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China Takes Off

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CHINA'S ECONOMIC EXPLOSION

FEW NATIONS have changed as fast—or as dramatically—as China has since the 1970s. The world's most populous nation has radically liberalized its economy and gone from producing low-quality and simple exports to sophisticated high-technology goods, while nurturing a vibrant private sector and attracting nearly \$500 billion in foreign direct investment (FDI). The country has turned into a formidable exporting machine: China's total exports grew eightfold—to over \$380 billion—between 1990 and 2003; and its exports in the electronics industry now account for 30 percent of Asia's total in that sector. China's share of global exports will reach 6 percent in 2003, compared to 3.9 percent in 2000. Last year, China accounted for 16 percent of the growth in the world economy, ranking second only to the United States.

There is no question, therefore, that China's emergence as a great economic power will rank as one of the major issues confronting world leaders in the next few decades and that its progress demands careful analysis. To start, it is worth examining China's winning strategies—economic liberalization, a focus on high technology, and its resolve to become a regional leader—as well as its challenges—the widening gap between its urban and rural populations, growing unemployment, and the increased challenges posed by its aging population. Next, it is important to consider the effects that its stunning success has had both at home and abroad. China's progress has unnerved many of its neighbors and trading partners: Asian countries worry about losing their competitive edge, especially in high-technology markets; in

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China Takes Off

the United States, concern has been mounting over the country's considerable—and growing—trade deficit with China.

Beijing has tried to assuage its neighbors' concerns by spearheading a project to create a regional free trade zone and tightening economic cooperation in Asia through local mechanisms. But its goodwill gestures have not put everyone at ease, and the United States, Japan, and South Korea have asked it to revalue its currency. Although China is unlikely to oblige anytime soon, and the currency question is likely to garner still more attention, it should not distract from the essential point—that China, the United States, and the rest of the world still have much more business to do with one another.

OPENING THE DOOR

THANKS TO dramatic progress in technology, transportation, and communications systems, China will wield far more power in the global economy the next time it peaks than it did on the eve of Europe's Industrial Revolution, in 1820, when it accounted for as much as 32 percent of the world's economy. Beijing now has “soft power” and growing diplomatic clout to buttress its economic and political strength. It expects to launch its first manned space mission, Shenzhou 5, this fall. China is also better prepared to be a world leader, because its new elite is not isolated from the Western world, as were preceding Chinese leaders. Today the Chinese media bring information and entertainment from abroad to almost every Chinese household. Opportunities for interchange with foreign cultures, once nonexistent, are now numerous.

During the past quarter century, China reformed the command-and-control model of its economy in favor of a market-driven one. But there are no precedents for its recent emergence as a potential economic superpower. And as the chaos of Russia during the 1990s vividly illustrated, there is no simple—or safe—formula for liberalizing economic roles in this fashion.

Nonetheless, so far the record seems good. China's decision to open its economy by promoting trade and FDI seems to have given it an edge and helped it integrate more thoroughly into the world economy than did Japan or South Korea after World War II. On the

eve of the financial crisis of 1997–98, Japan and South Korea had only \$17 billion and \$12 billion of FDI, respectively, because of their protectionist policies. The crisis broke down some of these barriers, but today, FDI in Japan still accounts for only 1.1 percent of GDP, compared with over 40 percent in China.

To alleviate the strain recently caused by massive layoffs in state-owned companies—45 million workers over the past five years—Beijing has allowed foreigners to pour \$450 billion into its economy. That figure makes China the world's fifth-largest recipient of FDI, after the United States (\$1.3 trillion), the United Kingdom (\$497 billion), Benelux Economic Union countries (\$482 billion), and Germany (\$480 billion). At its current growth rates, China could easily leapfrog to second rank in 2004. Foreign companies now hold large shares in many sectors of China's economy, including in its markets for automobiles and cellular telephones. They also account for half of China's exports—compared to 45 percent for Malaysia, 38 percent for Singapore, 31 percent for Mexico, and 15 percent for South Korea—and, thanks to their participation in the country's global supply chain, for 60 percent of China's imports.

