

Testimony before the US-China Economic and Security Review Commission

Hearing on U.S.-China Relations at the CCP's Centennial

Panel I: "The State of U.S.-China Relations Heading into 2021"

A Statement by

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January 28, 2021

1. Introduction

The convening of a new Congress provides an opportunity to forge a more effective American approach to China. The Chinese economy is no longer in transition from plan to market. Successive waves of economic reform have eliminated direct government control of resources and their uses. The plan has been replaced by a modern, decentralized, and integrated economy in which prices drive demand and supply decisions. Under General Secretary Xi Jinping, however, the party-state continues to direct its development. It maintains control of energy, telecommunications, transportation, banking, and heavy industry through the dominant position of state-owned enterprises in these sectors. Subsidies, taxes, and regulation are used to promote desired activities. The Chinese model, thus, is a hybrid in which both the market and the state influence economic activities and outcomes.

This hybrid economy has propelled China into the league of upper-middle-income countries while creating deep linkages to economies in both the East and the West. For US policy toward China to more successfully protect American interests, it must recognize these successes as well as the profound challenges facing Chinese leaders in the new century. For this hearing, I have been asked to comment on the Chinese government's assessment of its progress in its goal to "catch up and surpass" the United States and achieve global economic leadership. I have also been asked to identify internal and external economic challenges that are likely drivers of Chinese behavior toward the United States. Lastly, I have been asked to describe new frictions that have emerged in the U.S.-China economic relationship since the signing of the "Phase 1" deal in January 2020.

China has long benchmarked its performance against the US, seeking to match and exceed it in size and strength. Viewing the US-China relationship through this lens, however, is unproductive. China "overtaking" the United States in terms of economic size is a given in all but the most

¹ The author thanks Tianlei Huang and David Xu for assistance with data analysis. She acknowledges, without implication, useful conversations with Chad Bown, Martin Chorzempa, Tianlei Huang, Nicholas Lardy, and Jeffrey Schott.

extreme scenarios. If this is its goal, the Covid-19 pandemic has given China much to celebrate. The Chinese economy grew in 2020 while the US economy shrank. And because flows of foreign investment into the United States almost halved in 2020, China eclipsed the US as the world's largest recipient of inward investment for the first time (Hannon and Jeong, 2021).

The Chinese leadership, while aspiring to lead, has consistently recognized the importance of access to the world economy to its own success. A healthy world economy is beneficial to China not only as a growing market for its exports, but as a source of key inputs and advanced technology. New American approaches to engagement should be built on a clear understanding of these linkages and how they present both opportunities and challenges for China.

2. Foundations of Chinese Confidence

The Chinese Communist Party (CCP) held the fifth plenary session of the 19th Communist Party Central Committee in October 2020. Presided over by General Secretary Xi Jinping, the primary task was to assess the results of the 13th Five-Year Plan (2016-2020) and consider the draft proposal for the 14th Five-Year Plan (2021-2025). The plenum also provided guidance for setting development goals through 2035. The [communique](#) released at the session's conclusion expresses the party-state view that great progress has been made by adhering to its own development concept and advancing reform and opening-up. As in earlier five-year plans, specific targets reflect a broad spectrum of national development goals rather than a simple metric of global economic leadership. Indeed, the communique omitted an explicit GDP growth target for the next period.

a. Basis for Domestic Confidence

A recent [scorecard](#) (Kennedy, 2020) shows that China has, at least by its own accounts, largely met the goals set by the Party in its 13th Five-Year Plan. Notably, the country met targets set for economic growth, social welfare, and the environment. Two areas where progress was made but still fell somewhat short were research and development (R&D) spending as a share of GDP, which at 2.2% is nonetheless high for a middle-income country, and in the services share of the economy, which currently is about 54% and its growth is seen as a necessary adjunct to domestic-demand-led growth.

Despite fears that gravity would slow performance once it reached upper-middle-income status, the Chinese economy exceeded state targets, growing by an average of 6.7% over the five-year period of the 13th plan. Per capita income now exceeds US\$10,000. Poverty, largely a rural phenomenon, was alleviated as another 50 million people were raised above the national poverty threshold. Social supports, including rural health care system and old-age pensions, received expanded government contributions. Government data show improvements in air quality, water quality, and an increase in the share of energy from non-fossil fuels.

The Chinese economy's performance during the Covid-19 pandemic illustrates the resilience of the Chinese model. Hard lockdown policies constrained individual freedoms and exacted high

costs on specific businesses and individuals, but nonetheless permitted a comparatively quick economic recovery. Factories reopened in the spring, while other countries continue to struggle to control the virus. Growing rapidly after contracting 6.8% in the first quarter, China's GDP grew by 2.3 % year-on-year, becoming the only major economy to expand in 2020. The head of China's national statistics bureau [called](#) this performance "an extraordinary achievement."

a. Basis for Foreign Trade and Investment Confidence

China remains an increasingly important part of the global economy, despite the US-China trade war and the global economic impact of Covid-19. It embraces and seeks to accelerate its ongoing transition from parts producer and assembler to technology supplier. In this transition, China's leadership proclaims its steadfast support for multilateralism. It has devoted considerable diplomatic energy to negotiating regional and bilateral trade and investment agreements.

