

Global Challenges of China's New Era¹
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In looking back on its extraordinary accomplishments since 1978, China has much to be proud of in celebrating this year's 40-year milestone on the road to economic development. But as President Xi Jinping implied at the opening of the 19th Party Congress last October, this milestone should be viewed as more of an intermediate stop on a long journey rather than a final destination. In essence, it is a pivotal transition point between the economic take-off of a poor nation and the sustained growth of a moderately well-off society that aspires to Great Power status by 2050.

In keeping with this sense of transition, for the first time in 36 years, the Party has revised the all-important "principal contradiction" facing Chinese society — from the backward social production of a poor nation as stated in 1981 to inadequate and unbalanced economic development as restated in October 2017. This underscores a very different focus for China's basic strategy over the next several decades — moving away from old drivers of manufacturing-led growth and uncovering new sources of innovations- and services-led growth.

But with this shift in strategy also comes an equally daunting reassessment of how China's shifting trajectory fits into the broader world — both from an economic as well as from a geostrategic perspective. Long dependent on external demand as the sustenance for economic growth and development during the early stages of its take-off, China is now playing an increasingly important role in driving and shaping the rest of the world. Fitting the "Next China" into a world that is facing its own set of very daunting problems — ranging from climate change and environmental degradation to mounting inequalities and trade tensions — promises to present China with enormous challenges in the years to come.

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Global Lessons for China

China's experience over the past 20 years underscores that it should not take global risks lightly. That lesson is all the more meaningful in 2018 — a year that marks the 10th anniversary of the Great Financial Crisis and the 20th anniversary of the Asian Financial Crisis, two singular events that dealt serious blows both to China and the world. While China was adept at dealing with the short-term repercussions of these crises, there are enduring strategic implications that are only now becoming evident.

While the Chinese economy is a good deal less dependent on the vicissitudes of external demand than was the case before the Global Financial Crisis, exports still account for fully 20 percent of the nation's GDP, or about half the share going to household consumption.³ With consumer-led rebalancing still in its very early stages and not strong enough to buffer unexpected shocks elsewhere in the economy, any disruption in the global climate could prove quite problematic for China.

In the early days of China's economic development, export-led growth was a powerful antidote to a nation that was afflicted by 20 years of internal instability from the mid-1950s to the mid-1970s. It was hardly a coincidence that as the export share of the economy went from 4.5 percent in 1978 to 37 percent in 2006, Chinese GDP growth surged to 10 percent for three decades. Two factors were at work — an increasingly powerful Chinese export machine and a major acceleration in global trade. It was a most fortuitous combination — coming at just the right point in time to spark China's economic takeoff.

While Chinese reforms were an essential ingredient in the successes of this export-led growth strategy — especially the sharp reductions in tariffs in the years prior to WTO accession in late 2001 — the export machine didn't materialize out of thin air. It required massive investments in productive capacity and infrastructure that pushed the fixed investment share of GDP above the 40 percent threshold by the early 2000s. Unlike other developing economies that borrowed heavily from abroad in order to fund their investment programmes, China's investment boom was largely self-funded — supported by a surge in domestic saving that ultimately pieced the once unheard-of threshold of 50 percent of GDP in the pre-crisis 2000s.

Yet as President Xi implied in his report to the 19th Party Congress, there is good reason to doubt the staying power of China's stylized externally-focused growth gambit. His

³ See National Bureau of Statistics (China)

warning, of course, was very much in sync with concerns originally expressed by former Premier Wen Jiabao. In March 2007, Wen famously cautioned of the “Four Uns” — a Chinese economy that had become increasingly “unstable, unbalanced, uncoordinated and ultimately unsustainable.”⁴ Ten years later, Xi’s message has sharpened the focus on an “unbalanced and inadequate” system, but the implications of the basic message are very much the same: China can only stay the course if it resolves the contradiction of its imbalances. That underscores the long-standing case for structural rebalancing of the Chinese economy away from exports and external demand toward services, innovation, and consumer-led growth.

Like the prescription that followed from the critique of Wen Jiabao, Xi Jinping’s reassessment of China’s principal contradiction is also shaped importantly by the trials and tribulations of the outside world — a world as Xi put it that remains “...in the midst of profound and complex changes.”⁵ That gets to the second building block of China’s export-led growth miracle — the strength of external demand that supported the global distribution of goods from the all-powerful Chinese export machine — now the largest exporter in the world.

That approach turns out to have been fleeting. The Asian Financial Crisis of 1997-98 was a warning shot of what was to come — a severe and protracted slowdown in global trade that has continued with a vengeance in aftermath of the Global Financial Crisis of 2008-09. It was tempting, of course, to ignore the first of these two external shocks, as Asia and the world bounced back sharply from the crisis of the late 1990s. China was particularly adept in deploying what it called “pro-active fiscal policies “in order to side-step the pan-regional contagion back then. Meanwhile, with another eye on the opportunities of WTO accession that were about to come China’s way, it was hardly a time to doubt the opportunities of export-led growth.

Yet, unfortunately, there was trouble brewing in an increasingly crisis-prone world. The underpinnings of external demand for Chinese exports turned out to be built on quicksand. The bursting of the US subprime mortgage bubble, eventually accompanied by the implosion of global credit and equity bubbles, as well as a virulent European sovereign debt crisis, led to a full-blown collapse on the demand side of the world economy, with lasting repercussions for global trade. Following the unprecedented 10.5 percent plunge in global trade in 2009, growth in global trade has

⁴ See S. Roach, *The Next Asia* (John Wiley and Sons: 2009)

⁵ See Xi Jinping, “Secure a Decisive Victory in Building a Moderately Prosperous Society in All Respects and Strive for the Great Success of Socialism with Chinese Characteristics for a New Era,” Delivered at the 19th National Congress of the Communist Party of China, October 18, 2017

averaged only 3 percent — literally half the 6 percent pace over the 1980 to 2008 period.⁶ China, the world’s biggest exporter, could hardly dodge that bullet.