The investment of American companies in China is worth more than \$70 billion in contracts, which generate greater revenues for these corporations than their contracts in any other developing country. In 2000, U.S. corporate revenue from China reached \$7.2 billion, compared to \$4.6 billion from Mexico, \$3.5 billion from Singapore, and \$1.85 billion from Brazil.

Although China's reliance on FDI has proved vastly successful, the strategy is not without its dangers. Massive investment—foreign and domestic—has created a tremendous expansion of productive capacity, which may make it more difficult for producers to earn an adequate return on their capital. Investment share of GDP in China reached 42.2 percent last year, considerably more than in other Asian countries. With a large share of the economy still owned by the state, China runs the risk of developing too much industrial capacity, which could cause profitability to drop and, ultimately, firms to go bankrupt. China now has the capacity to produce 2.8 million automobiles, for example, but only 1.8 million are actually sold. Although China witnessed eastern Asia's 1997–98 financial crisis and the price that South Korea paid

for overdeveloping its industrial capacity, misallocation of capital remains a real risk in China, given the sheer level of the country's fixed capital formation.

China's fixed asset investment grew by 31.1 percent during the first half of 2003, triple the growth rate in all of 2000. But consumption only grew annually by 8.8 to 10.1 percent during the same time. Chinese economists worry that this disparity may create excess capacity, limit profit margins, and eventually lead to corporate solvency problems. China's apparent decision to maintain a stable exchange rate is also increasing the risk of excessive investment. The fixed exchange rate has encouraged the growth of foreign exchange reserves, which has pushed the growth rate of money supply and credit above 20 percent, up from 10 to 12 percent two years ago. That rise may in turn encourage firms to overinvest in real estate or manufacturing capacity.

A THOUSAND CONSUMERS BLOOM

IN 1979, Deng Xiaoping popularized the term *xiaokang*, which was first used in *Shijing*, a classic book of poetry from the tenth to sixth centuries BC. According to Beijing scholar Lu Shuzeng, *xiaokang* represents the concept of an ideal society that provides well for all its citizens—a poetic notion to which Deng set out to give an economic dimension. For him, the concept translated into reaching a per capita GDP of \$800 by the end of the twentieth century.

Deng achieved his goal, and visibly improved China's real income and living standards, thanks largely to economic liberalization. The country's real GDP has grown to over \$1.3 trillion from \$106 billion in 1970. Although the jump is impressive, it has left China comparatively poorer today than Japan and Germany were in the aftermath of World War II. (China's GDP today is equal to 11.5 percent of the United States', compared to 13 percent for Japan and 19 percent for Germany in 1950.) But because Beijing has managed to stem population growth—down to 1 percent a year, from 3 percent during the 1960s—China's growth of output has translated into large gains in income per capita.

As a result, China now has high penetration rates for a wide range of consumer goods—that is, today many more Chinese consumers buy many more goods. There are color television sets in almost every

urban home, refrigerators and washing machines in more than four out of five, videodisc players and air conditioners in half of them, microwave ovens in almost a third, and computers in one out of five. Automobiles are the only consumer item with a low penetration rate (0.9 percent), but with sales expanding at an annual rate of 40 to 50 percent, they are likely to catch up in the next few years.

Residential real estate sales in Shanghai in 2000 were equal to 13.4 million square feet, compared to 1.4 million in 1994. (In Beijing, they more than tripled during that time—to 4.8 million square feet; in Guangdong, they almost doubled—to 16.2 million square feet.) In many urban centers, two-thirds of housing is now privately owned. Close to 90 percent of urban Chinese now own a home, compared to only 52 percent of the population in Hong Kong and 61 percent in Japan. Among Asian countries, only Singapore has a higher home ownership rate (92 percent).

So instead of government guarantees for housing and social services, China now has a rapidly expanding private market for housing, education, health care, and other services. The private sector now produces about 45 percent of output, compared to state enterprises' 37 percent share. Since the private sector also employs about one-half of all urban workers and the rural sector is now effectively out of government control, it could be said that the private sector employs over 80 percent of China's total labor force.