China is the center of East Asian production networks and its position in global supply chains has proved to be resilient despite pressures from US tariffs and pandemic delays. Figure 1 shows Chinese exports relative to total world exports, relative to US exports, and relative to exports from East Asia (excluding China). As shown, China's share of exports rose between 2009 and 2019, with China now providing 15% of the world's exports. The structure of global supply chains has made Chinese exports even more prevalent in the US import bundle than for the world. As shown in Figure 1, Chinese exports now comprise 17% of all US imports.

China remains America's largest source of imports and its third largest export destination. US imports from China are dominated by exports from foreign multinationals operating in China, the source of 60 percent of total exports to the US in 2014, the last year for which we have data (Lovely and Liang, 2018). These exports are primarily intermediate parts and components imported for US producers.

China's share of exports to other countries in East Asia rose from 17% in 2009 to 21% in 2019, reflecting its heightened centrality in these production chains. China's early recovery from Covid-19 relative to other suppliers suggests that its share of world exports may exceed 15% for 2020. Reflecting the deep linkages among suppliers in the region, exports from the Asia-Pacific region excluding China have followed those from China, bouncing back strongly since the start of the pandemic in early 2020 (Cherney, 2020).

Despite the US-China trade war, which focused attention on theft of intellectual property from foreign affiliates, China maintains its attractiveness as a host for foreign direct investment. Figure 3 illustrates cumulative foreign investment inflows to China in 2018, 2019 and 2020. By the end of summer, inflows during 2020 exceeded those of the prior two years, despite the ongoing pandemic. Reviewing data through September, Lardy and Huang (2020) find that:

"As a result of the Covid-19 pandemic, global FDI flows in the first half of 2020 declined by the largest amount on record. Inflows into the United States, usually the largest

recipient of FDI, were down 61 percent; inflows into the European Union were off 29 percent. In contrast, inflows into China were down only 4 percent, and China's monthly inflows have strengthened since. In the third quarter of 2020, FDI inflows expanded nearly 17 percent compared with the same period in 2019. As a result, cumulative FDI inflows through the third quarter of 2020 were up about 2 percent, putting China on track to set an annual record inflow of more than \$140 billion." (p.10)

The implementation of a new foreign investment law in January 2020 signaled China's commitment to welcoming foreign companies, even as investors remain concerned about behind-the-border treatment of their intellectual and physical property. The new law provides expanded rules around investment promotion, protection, and administration (Jones Day, 2020). Features of the new law, including the creation of a "negative list" for restricted activities, national treatment, and protection of foreign IP rights and trade secrets, addressed some of the US demands in the Phase 1 trade negotiations with China.

Figure 4 illustrates cumulative foreign investment outflows to China in 2018, 2019 and 2020. While the value of China's outward investment kept pace with previous years through the first quarter, outflows ended a year just slightly below 2019. Of note is that Chinese foreign investment into the United States fell dramatically after the initiation of the trade wars, compounded by heightened US review of inward investment on national security grounds.

Meanwhile, regulatory reform opened China's financial market to many US and other foreign financial institutions (Lardy and Huang, 2020). The presence of these firms follows foreign investors interests in Chinese assets. Figure 5 shows that that foreign investment in China's onshore stock and bond markets now exceeds 5.5 trillion RMB

China concluded major foreign economic policy negotiations in 2020. While still facing tariffs on about two-thirds of its exports to the United States, trade tensions diminished with the January 2020 signing of the "Phase 1 agreement," most notable for its ambitious purchasing targets. As charted by Bown (2021), China has fulfilled only 58% of the purchase levels needed to smoothly meet these targets, even as it has reached three-quarters of its import goal for agricultural products, a category of great importance to President Donald Trump.

Perhaps of more far-reaching consequence for China's external trade is the successful conclusion of negotiations for the Regional Comprehensive Economic Partnership (RCEP), which combines and expands existing trade agreements in the Asia-Pacific region. By providing a forum for organizing this "noodle bowl" of overlapping trade rules, China views the RCEP as trade coordination like the Comprehensive and Progressive Trans-Pacific Partnership (CPTPP) without CPTPP-level restraints (Gueorguiev and Lovely (2016). China advanced the agreement as a "win-win" approach to integration focused on breadth of membership, not depth of commitment. Despite the final-hour withdrawal of India, RCEP deepens China's ties with the 10-member Association of Southeast Asian Nations (ASEAN), plus Japan, South Korea, Australia, and New Zealand. RCEP rules of origin encourage investments in supply chains that span the region,

strengthening and complementing China's infrastructure investments and lending through its Belt and Road Initiative.

Both CPTPP and RCEP will refocus East Asia's economic ties within the region itself. Although the United States was once seen as an essential partner in the TPP, the agreements moved forward once the US withdrew in 2016. Figure 6 shows membership overlaps among the US-Mexico-Canada Agreement (USMCA), which took effect in July 2020, the CPTPP and the RCEP. The United States is the only North American country outside of the two wider regional agreements.

US absence is likely to tie countries in the Asia-Pacific region closer to China. Using a computable general equilibrium model, Petri and Plummer (2020) show that the agreements will yield especially large benefits for China, Japan, and South Korea and losses for the United States from trade diversion. Their simulations suggest that RCEP is particularly valuable in the context of the US-China trade war because it strengthens East Asian interdependence, raising trade among members and reducing trade among nonmembers. Petri and Plummer conclude that these shifts will further incentivize cooperation among China, Japan, and South Korea.

