

Testimony before the U.S.-China Economic and Security Review Commission

Consumer Products from China: Safety, Regulations, and Supply Chains

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Adam Wolfe

Emerging Markets Economist, Absolute Strategy Research

Chairman Cleveland, Commissioner Glas, all the members and staff of the Commission, thank you for the invitation to testify before the Commission. In my testimony today, I would like to emphasize four points.

First, China's development objectives shifted dramatically in 2020 in ways that are still not widely appreciated. Maintaining a relatively large manufacturing sector and becoming the global leader in seven strategic technologies are now the state's primary economic targets. But holding on to a large manufacturing sector will require China to lean against the normal pattern of economic development. The only way it will be able to achieve this is by ramping up its exports.

Second, this new development strategy seems destined to fail. China's economy is just too big to make it work. China's exports have risen only modestly since 2019 relative to its own GDP, but it has felt like a deluge to the rest of the world. A further increase is likely to be met with trade protectionism. And it would take an implausibly large increase in its exports to achieve China's growth targets because it, like all large economies, has a relatively low trade-to-GDP ratio. The strategy also won't create enough jobs, and the government's resources to subsidize the manufacturing sector are shrinking.

Third, that failure does not appear to be imminent. In the short term, weak domestic demand, chronic excess capacity, and a cheap currency could help China gain even more global export share. Producer prices are falling fast in renminbi terms, and they're falling even faster in dollar terms, making Chinese goods more competitive globally.

Fourth, there is no reason to believe that the US will be immune from the global impact of China's increased export competitiveness. Efforts to decouple or de-risk from China have come to little more than increased tariff avoidance and longer supply chains.

China's pivot back to manufacturing

China's Five-Year Plan for 2021-2025 signaled a radical shift in the state's development objectives. Increasing the service sector's share of GDP was one of four headline economic development targets in the previous plan, and one of three in the plan before that. But that goal was dropped completely for 2021-25. The explanation for its removal is buried in a single sentence in chapter 8, which said China

should maintain the manufacturing sector's share of GDP going forward.¹ The following chapter also set a target to boost the Strategic Emerging Industries' share of GDP from about 12% in 2020 to more than 17% by 2025.² Most of the targeted high-tech industries would be included in the manufacturing sector.

This pivot back to manufacturing, with a focus on a few high-tech industries, was motivated by two concerns. The first focused on productivity and growth. The relative decline of the manufacturing sector over the previous two Five-year Plans may have contributed to a decline in China's GDP growth rate. Growth slowed from 9.6% in 2011 to 6% in 2019 while the manufacturing sector's share of GDP fell from 32% to 27%.³

The decline in China's total factor productivity (TFP) over this period was largely due to an increase in investment in real estate and infrastructure. TFP for the business sector did not decline⁴. Presumably, if a larger share of savings had instead been invested in manufacturing, productivity growth would not have deteriorated to the same extent. Faster productivity growth will be needed to achieve China's development targets, given its deteriorating demographics and maturing capital stock.

Geopolitical concerns were the other motivation. Fears about China's vulnerability to imported "chokepoint" technologies spiked after the US imposed a denial order on ZTE in 2017, a telecoms firm, and later sanctioned Huawei, another telecoms firm. That's why the plan calls for "self-reliance" in science and technology and the "independent controllability" of the industrial sector. Or, as President Xi Jinping put it, "I've always said there are two critical areas for China: one is to safeguard our rice bowl, and the other is to build up manufacturing."⁵

But China's geopolitical motivations were not only defensive. From its start in 2009, the Strategic Emerging Industries program was aimed at improving China's international power. As a 2010 State Council planning document explained, "to occupy a favorable position in future international competition, China must accelerate the development of the Strategic Emerging Industries."⁶ China views the technological competition with the US as an extension of its geopolitical competition.

To be sure, the plan for China's pivot back to manufacturing didn't call for a return to the export-led development model used in the 1990s and 2000s. The new "dual-circulation strategy" called for

¹ "The 14th Five-Year Plan for National Economic and Social Development of the People's Republic of China and the Outline of Long-Range Goals for 2035 (中华人民共和国国民经济和社会发展第十四个五年规划和 2035 年远景目标纲要)", Xinhua, March 13, 2021. https://www.gov.cn/xinwen/2021-03/13/content_5592681.htm

² The strategic industries listed in the Five-Year Plan are new generation IT, biotechnology, new energy, new materials, high-end equipment, new energy vehicles, environmentally friendly products, and aerospace and marine equipment.

³ Data for 2020 are excluded due to distortions from the pandemic and because policymakers would not have had the full 2020 data when drafting the 14th Five-Year Plan. Data are from the National Bureau of Statistics accessed through LSEG Datastream on February 13, 2024.

⁴ Herd, Richard. 2020. "Estimating Capital Formation and Capital Stock by Economic Sector in China." World Bank.