Recently, Chinese politicians have emphasized the need to focus on the social effects of China's economic transition, rather than just promote rapid growth. The new president, Hu Jintao, has made numerous speeches about economic inequality, and the new premier, Wen Jiabao, has highlighted the need to bolster domestic consumption, not just exports. Raising standards of living matters to China's leaders today, as it did to Deng 25 years ago, but achieving *xiaokang* now means reaching a per capita GDP of \$2,000 by 2020.

THE DRAGON'S AILMENTS

ALTHOUGH CHINA is often thought of as a rural economy, it has more than 200 cities with populations of over a million. In the 1970s and 1980s, economic transformation was led by agricultural reforms

that gave peasants an incentive to expand output significantly. During the 1990s, however, the revolution moved to the urban centers and industry. Its economic benefits have been concentrated in these urban areas and have produced great disparities between the integrated, largely urban coastal areas in the eastern parts of the country and the fragmented, rural economies in the western parts. China now produces 57 percent of its GDP in its east, 26 percent in the central region, and only 17 percent in the west. Foreign investors have reinforced this division by placing 86.4 percent of their capital in the east, 9 percent in the central region, and only 4.6 percent in the west.

Beijing is trying to compensate for regional inequalities by investing in depressed areas. The state budget, for example, accounts for 13.9 percent of construction in the western region, compared to 8.7 percent in the eastern region. And state-owned companies account for 75 percent of industrial production in the western region, compared to 39 percent in the eastern region. The government is also promoting private investment in the western region.

Those measures, however, are unlikely to bridge the regional divide. Income growth in rural areas lags far behind that in urban areas. And China's membership in the World Trade Organization (WTO) may further depress rural income by opening up the country to greater food imports, which could compete with local production. Millions of people may flock to the cities from the countryside, jeopardizing the social stability of urban centers.

China's second great problem is unemployment. The unemployment rate in urban areas is estimated at more than 8 percent; there may be an additional 200 million jobless workers in the countryside. According to Zhai Zhenwu, the director of the Population Research Institute at China's Renmin University, China will need to create 20 million new jobs a year to absorb the 8 million people who have lost their jobs in state-owned enterprises.

The most effective cure for unemployment—other than encouraging FDI—is to use domestic capital to create more private-sector service jobs. Although the service sector accounts for only a third of China's GDP, it accounts for 85 percent of the jobs created during the past five years. But lack of credit for small private firms has stifled growth; big banks still lend primarily to large state-owned companies; and the

stock market has been restricted, also largely to state-owned enterprises. Once the current political transition is complete, the government will have to take effective action to promote lending to small businesses and create a stock exchange for truly private companies.

There are signs that changes in these areas have already begun. Lending by the big state-owned banks is now growing by only 8 percent annually, whereas lending by other institutions, such as the 110 new commercial city banks, is growing at an annual rate of 27 percent. These institutions now account for a quarter of all loans and 45 percent of recent loan growth. Hundreds of private companies plan to apply for stock market listings. Some are also looking at foreign markets such as Hong Kong and Singapore.

China has had to turn to capitalism to fund the retirement of its aging population.

Researchers at the Australian National University have proposed that to ease rural unemployment China should also promote microlending institutions in rural areas so that the savings of farmers can be used for local development. Rural populations have been a sorely underserved market, especially

since 1997, when in an effort to stem losses and reform the banking system, nearly all branches of state-owned banks were closed in rural areas. The move left local populations with virtually no lending source, because the rural credit cooperatives that remained were saddled with nonperforming loans and were ill equipped to handle retail lending. Today these cooperatives do 60 percent of their business outside the agricultural sector. With China's rural population expected to reach some 800 million people by 2020, it is essential for the stability of its economic development that China help the people of its countryside.

China's third main challenge is to find a way to support its rapidly aging population. In 2030, a quarter of China's population will be over 65—a figure comparable to that for the United States. Unlike the United States, however, China does not have pension funds. Thus it must introduce pension funds and promote efficient stock and bond markets to absorb the savings of those preparing for retirement.