Global healing in the aftermath of such a wrenching crisis is a long and arduous process. While the world economic outlook looks a little bit better today than it has in recent years, the patient is only in the early stages of recovery. This resonates with Xi Jinping’s lingering concerns about the still fragile state of the world economy. Ten years after the Global Financial Crisis and 20 years after the Asian Financial Crisis, the toughest global lesson may well be that China needs to look elsewhere to resolve its principal contradiction. Quite simply, it can no longer afford to bet on the once seemingly unstoppable momentum of global trade. Moreover, recent populist hints of a “de-globalization” only underscore the perils of the external solution to China’s remaining development challenges.

The Lessons of Japan

The legacy effects of these two global crises offer some very important cautionary lessons for China — mainly that it cannot take external demand for granted in a crisis-prone world. But there is another set of important lessons from even closer to home that can be drawn from the rise and fall of the modern Japanese economy — the first Asian economic miracle of the post-World War II era. After 45 years of 7 ¼ percent GDP growth from 1945 to 1990, the Japanese economy has slowed to just 1 percent average growth since 1991. Were a similar growth compression to occur in China, all bets would be off of the New Era of Xi Jinping.

China has studied the Japanese experience quite carefully and its senior leadership has actively debated the risks of Japanese-like Lost Decades. In a celebrated interview on the front page of *People’s Daily* in May 2016, a so-called “authoritative person” warned of the overhang of China’s debt-intensive growth and the Japan-style quagmire it could lead to.⁷ The focus was not just on debt but on the perils of asset bubbles, unsustainable currency policy, banking system perils, and the deadweight of “zombie industries” — all of which could sap the Chinese economy of its underlying vitality.

⁶ See International Monetary Fund, *World Economic Outlook* database, October 2017

⁷ See *People’s Daily Online*, “China’s economy likely to follow ‘L-shaped’ path in coming years, says an ‘authoritative insider,’” 9 May 2016

While no two economies are alike, there are many features of the Japanese experience that ring true in today's China. Both high-growth eras were driven by export-led mercantilist growth models – underpinned by currency suppression that subsidized export competitiveness. Japan's fatal mistake came in 1985 when it caved into global pressure and agreed to the sharp yen appreciation of the Plaza Accord. Fearful of the toll that *endaka* (a high-yen recession) would take on its all-powerful manufacturing-led growth impetus, the Ministry of Finance ordered the Bank of Japan to ease monetary policy aggressively in response. That, in turn gave rise to two monstrous asset bubbles — equities and property — that eventually burst in the early 1990s.

The unraveling of Japan was quick to follow — compounded by the interplay of denial and a succession of policy blunders. The denial was deeply rooted in Japanese hubris — over-confidence in the miracles of the so-called plan rational development state, steered judiciously by the elite bureaucracy of the Ministry of International Trade and Industry (MITI).⁸ Japan, and for that matter, many others in the world, truly believed that its growth model was infallible as a new recipe for economic prosperity. Steeped in denial, Japanese authorities felt that all they had to do was buy time before the miracle economy would spring back and quickly bring its post-bubble disruption to an end.

This proved to be an impossible task. Corporate Japan was quickly ensnared by a balance sheet recession brought on by the bursting of the twin asset bubbles. The so-called *keiretsu* system of vertical and horizontal integration compounded the problem, as *keiretsu* members owned each other's assets and levered their balance sheets with the over-valued collateral of these cross-holdings. When the bubbles burst, the ensuing “under-water” collateral led to a massive compression in business spending and a concomitant surge in nonperforming bank loans. Japanese bank regulators not only looked the other way in allowing banks to avoid earnings write-downs, but they encouraged more lending to increasingly insolvent zombie borrowers in an effort to buy even more time. This “evergreen lending” kept zombies on life support at a time when market-driven forces of creative destruction would have purged the system of its excesses — leading to stagnant productivity and an overhang of excess supply of both labor and capital now known as zombie congestion.⁹

⁸ See C. Johnson, *MITI and the Japanese Miracle: The Growth of Industrial Policy, 1925-1975* (Stanford University Press: 1982)

⁹ See R.J. Caballero, T. Hoshi, and A.K. Kashyap, “Zombie Lending and Depressed Restructuring in Japan,” *American Economic Review*, 2008

While this is an over-simplification of all that ailed Japan, three major lessons for China are inescapable: First, the currency suppression of a mercantilist growth model is bound to elicit a strong response from the rest of the world — especially if other nations are struggling with their own growth problems. That was the case in the mid-1980s when the Plaza Accord put Japan under major pressure and it is the case today when the United States and other major developed nations are objecting to Chinese trading practices.

Second, economies are at great peril if they ignore the interplay between asset bubbles and leverage. Japan's balance sheet recession of the 1990s is an obvious and painful example of the mounting risks to financial and economic stability. Other nations have struggled mightily with the tradeoff between growth shortcuts and stability — including the United States and its sub-prime crisis and Europe with its sovereign debt crisis. The stability-growth tradeoff is at the core of any system's political economy balancing act. Resisting the temptation for risky growth gambits is the only way out. China's newfound focus on deleveraging and financial stability is a hopeful sign that it has learned this important lesson.