⁵ Du, Shangze. "China cannot lack manufacturing at any time (任何时候中国都不能缺少制造业)," Qiushi, March 6, 2023. http://www.qstheory.cn/qshyjx/2023-03/06/c_1129415963.htm

⁶ "State Council Decision on Accelerating the Cultivation and Development of Strategic Emerging Industries (国务院 关于加快培育和发展战略性新兴产业的决定)," Office of the State Council, October 18, 2010. https://www.gov.cn/zwgg/2010-10/18/content_1724848.htm

domestic demand to be the main growth driver, with external demand playing a secondary role.⁷ But the plans to boost domestic demand mostly focus on optimizing the domestic market, not expanding the social safety net or increasing the redistribution of income. Instead, factor market reforms are supposed to lead to a more productive allocation of resources⁸, while plans for a national unified market are supposed to help the strongest companies achieve greater scale.⁹

Reforms along these lines would likely boost China's TFP and thus its domestic demand. But they would do little to adjust the distribution of income, so would likely have little impact on the consumption share of GDP. But reshaping the economy in these ways would create a more powerful training ground for firms seeking to go abroad. That would be aided by efforts to align domestic product standards with international norms so that a single production line can serve both markets.¹⁰

This is important, because economic theory and precedent suggest that domestic demand won't be enough to halt the decline of China's manufacturing share of GDP. That would require higher exports.

Challenges to China's pivot, in theory and practice

Several theories suggest the service sector should rise as a share of GDP as an economy matures. Beyond a certain development stage, when "surplus" labor in the agricultural sector has been exhausted, wages in the tradeable goods sector should rise in line with the improvement in output per-worker.¹¹ But wages will also rise at a similar pace in the non-tradeable sector because workers can move between the two.¹² That implies that aggregate spending will gradually shift toward non-tradeable services, where output per-worker tends to rise more slowly, leading to higher relative services prices. William Baumol called this process the "cost disease" because it results in a lower potential growth rate.¹³

This development pattern is well documented in the historical data. Manufacturing typically declines as a share of GDP and employment around the time an economy reaches middle-income status, although that tipping point may be occurring earlier lately.¹⁴ So far, China has followed this pattern. Its

⁷ See part 4, chapters 12-14 in The 14th Five-Year Plan: https://www.gov.cn/xinwen/2021-03/13/content_5592681.htm

⁸ "Notice of the General Office of the State Council on Issuing the Market-oriented Allocation of Factors (国务院办公厅关于印发要素市场化配置)," General Office of the State Council, January 6, 2022. https://www.gov.cn/zhengce/content/2022-01/06/content_5666681.htm

⁹ "Opinions of the Central Committee of the Communist Party of China and the State Council on Accelerating the Construction of a National Unified Market (中共中央 国务院关于加快建设全国统一大市场的意见)," Xinhua, March 25, 2022. https://www.gov.cn/zhengce/2022-04/10/content_5684385.htm

¹⁰ "Several measures to accelerate the integrated development of domestic and foreign trade (关于加快内外贸一体化发展的若干措施)," General Office of the State Council, December 11, 2023. https://www.gov.cn/zhengce/content/202312/content_6919596.htm

¹¹ This is commonly called the Lewis turning point; most estimates suggest China reached this point sometime between 2004 and 2014. Lewis, W. A., 1954. "Economic Development with Unlimited Supplies of Labour," *The Manchester School*, 22, pp. 139–92.

¹² This is the Balassa-Samuelson effect. Balassa, Bela. 1964. "The Purchasing-Power Parity Doctrine: A Reappraisal," *Journal of Political Economy*, Volume 72, Number 6, December.

¹³ Baumol, William J. 2012. *The Cost Disease*. New Haven: Yale University Press.

¹⁴ Rodrik, Dani. 2015. "Premature Deindustrialization," National Bureau of Economic Research Working Paper, February. <https://www.nber.org/papers/w20935>

manufacturing sector began to decline as a share of GDP in 2011 and employment in 2012 shortly after crossing the World Bank's threshold for upper-middle income status in 2010¹⁵.

Still, a handful of countries have maintained a large manufacturing sector even with GDP per-capita levels above China's. The Czech Republic, Germany, Korea, Slovenia, and Taiwan all have higher per-capita GDP levels than China and their manufacturing share of GDP is close to or above China's. Critically, they've all maintained a stable or rising manufacturing share of GDP over the past three decades.¹⁶

These countries have three things in common that set them apart from other developed economies: a high national savings rate, a large current account surplus, and an elevated trade-to-GDP ratio (Charts 1 & 2).

A high savings rate was needed to move up the value-added ladder since this requires a lot of investment. But boosting savings required suppressing consumption, which resulted in low domestic absorption rates and higher net exports. Exports also allowed these countries to overcome the relative price dynamics that otherwise would have shrunk the manufacturing sector's share of GDP. Even as their domestic consumption shifted toward services, they continued to ramp up goods production by selling the excess abroad. Finally, generating much growth from an economic model along these lines required a large export-to-GDP ratio.