It is no exaggeration to say that China is embracing capitalism partly because its demographics are becoming like those of the Western world. In the 1950s and 1960s, life expectancy in China was short, and

the elderly population tiny. But as its birthrate drops and its population ages, China will have to generate returns on savings to provide income for its vast population of retirees. Societies with large elderly populations need highly efficient, if not ruthless, forms of economic competition to generate the return on capital that is needed to finance a comfortable lifestyle for retirees. Without the economic reforms of the last two decades, China could not have hoped to provide reasonable living standards for the 400 million elderly Chinese expected by 2030. The problem is more acute in rural areas, where the elderly, who essentially have no pension benefits, are dependent on their shrinking families for support.

Fortunately, many of the world's leading investment organizations are already opening offices in China and establishing joint ventures to develop the country's pension-fund sector. In 2001 and 2002, investors placed billions of yuan in new equity-oriented mutual funds. By the end of 2001, the country's nine largest asset managers had over seven billion yuan under management. But Beijing must do more to encourage the growth of such funds.

WIRED FOR CHANGE

IN ADDITION to its remarkable growth, especially in FDI, China's progress is distinctive for its commitment to developing high-technology industries. Although this technology will inevitably weaken the government's control over communications networks and the distribution of information throughout the country, China has been quick to embrace the new information economy.

The total number of fixed phone lines—now 397 million—has multiplied by a factor of 90 since 1989. Sixty-nine million people now access the Internet through personal computers—up from 8.9 million in 2000—and even more users now log on with their cellular phones. More than 200 million Chinese households now have cable television—making China the world's largest cable market—and the number may double by 2005. China is also the biggest market for cell phones, with 200 million already in use and average monthly sales of about 2 million.

China now wants to become a player in the computer hardware and software industries as well. In recent years, its domestic consumption in

both sectors has grown rapidly: software sales jumped from \$819 million in 1995 to \$3.5 billion in 2001, and hardware sales rose from \$759 million to \$9.68 billion. China's international aspiration is to match India's success as an exporter of software and Taiwan's as an exporter of hardware. China is making progress: in 1999, India's software exports were worth \$5.66 billion, whereas China's totaled \$2.12 billion.

To help reach its goal, Beijing hopes to capture 60 percent of the domestic software market for local firms and to multiply exports by ten by 2010. India has enjoyed significant growth in this sector be-

China plans to match India's success as an exporter of software and Taiwan's as an exporter of hardware.

cause it invested in technical colleges after independence and because many of its citizens speak English. Although China does not have India's linguistic advantage, it has no shortage of engineers: some 325,000 new engineers graduate in China every year, three times as many as in India. China also has great potential to compete in the hardware sector. Chinese firms have already successfully taken on IBM, Dell, and other foreign

firms for shares of the market: in 2000, the Chinese computer firm Legend had a 26 percent market share, compared to 6 percent for IBM and 3.8 percent for Hewlett-Packard.

Thanks to foreign investment, China already leads the world in the production of certain types of electronics. In fact, this year, China—taken together with Hong Kong—will likely be the leading producer for 8 out of 12 key consumer electronics products. It is expected to produce more than half of the world's DVD players and digital cameras; more than a third of DVD-ROM drives and personal desktop and notebook computers; and about a fourth of its mobile phones, color televisions, personal digital assistants, and car stereos.

China's success is transforming the marketplace for Asia's electronics industry. China now accounts for 30 percent of the region's electronics exports, compared to only 14.3 percent in 1997. China's gains have been most costly for Singapore, which saw its market share slump over the same period from 19.3 percent to 9.8 percent. Other countries, such as Malaysia, Taiwan, and Thailand, are also under pressure. Only South Korea has managed to hold its own against Chinese competition: its

China Takes Off

market share for 2002 (17.1 percent) was higher than for 1997 (16.5 percent) but lower than its peak of 18.7 percent in 2000.

China's technology exports are likely to continue to grow rapidly, because the country's production is getting a boost from Taiwanese companies that are moving their operations to the mainland. The government of Taiwan authorized investments in China worth \$11 billion in 1997, \$19 billion in 2001, and \$32 billion in 2002. At present, 56 percent of Taiwan's large electronics companies, 63 percent of its medium-sized companies, and 73 percent of its small companies have manufacturing operations on the mainland. Taiwanese firms are also important suppliers of components to leading computer companies in China, which they increasingly plan to use as a base for exporting goods to the rest of the world. China's largest exporter in 2002 was Honhai Electronics, a Taiwanese manufacturer of computer parts, which exported \$4.38 billion worth of goods.