Third, zombies sap any economy of its underlying productivity sustenance and ultimately strangle economic growth as a result. In the end, subsidized lending to insolvent corporations and condoning bank reluctance to write down bad credits doesn't buy time — it only puts a struggling system in a deeper hole. Keiretsu-like systems are especially insidious in that they magnify cross-company and cross-sector spillovers in the aftermath of distress in asset and credit markets. Until Japan started dealing with its zombies in the late 1990s and early 2000s, the carnage of the first Lost Decade only worsened. China seems to understand this aspect of the Japanese disease quite well, with its senior leadership warning explicitly of the zombie-like perils of excess capacity.¹⁰ The challenge will be to transform this rhetoric into disciplined corporate and banking restructuring — a task that has yet to occur in China.

China is not Japan. It is more pragmatic in adjusting its growth model. It places a much greater emphasis on stability. And it knows full well the benefits of reforms in shaping the opportunities for economic development. But the Japanese experience is a painful reminder of what can go terribly wrong if China loses its focus and discipline at this critical juncture in its journey.

¹⁰ See Li Keqiang, *Report on the Work of the Government*, Delivered at the Fifth Session of the 12th National People's Congress of the People's Republic of China, March 5, 2017

Reform Agenda After the 19th Party Congress

In China, that focus and discipline has long been synonymous with reforms. The story of modern China's economic miracle is intertwined with the bold reforms that began under the leadership of Deng Xiaoping. While there are some who believe that post-Mao reforms didn't make much of a difference,¹¹ a simple extrapolation exercise says otherwise. Over the 1997 to 2015 period, China's real per capita GDP expanded at a 9.6 percent average annual rate — more than 50 percent faster than the 6.1 percent trajectory recorded from 1952-76 during the Mao era. As a result, by 2015, overall output per person was fully 3.4 times higher under the “Deng takeoff scenario” than would have been the case had the Chinese economy stayed on the more subdued growth path realized under Mao.

The debate is not whether Deng Xiaoping's reforms made a difference to China economic growth trajectory, but more over which reforms were most important in sparking the take-off. At work was a combination of both inward- and outward-facing reforms. Both strains of reforms had one important thing in common — unlocking market-based efficiencies by driving a wedge into the collectivization of a Soviet-style command economy. Starting in agriculture with the Household Responsibility System adopted in 1979, internal reforms spread quickly to urban areas and industry. At the same time, the creation of Special Economic Zones set the stage for an influx of foreign capital and technologies that proved crucial for the development of the now dominant Chinese export machine.

The payback was unprecedented in the annals of economic development — 30 years of 10 percent growth in the real economy from 1980 to 2010. But takeoffs, by definition, are transitory for any developing economy — and China is no exception. Starting about ten years ago, the Chinese leadership engaged in active debate over its post-takeoff growth strategy. Drawing on the experience of Deng Xiaoping's gambit, there was widespread consensus that a major shift in the growth structure was required — from manufacturing-led exports and investment to services-led consumption. There was also consensus that it would take a new round of reforms to spark the requisite rebalancing of the Chinese economy.

¹¹ See A. Chermukhin, M. Golosov, S. Guriev, and A Tsyvinski, “The Economy of the People's Republic of China from 1953,” NBER Working Paper No. 21397, July 2015

In late 2013, the Third Plenum of the Central Committee of the 18th Party Congress ratified a comprehensive agenda of reforms that was aimed at China's new growth imperatives. Implementation has been challenging. While many new initiatives have been put in place (i.e., interest rate liberalization, *hukou* and family planning reforms), other reforms have lagged (i.e., social safety net and SOE reforms). At the opening of the 19th Party Congress last October, President Xi Jinping left little doubt that China was in need of refocusing its efforts on a new round of reforms aimed at sustaining a new era of Chinese growth and development. At the recent World Economic Forum in Davos, Switzerland, senior advisor Liu He drew great attention to this very issue with his assertion that new and deeper reforms are likely to "exceed the expectations of the international community."¹²

Reform strategies are a moving target as nations progress down the road of economic development. What works in the early "catch-up" stage is very different than what is required later on in order to achieve the aspirational objectives of a "moderately well-off society" and avoid the dreaded "middle-income trap." While China has long stressed its own unique approach to economic development with Chinese characteristics, the greater the progress it makes, the more it stands to gain from the experience of others who have traveled a similar road.

One such lesson is particularly important in the current environment — the twin perils of financial instability and asset-dependent real economies. As noted above, Japan's lost decades of the 1990s and the 2000s are an obvious and important case in point, as are the wrenching adjustments in the United States and other advanced economies during and after the Global Financial Crisis of 2008-09. In all cases, policy makers and regulators made serious mistakes in their search for new sources of economic growth. They failed to distinguish between financial engineering and growth enabling reforms. Just as Japan placed enormous emphasis on protecting its interlocking *keiretsu* networks, the US stressed risky new financial instruments (home-equity loans, subprime mortgages, and derivatives) and Europe turned to dysfunctional new institutions (monetary union). The results were painfully similar — the confluence of asset bubbles, excess leverage, and protracted post-bubble aftershocks bordering on secular stagnation.

China is well aware of the pitfalls of financial instability and has taken major steps to avoid the disruptive outcomes that have afflicted the advanced economies repeatedly

¹² See Liu He, "3 critical battles China is preparing to fight," speech before the *World Economic Forum*, Davos, 24 January 2018

over the past quarter century. Last year, the State Council established a new financial stability oversight committee to address a multiplicity of related issues — from excess leverage and shadow banking to local government finance and coordinating issues between monetary and regulatory authorities. In contrast to the United States, which still has a very fragmented regulatory structure that leaves its system vulnerable to cross-product and cross-market spillovers, China’s new focus on a super oversight authority should make it better positioned to address the complexity of systemic risks that proved so damaging during the Global Financial Crisis of 2008-09.

