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On US-China: Winning the Economic Competition

Staying Ahead of a Slipping, Skittish China

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American economic competition with China may be more silver lining than dark cloud. Chinese competitiveness is likely to decline, due to aging, debt, and poor long-term choices affecting rural areas and innovation. As a more broadly innovative and soon to be younger country, the US has better economic fundamentals and can have them indefinitely.

This happy baseline however, makes for poor incentives. Beijing's are clear: try to offset declining competitiveness through more predatory policy. In particular, use subsidies and (coercive) transfer of intellectual property to undermine national and corporate rivals. Meanwhile, American incentives are muted. With better fundamentals and much more wealth, the US has room to make further mistakes, such as continued leveraging and unwillingness to take costly measures to respond directly to China.

This is seen in needed policies, which will be controversial. Some observers celebrate large budget deficits not causing higher interest rates, but $1 trillion spent with no sustained return is still a bad idea. Ideally, borrowing would fund research and human capital improvements – education and health – with future payoffs. Better China policy may be more politically feasible. Neither bilateral trade deficits nor long-term climate cooperation, for example, matter much to competitiveness. Instead, subsidies and intellectual property (IP) are vital. The US should:

1) Steadily increase federal research and development spending, which has been underemphasized for decades, through the 2020's.
2) Experiment with education programs aimed at boosting labor productivity, since education is a major advantage over China.
3) Document Beijing's harmful behavior with regard to competitiveness, featuring subsidies, IP transfer, and capital flows.
4) Using this, apply countervailing duties much more broadly to subsidized Chinese production.
5) Implement the export control reform passed in 2018.
6) Ban business with Chinese firms benefiting from stolen or coerced IP.
7) Evaluate the competitiveness impact of growing American capital flows to China, possibly restricting flows in a select set of industries.

China Starts Sinking

The People's Republic of China (PRC) is presently taking over the world, the same way the Soviet Union did in the 1960's and Japan did in the 1980's. Its economy is large, it grew rapidly in the past, and there is controversy over its trajectory. There should be less. Since Xi Jinping became General Secretary of the Party, the PRC has shown little interest in pro-competition, pro-property rights reform. Without that, Chinese competitiveness will unavoidably decline.

The debt situation is familiar. At the end of 1997, outstanding credit was 109 percent of GDP. Eleven years later, it was 139 percent. Eleven years after that, in 2019, it was 259 percent.[i] The equivalent American figures are 186 percent, 240 percent, and 254 percent of GDP. Here, China has indeed caught up. Beijing acknowledges that the era of fast growth is over, and aging will require more government spending. The only way to maintain or improve the contribution of capital to economic growth is to cut state bank lending to state-owned enterprises, whose debt easily exceeds $20 trillion. A cut is certainly not Xi's intention.[ii]

Demography will eclipse debt as a drag. According to the UN, Japan's media age was 22.3 years in 1950 and 37.3 in 1990, when its stagnation set in. In 1980, with reform under way, China's median age was 21.9. In 2020, it is estimated at 38.4, a slightly worse path than Japan's. By 2015, Japan's median age was 46.4; in a generation, China's is forecast to be 47.2.[iii] The 2022-2035 period will see the fastest aging, the age 65+ cohort expanding by close to 100 million within a roughly stable population.[iv] As retirees exit and unemployment shrinks, labor market reform will be easier, but it will not save productivity in the face of this kind of contraction.

Land is an underrated problem. The PRC imports commodities such as iron ore to a far greater extent than its economic size requires. One reason is a ban on private land ownership, which Xi has had years to change and refused.[v] Agriculture imports are the world's largest at $133 billion in 2019, crude oil imports were $100 billion more than that.[vi] Rural Chinese do not control their farming choices and cannot sell their land. Related to this is education, where rural attainment badly lags urban.[vii] As a result, official 2019 disposable income *per capita* was just $2300.[viii] The number reflects 550 million rural citizens still held back in contribution to competitiveness.