The migration of Taiwan's electronics companies to the Chinese mainland could have profound consequences for the world economy. In 1999, Taiwan's companies were the world's top producers of various electronics products, including keyboards (62 percent), motherboards (61 percent), monitors (54 percent), laptop computers (53 percent), and personal desktop computers (25 percent). Taiwan's companies already produce 25 percent of their desktop PCs in China. As much as 10 percent of Taiwan's active population may already be employed on the mainland. Indeed, Taiwan has a total population of 23 million and a labor force of about 10 million, and analysts estimate that there are now over 40,000 Taiwanese firms operating on the mainland, formally employing at least 500,000 Taiwanese and, informally, perhaps another 400,000. (Also, some 4,000 Taiwanese currently study in Chinese graduate schools.)

Although Taiwan has long represented a foreign policy challenge for China, this ongoing economic integration with the mainland will encourage both sides to avoid political friction. Beijing and Taipei are now actively discussing restoring air and sea links for the first time since 1992 talks in Singapore. If the opposition Kuomintang party returns to power in Taiwan next year, transportation links to the mainland are likely to be restored, because the party is committed to the notion of a single China (whereas the current ruling party has been flirting with independence for Taiwan).

A DUAL HUB

JAPAN'S ECONOMIC difficulties in the 1990s also boosted China's position relative to other economies in the region. Ten years ago, Japan consumed 20 percent of eastern Asia's exports, and it provided the region with a third of its bank loans. But Japan has slashed lending since then, and it now buys only 10 percent of eastern Asia's exports, whereas it sells 45 percent of its own exports to the region. In contrast, China's imports from the region have grown from 6.8 percent of the total in 1990 to 15 percent today—or, counting Hong Kong, 31 percent. In absolute terms, China's imports have skyrocketed from \$4.1 billion in 1970 to \$370 billion, and its exports from \$4.6 billion to \$380 billion. If China sustains its current growth rates for several more years, its exports could overtake Japan's by 2005 and be twice as large by 2010.

China's recent growth has been dramatic for both exports and imports. This is a sign, experts say, that China has become an essential link in the global production chain for many labor-intensive products. China's central position also helps explain why in 1999 the country absorbed 85 percent of the region's total FDI, up from 24 percent in the early 1980s. Fifteen years ago, intra-Asia trade flows were simple. Capital goods and components were shipped from Japan to Asia's newly industrializing countries for processing and then exported to industrial countries. China's opening to trade has added a link to this chain. Capital goods are now shipped to Taiwan and South Korea; capital-intensive components are then sent to China and elsewhere in Asia for labor-intensive processing and assembly, before being reexported to developed markets. This flow, according to Glen Hodgson and Mark Worrall, economists at Export Development Canada, is evidence that China has emerged as a "dual hub":

China has become a manufacturing hub for the rest of the world in low-end labour-intensive goods—and the rest of the world is becoming a manufacturing hub for China in high-end, capital-intensive goods. ...

... China may be a threat to certain parts of the global supply chain that rely on low-cost labour, but it represents an even greater opportunity via production efficiency gains, economic welfare gains and long-term dynamic potential. Its booming exports are more than matched by booming industrial imports and foreign investment opportunities. It has become the new engine of global growth. ...

China Takes Off

It is when one compares China's imports of goods intended to satisfy domestic demand with its imports of goods slated to be processed and reexported that it becomes plain how China's role in the global supply chain has changed. Total exports from the rest of Asia to China grew from \$72.1 billion in 1995 to \$160.6 billion in 2002. But while China's imports for domestic demand almost doubled during that time—growing from \$42.2 billion to \$78.7 billion—its imports for reprocessing nearly tripled—growing from \$29.8 billion to \$81.9 billion. As a result, imports for reprocessing now account for 51 percent of China's imports from Asia, compared to 41 percent in 1995.

