been the best period of growth since the 1960's. Right? The world economy has grown at about 5 percent per year for the last five years. The U.S. economy has done well, the world economy has done well. Every region of the world has experienced positive economic growth that's above trend over the last five years, including Africa. Okay? So there's a very peculiar interaction going on here, where American anxiety is interacting with a view of the world that's not quite on track. The simple reality of the world economy is that the world economy has done better in the last five years than it has for the last 2-1/2 decades, and that the causal factors for that involve both dramatically robust American demand that was perhaps somewhat unsustainable and also dramatic growth and productivity improvement on the part of many emerging countries, but of course more than anything else, China.

So when we look at the impact of China, of course it makes sense to feel some anxiety because China is not Japan in the 80's, it's not going to slow down its growth rate. In the very long term--we'll talk about that—obviously it will slow down somewhat, but over the next decade or two China's going to continue to grow rapidly. So it is going to be big, it is going to be a challenge for the United States, it is an authoritarian regime, and it is an independently growing military power. So it certainly makes sense that the U.S. should feel some anxiety about the role of China, and in many respects we have to work out the multi-stranded relationship between China and the United States, and it's something that's going to challenge our policymakers, to be sure. But at the beginning of this process we certainly should keep in mind the fact that China's economic role has been at least as positive to the United States as it has been negative. In other

words there are as many up sides to U.S. increasing integration with China as there are down sides. There are up sides through cheaper consumption goods and there are up sides to a process of integration and stabilization in the world economy is going to benefit all of us.

Now if we look at the economic relationship between China and the United States something very peculiar has happened. David kind of mentioned this piece that I wrote about China / U.S. trade for Great Decisions. A remarkable thing has happened, namely that when I wrote that piece, which is only six to nine months ago, it was reasonable to think of China / U.S. trade as a relatively contentious part of a more stable world economic environment. What's happened since then is that the U.S. economy has become clearly the most unstable part of the world economic environment, while the U.S. / China relationship has remained remarkably stable. And this reversal of roles has some very peculiar ironies. When the United States first began to talk about Chinese currency manipulation the key demand that was made in the U.S. Congress at that time was that the Chinese currency, the - - should appreciate, vis-à-vis the dollar by about 15 percent, as a beginning. Okay? Now the strange thing that's happened in the last two years is that the Chinese have indeed allowed their currency to appreciate and the total appreciation as of the last month was about 15 percent. And in fact, what we have seen is that since November, the time when the Chinese began to be concerned about inflation within China, the Chinese allowed the pace of appreciation to accelerate substantially. So in other words, oddly enough, this initial demand that China cease pegging its currency at this low level and allow it to appreciate has been at least, in a traditional sense, met by China, in the sense that the currency has in fact risen by that amount. Of course the peculiar thing is in the meantime the dollar overall, against all of its trading partners, the dollar has declined by about 25 percent. So the overall decline of the dollar has been greater than the relative increase of the Chinese currency. So Chinese currency has appreciated against the dollar but actually still depreciated slightly against the Euro and a number of other key currencies. But the key point here is, at least from the U.S.'s standpoint, China has begun to move in a direction that fits with the initial demands of the United States, first territories, a couple years ago.

Now, we would need to ask does that mean that Chinese trade relationships have also begun to change? And again the answer is yes. In the first quarter of 2008 Chinese exports continued to grow robustly, they grew at 21 percent compared to a year previously. But now Chinese imports are growing more rapidly than Chinese exports, so Chinese imports grew at 29 percent in the first quarter of 2008. Now that means that eventually the Chinese surplus will start to diminish but more important, what it means is that at this stage, where the U.S. economy is wobbling, that the Chinese economy is contributing some stability and some growth impetus to the world economy—just what we need, just what we want. The surprising thing really has been that even though projections for U.S. demand have fallen off that the Chinese economy has continued to grow quite robustly and in fact the most recent report was that the Chinese economy grew still over 10 percent in the first quarter of 2008. So the strange thing here is that really the Chinese economy is doing right now exactly what we want it to do, which is provide an autonomous source of growth and stability in the world economy during this period where the U.S. is shaky.

What else does the U.S. need predominantly? We need an inflow of investment because we need to re-capitalize some of our financial institutions. Now ironically, because of the political friction between the U.S. and China, the Chinese feel mmm, investment from China in sensitive sectors

is not welcomed and so far the Chinese have been quite cautious about using their foreign exchange reserves to buy into American financial institutions. So instead we're welcoming investment from sovereign wealth funds from Dubai, the Emirates, and Kuwait, as part of the process of re-capitalizing our financial institutions. But the point is here that the fundamental underlying economic interests of the United States are currently in line with what China is providing and not in conflict with them. That's not to say that there are not occasional areas of conflict, there certainly are. There are many areas that given the nature, the depth, and the breadth of the U.S. / China economic relationship, but still the fundamental simple relationship is one where economic complementarities are at least as important, indeed I would argue much more important than the areas of economic conflict.

