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Statement before the

House Committee on Foreign Affairs,

Subcommittee on Asia and the Pacific

"REVIEWING PRESIDENT XI'S STATE VISIT"

A Testimony by:

Scott Kennedy

Deputy Director, Freeman Chair in China Studies

Director, Project on Chinese Business and Political Economy

Center for Strategic and International Studies (CSIS)

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I am honored by the opportunity to testify before the committee to present my thoughts on the Chinese economy and US-China commercial relations. The main point I want to convey today is one of caution. In broad historical terms, China's economy is much more market-oriented than it was 30, 20, or even 10 years ago, and the United States -- business and consumers -- have largely benefited from the commercial relationship and China's growing role in the global economy. However, over the past few years the pace of liberalization has slowed, and in some ways the state is expanding its intervention in the economy. At the same time, China's economy is slowing and is becoming more volatile. As a result, doing business with China is more challenging, and the slowdown and volatility we see in China is creating new challenges and risks for foreign businesses and other economies. Ongoing efforts to engage China bilaterally and multilaterally, as well as the adoption of the Trans-Pacific Partnership (of which China is not a member), are addressing many of these problems, but we should expect continued commercial frictions in the coming years.

Let me briefly elaborate on this conclusion by providing my views about the state of the Chinese economy, progress (or lack thereof) on economic reforms, the state of US-China commercial relations, the results of President Xi's state visit, and the potential implications of the Trans-Pacific Partnership (TPP) for all of the above.

The State of China's Economy

There is broad consensus that China's economy has slowed dramatically. There is no consensus as to exactly how much, why or what the future trajectory of growth is. Officially, growth is still somewhere near 7 percent, while the most skeptical argue that growth has fallen under 4 percent or that the country is in a recession. I'd place myself in between these two poles. Manufacturing has slowed substantially, as has use of electricity, steel, and other inputs into infrastructure. However, services and consumption are still growing, as are wages, which suggests to me that the economy is still far from a recession. Although China has built up a substantial amount of debt, primarily corporate loans and bonds, the current slowdown is not just the product of economic gravity (growing too fast on easy money), but is also the product of a government-induced slowdown brought about by tighter credit conditions and a vast anti-corruption campaign that has made officials throughout the system far more hesitant to approve projects. This has not only slowed investment in areas with overcapacity, but also limited expansion in areas with under-investment, including in high tech and services.

Retreat on Economic Reforms

Xi Jinping came into power promising a much more aggressive reform agenda than his predecessor, Hu Jintao. The 60-point "Decision on Major Issues Concerning Deepening Reform," issued in November 2013, put forth a full reformist agenda to raise overall productivity and transition from an investment-led to consumption- and services-led economy. Over the past two years, there have been a series of individual reform policies announced and implemented, but they have not been all-embracing and comprehensive. And more recently, within the last 18 months, the trend has decidedly been in a statist direction. The government has chosen monetary and fiscal stimulus over liberalization in an effort to get economic growth moving. It pushed up the stock market in 2014, and this past summer famously and unsuccessfully intervened to keep the bubble (it created) from bursting. The reform package for state-owned enterprises (SOEs), announced in mid-September, is anything but reformist, as it encourages strengthening the Party's role in SOEs, promoting mergers and acquisitions across a range of sectors even if not commercially appropriate, and limiting opening markets where SOEs predominate to competition from domestic private and foreign companies. China is in midst of designing its 13th Five-Year Plan to guide overall economic policy for 2016-2020, and early signs are that this document, which will be released in full in early March 2016, will include only incremental reforms to the economy and the country's governance institutions.

US-China Commercial Relations

Commercial ties between the two countries have expanded dramatically since diplomatic ties were restored in 1979. Two-way trade reached almost $600 billion in 2014; US companies are heavily invested in China, and Chinese are increasingly investing in the United States. Although the US trade deficit has grown consistently since the late 1980s, broadly speaking American industry and consumers have benefited immensely from these ties. The picture is more mixed with US labor, as lower-wage manufacturing has moved off-shore, but higher-end manufacturing and services jobs have been created. And US unemployment has dropped and wages are rising (albeit very gradually) even as the deficit increases.