The changes in the composition of China's trade have had dramatic effects for some Asian countries. The reexport share of Singapore's exports to China, for example, grew from 25 percent in 1995 to 53 percent in 2002, but the share of Indonesia's grew only from 11 percent to 24 percent. Over the same period, the United States' total exports to China increased from \$16.1 billion to \$27.3 billion, with the share of exports for reprocessing growing from 37 percent to 44 percent. And exports from Europe to China grew from \$21.3 billion to \$38.5 billion, with the share of exports for reprocessing increasing from 40 percent to 47 percent.

As a result of its new role in the global supply chain, China is now running trade deficits with eastern Asia and trade surpluses with North America and Europe. According to Chinese data, China currently has trade deficits of \$31.5 billion with Taiwan, \$13.1 billion with South Korea, \$7.6 billion with the Association of Southeast Asian Nations (ASEAN), \$5 billion with Japan, and \$1.3 billion with Australia. China has also displaced the United States as South Korea's largest trading partner.

China is emerging as a player in regional economic policy development for the first time ever. It is anxious to promote cooperation and quiet its neighbors' concerns that it is gobbling up too large a share of the region's FDI. As a result, China has held extensive discussions with the ASEAN countries about creating a regional free trade zone that would create a market of 1.7 billion people with a nominal GDP of over \$2 trillion. China has also joined the new group known as "ASEAN + 3," which includes the ten ASEAN members plus China, Japan, and South Korea and is designed to encourage regional cooperation

on issues such as financial stability. Japan had proposed the creation of a regional monetary fund in 1997, but the project foundered because the United States opposed it and other important countries, such as China, had not been consulted. Future ASEAN + 3 forums are expected to institutionalize regional cooperation on such issues within the group. Beijing hopes this will reduce the perception that it is a dangerous superpower. That is a tall order, however, because it would be difficult to exaggerate China's remarkable progress and overestimate its likely consequences. China's unprecedented growth will have repercussions far beyond the region and the industries that garner China's immediate attention.

Mexico, for example, has already suffered from China's progress. Despite the North American Free Trade Agreement (NAFTA) and the great American investment boom in Mexico, China recently

For the first time,
China is acting as a
regional economic
policy leader.

overtook Mexico as the United States' second-largest trading partner. In June, China's share of U.S. imports over the previous 12 months rose to 11.4 percent—up from 6.1 percent in 1995—whereas Mexico's grew only to 11.2 percent—up from 8.2 percent. Mexico is no longer competitive enough. Its labor is four times more expensive than

China's, and its electricity twice as expensive because of government policies limiting private investment in the energy sector.

China's emergence as a major trading nation is likewise transforming the world's commodities markets. Already in 2001, it accounted for 30 percent of iron ore consumption worldwide, 21 percent of platinum consumption, and 15 percent of aluminum consumption. Although in absolute terms these figures are large, China is a modest consumer per capita: for example, in 1998, it consumed only 3,083 tons of aluminum per million people, compared with 26,201 tons for the United States. China's continuing industrialization will increase its consumption of a wide range of raw materials further still, which will prompt a dramatic expansion of its trade with commodity producers such as Africa, Australia, Latin America, and Canada.

China's growing need for energy imports will also help reinforce its integration into the global economy, by pushing it to boost its

China Takes Off

exports to generate revenues and forge new alliances with suppliers. The International Energy Agency projects that China's net oil imports will grow from 1.7 million barrels a day in 2001 to 9.8 million by 2030. China will be able to satisfy this huge demand for oil only if it increases its exports of manufactured products. Rising needs could prompt it to become one of Russia's major oil customers. There are currently no pipelines connecting the two countries, but plans are under way to link Russia's eastern oil fields to both China and Japan.

