



## **CIGS Seminar**

### **"U.S.-China Politico-Economic Relations under the Treacherous Global Circumstances"**

(Summary of Q&A)

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Venue: Shin-Marui Conference Square, Tokyo, Japan

**Kiyoyuki Seguchi, Research Director, CIGS:**

The present situation is so complicated. I would like to make three or four points about Mr. Saich's presentation. First of all, regarding internal products, I partly agree with the point about the middle income trap of the Chinese economy. However, I think the situation of China is different from other developing countries, because China is a huge country and the coastal areas have reached the level of a developed country.

From a long-term view, the risk of China is due to its weak or declining economic resilience. In the long term, the Chinese economy will transition from a rapid growth phase to a stable growth phase. Like all other developed countries, China will lose economic resilience. The big difference between China and other developed countries, however, is China's one-party system. With a democratic system, a developed country can change its administration through elections but for China, this is very difficult. If China loses economic resilience and goes into long-term depression, the Communist Party will lose legitimacy and its economic policies will become less effective.

With regard to the Belt and Road initiative (BRI), it is very difficult for China to resolve that because basically they do not understand the foreign situation and foreign cultures. In European countries, the Chinese cause many problems but it seems they do not understand what is wrong. This is a basic problem of China. It wants to make BRI a strong platform to build good relations or good communication with other countries, especially with European countries, but without understanding other countries, it is very difficult.

The third point is a very basic one. Because I am Japanese, I love the friction between China and the U.S. The basic reason for that friction is development of China itself. The U.S. views this as a threat that will continue to grow as long as China continues to develop. Relations between China and the U.S. will become even more difficult. As a result, Japan and China will improve relations and start to enjoy win-win relationships. This will in turn accelerate the development of China. If that is the case, I wonder what the U.S. will think about Japan.

**Fengjun Duan, Senior Research Fellow, CIGS:**

In addition to China being an X factor to the global energy sector and markets, I think there are also some X factors inside China. I think the largest one is how necessary energy is for the future of China. That will greatly affect China's impact on global markets or global society.

There are three examples from history that are relevant to China today. These are the industrializations of the U.S., Japan, and Germany in the 1970s and 1980s. At the time, the U.S. consumed almost 25% of the global energy with 5% of global population, while producing around 20% of global GDP. It was a very energy-intensive economy. Meanwhile, Japan consumed about 5% of global energy and generated over 10% of global GDP. Germany was somewhere between the two. Which path China goes down will make a very big difference.

Another X factor is the viability of renewable energy. Last year, Europe increased hydro capacity because of the decrease in nuclear energy but it also lost about 10% of hydroelectricity due to water resources. Because climate change will also impact water resources, the question is if China will get enough hydropower in the future.

The third one is international cooperation. During the Obama administration, China and the U.S. had very good collaboration. They created a clean energy research institute, which has been very successful. So, international cooperation, especially in technology development and the energy sector, will influence the global energy sector. How should we evaluate the output of the center during the Obama administration and what will happen to it during the Trump administration?

**Anthony Saich, Professor of International Affairs, Harvard Kennedy School:**

I think Mr. Seguchi has made two very smart observations and raised one difficult question. I agree that it is not the whole of China that is in the middle income trap. If you globalize the figures, then there are very different consequences and that does raise questions about regional development planning and so forth.

Regarding growth, I think there are a number of different aspects. First, the Chinese themselves have now accepted that the high growth period is clearly over. The question now becomes whether or not China can achieve high quality growth and what affects the growth. My concern is, even if China maintains 6% growth, it is because the government is pumping in a lot of resources to keep up the low levels of efficiency. If the government keeps funneling investment into less efficient, lower productivity sectors, we will start to see a growth rate more in the 3-4% range. Furthermore, unless investment in human capital development is done effectively, growth may fall further to 2-3%.

