Working Paper
Research Unit The Americas
Stiftung Wissenschaft und Politik
German Institute for
International and Security Affairs

Jens van Scherpenberg

Coping with China as an Economic Power

European versus American Approaches*

Ludwigkirchplatz 3–4
10719 Berlin
Telefon +49 30 880 07-0
Fax +49 30 880 07-100
www.swp-berlin.org

* published in: Bates Gill / Gudrun Wacker (eds.), Diverging U.S. – EU Perceptions and Approaches, TFPD project paper, 2005.

Working paper FG 4, 2005/ 04, September 2005
SWP Berlin

Content

Introduction

If differing European and American approaches towards China's rise as a political as well as an economic power can be summarized, the prevailing attitude among Americans would have to be characterized as one of concern—be it with regard to China's might or with regard to more mundane issues such as job losses—whereas among Europeans the dominant perception is one of amazement and opportunity.

Clearly the reason for such diverging views lies in the relative position of the viewer. The U.S. view is that of the incumbent dominant power that keeps a suspicious eye on an emerging potential competitor. From the perspective of many major EU member states, China may by now already have become a peer to the EU in many if not all regards. This, however, is not seen as a threat to the EU's own international power position.

Economic history tells us of quite a few new economic powers rising—and reshuffling the international division of labor. In an open world economy—such as the one prior to World War I and after World War II—newly-rising economic powers have been relentless agents of structural change. As they moved into manufacturing they quickly took over low-tech, labor intensive manufacturing, climbing the technology ladder more or less quickly. Among the current major economic powers, Germany was an early example, and Japan the most recent one before China.

There is a good chance that the global economic regime put in place by the U.S., as the benevolent hegemon, and since then co-supported by the European Union member states could well accommodate yet another big newcomer. The more so since China has been undergoing a substantial transformation into a responsible player within the international system of economic and political multilateral institutions. This at least is—in a nutshell—the predominant European view towards China's rise.

American foreign economic policy towards China has continued to vacillate between, on the one hand, containing a strategic rival and preventing it from acquiring the technological wherewithal to challenge the incumbent by a variety of direct and indirect sanctions and political trade impediments, and on the other hand, co-opting an emerging power into America's international system and thus integrating a promising new sphere of trade and investment into the global economy.

The divergent approaches of the EU and the U.S. are reflected in the comparative pattern of American vs. European trade and investment relations with China. I will provide some empirical evidence to underline this diverging trade pattern. Subsequently, I will address the issue of macroeconomic imbalances, closing with some remarks on political conclusions to draw from trade patterns as well as from imbalances.

Patterns of Trade

For economists, China's rise in the world economy has become a textbook paradigm for globalization at work. Therefore, I will briefly phrase what is happening in a textbook manner, too.

Imagine an emerging economy with abundant cheap labor, a fairly decent provision of public goods such as education, transport and communications infrastructure etc. and a rather favorable business environment. With open international markets, such an economy would naturally evolve into a prime location for labor-intensive production of any kind. It would attract foreign direct investment, and would be a major importer of machinery and equipment and of other high technology goods while exporting predominantly products with lower technology content. Its exports would gradually displace higher cost production in developed economies while the latter move upscale to more knowledge-intensive high technology products in the composition of their exports.

This is roughly what happens with trade between China and the EU.

In a rather simplistic manner, based solely on one-digit trade classification, Graph 1 (p. 4) shows the share of exports in class 7 of the Standard International Trade Classification (SITC) system, which

comprises “machinery and transport equipment,” thus most products with higher technology content, as a percentage share of total exports to China, for the EU-15 countries and for the United States.

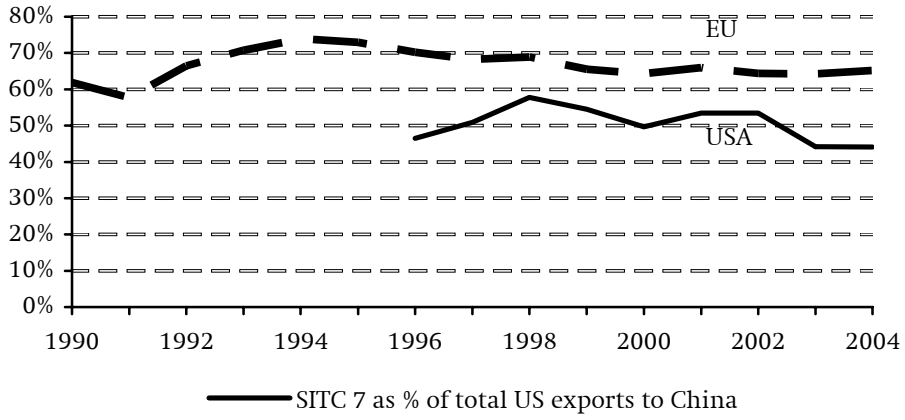
EU-15 SITC 7 exports to China throughout the last ten years have been in the range of 65–70 percent of overall exports to China. Civil aircraft, one of the most important single items among SITC 7 goods, account for some 7 to 8 percent of European SITC 7 exports to China—an indicator of the diversified nature of these exports.