To complement RCEP, according to Schott (2020), China is negotiating a separate trilateral free trade accord with Japan and South Korea to deepen liberalization among the three northeast Asian countries beyond RCEP requirements. It also has been upgrading its bilateral free trade agreements with other CPTPP countries that are highly dependent on the Chinese market. Recent Chinese statements about its potential membership in CPTPP, moreover, suggest that the country now believes its reform program is on track to meet CPTPP disciplines for policy transparency, subsidies for state-owned enterprises, and data flows.

Most recently, China completed negotiations with the European Union for the Comprehensive Agreement on Investment (CAI), a pact that is intended to replace existing bilateral investment treaties between China and EU member states. Although we await the completed text, the agreement is expected to improve market access for European investors, to promise that state-owned enterprise will not discriminate against EU-invested firms in procurement, and prohibit forced technology transfer (Jones Day, 2021). China has reportedly agreed to implement the Paris Agreement on climate change and to make sustained efforts to ratify the International Labor Organization's conventions on forced labor. Importantly, Chinese investments will remain subject to European national security screening mechanisms, which have recently been updated and tightened.

3. Foundations of Chinese Anxiety

Despite these domestic and international successes, China faces profound challenges at home and abroad. The need to meet these challenges, among other objectives, drives China's fervent pursuit of advanced technological capabilities. Although it has almost eliminated abject poverty, Chinese economic performance must reduce economic insecurity and lift living standards. China's prospects for consistent and inclusive growth, however, are clouded by the onset of deindustrialization, slow productivity gains, and demographic change. It faces these challenges

as some of its most important export customers are repelled by Chinese security, labor, and human rights practices, resulting in new trade restrictions and financial sanctions.

a. Domestic Economic Challenges

China's economic successes both at home and abroad have sown the seeds for new challenges. After more than two decades of rising real wages, the international competitiveness of its manufacturers, especially in labor-intensive sectors, has eroded. The global supply chains that brought investment and employment to Chinese shores are on the move, seeking lower labor, land, and environmental compliance costs elsewhere. So far, these movements have not lowered China's share of world exports but rapid investment in labor-intensive activities in nearby locations, such as Vietnam, suggest that change in the composition of Chinese manufacturing output is already underway.

Chinese economic growth has dramatically reduced poverty, but it has also delivered a high level of inequality. The Gini coefficient, a measure of income inequality, indicates that China's income distribution remains highly unequal although not worsening. Its Gini coefficient has hovered around 0.465 for the past five years, down from a high of 0.49 in 2009 (Naughton, 2018). For comparison, the Gini coefficient for the United States is 0.484 for 2019 (Semega, et al., 2020).

The ratio of urban to rural income held steady over the past five years and is projected by the IMF (2021) to be 2.67 in 2020. Huang (2020) notes that migrant workers, already a vulnerable population with limited social supports, may have fared particularly badly in the pandemic lockdown. The largest employer of migrant workers is the urban service sector, which contracted by an unprecedented 5.2 percent in the first quarter of 2020. This sector has been slow to recover. The resulting loss of income undoubtedly hits migrants themselves and the rural family members that rely on remittances from them.

Figure 7 illustrates changes at the macro level in the structure of the Chinese economy. The year 2012 stands out as a turning point when industrial employment growth stopped. In subsequent years, not only did the industry share of employment fall but the sector also shed millions of jobs. In this sense, China is already "deindustrializing." This downward trend is likely to continue as China's manufacturing share of GDP remains significantly high when compared to other upper-middle-income countries.

The service sector claims a rising share of employment, reaching 47% by 2019. Despite employing a larger share of the labor force, however, the service sector contributes less to national income than industry and construction. Service sector productivity is low, on average, and as in other economies, raising it can be difficult. China's service sector is underdeveloped, and the government maintains near-monopoly controls over high skill activities such as finance, education, and health care. Recent opening to foreign investment in the finance sector will prompt faster productivity growth and could set an example for the health care sector.

China's labor force is a source of its comparative advantage. Its work force is comparatively young, literate, and numerate, and labor force participation is high. The average years of schooling for the Chinese working age population is 10.7 years, close to the goal of 10.8 years set by the 2015 plan (Kennedy, 2020). Despite being on target, however, China has the lowest level of secondary school attainment among middle-income countries. According to Rozelle and Hell (2020), only 30% of the Chinese work force has completed a high-school education.

China is poised for a prolonged period of declining labor force size. Its population will age rapidly, with the elderly making up about 30% of the population by the end of this decade (Naughton, 2018). Projections of the dependency ratio suggest that the burdens on young workers will rise steadily from current low levels through 2050. Thus, as China shifts down from high growth to Xi's desired "high-quality" growth, it faces rising real wages and absolute declines in labor supply, making the transition more complicated.

With these structural and labor force changes clearly on the horizon, the Chinese government recognizes the need to improve the skills of each worker. The state has poured millions of RMB into building and equipping new schools, especially in rural areas. The challenge is formidable, according to Rozelle and Hell (2021), who find that early childhood development deficits in rural China hinder educational attainment and that young people leave formal schooling with few of the skills needed for an advanced economy.

These structural changes underscore the importance of achieving robust productivity growth to maintain per-capita income growth. After four decades of rapid increases, however, China is no longer able to squeeze more and more from a set of inputs as it once did. Reforms that raised productivity growth in the past, by inducing rapid entry and exit within sectors and shifts in resources between sectors and between state and private firms, have slowed. Using available micro and macro data, Brandt et al. (2020) find that China's productivity growth has declined markedly in recent years. Convergence between state and private firms, evident prior to the 2008 global financial crisis, appears to have stalled. They also argue that the allocation of a larger share of credit and investment to infrastructure and housing has led to lower returns to capital and a rapid buildup in debt.