REACTIONS ABROAD

PREDICTABLY, China's newfound prominence has unsettled many of its trading partners, including the United States. In particular, the jump in China's exports, and the massive trade deficit it has caused for the United States (\$105 billion for 2002), has American manufacturing firms worrying about more trade losses. However, their perceptions of China today are far more nuanced than their perceptions of Japan were ten years ago. When trade tensions with Japan developed during the 1970s and 1980s, Tokyo had few allies among American corporations because it had effectively banned them from investing in Japan. By contrast, China has won over many U.S. firms by inviting them to make large investments in and take shares of its market. General Motors, Motorola, and Procter & Gamble are earning healthy profits in China. The U.S. corporate sector has \$26 billion worth of sales in China, compared to \$20 billion worth of exports. The U.S. companies that are demanding trade protection from China or a revaluation of its currency are primarily small- and medium-sized firms that have not been able to access its market. If Beijing can find ways to encourage them to trade with and invest in China, they too are likely to become less protectionist.

Nonetheless, China's export success has prompted Japan, South Korea, and the U.S. Treasury to ask China to revalue its currency, which has been pegged to the U.S. dollar at a fixed exchange rate (8.3 yuan) since 1994. China resisted fierce pressure to devalue during the Asian financial crisis of 1997-98, on the grounds that it wanted to limit the risk that the crisis would spread. Since then it has been reluctant to introduce flexible exchange rates from fear that they

might affect its unemployment rate and upset its financial stability. Because the Chinese government views export growth as a measure to reduce unemployment, it is reluctant to tamper with the country's competitive advantages.

China also has an undeveloped financial system, with many non-performing loans and limited capital account convertibility, which could complicate a transition to fluctuating exchange rates. The government fears, for example, that local companies would not understand currency hedging and that volatility in the exchange rate would cause some to question the banks' stability. Because China's foreign exchange reserves are growing, and spurring monetary growth, China should consider replacing its fixed exchange rate with an exchange band, or range. Such a target band would probably allow the currency to fluctuate by 3 to 5 percent—far short of the 30 to 40 percent revaluation that American firms are clamoring for.

Although the Bush administration insists that it wants China to revalue, it cannot be entirely displeased with the peg's side effects. Thanks to the peg, China now belongs to a bloc of countries in eastern Asia that holds \$1.7 trillion in foreign exchange reserves—or 70 percent of the world's total (up from 30 percent ten years ago). China, Japan, and other countries in the region have been trying to stabilize their currencies by buying U.S. dollars. In the past 18 months, for example, China has purchased \$100 billion of U.S. government securities, and Japan \$150 billion. In doing so, these countries have effectively become the primary source of funding for the United States' growing fiscal deficit and current account deficit. Japan already played that role during the late 1980s, but China is funding U.S. deficits for the first time.

Were China or Japan to withdraw support for the dollar, U.S. bond yields would likely rise sharply, driving up mortgage rates and threatening the housing boom that has sustained American domestic consumption since 2001. But China and Japan have become so heavily dependent on the U.S. market that they will not want to jeopardize the United States' prosperity by shifting their reserves from the U.S. dollar to gold or the euro. Despite potential disagreements about foreign policy or other issues, they will not threaten the dollar because they need the United States to remain a healthy export market for

them. In this respect, the foreign exchange reserves of eastern Asia's central banks have become a financial backbone to the United States' economic well-being.

HOMELAND (IN)SECURITY

CHINA'S ECONOMIC transformation has not yet threatened the supremacy of the Chinese Communist Party. Nonetheless, the political situation in China should not be assumed to be static. Discontent there is less likely to be voiced because of the regime's authoritarian nature, but it is no less likely to exist. In fact, because China's economic reforms disrupt the lives of millions of people, they are often unpopular. Were China a democracy, it would probably have to weather a populist movement opposing the reforms. But it is run by an authoritarian regime—a feature that allows it to implement radical change quickly.

Changes in China's leadership should only speed the cause of reform. Jiang Zemin, the country's former president and leader of the Communist Party, and Zhu Rongji, the former premier, were recently replaced by younger politicians with more varied experiences and potentially more liberal views. For example, Wen Jiabao, the new premier, is a respected manager who nonetheless was very close to Zhao Ziyang, the liberal premier who was sacked for sympathizing with the Tiananmen students. Moreover, five of the Politburo's seven members and more than half of the Central Committee's 200 members stepped down last year, and all were replaced by leaders who hold university degrees. That is a drastic change from 25 years ago, when almost none of the party's leaders had higher education. The party's decision to institutionalize political change by rotating its personnel has led Henry Kissinger to suggest that it might soon come to look more like Mexico's Institutional Revolutionary Party than like the rigid totalitarian party it once was.