The U.S. trade pattern looks quite different. The SITC 7 share of American exports to China since 1996 has on average been more than 15 percentage points lower than the respective EU figure; in recent years, the differential has even reached 20 percentage points. And civil aircraft exports account for a quarter to a third of total American SITC 7 exports to China, three to four times the respective EU share.[1]

There are several possible explanations for this rather stark divergence, such as the following:

- The US dollar might be too expensive vis-à-vis the Renminbi compared to the Euro. But actually it has been the Euro which has appreciated

Graph 1
U.S. and EU exports of SITC 7 goods to China



Sources: Eurostat and U.S. Census Bureau, International Trade Statistics.

against the Renminbi, thus European exports to China should be at an exchange rate disadvantage versus American exports.

- The U.S. may have been losing market share in SITC 7 goods—machinery and transport equipment—to Japan and Europe, and increasingly also to other emerging economies for quite a while. But that would not account for shifts in the composition of U.S. exports to China.
- The U.S. may be particularly competitive in primary products, such as agricultural products, food and beverages, crude materials (SITC 2) or chemicals (SITC 5). But the U.S. figures—for SITC 7 exports as for total exports—are substantially lower than the European figures even on an absolute value basis.

Therefore, the most likely explanation—and indeed the one which best accounts for the drop in U.S. SITC 7 exports to China since 2000—seems to be the explicit and implicit U.S. bias against technology

[1] An especially high volume of aircraft sales to China registered in the trade balance of that year, does indeed almost fully account for the peak in the U.S. SITC 7 share of exports to China for the year 1998.

exports to China, as an expression of its policy of constraining the potential peer competitor.[2] This policy framework would have a restrictive effect even on U.S. technology exports to China that are not controlled or for which approval is usually granted, as well as on Chinese purchases of such products, because from the buyer's perspective it introduces an element of unreliability and risk that creates a disincentive with regard to high technology imports from the U.S.

A recent study by a research team from George Washington University has been looking into the enduring if difficult to measure negative effects on American exports of U.S. sanctions and export controls against China.[3]

Adam Segal from the Council on Foreign Relations has recently raised similar arguments in a Washington Quarterly article.[4] He pleads for a strategy of commercial engagement with China while keeping in place narrowly defined export controls on a few sensitive military technologies. That would amount to a sound and restrictive redefinition of the ominous "Critical technologies" list of the 70s and 80s. From an economist's point of view, Segal is correct in arguing that the way for the U.S. to maintain its technological and hence military superiority today is through competition and innovation in mutually open markets, not through strict export controls of high tech products. The latter would only create additional incentives for China to catch up as quickly as possible in technological development through technology imports from other countries while stifling the pressure for innovation. In the U.S. Segal's views are mostly shared, in a wider perspective, by a recent CSIS study on Globalization and Security.[5]

To some extent, the current U.S.–EU debate about high-tech (and dual-use) exports to China calls to mind the trans-Atlantic disputes about trade relations with the Soviet Union and Eastern Bloc countries, not least the notorious U.S.–German conflict about high-performance natural gas pipes and pipeline technology to be delivered to the Soviet Union in exchange for long-term contracts for natural gas shipments to Germany. From the U.S. perspective, Germany was seen as not paying appropriate respect to the American policy of restricting its strategic rival's access to technological and financial resources. At the time West-East technology transfer may to some extent have been slowed down by strict export control policies contributing to the lagging technological development of Eastern Bloc countries. In today's globally integrated economy, however, technology diffusion processes are much less controllable and the technology sources much more diverse than in the 1960s. It is highly likely, therefore, that any widespread restrictions on high tech exports to China by the U.S. will not have the desired effects, but on the contrary, substantial undesired ones, creating strong additional incentives for China to devote ever more resources to research and development as well as reducing its stake in the US-sponsored international order.

(Im-)balances

As can be concluded from the last section, with a view to trade patterns, it is no wonder the U.S. trade balance with China runs a steep deficit. But of course there are other reasons for that deficit. The textbook case for a major emerging economy like China in an open international economic environment would be to run a current account in balance or slightly in deficit, reflecting the country's need to import large amounts of capital goods as well as raw materials and energy. Such a deficit would be financed by substantial inflows of foreign direct investment, intent to capitalize on the superior returns of a high-growth emerging economy. And except for its bilateral balance with the U.S. China's

---

[2] For the concept of hegemon—potential peer competitor relationship and the policy instruments available in that relationship cf. Thomas S. Szayna et al., *The Emergence of Peer Competitors. A Framework for Analysis*, Santa Monica, CA (RAND), 2001.

[3] Jiawen Yang, Hossein Askari, John Forrer, Hildy Teegen, "US Economic Sanctions Against China: Who Gets Hurt?," *The World Economy* 27:7 (July 2004), pp. 1047–1081.

[4] Adam Segal, "Practical Engagement: Drawing a Fine Line for U.S.–China Trade," *The Washington Quarterly*, 27:3 (Summer 2004), pp. 157–173.