The International Monetary Fund (2021) reports that state firms account for 40% of assets but only 27% of sales by industrial enterprises above a designated scale in 2019. The IMF also finds that these large state-owned industrial firms provided a rate of return on 3.5%, compared to a rate of return of 6.3% for private industrial firms. Lardy (2019) points to poor performance in the state sector as a cause for concern. He argues that the Xi administration has consistently championed state-owned or controlled enterprises, tilting the allocation of investment funds in favor of state companies, despite their weak performance compared to private companies. Like Brandt et al. (2020), Lardy believes that China's growth potential remains high, but its long-term growth prospects depend on returning to reform and the consequent improvement in the return on investment.

As noted above, the Chinese economy has bounced back from Covid-19 lockdowns faster than many other economies. Economic stimulus, primarily financed through debt expansion, has been funneled to construction and heavy industry, which have rebounded faster than household spending. Because state enterprises dominate these activities, the private sector has played a diminished role coming out of the pandemic. When the stimulus is unwound, the need to shift capital toward private firms will remain key to boosting economy-wide productivity, but Party Secretary Xi's will and ability to create this shift is unknown.

Quality of life depends on factors other than economic growth, especially in a country where environmental degradation contributes to serious public health concerns. China is racing against time in its efforts to improve domestic air quality and meeting its Paris carbon commitments. Reining in the continued installation of coal-fired power plants is essential to both goals. On a downward trend since 2007, new coal-fired capacity increased in both 2018 and 2019 (Myllyvirta et al., 2020). These plants were built despite significant overcapacity in the sector, with more than half of coal-power firms already loss-making and with typical plants running at less than 50% of their capacity. After the Covid-19 lockdowns ended, permitting for new coal power plants accelerated immediately, with more permits being handed out in the first half of 2020 than in all of 2018–2019 (Myllyvirta et al., 2020).

The trajectory of Chinese emission is a key variable in progress toward the global Paris accord climate targets. While China has set ambitious targets for carbon reduction, promising to hit peak carbon emissions by 2030, meeting those commitments will be costly. Coal supplied almost 60% of the country's energy in 2019 (Myllyvirta et al., 2020). At the same time an energy transition is taking shape, driven by the state enterprises that dominate the energy sector. In 2020, China installed almost 120GW of wind and solar power, with new wind installations almost three times their previous record (Shaw and Hall, 2021). Reportedly, the government is targeting the same levels of new capacity for 2021 in a sign of renewed action on clean energy. Political resolve is necessary for China to fully commit to reduced reliance on coal.

b. External Economic Challenges

China has maintained its share of global exports in the face of unprecedented tariffs levied by the United States against another WTO member. Nevertheless, these tariffs did affect bilateral goods flows. Tit-for-tat tariff rounds in 2018 and 2019 have left behind reciprocal imports tariffs of almost 20% (Bown, 2020). Careful analysis by Fajgelbaum et al (2019) finds that tariffs levied in 2018 reduced US import values from targeted sources of targeted goods by almost 32%. Supply chains appear to have adjusted, perhaps permanently, as imports from Vietnam, Thailand and Mexico rose to replace some of the exports diverted from China. The "Phase 1" agreement completed by the US and China in January 2020 did not include provisions to roll back these import duties, even as it provided for mandated purchases of American exports by China.

China is also encountering heightened pushback to its domestic human rights violations. Most recently, the United States banned the importation of cotton and tomatoes from the Xinjiang

region in response to what the American government has labeled genocide. Australia has remained resolute in its calls for investigation of the origins of Covid-19 despite Chinese retaliation via export bans and prohibitive tariffs.

More threatening to China's technology drive are general restrictions on flows of advanced products and processes and ownership of the companies that produce them. Tariffs levied during the 2018-19 trade war did not isolate products or technologies to which the US would like to restrict Chinese access. To protect technologies deemed critical to American interests, the US has implemented both export controls and expanded investment review. An updated list of those actions taken by the Trump Administration, with links to relevant government reports, has been prepared by the IP Commission (2019).

Over the past three years, the United States has passed significant legislation to reduce the flow of US technology to China. Defensive measures to protect American technology assets from Chinese control are the Foreign Investment Risk Review Modernization Act (FIRRMA) of 2018 and the Executive Order on Information and Communications Technology and Services (ICTS) of 2019. The Export Control Reform Act (ECRA), together with the Entity List blacklisting end-users rather than products, provides mechanisms to create chokeholds on Chinese technology development, at least in the short run, while adding further incentives for Chinese leaders to promote indigenous substitutes.

These changes to US policy, with similar efforts completed or underway in other countries, imply that Chinese acquisition of foreign technology will be more difficult moving forward. These have already induced the Chinese leadership to place greater emphasis on domestic technology created through indigenous innovation, as reflected in recent announcements regarding China's next five-year plan.

4. China's next plan reflects its accomplishments and challenges

Through the reform period, China relied on domestic investment and exports to drive growth. Since the Global Financial Crisis in 2008, its leadership has sought to "rebalance" the economy by raising domestic consumption relative to investments and exports. Rebalancing is underway, albeit slowly and with recent setbacks. Consumption contributed more to income growth than investment in each of the four years between 2016 and 2019 (IMF, 2021). IMF projections for 2020, however, reflect the depressing impact of Covid-19 on consumption, and for the first time in five years the contribution of consumption to growth will be less than that of investment. The process of rebalancing is difficult: even today 45% of Chinese GDP is saved. Private consumption accounts for about 38% of GDP, far below the world average of 60%.