More changes are to be anticipated, as new generations of leaders with vastly different experiences and sensibilities take over the reins. Mao and survivors of the Long March made up China's first generation of leaders after the revolution; the men who launched the market reform process during the 1970s count as the second. The third generation came of age during the chaos of the Cultural Revolution and then

managed two decades of economic reform. Leaders of the fourth generation, who have just taken power, will have spent most of their careers observing a liberalizing economy. Their successors, who will take office in 2010 to 2015, will be even better versed in market economics and more widely exposed to the rest of the world. The return to China of politicians trained at U.S. universities is also likely to encourage economic reform, while opening the door to even more political liberalization.

Already, China's leaders have begun to run the country differently, with more transparency. Their reaction to the recent SARS epidemic was telling. After an initial cover-up, the government publicly admitted the magnitude of the problem and sacked a minister and Beijing's mayor for failing to act to contain the illness. The new leadership has also begun to release publicly the dates, agendas, and decisions of high-level party meetings that were once kept secret.

More radically, the government of the city of Shenzhen recently announced an experiment in political liberalization, which could ultimately set the stage for far-reaching reforms at the national level. Shenzhen wants to remove the Communist Party from its government in order to make it more independent and, the authorities claim, thereby help China satisfy its obligation under the WTO to introduce the rule of law at home. Although the local government has yet to make plans to hold direct elections, the prospect that administrative and legal institutions may operate independently of the Communist Party is a major breakthrough—and a promising sign that the government may become more accountable to the people.

There is now much general excitement about China in Asia and elsewhere, fostering various forms of international exchange. China's universities now have 85,000 foreign students, mostly from its regional competitors, Japan and South Korea. China will host the Olympics in 2008, and cities such as Shanghai are planning regional sporting events. A vast network of Chinese expatriates in eastern Asia, North America, Europe, and Australia has provided assistance to relatives back home for many generations; during the 1980s and 1990s, it also helped promote the first wave of FDI in China. This overseas network has served, and continues to serve, as a conduit for new business, cultural, and political relationships. Instead of leaving China for better opportunities elsewhere, as they once did, millions of Chinese who

China Takes Off

travel abroad for tourism or for education now return home, bringing with them newfound insights about other lands. There were some 16.5 million Chinese tourists in 2002; there could be as many as 50 million by 2010. Although it is too soon to assess the precise effects of this growing interaction, it can only be assumed that it will bring greater understanding between China and the rest of the world.

The changes that have propelled China to a leading role in the global economy have no direct antecedents. China is sometimes compared to pre-World War I Germany, but the two countries are more different than similar. One of that war's chilling lessons was that even countries with economies that are highly integrated into regional or international markets—such as Germany then and China now—sometimes wage war. In Europe before 1914, rising nationalism and imperial rivalries undermined the chances that economic integration alone could contain mounting belligerence. But that is not so in eastern Asia today. World War II discredited nationalism in Japan, and whatever nationalism emerged in Asian countries during the early years of their independence has been replaced by an obsession with economic growth. China's own nationalist instincts are balanced by the Communist Party's economic aspirations.

No doubt, China will increasingly regard itself as a great power and expect more deference from other countries. But although it is understandable that its spectacular growth would spark unease in Washington, there is no compelling reason to assume that China will become an enemy of the United States. In a speech last year, President George W. Bush suggested that he strongly sympathized with those states that believe in the power of economic engagement to help solve other problems, ranging from human rights to security issues. China continues to signal its desire to integrate into the global economy by pursuing liberalization at home and encouraging trade, as well as by joining international institutions, such as the WTO, that promote economic competition and integration, not nationalist rivalry over territory and colonies. Assuming that China can sustain the momentum that has driven its economic boom in recent years, there is little doubt that a mutual search for economic opportunity will be the defining feature of China's relationship with the United States, and the rest of the world, for many more years to come. 🌐