So, I agree that economic resilience is a key factor. When I was talking about the development of institutions, I was not talking about multiparty systems. Rather, I meant the institutional design for the economy and whether that can transition the economy to one that is driven more by consumption. China has had a lot of options to deal with this actually. For example, it has dropped the reserve rate of financial institutions. Ultimately, one of the best ways is to develop service sectors and consumption domestically.

The question around legitimacy is difficult to answer. Most analysts believe China's Communist Party has shifted to an economic base of legitimacy and, therefore, if the economic growth goes away, it will be in trouble. That may or may not be true, but I do think nationalism plays a part. It is very difficult for China to be sympathetic to alternative approaches that could be classed as being American approaches to the economy. I think the biggest push for Xi Jinping to change will be if those factors kick in and the growth rate really starts flowing.

Regarding the second point, I think part of the problem is that in Europe or the U.S., there are multiple levels of engagement with different societies and lot of different feedback. China tends to be more monolithic in the way it gets feedback and that often leads to misunderstanding about particular countries. I agree that this could lead to serious misallocation of foreign investment in different countries under BRI. There have been a number of cases where China and another country's leaders are positive about an investment, but the investment project is unsuccessful because the local communities are against the project and the government.

With regard to Japan-China relations, I think there are two dimensions. First, this is a great opportunity for Japan to try and negotiate the space in the friction between the U.S. and China. The Trans-Pacific Partnership is a great opportunity. More broadly, Japan can play a meaningful role in Southeast Asia. Japanese projects there have been really well received and much less controversial than Chinese investments.

The problem, however, is that Japan will come under tremendous pressure from the U.S. to not be seen as moving towards a closer alliance with China. Japan needs to apply pressure on China in areas where there is a common global consensus, such as business practices, while at the same time taking advantage of the opportunities. Still, it is also worth noting that the relationship with China has always been really unstable.

**Edward Cunningham, Adjunct Lecturer of Public Policy, Harvard Kennedy School:**

As for the other X factors, first, regarding China's path, I would guess that China will end up somewhere between Germany and the U.S., falling closer to the U.S. model than the German model. This is because of a variety of reasons. The first is China's enormous size. Its composition, namely being debt-led, investment-led, and industry-led, is another factor. Furthermore, while there have been large gains in efficiency, when they are compared to the overall size of China, there is still major inertia. In the long-term, another factor will be services. Services will probably grow if it is politically expedient, such as when growth slows and there are significant employment pressures. If the nature of the economy changes and consumption grows, it would enable services to grow and China could end up closer to the German model.

Concerning the second point, I agree that climate change could challenge renewables by reducing water resources. However, I think the main impact would be on Southeast Asia as opposed to China. Rather, the bottleneck is probably in storage and where the storage revolution, which would take renewables to next level, will come from.

Lastly, with regard to the joint research center, the outputs were measured by research, development and deployment but I think it is still too early to determine how successful it has been. One challenge for energy is that it is capital intensive, so it is hard to have an impact through the investment of money in some ways. Also, the cycle is long so it is too early to judge on the R&D side. On the deployment side, however, which is more short-term, it has been less successful. There are not many good examples of powerfully different deployment of technology being funded. There were a lot of issues in terms of actually aligning incentives.

**Questioner 1:** Regarding China's reform policy, recently Xi Jinping visited northeastern China, where he sent a very complicated message. He visited state-owned enterprises and emphasized the role of state-owned enterprises, but then he also visited private enterprises and emphasized the role of the private sector. How should we interpret this? Secondly, Xi has also sent mixed messages by emphasizing self-regeneration on the one hand, but also a policy of opening up the country, which is very puzzling.

**Saich:** I think that Xi really believes that an economy dominated by state-owned enterprises is an effective one. Many people thought that, having worked previously in

some of the coastal provinces, he might be more sympathetic to the private sector but that has not been the case. I have heard that Xi was very impressed with what he considers to be the Shanghai model of development, which is a modern city and economy but where the state is dominant, and feels that it would be effective at the national level. At the same time, there has been a lot of pushback against private enterprises and reforms. A number of members of the Party have spoken out quite critically and openly about it. Xi probably needs to show some consideration for those kinds of views. The real question is whether the support for the private sector is backed up by policy initiatives or whether it is purely rhetoric.