Rebalancing requires profound structural changes to the Chinese economy. The service sector must continue to increase its share of employment relative to manufacturing. Export growth must slow relative to income growth. Chinese leaders see technology upgrading as key to both goals. Moving the country's manufacturing base away from labor-intensive activities and toward advanced processing can raise productivity and its contribution to national income, even as its

share of employment falls. Such adjustment also is expected to raise the value-added in Chinese exports by replacing sophisticated imported intermediates with domestic inputs.

China's current grasp for advanced technology is best understood within the context of the long-term development challenges. Even as its exports surged and foreign investment flowed inward following its accession to the WTO, Chinese leaders acknowledged the limits to export expansion and labor-intensive manufacturing as engines to move the country out of middle-income status. China turned from reliance on reform and structural change to modernize its economy toward direct government support of technology development. As Naughton (2018) notes, "although the overall trend since 1978 has been for the reduction of direct government intervention as the market economy grows, in high-technology sectors government intervention has increased steadily since 2003" (p. 363).

China continues to promise policies that advance domestic innovation yet remain consistent with its international obligations. China's industrial policy is offered as a complement, not a substitute, to ongoing reform and opening up. However, under Party Secretary Xi leadership, China's advanced economy partners share concerns that China is skewing its market toward domestic firms, and especially toward state enterprises, and question the government's commitment to a level playing field for foreign companies either exporting to or producing in China. Certainly, numerical targets for Chinese market dominance in key sets, offered by document tied to China's "Made in China 2025" effort, raised alarm bells in the West, even as Chinese officials downplayed their significance.

The Chinese government's Central Economic Work Conference, convened in December 2020, offers some clues to China's ongoing response to these challenge and constraints. Its communique announced China's commitment to high-quality development, improved government efficiency, and heightened national security, as well as expanded openness to international trade and investment. The Chinese press releases portrays the country as a strong and growing nation, able to become a key demand driver for its domestic producers as well as those within the Asia-Pacific region. It sees itself as responding in creative and forward-looking ways to demographic, economic, and environmental growth challenges. While noting that "the international environment is becoming increasingly complex" and that in external relations "uncertainty has increased significantly," the Work Conference announced Chinese resolve to open further to international flows.

The Work Conference portrayed technology as key to China's goal of self-sufficiency. It elevates innovation to "the core of China's modernization" and given the highest priority in the plenum communiqué, the first time in CPC history. The plenum also called on China "to make major breakthroughs in key core technologies and become a global leader in innovation" by 2035. Faced with a "technology war" with the US, China is determined to reduce its reliance on the US and other advanced economies for cutting-edge technologies, which, though not specified in the communiqué, include semiconductors, artificial intelligence and 5G, among others. Beijing is

currently drafting a long-term plan promoting the development of key technologies in the next 15 years.

The statement clearly embeds the ongoing tension between China's drive for technological self-sufficiency, on the one hand, and openness on the other. The oft-repeated concept of "dual circulation" and the policies that would enhance it remain vague. A heightened emphasis on domestic markets and domestic innovation appears to be part of the leadership's push for greater self-sufficiency in technology, and thus less intense involvement in global supply chains. At the same time, China's government has pushed forward long-awaited reforms of laws governing foreign invested enterprises and promised that foreign firms may participate in its industrial development programs. As Barry Naughton testified before this committee almost a year ago, it appears that the Chinese "hope to foster the continuing presence of GPNs (global production networks) in China—perhaps held there by the attractions of the Chinese market—as a continuing source of technology transfer, while also aggressively squeezing out the foreign links in the GPNs."

With many of its trading partners convinced that China has not met its existing obligations, the contradictions in China's next five-year plan may come to the fore. This will increase pressure on China in three ways. First, as China ramps up subsidies there are growing and likely more united calls for transparency and, if needed, countervailing duties. This will confine Chinese firms to the domestic market. Secondly, efforts to restrain the transfer of advanced technology to China may become more effective and conflictual. China's recent Blocking Law already increases risk for third-party nationals adhering to US export controls in ways that damage Chinese interests. If China chooses to vigorously enforce the law, ongoing bilateral tensions will quickly become multinational. Lastly, China risks pushing multinationals to find alternative ways to enter the Chinese market, other than by locating production onshore. In these ways, China's reach for technology may reverse the trajectory of its ongoing integration.

5. Recommendations

China's vision reflects a realistic assessment of its strength and challenges, if overly kind in its own policy evaluations. While tone deaf in its pronouncements to the world and willfully blind in its refusal to recognize its own aggressions, China nonetheless continues to seek the benefits of international trade and investment and the country's leaders have invested diplomatic effort in sealing new agreements in these arenas. As the new Congress considers US-China relations, this assessment suggests three guides for legislative and oversight efforts.