Despite the overall benefits, there are a wide range of challenges created by China's continuing intervention in its economy, its slowdown, and growing volatility. Based on data from the American Chamber of Commerce in China, most American firms are still profitable in China, but they are increasingly worried about the slowing pace of liberalization, the continued use of industrial policies to promote domestic firms, and the opacity of China's policy process. The worries are highest in information and communication technology (ICT) firms, as China is using the goals of acquiring "secure and controllable" technologies to promote domestic firms at the expense of foreign competitors. Even in less sensitive services -- such as healthcare and education -- the Chinese are not embracing liberalization even though there would be immediate benefits to economic growth and to the broader public.

In addition to the concerns the US has had for a long time about market access and fairness of the relationship, the most important emerging issue is about the potentially negative effect that China's economic volatility and slowdown can have on the global economy. China's economy is now so large and financial flows so substantial that developments in its economy ripple throughout the rest of the world very quickly. As we saw this summer, the linkages between China and elsewhere are instantaneous in the financial sector, as the volatility in its stock market and the Renminbi caused markets to react everywhere. As China's capital markets open further, that connection will become only tighter. This will put a high premium on the Chinese government doing a much better job of explaining its economic conditions and policies in a way that markets and governments understand and find convincing.

The most immediate area where clarity and transparency are needed concern the RMB. If growth does not pick up soon, the government will not only need to step up monetary and fiscal stimulus even further, it may also decide to depreciate the Renminbi (RMB), in part to support exports, but primarily to limit capital outflow. In my opinion, the RMB is currently over-valued, so depreciation is likely warranted; but given concerns over currency manipulation and China's poor communication of its economic conditions and policies, any further deprecation will likely generate extensive criticism from others, including in the US Congress. I would expect that this issue may get wrapped up in the ongoing conversation about whether the RMB should be included in the International Monetary Fund's "Special Drawing Rights" basket of currencies, scheduled to be determined by early in 2016.

The Summit

The Chinese President's visit to the United States was an opportunity to address many of these issues. There was some progress. Xi Jinping repeatedly affirmed the importance of continuing economic reform and keeping the country's doors open to foreign businesses. He specifically said he would not use national security as an excuse to block foreign investment and exports to China. He also reaffirmed the importance of the Bretton Woods institutions and pledged collaboration between the Asian Infrastructure Investment Bank (AIIB) and the World Bank and other multilateral development institutions. At the same time, it remains to be seen whether these general promises of market access will translate into fairer treatment for American companies or how strongly Xi Jinping is committed to economic reforms more broadly. And although there may have been private conversations about the recent economic volatility and related policy responses, there was little public discussion of this problem. At the press conference President Xi did try to reassure markets by saying there is no reason for the RMB to depreciate over the long-term. But this still leaves unresolved a better explanation for recent policies or how the RMB's value may move in the short-term.

Just prior to the summit the US and China exchanged the second versions of their "negative lists" that are part of negotiations over a bilateral investment treaty (BIT). Those offers were improvements on the initial ones made in the spring, but the offers from both sides were reportedly far short of satisfying the other side's bottom line. Although there is interest in the leadership of both countries to reach a BIT, it appears both sides have higher priorities. China is focused on its anticorruption campaign and avoiding economic instability, while the number-one US economic policy toward the region is passage of the Trans-Pacific Partnership (TPP). It seems highly unlikely the US will seek to conclude a BIT, let alone submit it to Congress, prior to the passage and adoption of TPP.

TPP: A Potential Game Changer

Although the Chinese economy and economic policies are muddling along, the conclusion of TPP negotiations among the twelve member countries and the movement toward review by the members' governments presents both a challenge and an opportunity. It is possible China will react by expanding its own regional arrangements, including agreements with neighbors in Southeast and Northeast Asia, and ramping up more quickly investments as part of the its "Belt & Road" strategy of building maritime and land infrastructure and communications links between itself and the rest of Asia westward to Europe and Africa. But expanding those ties in basic trade and investment will not address all of China's international economic challenges. Being outside of TPP would put Chinese companies at a competitive disadvantage in those sectors it needs to move into to have sustainable growth over the long-term, including high technologies and advanced services. The United States would do to better to use TPP not as a tool to compete with China but as a lever to help induce greater economic reforms in China. China has expressed some interest in joining TPP, but has not made a commitment yet to do so. Current TPP members account for 40% of the world's economy, but it will not achieve its full potential unless China and India are eventually included. Whether this is through an expanded TPP itself, a Free Trade Area of the Asia-Pacific (FTAAP), or under a more comprehensive multilateral umbrella, such as WTO is less important than making the goal one of expansion and inclusion and not exclusion. The latter approach would likely generate intensified conflict between the United States and China and likely hurt the US economy in the long run.