As always, the biggest challenge for reforms boils down to implementation. State-owned enterprise reform is near the top of the list, touching many different aspects of the growth challenge that China faces — excess debt, excess capacity, and the inefficiencies that plague the supply side of the economy. As was the case in the late 1990s and early 2000s when the first wave of SOE reforms led to the losses of some 37 million jobs,¹³ today’s efforts are not without further risk to headcount reductions and social instability. Perhaps because of those concerns, the government has been surprisingly timid in addressing the current round of SOE reforms.

The current SOE reform strategy seems to be coalescing around the so-called mixed ownership restructuring followed by China Unicom last August.¹⁴ In light of the lessons noted above, this approach could be problematic. The \$11.7 billion (USD) capital injection into China Unicom came mainly from 10 other companies, with 46 percent of those funds provided by other SOEs. This is very reminiscent of the Japanese *keiretsu* structure which spawned a massive problem with zombie enterprises in the aftermath of the bursting of the Japanese equity bubble in the 1990s. With China having experienced two major equity bubbles in the past ten years, a “keiretsu with Chinese characteristics” is a potentially worrisome development. Moreover, like the financial engineering of the West, this refinancing does more to rearrange China Unicom’s equity structure rather than refocus the company on more strategic growth objectives.

Yes, China’s extraordinary progress over the past 40 years is deserving of great praise. But as the Chinese economy has grown and the base of economic activity has broadened, its reform challenge has become exceedingly complex. Perhaps the most salient lesson from others is that financial engineering is not a substitute for the heavy

¹³ See International Monetary Fund, “People’s Republic of China: Selected Issues,” August 2017

¹⁴ See *South China Morning Post*, “China Unicom gets funding and stake boost from parent in ‘mixed ownership reform,’” 23 August 2017

lifting of reforms. There are no shortcuts on the road to China's new era. Reforms must remain at the core of China's economic development strategy.

The Big Risk

In the meantime, China's global challenges must contend with a new and serious risk — the possibility of mounting trade frictions with the United States. In his inaugural address a little over a year ago, US President Donald Trump asserted that "... protection will lead to great prosperity and strength." The Trump Administration has now moved from rhetoric to action in its avowed campaign to defend US workers from what the President calls the "carnage of terrible trade deals."

China is clearly the target. Under Section 201 of the US Trade Act of 1974, actions commenced with the January 22 imposition of so-called safeguard tariffs on imports of solar panels and washing machines, aimed largely at China and South Korea.¹⁵ Section 232 investigations into the national security threat posed by unfair steel and aluminum imports, which take dead aim on China as the world's largest steel and aluminum producer, have led to the March 1 announcement of steep tariffs on both products. Moreover, last August, under instructions from President Trump, the US Trade Representative commenced so-called Section 301 investigations against China in three broad areas of alleged harm to US interests: intellectual property rights, innovation, and technology development.¹⁶ These investigations, which will focus on whether China's laws, policies, practices, or actions are "unreasonable or discriminatory" in these key areas of the so-called new economy could well lead to follow-up sanctions on a broad array of America's imports from China.

Contrary to the arguably compelling political arguments in favor of trade protectionism, these actions will most assuredly backfire. For starters, tariffs on solar panels and washing machines are hopelessly out of step with transformative shifts in the global supply chains of both industries. Solar panel production has long been moving from China to places like Malaysia, South Korea, and Vietnam, which now collectively account for about two-thirds of America's total solar imports.¹⁷ And Samsung, a leading foreign supplier of washing machines in the US, has recently opened a new appliance factory in South Carolina.

¹⁵ See Office of the United States Trade Representative, "President Trump Approves Relief for U.S. Washing machine and Solar Cell Manufacturers," 22 January 2018

¹⁶ See Office of the United States Trade Representative, "USTR Announces Initiation of Section 301 Investigation of China," 18 August 2017

¹⁷ See C. Roselund, "Malaysia, Korea and Vietnam dominate U.S. solar imports," *PV Magazine*, 22 January 2018

Significantly, the Trump administration's narrow fixation on an outside bilateral trade imbalance with China continues to miss the far broader macroeconomic forces that resulted in a US multilateral trade deficit with 102 countries in 2017.¹⁸ Lacking in domestic saving and wanting to consume and grow, America must import surplus saving from abroad and run massive current-account and multilateral trade deficits to attract the foreign capital.

Consequently, going after China, or any other country, without addressing the root cause of low saving is like squeezing one end of a water balloon: the water simply sloshes to the other end. With President Trump having just signed a tax cut estimated at \$1.5 trillion over the next ten years, and with the US Congress adding another \$300 billion to the federal deficit in its latest effort to prevent a government shutdown, pressures on domestic saving will only intensify. In this context, protectionist policies will pose an increasingly serious threat to America's already-daunting external funding requirements — putting pressure on US interest rates, the dollar's exchange rate, or both.

In addition, America's trading partners can be expected to respond in kind, leaving export-led US economic growth at serious risk. For example, retaliatory tariffs by China — the third-largest and fastest-growing US export market — could put a real crimp on America's leading exports to China: soybeans, aircraft, a broad array of machinery, and motor vehicles parts. And, of course, China could always curtail its purchases of US Treasuries, with serious consequences for financial asset prices.