- a. Congress should Insist on policy that acknowledges China's integration into the global economy*

Whatever policies the Biden Administration pursues, they are constrained by the reality of China's deep integration into the global economy. The vision of any group of nations joining forces to confront China cannot succeed if it implies that allies must choose sides, at least under

present economic and security conditions. Successful policy will recognize the value to our partners of trade and investment relations with China and the potential for multilateral cooperation on climate change and public health. Thus, the benefits of any united action must be clear and impose commensurate costs. (don't isolate the US while trying to isolate China

b. Congress should enable US leadership in setting international standards

Chinese policymakers see innovation-driven growth as imperative to meet the challenges of a maturing economy with a slowly shrinking, but ever more educated work force. The country's most advanced segments have the capacity to create and absorb technology at the world's innovation frontier. Indeed, the drive to access and the ability to absorb foreign technology, sometimes by illegal means or by force, lies at the heart of frictions between China and the West. The US should work to create structures that allow China to access the (non-military-use) technology it needs, through means that are in keeping with international norms and compensations. Creation of such a framework requires the US to engage like-minded partners in setting standards for AI, biotechnology, data protections, and other emerging technologies. Clear standards will begin the difficult process of identifying behaviors that violate internationally accepted norms, such as IP theft, as well as define obligations for reporting and transparency in rulemaking and enforcement.

While many see cooperation and rulemaking as having been tried and shown useless, such views ignore the interdependence of Chinese and American actions. Over 40 years of reform have removed the Chinese Communist Party from almost total control over every individual life, even as it continues to shape and influence organized economic activity. The party exercises this influence in a flexible way that provides resilience to changes in its domestic and external environment. China will continue to adapt to the structures that determine risk and reward – this is the essence of its “strategic opportunism.” The United States must design structures that move China's strategic calculus in desired directions.

c. Congress should ensure that decoupling efforts are targeted and provide clear net benefits

The Section 301 tariffs covered hundreds of products that have no relation to national security. Simultaneously, the US implemented a host of export controls and sanctions. These actions raised costs and limited markets for US manufacturers, who either absorbed these costs or passed them through to their customers. Such collateral damage should not be denied, but rather limited to actions that are likely to provide security or other compensations for the American public.

Collateral damage can be reduced through proper targeting of restrictions and barriers to US imports, with consideration of third-party suppliers of the same goods. The principle of targets based on threat assessment is embedded into US reviews of inward foreign investment. Applying this principle to trade in high-technology goods would raise the effectiveness and reduce the cost to the US of risk mitigation.