Innovation to the rescue? The Party hopes so.[ix] In contrast to other factors, innovation trends are positive. Annual research and development (R&D) spending is rising as a share of GDP. So are Chinese patents granted in the US (grants in China are not useful information).[x] But it is difficult under ideal conditions for innovation to carry such a large economy in the face of aging and high debt. Innovation conditions are not ideal, due to the insistence on huge state quasi-monopolies in more than a dozen major industries. To illustrate, the PRC has 10 companies in Fortune's top 50. Seven are guaranteed a degree of monopoly power and have little reason to innovate.[xi]

US Treading Water

2019 Competitiveness Snapshot

	US	China
Outstanding credit / GDP[xii]	2.54	2.59
Money supply / GDP	0.72[xiii]	1.93[xiv]
Labor productivity[xv]	$128,768	$30,143
Median age[xvi]	38.2	38.1
R&D spending, % GDP	2.8%[xvii] ($597 billion)	2.2%[xviii] ($322 billion)
Outside citations[xix]	300,000	164,000

Share of global trade (g&s)[xx]	11.3%	10.7%
Share of global FDI[xxi]	22.3%	6.1%

Other witnesses may examine US competitiveness in more detail. The World Economic Forum identifies key American strengths in internal labor mobility, availability of venture capital, and scientific publications, among others.[xxii] The near-elimination of very large net petroleum imports in 15 years is both a signal of and a minor input to long-term competitiveness.[xxiii] In a comparison to China, the US leads almost across the board, with the most sizable advantage in the crucial measure of labor productivity. Related, mean years of schooling in the US is 5.5 years higher than in the PRC and it would take decades to close the gap.[xxiv]

But the better team still loses when it call the wrong plays. For two decades, policies important for economic competiveness have been made more for political convenience. At the end of 1999, public debt was 13.4 percent of household net worth. At the end of 2019, it was 19.6 percent.[xxv] The economy did not become more dynamic during this time – it was not the borrowing for long-term return always touted by advocates of deficit spending. In a further sign of ill health, the discount rate the Federal Reserve offers banks has not passed three percent since 2008.[xxvi] If growth can only be achieved through leveraging, it will stop. The only question is how soon.

What China Will Do

Xi's been General Secretary for seven years, he's not suddenly going to become a market reformer. Barring internal failure or external confrontation, the policy path is set. The fiscal deficit will remain large - as a share of GDP, it was larger than ours in 2019. Bank lending will continue to outpace nominal GDP, as it has since 2002.[xxvii] Leveraging will thus worsen. Land rights will be limited, keeping rural Chinese poor. On the labor side, the two-child policy has had little impact to now and cannot boost competitiveness for two decades.[xxviii] Labor mobility will increase, improving educational attainment for rural migrants, but that will also be slow.

The PRC will continue to spend heavily on innovation, with some success. But the aversion to competition will blunt innovation in industries where state firms are mandated to play the leading role. This undercuts expectations from 10-15 years ago that China would come to respect foreign IP. With innovation nonetheless becoming more important economically, theft from and coercion of foreign IP holders will be intense. It's possible to identify some targets. Beijing will focus on IP transfer in sectors and products where the state leads and results are obviously lagging, as seen with chipmakers Tsinghua Unigroup and Wuhan Hongxin recently.[xxix]

The incentive for more predatory behavior in IP extends to more predatory behavior generally. Intense subsidies have cost the PRC a great deal financially but have generated technology, industrial, and employment benefits, due in part to the complete lack of foreign response. They result in China's preferred outcome: the costs of limited competition being imposed globally

while its benefits go disproportionately to Chinese entities. Limiting state intervention in favor of the market, in comparison, would save money but extend dependence on foreign companies. Barring durable and serious foreign retaliation, there is no reason for Beijing to curb subsidies.

Complementing its attempts to be more independent are louder attempts to use others' dependence as a weapon. These are not new, but the PRC's greater willingness to be open about them is an important signal of future behavior for dependent countries and companies. Australia is currently facing a series of Chinese trade sanctions, in part for enforcing its own laws. A number of governments have boasted of billions in Chinese loans and investment, which will only materialize under difficult conditions, either in terms of costs or ownership of prized assets.[xxx] The past year or two has seen some American financials possibly becoming dependent on the China market, with total US-to-PRC capital flow exceeding $900 billion.[xxxi]