Finally, it is important to think about price adjustments likely to arise from tariffs. For example, competitive pressures from low-cost foreign production have driven down the average cost of solar installation in the US by 70 percent since 2010.¹⁹ The new tariffs will boost the price of foreign-made solar panels — the functional equivalent of a tax hike on energy consumers and a setback for US efforts to boost reliance on non-carbon fuels. A similar response can be expected from producers of imported washing machines; in fact, LG Electronics, a leading foreign supplier, has already announced a price increase of \$50 per unit in response to the imposition of US tariffs. American consumers are on the losing end in the Trump administration's first trade skirmishes.

¹⁸ See US Department of Commerce (Bureau of Economic Analysis), "U.S. International Trade in Goods and Services," December 2017

¹⁹ See Solar Energy Industries Association (SEIA), "Profiles in American Solar Manufacturing," August 2017

Contrary to tough talk from the Trump Administration, there is no winning strategy in a trade war. That doesn't mean US policymakers should shy away from addressing unfair trading practices. The dispute-resolution mechanism of the World Trade Organization was designed with precisely that aim in mind, and it has worked quite effectively to America's advantage over the years. Since the WTO's inception in 1995, the US has filed 123 of the 537 disputes that have been brought before the body – including 21 complaints lodged against China.²⁰ While WTO adjudication takes time and effort, more often than not the rulings have favored the US.

As a nation of laws, the US can hardly afford to operate outside the scope of a rules-based global trading system of which it is a key member. If anything, that underscores the serious mistake the Trump Administration made in withdrawing from the Trans-Pacific Partnership, an agreement which would have provided a new and powerful framework to address concerns over Chinese trading practices.

At the same time, the US has every right to insist on fair access for its multinational corporations to operate in foreign markets; over the years, more than 3,000 bilateral investment treaties have been signed around the world to guarantee such equitable treatment.²¹ The lack of such a treaty between the US and China is a glaring exception, with the unfortunate effect of limiting of US companies' opportunities to participate in the rapid expansion of China's domestic consumer market. With trade tensions mounting and the US Congress now considering legislation that would expand oversight of outbound foreign investment by American companies,²² hopes of a breakthrough on a US-China investment treaty have dimmed to a flicker.

Of course, there are two sides to every dispute, and mounting economic tensions between the United States and China is an obvious case in point. The ongoing structural transformation of the Chinese economy is not without important consequences for its codependent partner, the United States.²³ As China shifts from surplus saving to saving absorption — drawing down its outside 45 percent domestic saving rate to fund the safety net of the Chinese people — it will have less saving to loan to the United States and subsidize the safety net of the American people. Yet

²⁰ See World Trade Organization, WTO dispute settlement gateway at www.wto.org/english/tratop_e/dispu_e/dispu_e.htm

²¹ See D.M. Price and M.J. Smart, "BIT by BIT: A Path to Strengthen U.S.-China Relations," *Paulson Policy Memorandum*, The Paulson Institute, July 2013

²² See S. Donnan, "Trump's protection plan to keep 'competitor' China at bay," *Financial Times*, February 25, 2018

²³ See S. Roach, *Unbalanced: The Codependency of America and China* (Yale University Press: 2014)

with the budget deficits of Trumponomics likely to require more surplus saving from abroad, China's shift to saving absorption comes at a particularly vulnerable time for the United States.

Consequently, a growing disconnect is increasingly evident between the US and Chinese economies. Resolution of the twin contradictions facing both nations seems increasingly unlikely. America shows little inclination to address its own contradictions — especially, with the Trump Administration and Congress willing to exacerbate America's saving dilemma in the years ahead. China, by contrast, seems determined to tackle the imbalances and strategic challenges of a New Era.

That's where the divergent strategies of the two nations could well become destabilizing. Codependent relationships, such as the one that has long bound the US and Chinese economies together, are inherently reactive. When one partner changes the terms of engagement, the other often feels scorned — lashing out in response. China is changing. The United States is not. The Trump blame-game mentality borrows a page right out of the script of the scorned partner.

Trade wars are for losers. Perhaps that is the ultimate irony for a president who promised America it would start “winning” again. Senator Reed Smoot and Representative Willis Hawley made the same empty promise in 1930, leading to protectionist tariffs and a global trade war that exacerbated the Great Depression and destabilized the international order. Sadly, one of the most painful lessons of modern history has all but been forgotten.

A China-Centric Global Economy

Mounting global tensions have not displaced China's newfound role as the world's most powerful growth engine. Even in the face of its recent downshift from 30 years of 10 percent growth from 1980 to 2010, Chinese GDP growth has still averaged 7.5 percent, fully 2.1 times the global average.

This impetus is likely to persist for the foreseeable future. If China holds in the 6 percent to 7 percent growth range over the next few years — a reasonable prognosis, in my view — it will continue to outdistance the rest of the world by a wide margin. In that case, China would account for slightly more than 30 percent of total global growth in 2019 (as measured on a purchasing power parity basis). That would mean its contribution would be about 67 percent greater than the combined growth of the

United States and the European Union, even if the latter two economies increased somewhat more rapidly than expected in 2019 (2.5 percent in the US and 2 percent in the EU in 2019) and China slows to the lower end of expectations (to 6.0 percent). Indeed, in the absence of China's diminishing but still powerful growth assist, the world economy would be struggling.²⁴

Notwithstanding the recent firming of the global economy, there are important reasons to be concerned about the fundamental underpinnings of the so-called advanced economies. Impaired productivity growth remains a common thread running through Europe and Japan — and actually a persistent problem in the United States as well. Since 2010, productivity in the advanced economies has fallen well short of its pre-crisis trend. Without support from productivity, output growth invariably faces stiff headwinds. Recent research suggests that about 40 percent of the shortfall in post-crisis output growth in the advanced economies is traceable to a protracted slowdown in total (multifactor) productivity growth.²⁵

In a weak productivity climate, any acceleration in GDP growth, such as the modest pick-up that appears to have occurred in late 2017 and early 2018, is likely to be only transitory, inevitably returning back to its underlying sluggish trend. The only way to avoid that “growth fade” is for nations to embrace structural reform imperatives — all the more urgent in light of stiff demographic headwinds throughout the industrial world. The policy remedy is hardly a secret: innovation, technological change, investment in human capital, and trade liberalization. In the absence of more efficient and dynamic economic structures, the benefits of infrastructure and other investment spending activity will be short-lived, at best.