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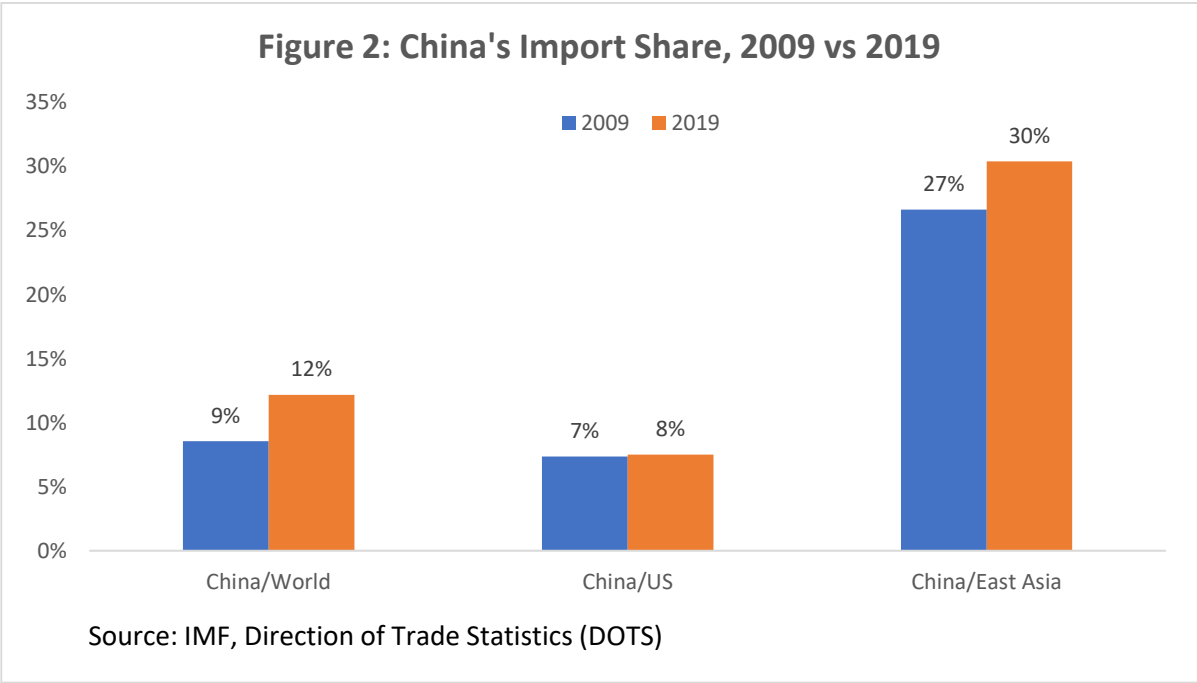
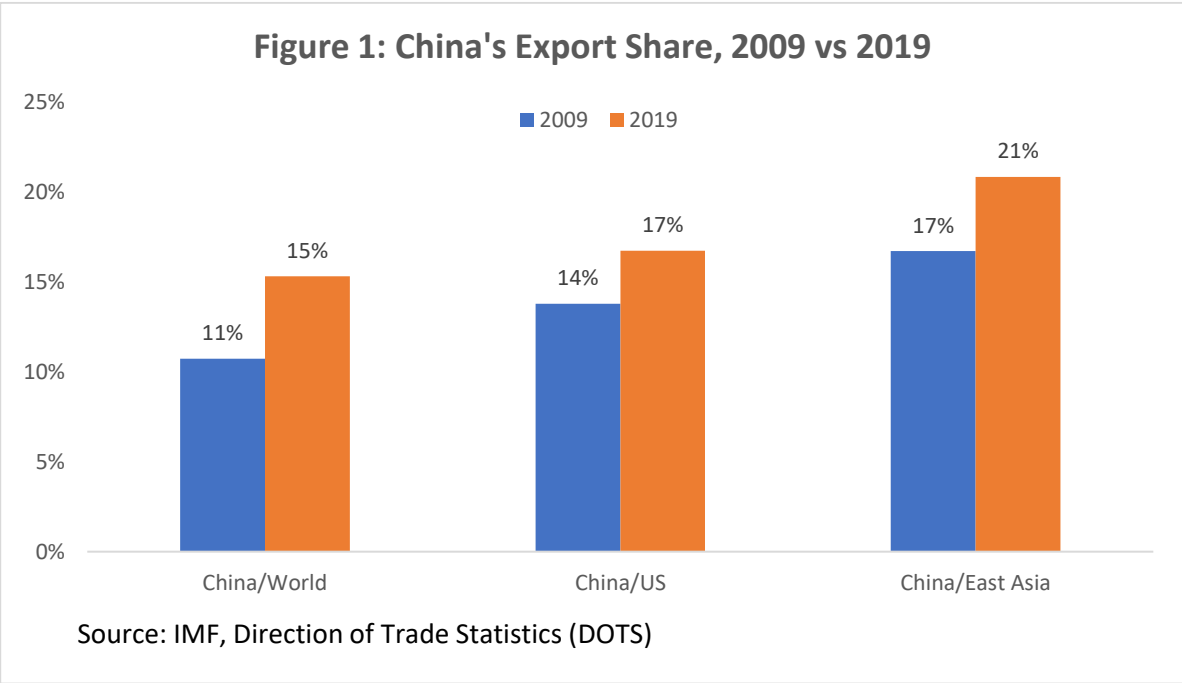
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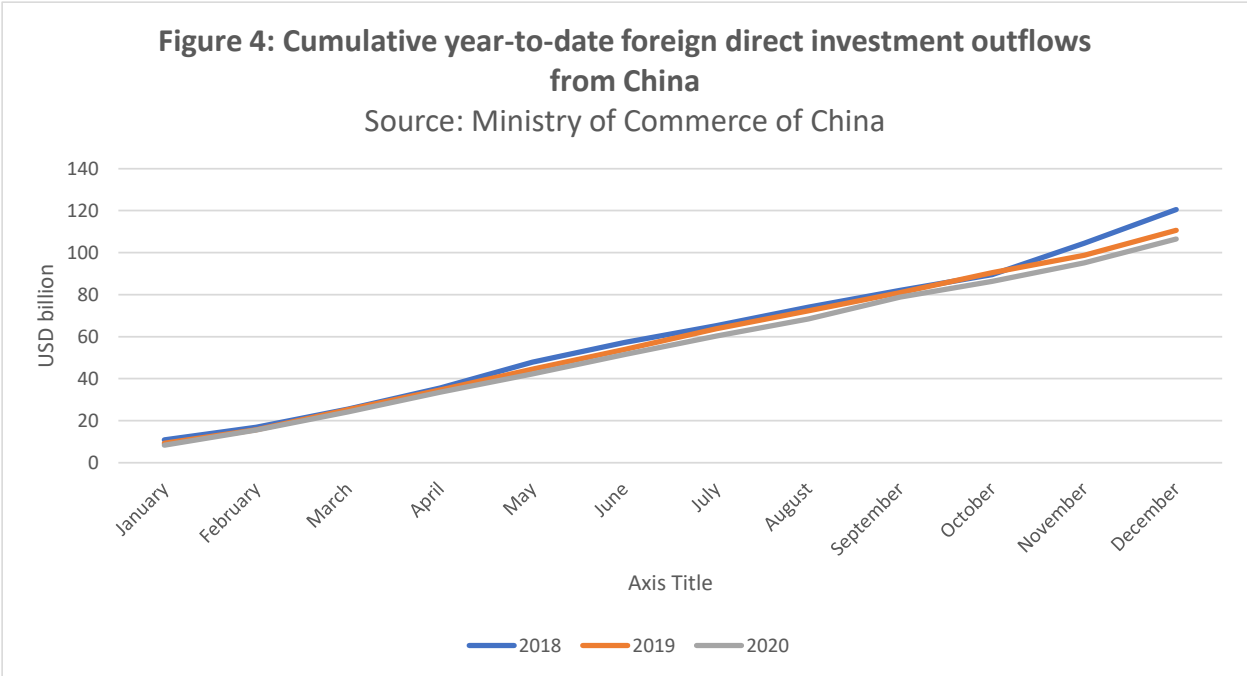
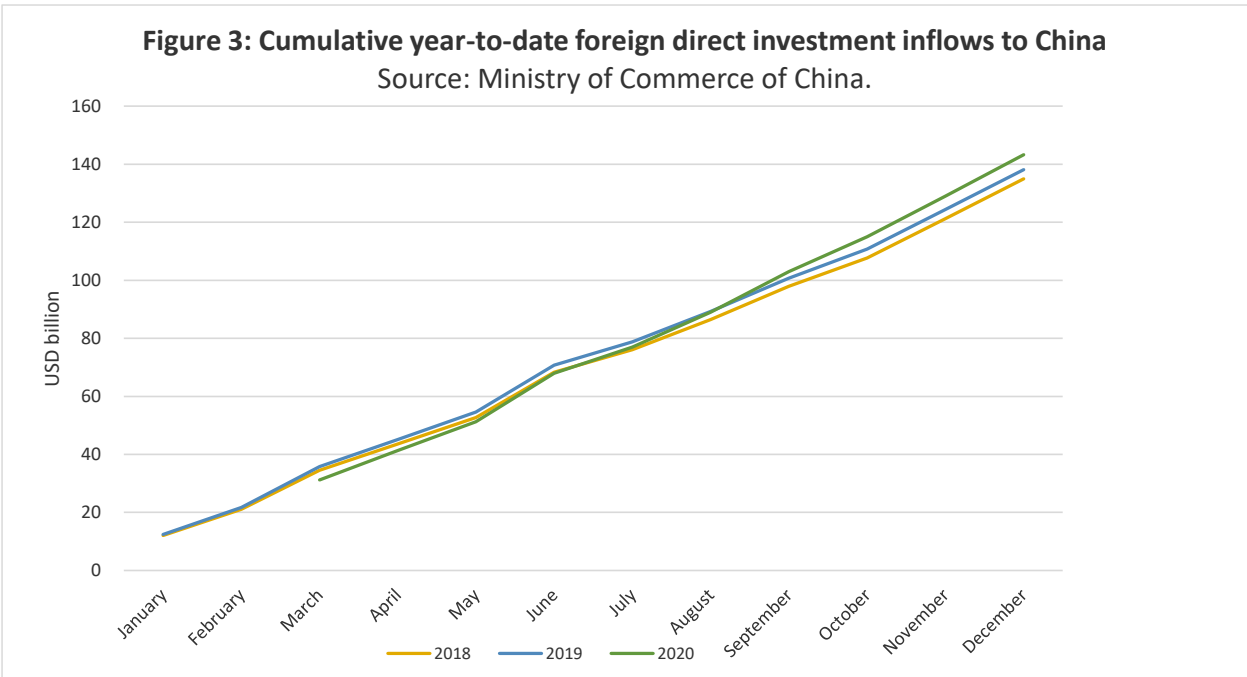
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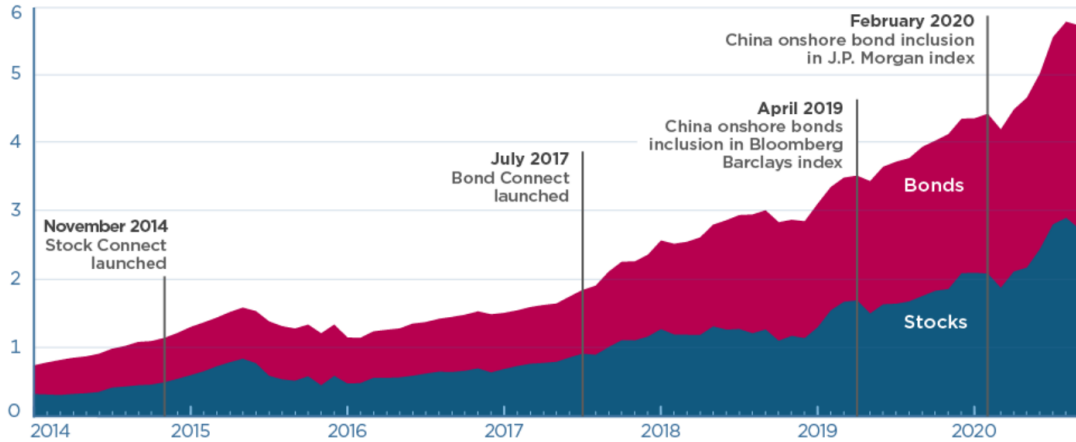
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Figures and Tables