**Cunningham:** I think Xi believes that the state-owned enterprises remain the backbone of the economy, while also recognizing their failures. He has to straddle those two issues. He knows there is dynamism in the private sector. That is why there is very clear coordination to force those private enterprises that are directly undermining state-owned enterprises to provide stakes in those backbone state-owned enterprises, in a sort of mixed-ownership model. In that way, it is possible to change the incentives in the state-owned enterprises, without undermining them as rapidly.

**Questioner 2:** My question concerns the growing contradiction between the market economy and autocracy in China. The return on equity of state-owned enterprises seems to have dropped to half in the past decade. It is also less than half of the average of U.S.-European companies. State-owned enterprises do not seem to be doing well. I am concerned we are seeing even bigger zombie enterprises. Also, in relation to that, I have concerns about shadow banking, particularly payment guarantees. The world tends to suffer a financial crisis every 10 years. 10 years have passed since the last one. Last time, the crisis was overcome through good U.S.-China-Europe cooperation. If a crisis were to happen today, however, the consequences may be more disastrous. Would the Chinese economy survive such a crisis now?

**Saich:** The rate of return with state-owned enterprises has been declining consistently. Of course, not all of these enterprises are disastrous cases. Some of them are announcing record profits, but given the level of state preference and state support they receive, the real question is whether they are real profits or just the result of being supported within the system.

Shadow banking is an interesting issue because the private sector currently has to rely on shadow banking and informal banking to get the resources it needs. A few years ago

there was a big push to shut down a lot of the shadow banking. However, the question, again, is how to keep the growth up. If the authorities relax again then shadow banking may increase again.

I still do not really know if there will be a financial crisis in China or not. Yes, there are tremendous problems but not necessarily at a level that would cause a crisis. There is nothing that would seemingly spark a real crisis. With that being said, what is extremely worrying is that, were a crisis to occur, there may not be the necessary global collaboration in the current circumstances to avert the crisis.

**Cunningham:** From years of speaking with various finance people, I too cannot find the fuse that would set off the metaphorical bomb and spark a crisis. I think we underestimate the capital account control.

**Questioner 3:** I would like to ask about the quality of the decision making in the U.S. and China. The U.S. decision making process today seems very sporadic, personal or even fickle, while the Chinese decision making process seems to consist of a good mixture of top-down and bottom-up factors. What impact will such contrasting decision making qualities have?

**Saich:** As for the quality of decision making, this is an interesting challenge. China always portrays itself as having a much better system for picking leaders and so on. A lot of that is true. However, one important difference is that the U.S. has a lot of different checks and balances. A lot of critical voices will be raised about different policy challenges, which is much more difficult to articulate in China. I agree that there is a good system of training people but these people are still very much constrained by policy parameters that are set by the Party. Not everything works out well. A good example is the issue with the stock market around 18 months ago. One could argue that the leadership made every conceivable mistake that could be made and really lacks any kind of financial understanding.

**Cunningham:** The current U.S. decision making style is absolutely frightening. Most people who previously had their hands on the rudder are gone. Lighthizer and some others are among the few remaining Republicans that had some government experience who were willing to enter. Most people with government experience were unwilling to enter because of the trade issue. That is very significant.

**Saich:** I think the example in the energy sector with the alliance of state governments is also illustrative. California is the biggest market for car sales in the U.S. and if California sets an emission standard at a certain level, car manufacturers are going to follow that standard because they are not going to produce two cars, one for California and one for the rest of the U.S. There is a lot more push and shove and give, even with a very dysfunctional national decision making system.

**Questioner 4:** With respect to the sustainable energy sector in China, considering the condition of investment and return on investment, supporting this sector financially seems to be a very risky proposition, because of instability and the changing market, etc.