Japan is the poster child for failed structural reforms. After nearly three “lost decades,” the recent modest pick-up in the Japanese economy has sparked optimism that its long nightmare is finally over. However, with structural reforms stymied by special interest politics — especially Japanese labor market reforms — the so-called Third Arrow of the Abenomics strategy has never been successfully implemented. As a consequence, Japanese growth could fade quickly in late 2018 or 2019.

Europe's long dysfunctional monetary union poses a similar challenge to the seemingly encouraging pick-up in that region's economy — especially with trend productivity growth having been cut in half in the aftermath of the Great Financial Crisis of 2007-

²⁴ See S. Roach, “The World Economy Without China,” *Project Syndicate*, October 24, 2016

²⁵ See G. Adler, et. al., “Gone with the Headwinds: Global Productivity,” *IMF Staff Discussion paper*, April 2017

08 relative to an already sluggish pre-crisis trend of just 1 percent.²⁶ Without a meaningful productivity pick-up — unlikely for long sclerotic European labor markets — a growth fade is also likely in Europe.

Nor should the United States be spared the same fate from productivity headwinds that continue to afflict Japan and Europe. Notwithstanding the unsubstantiated and highly politicized claims of supply-siders, a large body of macroeconomic theory and empirical evidence points to little relationship between corporate tax cuts (like those just enacted) and investment, innovation, and productivity.²⁷ In light of the downside cyclical risks to the US economy noted above, America's lingering structural headwinds are all the more problematic.

All this poses great challenges to China. The debate at China's annual Central Economic Work Conference held in December 2017 underscored the delicate balancing act of a Chinese policy strategy that is attempting to address a multiplicity of risks, challenges and opportunities — from monetary and fiscal policy coordination and currency flexibility to property market excesses and deleveraging. Meanwhile the structural reform agenda, which is so critical to China's own productivity challenges, continues to be dominated by supply-side initiatives, with only minimal and disappointing emphasis on demand-side support to household consumption. And there were no new signs of progress on long overdue State-owned enterprise reforms. Add to all that, the multiplicity of global risks stressed above. The bottom line for China is perhaps more challenging than ever before.

Framing the Global Outlook

This broad constellation of forces makes for great uncertainty in looking to the future. On one level, there is good news. After years of post-crisis despair, the broad consensus of forecasters is now quite upbeat about prospects for the global economy in 2018. World GDP growth is viewed as increasingly strong, synchronous, and inflation-free. The latest IMF projection call for 3.9 percent global GDP growth over 2018-19, an acceleration of almost 0.5 percentage points from the 3.4 percent pace of the past two years.²⁸ Exuberant financial markets could hardly ask for more.

²⁶ See European Commission, *Quarterly Report on the Euro Area*, Volume 16, No 2 (Institutional Paper 060: September 2017)

²⁷ See B. R. Page, et. al., "Macroeconomic Analysis of the Tax Cuts and Jobs Act," Tax Policy Center, December 20, 2017; also see C.E. Weller, "Supply-Side Follies: Wasteful Tax Cuts Will Not Boost the Economy," Center for American Progress, October 25, 2017

²⁸ See International Monetary Fund, *World Economic Outlook Update*, January 2018

While all seems well on the surface, it is a stretch to call this a vigorous global growth outcome. Not only is it little different from the post-1965 trend of 3.8 percent growth, but the expected gains over 2018-2019 follow an exceptionally weak recovery in the aftermath of the Great Recession that pushed average global growth down to just 1.4 percent in 2008-2009 — an unprecedented two-year shortfall from the longer-term trend.

The absence of a classic vigorous rebound in the aftermath of this exceptional shortfall is of great significance. Historically, V-shaped recoveries have served the useful purpose of absorbing slack and providing a cushion to withstand the inevitable shocks that always seem to buffet the global economy. The lack of such a cushion leaves the world economy vulnerable to the likely unwinding of three mega-trends: unconventional monetary policy, the vulnerability of an asset-dependent real economy, and a potentially destabilizing global saving arbitrage. At risk are the very fundamentals that underpin current optimism.

The die has long been cast for this moment of reckoning. Afflicted by a profound sense of amnesia, central banks have repeated the same mistake they made in the pre-crisis froth of 2003-2007 — over staying excessively accommodative monetary policies. Misguided by inflation targeting in a largely inflationless world, monetary authorities have deferred policy normalization for far too long.

Moreover, there is an important twist today that wasn't in play back then — central banks' swollen balance sheets. From 2008 to 2017, the combined asset holdings of central banks in the major advanced economies (the United States, the eurozone, and Japan) expanded by \$8.3 trillion, according to the Bank for International Settlements.²⁹ With nominal GDP in these same economies increasing by just \$2.1 trillion over the same period, the remaining \$6.2 trillion of excess liquidity has distorted asset prices around the world.