**Figure 5: Foreign onshore portfolio investment in China, trillions RMB
(taken from Lardy and Huang, 2020)**



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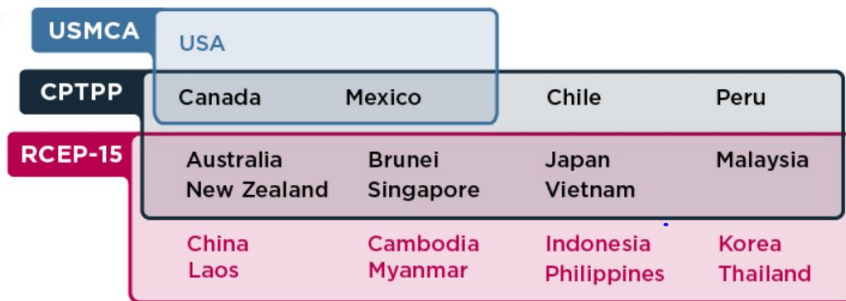
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Note: Data refer to onshore securities issued by Chinese entities in mainland China.

Source: People's Bank of China via Wind Financial Information.

**Figure 6: Trade Agreement Membership in the Asia-Pacific Region
(Source: Petri & Plummer, 2020)**



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USMCA = United States-Mexico-Canada Agreement; CPTPP = Comprehensive and Progressive Agreement for Trans-Pacific Partnership; RCEP = Regional Comprehensive Economic Partnership

Note: India was originally part of RCEP-16 negotiations, but opted out, leading to the formation of the RCEP-15.

Sources: data.worldbank.org; authors' simulations.

Figure 7: Structural Change in Chinese Employment

Source: National Bureau of Statistics of China