**Cunningham:** With renewable investment in China there are two tracks. One is to invest in technology companies and the other is through infrastructure assets. The risk with technology companies is significant because they are very dependent on policy shifts. Still, it is possible to have success. From my experience, the most successful foreign investors have come in at an early stage or the growth stage already knowing who the buyer will be and having some sense of what the spectrum of terms will be. Assets are easier if you are a fund that has a fairly short term life. A lot of tariff changes that have happened recently have been fairly well signaled. They are nowhere near as volatile as, say, the U.S.

**Questioner 5:** I have a question concerning the argument by the Trump administration that the previous administration's policy towards China has failed. Is this really the case? If not, then what is the reason that China has gone from being a strategic partner to a strategic competitor? Also, I am having difficulty making sense of Vice President Pence's recent speech. If you were to advise the president, what advice would you give?

**Saich:** I think, originally, the Trump administration viewed China as a partner in relation to the Korean Peninsula and denuclearization. However, I think President Trump's attitude shifted dramatically after he met Kim Jong-un, and he now feels he no longer needs China's involvement and can take a much more aggressive approach to China. I think his view is incorrect, but that is the situation.

There is now a huge argument in the U.S. about where the previous policy has failed. A lot of people are arguing that engagement has produced nothing for the U.S. Those who

favor engagement are saying that engagement has failed but are continuing to call for more engagement. It has become a very contentious area.

I do not think Trump would listen to any advice I have, but my first advice might be that he should step down. More seriously, the ground has clearly shifted so even those who favor continued engagement at some level have to recognize that the relationship is now very different. I think there has to be a clearer delineation of those areas where the U.S. would want to take China on, such as its trading practices or intellectual property theft, although not necessarily with tariffs.

At the same time, the relationship can only be improved through building incremental trust, and that is difficult to do with a lot of areas where interests are already set very deeply. I think where it might be easier for the U.S. and China to engage is around new questions of global engagement and developing global norms where the international architecture and structures are not already set. There are in fact areas where there is still good collaboration between the U.S. and China, such as disease control or anti-piracy. One big area where a lot of work is needed is cyber regulations. Overall, I think, in terms of setting new global norms and regulations, China could be an important part of that decision making framework. That might make China feel that it has been accepted and that it is having a say.

**Questioner 6:** It seems like a significant gap is opening up between the U.S. and China in relation to nuclear power. Through BRI, China is starting to build nuclear power stations in other countries and list nuclear power companies on stock exchanges. Could you comment on that?

**Cunningham:** Some interesting technologies have emerged and China has done a good job promoting some of those technologies. By acquiring some of the best technologies from other countries through auctions and by promoting creative intellectual property transfers, China has created national champions in the sector. Chinese corporate nuclear capacity is fairly high and I think they will be able to manage the external investments they have made and are promoting. The technology, in terms of engineering and services, is very impressive. The only issue is safety outside China, given how rapidly they are expanding. The risk comes when mixing Chinese investment with national regulatory regimes that are fairly weak.

**Seguchi:** To offer some closing remarks, if the Chinese economy maintains a very stable situation until 2030 then the structure of state-owned enterprises would pose little problem. The private sector would enjoy a higher growth rate and the relative weight of state-owned enterprises would then decrease. If most of them go into bankruptcy, gradually, not at once or twice, then probably some of them could be absorbed by China's market economy. However, the Chinese economy is facing U.S.-China trading friction. If this causes economic depression, probably the Chinese government would adopt public policies that may create a bubble economy.

**Duan:** Mr. Cunningham mentioned that China will end up somewhere between the German and U.S. models, so the amount of the Chinese energy consumption will jump again. This would be a very big problem. However, in China, energy is not a common commodity. It is a kind of social infrastructure and so it cannot be operated by the private sector. The main parts of the energy sector will be operated by state-owned companies for a long time.

Another point is that Chinese energy policy is a complicated combination of environmental policy, industrial policy, security policy, and so on. One motivation behind the current energy shift in China came from supply security. The current trend will continue but technology efficiency will be an essential factor in the future.