And that's where the plot thickens. Real economies have been artificially propped up by these distorted asset prices —and glacial normalization will only prolong the drip feed of this dependency. Significantly, the risks are likely to be far more serious today than a decade ago, owing not only to swollen central bank balance sheets, but also to the over-valuation of assets.

²⁹ See Bank for International Settlements, *87th Annual Report*, Basel, 25 June 2017

That is particularly true in the United States. According to Nobel laureate economist Robert Shiller, the cyclically adjusted price-earnings (CAPE) ratio of 33.4 in February 2018 was about 21 percent higher than it was in mid-2007 on the brink of the subprime crisis.³⁰ In fact, the CAPE ratio is now slightly higher than it was in September 1929 on the brink of the Great Depression. The current reading of the CAPE valuation multiple has been surpassed only by the excesses reached in late 1999 and early 2000 on the eve of the bursting of the dot-com bubble. Those are not exactly comforting precedents.

As was evident in both 2000 and 2008, as well as in the brief correction of early February 2018, it doesn't take much for overvalued asset markets to fall sharply. That's where the third mega-trend could come into play — a wrenching adjustment in the global saving mix. In this case, it's all about China and the US — the polar extremes of the world's saving distribution.

As noted above, an important shift in the composition of global saving is at hand. China is in the early stages of a transition from surplus saving to saving absorption while the United States is opting for a fiscal stimulus that will take its already low saving rate even lower. As shock absorbers, overvalued financial markets are likely to be squeezed by the arbitrage between the world's largest surplus and deficit savers. Asset-dependent real economies won't be too far behind — a potentially ominous development for the global economy and ever complacent world financial markets.

China's Prognosis

With these considerations in mind, China's leadership faces yet another set of daunting challenges as it sets economic policy for a new year. Particularly worrisome is premature celebration of a New Era. In this case, there is a risk of putting the cart before the horse — confusing the path with the final destination. As always, the problems arise during the journey. The possibilities span the gamut — including structural transformation (from exports and investment to consumer-led growth), ongoing ownership transitions (especially State-Owned Enterprise reforms), avoiding the middle-income trap (by focusing more on indigenous innovation), and managing a blended growth model (comprised of State-directed industrial policies such as Made in China 2025 and an increasingly vigorous and dynamic private sector).

³⁰ See R. Shiller at www.econ.yale.edu/~shiller/data.htm

Accomplishing all these objectives while, at the same time focusing on deleveraging and financial stability, is a tall order for any nation, including China.

At the same time, it is important to start viewing China's growth targets in a very different light. The first 30-years of China's economic development miracle was driven disproportionately by emphasis on the quantity dimension of the Chinese growth experience. While hyper growth of 10 percent from 1980 to 2010 produced stunning results — a 26-fold increase in dollar-based measures of per capita incomes as well as poverty reduction of around 700 million people — it was an outgrowth of a powerful industrial model underpinned by export- and investment-led growth that placed enormous demands on energy-intensive resource consumption and environmental degradation.

The 2007 critique of Wen Jiabao raised serious questions about China's fixation on quantity-driven development metrics. Wen's emphasis on the pitfalls of an unsustainable growth model were underscored by public concerns over devastating air and water pollution. Rebalancing then took on the added significance as an important aspect of the sustainability solution — especially, by emphasizing the shift from resource-intensive manufacturing to resource-lite services. This cast China's structural transformation in a broader light — not just as a shift from exports to consumption, or from low value-added production to higher-value added emerging industries, but also as a greater emphasis on quality over quantity in order to capture important and long overlooked externalities of the growth experience. This puts China's newfound services led transformation — with tertiary activity having risen from 43 percent of GDP in 2007 to 52 percent in 2016 — in a very different light. While China is making solid progress on the road to higher quality growth, this aspect of the journey has only just begun.

Over the years there has been a blurring of the distinction between economic growth targets and growth forecasts. To the extent that growth targeting is a holdover from the old vestiges of Soviet style central planning that were so prevalent in the early five-year plans of the Mao era, the evolution to a more modern style forecasting approach should continue in the years ahead. At the same time, there is nothing wrong with goal-setting — either in the form of a target or a forecast. The aspirational vision of the New Era as articulated by President Xi is very much a goal-oriented exercise in terms of per capita incomes, economic structure, productivity, innovation, and the quality considerations noted above. Yet it is critical that China's strategy be framed analytically — not just rhetorically. Goal or target-oriented forecasts are very effective

in understanding how all the pieces fit together and in maintaining the related focus and discipline required to get from point A to point B over the next 32 years.

The Chinese economy is at a critical juncture for another set of reasons. It has moved into the middle-income zone that has long proved so problematic for sustained economic development. Nations get ensnared in the “middle-income trap” if they stay stuck in their early-stage development mindset — drawing on the innovations of others and the external demand of their trading partners.³¹ For that reason, alone, China’s current and prospective focus on indigenous innovation is both important and encouraging.

In this vein, there can be no mistaking the increasingly important role that research and development will play in driving this next phase of innovation-led growth in the Chinese economy. While increased R&D is a necessary condition to achieve this transformation, it is by no means the whole story. Related efforts need to be made in upgrading the Chinese educational system as a means to increase its investment in human capital; similarly, establishing a Silicon Valley-like start-up culture, together with a flourishing venture capital industry, is also vital in bringing innovation-led growth to the fore in shaping China’s New Era. Recent trends are very encouraging in this regard — especially strong growth in e-commerce and payments platforms, fintech, green technology, breakthroughs in biotech, genetics and other medical sciences, and electric vehicles. But the key for China will be in what comes after R&D. Making the leap from R&D to the *commercialization* of innovations could well be decisive in the years ahead.