[5] James A. Lewis, *Globalization and National Security. Maintaining U.S. Technological Leadership and Economic Strength*, Washington DC (CSIS), December 2004.

current account balance mostly fits the textbook case of a developing economy that has still a long way to go to overcome its deficiencies. With the exception of the substantial surplus in the first months of 2005 that obviously reflects a surge in textile exports after the expiry of the WTO Textile Agreement, China's overall current account has more or less been in balance. Chinese accumulation of currency reserves corresponds more or less to a surplus of capital inflows from FDI as well as portfolio investments.

Therefore, the problem lies in America's bilateral trade deficit or capital flow surplus with China. But is it a problem at all and if so for whom? Opinions vary widely on the issue. Some of these, however, should clearly be refuted.

First among them is the view that China is gaining political leverage on the U.S. from its large dollar holdings and its ongoing massive investment in U.S. treasuries. This allegation is not at all supported by political and market realities. The Japanese once, in the early 1990s, were rumored to have tried to exercise their leverage on the U.S. with their treasury holdings and to have very discretely been told by the U.S. Treasury to refrain from any such idea—which they obviously did. Today, the American financial markets are even deeper, wider and more sophisticated than at the time and thus probably even less susceptible to disruption. Using dollar and treasury reserve holdings as policy leverage would be of no avail to China, hurting its own economy much more than the U.S.

Second, it has been argued, among others by Fred Bergsten[6], that the bilateral U.S.–China imbalance is due to deliberate and trade-distorting Chinese exchange rate manipulation. But with the Euro rising against the dollar and hence the dollar-pegged Renminbi, the trade balance effect of such "manipulation" should have been even more devastating on the bilateral EU-China trade balance—which is not the case. Revaluing the Renminbi against the dollar and pegging it to a currency basket instead of the dollar will do little to reduce the U.S. trade deficit with China. The pattern of U.S. exports is one reason for the resilience of the U.S. trade deficit towards exchange rate changes—there is very little capacity and capability to translate a more favorable exchange rate into higher U.S. exports. Possibly, the Eurozone countries could even gain more from the Renminbi revaluation than U.S. exporters of manufactured products. The low American savings rate—and hence the high import demand—is another reason for the presumably negligible impact of Renminbi rebasing on the U.S.–Chinese trade balance.

Third, it is said that the U.S. current account deficit—and specifically its deficit with China and other Asian countries—cannot go on forever. If it were to be more than a truism—nothing goes on forever in the human sphere—this assertion would require clearly identifying the causes that might trigger the breaking point of the current mechanism of balance of payments adjustment. Currently, deficits are balanced through corresponding capital movements without disruptive movements of exchange rates or interest rates. Several economists, as well as Governor Gramlich from the Federal Reserve have convincingly argued that current imbalances can go on and keep increasing for quite another while.[7]

Addressing the bilateral US-Chinese imbalance, therefore, is not so much an issue of bilateral economic relations, even less so of unilateral U.S. trade policy measures against China, than it is a matter of U.S. domestic economic policy, which may have to support an increase in the household savings rate and thus a reduction of domestic private consumption and import demand.

Policy Conclusions

Whether to engage or to contain China is very much a decision to be implemented through foreign economic policy. And the economic facts point strongly against containment. As a big importer, as the

[6] C. Fred Bergsten, "Reform of the International Monetary Fund," Testimony before the Senate Subcommittee on International Trade and Finance, Committee on Banking, Housing, and Urban Affairs, June 7, 2005, http://www.iie.com/publications/papers/bergsten0605.pdf.

[7] Edward M. Gramlich, "Budget and Trade Deficits: Linked, Both Worrisome in the Long Run, But Not Twins," Remarks by Governor Edward M. Gramlich, presented at the Euromoney Bond Investors Congress, London, February 25, 2004, http://www.federalreserve. gov/boarddocs/ speeches/2004/20040225.

third largest trading power, as a regional center of gravity and by the sheer weight of its absolute GDP, be it calculated on exchange rate parity or PPP, China simply cannot be contained any more. Instead, it should be prominently engaged in a strengthened system of global economic governance.[8]

Europeans' perceptions of the rise of China tend to be shaped by their own historical experience post-WWII. Create a strong web of economic and political interdependence based on strong multilateral agreements and institutional links and everything will fall into place, including eventually the one most sensitive issue: Taiwan. Ever deeper economic integration may ultimately make formal national unification superfluous. But even before such a still remote idea can become reality, the diffusion of ideas and democratic values that goes with a dynamically growing economy based on private initiative might defuse the Taiwan straits conflict. The European approach to promote such a process is the same as the one towards East European countries during the Cold War, banking on "Wandel durch Handel," (democratic) change and transformation through trade and economic integration.

With a view to China's already strong position in the global economy and its increasing integration into the multilateral economic order, any such policy of engagement today would have to happen on China's terms as much as on those of the incumbent powers, be this on currency and exchange rate issues, on furthering the WTO regime or, more particularly, on achieving more mature, competitive and integrated capital markets among the major economic powers. The willingness of China to engage as a major player in its own right, however, should be fostered and embraced.

[8] Cf. Jeffrey Garten, "The Global Economic Challenge," *Foreign Affairs*, Jan/Feb 2005, pp. 37–48.