What America Should Do

Changing American policy to compete with China will be controversial. Since the end of the cold war, fiscal and monetary policy has often looked like an exercise in buying short-term popularity. A large budget deficit was justified from 2008-2010 and in 2020-1. Excluding those years, federal debt since 1990 has still risen over $9 trillion. Little of it was invested in the future in any meaningful sense; there was no economic or strategic justification for borrowing. The discount rate has never returned to 1990 levels. Low interest rates value the present over the future, making it difficult to raise productivity and thus competitiveness.[xxxii]

That's a 30,000 foot view; closer to the ground is no better. Defense R&D was lower in absolute terms -- forget inflation and economic growth -- in 2019 than 1990. Interest on the debt is often said to be low. It was $190 billion higher in 2019 than 1990, while non-defense R&D was only $33 billion higher, the opposite of pro-competitiveness spending.[xxxiii] The government must not boost individual companies or bring particular products to market. But development spending is only 0.3 percent of GDP and should return to near 0.7 percent, as seen in the 1980's.

Human capital, featuring education and health, is vital to competitiveness. A healthy population is not measured by spending; they may even be negatively related. In 2019, federal health care spending was $1.2 trillion, with research, training, and occupational safety only $42 billion of that. More spending to improve health would be superior to paying to treat ill health. Federal education outlays have been rising, but totaled only $115 billion in 2019. It will certainly be a challenge to make greater education spending valuable in raising productivity, but competing with China makes it at least worth an attempt.

Direct responses to China

Enhancing economic competitiveness is unavoidably slow. If the US-PRC rivalry is at its most intense in 2035, there's time. If the threat from China peaks in the 2022-2028 period, though, more urgent action is required. The 2030s may see lower tension than the 2020s because Chinese demographic deterioration will become stark and Xi will be increasingly weak or have departed (he would be 74 at the 2027 Party Congress). If the greater danger is over the next eight years or so, reacting directly to Beijing on competitiveness is correspondingly more important.

There are generally three China camps: (i) the status quo is fine; (ii) sanctions will best improve America's position; or (iii) separation will best improve America's position. Endless talk aside, the first view remains dominant, as seen in the widespread unwillingness to bear sizable costs to change the status quo. If that continues, so will loss of jobs and companies, while some sectors continue to benefit. On sanctions, President Trump's tariffs, if sustained, can narrowly boost American competitiveness over Chinese. But they have not been accompanied by any other meaningful sanctions, probably due to the President's overemphasis on bilateral goods trade.[xxxiv]

While Xi remains in power, it will be more productive to partly separate the two economies.[xxxv] Outside of competitiveness, this will reduce both benefits being provided to the People's Liberation Army and indirect US support for worsening Chinese repression. Decoupling can also improve our relative competiveness in advanced technology, in Covid-related and other critical products, and in many ordinary goods, in light of pervasive Chinese economic distortions

The first step is the same for all serious China policies: better document the subsides Beijing employs (regulatory protection as well as financial support), the sectors and firms involved in IP theft and transfer, the end-users of the huge amount of American investment in the PRC, and so on. Countervailing duties (CVDs) against subsidies can easily exceed 100 percent. With better documentation, the scope of CVDs can be greatly expanded, improving relative American competitiveness here and blunting some of the advantages granted by China's subsidies. This may encourage the PRC's other partners to follow suit, when shipments originally intended for the US hit their markets.

Technology transfer that boosts Chinese competiveness should be sharply curbed by finally implementing the export control reform passed by Congress in 2018. Most important to competitiveness are "emerging technologies" as designated by that legislation.[xxxvi] Further, Chinese entities that have benefitted from illegal IP transfer should not be permitted to do any business with American partners for a period suiting the value of the IP. Finally, US funds flowing into China should be evaluated for competiveness effects – is the return for American investors worth the capital being provided to the PRC? This will almost certainly vary by sector and end-user. A large competitiveness loss would warrant limitations.

These actions would involve the Congress, United States Trade Representative, International Trade Commission, and departments of Commerce, Justice, and Treasury, at least. To actively improve American competitiveness versus China requires a comprehensive strategy and costly implementation. Or we can just hope for the best. That will probably work by 2035 or 2040, but passive policy will leave the next 15 years painful for many more companies and workers.

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