Now what's going to happen as we look ahead? I suggest there is two areas where we need to briefly look at the long term economic trajectory of China. The first is what's going to happen with economic growth as we go forward? Is China going to be another Japan—an economy that causes anxiety only to then stall out and become much less important economically? And then the second question is what's the trajectory that we see for China right now in terms of economic policy, social policy, the things that we are concerned about? Perhaps we're not concerned about them as much as we're concerned about political freedom and democracy but they are also very important, just a half a notch down.

China over the long term—growth. I know the people in this room are very knowledgeable about China. I don't need to teach the basics in any sense. But let me just make one simple observation that we sometimes forget and that is China's growth up through the present has already been completely unprecedented. Not unprecedented in the sense that it hasn't happened before. Of course this kind of growth happened before. Japan grew like this in the 50's and 60's. Taiwan and Korea grew like this in the 60's, 70's, and 80's. But China today has grown faster, longer, than any other economy we've ever observed in the history of the world. Period. And that's before we account for the fact that there's more people in China than in any other country. So when we say look, the U.S. experiencing some anxiety in coping with the magnitude of this phenomenon, you know, part of our response should be of course they are. We all are. It's never happened before. It's bigger than has ever happened before.

When we see this kind of super growth process in other economies what we also see is that it's very strongly associated with the multi-decade process where a country shifts from being a primarily rural economy to a primarily urban economy. That as long as that process is going on super high growth rates can continue because what you're doing is you're moving people out of low productivity agriculture, you're putting them in a factory in another relatively low paying—factory workers are a lot more productive there than they were in the countryside. So China today, how does it stand in this process? And the answer is it's almost exactly halfway through. 50 percent of China's population lives in cities now. We've had this super growth for two decades. We're going to get it for about another 15 more years. And then, and only then, China's going to start to slow down. It's going to slow down because urbanization will be basically complete. But it's going to slow down for another reason and that is China is going to age much more quickly, and much more dramatically, and at a lower level of per capita income than any other country because of those strict birth control policies beginning 20, 30 years ago. They're going to lead to dramatic population aging, starting in about 2025, 2030. So we have some idea

of what China's going to be. It's going to be a lot bigger. GDP right now 3.5 trillion, so it's kind of tied with Germany. The U.S. is about 13, 14 trillion. But China's going to come up very rapidly over the next 20 years and then the pace at which it closes the gap is going to slow. So we can adapt to that, but it's still going to be a huge, huge challenge. It's not going to be like Japan, stalling out just at the moment where it seemed to be creating the most anxiety.

So how will China change? We don't know how it's going to change politically but we do have an inkling of how it's changing economically. In the last five years Chinese economic policy has made a very dramatic shift away from a kind of growth at all costs policy and towards something that looks a little bit gentler, a little bit more in favor of regulation, including health and safety regulation, a little bit more in favor of welfare, a little bit more in favor of social security. Those changes are very preliminary. They're not fully successful yet. But the focus of policy in China has changed and it's changed in a way that in the long run might bring some of the improvements that Norm Ornstein was talking about as necessary for a more positive image of China in the United States. Politically, changes aren't coming fast enough but in terms of economic and social policies a lot has happened. Chinese society is not just more diverse, it's also a society that is being governed by a government that for its own reasons is seeking to provide a softer gentler face of growth and improve the way that the government acts on and regulates the economy.

Today—this will just be the last point, then we'll throw it all into questions—today, as was touched on in that webcast, there's so many different things happening in Chinese society and in the relationship between China and its neighbors. It's important, and interesting, and perhaps even ultimately useful that these dramatic demonstrations took place in the context of the Olympic torch. Maybe we'll look forward and we'll see a successful Olympics that will be a great counterweight to the raising of important issues and the controversy that's occurring right now. I wouldn't be nearly as pessimistic as Norm Ornstein is about how the Olympics will interact with the vision of China. I think probably the Olympics will be quite successful and people will come away with another dimension to the multi-dimensional way that they look at China. But even without that we should just signal, and then I'll stop talking and throw it open, but we should just signal how many different things are going on right now, and just let me stress the fact of the change of government in Taiwan, the fact that the vice-president elect of Taiwan just went to Chinese soil and met with Hu Jintao, the Chinese president. This is unprecedented, tremendously important, in general tremendously positive, but also creates a new set of challenges for the United State because of rapprochement between China and Taiwan, if it occurs, will tend to create an entity with even more economic clout, even stronger technological capabilities than we've ever seen.

In the meantime there are changes going on in North Korea, in Nepal, all over the world, so this tremendous complexity I think should lead us to say yes, China is a symbol of our anxieties but it's a lot more, and in that lot more there are many, many positive processes that are going to bring benefits not just to the Chinese people but also to the American people. So I'll stop there.