Notwithstanding the strategic shifts to indigenous innovation and internal demand, China must also address some important tactical risks in managing its large and increasingly complex economy and financial system. Shifting away from debt-intensive growth is especially important in that regard. China’s debt to GDP ratio has soared in the aftermath of the Global Financial Crisis, rising from slightly less than 100 percent in 2008 to around 250 percent of GDP in 2016, according to statistics compiled by the Bank for International Settlements.³²

The problem can be traced mainly to China’s debt-intensive, low-return State-Owned Enterprises. The corporate sector accounted for fully 60 percent of the total increase

³¹ See F. Zilibotti, “Growing and Slowing Down Like China,” *Journal of the European Economic Association*, July 2017

³² See Bank for International Settlements, “Credit to the Nonfinancial Sector database” 3 December 2017 update

in Chinese debt since 2008.³³ And SOEs accounted for 58 percent of the cumulative increase in Chinese corporate indebtedness from 2008 to 2016.³⁴

Long-delayed SOE reforms are compounding a resolution of this key problem. As noted above, the recent shift to “mixed ownership” SOE reforms along the lines of the \$12 billion (USD) capital injection into China Unicom last August does not address the core issue of excess SOE leverage. As China demonstrated in the late 1990s and early 2000s, SOE restructuring — namely downsizing and market-based efficiency enhancements — is ultimately the only way out.

China as the Next Great Power?

None of this is to say that China has it all figured out. While its strategy is impressive, as is its commitment to that strategy, the trick always comes in implementation. That puts the onus on rebalancing — in many respects, a broad and amorphous prescription. In one sense, rebalancing can be seen as the resolution of the “soft” principal contradiction of unbalanced development. If China is to realize its own aspirational objectives as a Great Power by 2050, as President Xi Jinping stated without equivocation in his address to the 19th Party Congress, it will also need to sharpen its focus on the resolution of a number of important “hard” contradictions — especially state-owned enterprise reform, capital markets development, and social safety net reforms. Progress has been lagging in all of these areas. China needs to resolve both its soft and hard contradictions.

But great power status is very much a relative achievement — the strength of one nation as compared to others. As argued above, China faces global challenges on many levels. Not only are there possible pressures from the global business cycle, but China also must contend with the existential threats of de-globalization and protectionism as noted earlier.

But now there is a new geo-strategic overlay to China’s global challenges that must be taken very seriously. A muscular America-First security approach recently unveiled by the Trump Administration is a potential game-changer. China is no longer viewed as a “responsible stakeholder” by the US in geo-strategic terms but now, lumped together with Russia, is characterized as more of a competitive threat that “... challenge(s) American power, influence, and interests, attempting to erode American

³³ See BIS credit database, *ibid*.

³⁴ See International Monetary Fund, “People’s Republic of China: Selected Issues,” *op. cit*.

security and prosperity.”³⁵ In this important respect, China’s new global role is being challenged as never before.

China should not believe that it can simply turn the other cheek and forge a new type of globalization through its Belt and Road Initiative (BRI) in an effort to engage the world on different terms. On the surface, the BRI strategy appears quite compelling: rather than rely on global trade and the external demand of a still weakened industrial world, China has turned instead to a massive pan-regional infrastructure plan aimed at some 60 percent of the world’s population and approximately one-third of the global GDP that lie along China’s historical trade routes. Visionary? Yes. Realistic — especially in light of the world’s and the region’s crisis-prone experience of the past 20 years? That remains to be seen.

While there can be no mistaking the potential scope of the BRI strategy, the planning, funding, and construction lags of this massive pan-regional infrastructure effort do not suggest any immediate impetus to Chinese or regional economic growth. Moreover, the BRI can hardly be considered a riskless endeavor. It runs through some of the most politically unstable nations in the world; 28 of the 64 BRI recipient nations are in Central Asia, the Middle East and North Africa, and South Asia, where aggregate political stability, as measured by *World Bank Governance Indicators*, is only in the 28th percentile of some 213 countries around the world.³⁶

Amid this shifting constellation of global tensions, President Xi still makes a compelling case for the rise of China to great power status by 2050. The two-stage strategy — first, modernization and then a flourishing prosperity built on strength at home and abroad — goes hand in hand with the rejuvenation promises of the China Dream. Left unanswered, however, are thorny and important questions that have long been raised about China’s internal structure and how that fits into an ever-complex global structure.

History tells us that nations are truly great only if they draw strength from within. Yale historian Paul Kennedy famously argued that point in his examination of the destabilizing interplay between shifts in relative economic power and global stability.³⁷ At the same time, he also warned of the temptations of “geostrategic overreach” —

³⁵ See Office of the President, *National Security Strategy of the United States of America*, December 2017

³⁶ See World Bank, Worldwide Governance Indicators database at www.info.worldbank.org/governance/wgi/index.aspx#home

³⁷ See P. Kennedy, *The Rise and Fall of the Great Powers: Economic Change and Military Conflict from 1500 to 2000* (Random House: 1987)

when nations attempt to expand their projection of power to the outside world without attending to the foundations of strength at home. For China and its increasingly ambitious global push, that lesson can hardly be ignored.

In the end, China's powerful economic takeoff was very much a levered play on globalization, global trade, and ultimately the global economy. Yet the lessons of Japan, the Asian Financial Crisis, and the Global Financial Crisis all underscore the systemic perils of an externally focused growth strategy. By recognizing the "unbalanced and inadequate" characteristics of China's great successes in the first stage of its development, Xi Jinping and the Party leadership seem to understand the pitfalls of staying this course. Clarifying the new course becomes all the more urgent as a result.