China's massive scale will make this a difficult path for it to follow. It accounts for about 30% of the global value added from manufacturing, roughly equal to the US and EU's shares combined. It became the world's largest exporter in 2009, and its global export share rose to about 15% in 2023 (Chart 3).¹⁷ It may be difficult for the rest of the world to absorb more exports from China, let alone a larger trade surplus. China's trade surplus peaked at 7.4% as a share of its own GDP in 2007, and the ratio slipped to 4.6% in 2023. But because China's economy has grown faster than the rest of the world, its trade surplus as a share of global GDP rose from 0.5% in 2007 to about 0.8% in 2023¹⁸.

China's scale will likely undermine the state's attempt to pivot back to manufacturing in two ways. First, holding the manufacturing sector's share of GDP steady may seem like an incremental shift in China's development pattern from Beijing's perspective, but it has already felt like a deluge to the rest of the world. China's global export share has risen by two percentage points since 2019. The world is unlikely to sit back and let another "China shock" happen. The European Commission's investigation into China's electric vehicle subsidies is likely to be the first of many trade protectionist efforts aimed at China's new development strategy.¹⁹

¹⁵ Data from World Bank's World Development Indicators, accessed via LSEG Datastream.

¹⁶ Japan also has a relatively large manufacturing sector, but its share has declined since 1991. Ireland, Singapore, and Switzerland also have relatively large manufacturing sectors, but the industrial share of their employment is not elevated, suggesting the sector's output share is overstated. All the data in this paragraph and the next are from the World Bank's Open Data Catalog, supplemented with national data for Taiwan.
<https://datacatalog.worldbank.org/home>

¹⁷ Data from the IMF's Direction of Trade database, accessed via LSEG Datastream.

¹⁸ National data from China and the IMF's estimate of global GDP, accessed via LSEG Datastream

¹⁹ "Commission launches investigation on subsidised electric cars from China" European Commission, October 4, 2023. https://ec.europa.eu/commission/presscorner/detail/en/ip_23_4752

China's heft will also limit the amount of growth that it can generate with a manufacturing-led development strategy. Economic scale tends to be negatively correlated with the trade-to-GDP ratio.²⁰ Here, too, China has fit the typical pattern. Its ratio fell from 64% in 2006 to 31% in 2020.²¹ The ratio has risen slightly since, reaching 34% in 2023. But it will be arithmetically impossible for China to generate much export-led growth if its total trade remains in the 30-40% of GDP range. And if China tries to rely on domestic demand to support its manufacturing sector, then the dynamics of Baumol's cost disease will kick in, just as they had in the decade to 2020, when the composition of GDP shifted toward services.

In short, it seems likely that China's attempt to pivot back to manufacturing will spark a significant global pushback and fail to generate sufficient growth to meet President Xi's implicit goal of doubling the 2020 real GDP level by 2035, which would require 4.5% annual growth.²²

Nevertheless, China may gain further global export share over the next few years, helped by the government's industrial policies. These efforts have already pushed China to the technological frontier in some sectors and have contributed excess capacity in nearly every industry.

Policies to support manufacturing

The pivot back to manufacturing has been supported by several government policies. Most prominently, the People's Bank of China (PBoC) has incentivized state-owned commercial banks to ramp up lending to manufacturers. Annual loan growth to the manufacturing sector has jumped to 26% on average since 2020, up from 5% in the five years through 2019. Meanwhile, total lending slowed to 13% from 16% before due to a sharp slowdown in real estate lending.²³

Re-lending windows are one tool for this. The PBoC lends funds to commercial banks at below-market interest rates if they lend the proceeds to targeted sectors. Since 2020, the PBoC has opened re-lending windows to support green energy, high-tech manufacturing, and equipment upgrades. In total, these programs could support bank lending of ¥2.5 trillion (2% of GDP), of which ¥1.2 trillion was outstanding at the end of 2023.²⁴

Other industrial support measures were put in place well before the 2020 policy pivot. The central government's industrial policy efforts started in 2009, with the Strategic Emerging Industries initiative. This was followed by the Made in China 2025 program in 2015. The new program brought new policy goals and support measures, but the targeted industries hardly changed at all. The seven industries that General Secretary Xi highlighted in his 2022 report to the National Party Congress²⁵ were the same

²⁰ Kindleberger, Charles P. 1966. *Foreign Trade and the National Economy*. New Haven: Yale University Press.

²¹ National data from China, accessed via LSEG Datastream.

²² Tabeta, Shunsuke and Iori Kawate, "Xi raises prospect of doubling China's GDP by 2035," *Nikkei Asia*, November 4, 2020. <https://asia.nikkei.com/Economy/Xi-raises-prospect-of-doubling-China-s-GDP-by-2035>

²³ Calculations based on the medium and long-term lending data from the PBoC accessed via Wind.

²⁴ "Structural monetary policy tools status (结构性货币政策工具情况表)," People's Bank of China, January 26, 2024. <http://www.pbc.gov.cn/zhengcehuobisi/125207/125213/4634692/4634700/5221308/index.html>

²⁵ "Full text of the report to the 20th National Congress of the Communist Party of China," Ministry of Foreign Affairs of the People's Republic of China, October 25, 2022.

https://www.fmprc.gov.cn/eng/zxxx_662805/202210/t20221025_10791908.html

highlighted by then-Premier Wen in his speech launching the Strategic Emerging Industries program²⁶: green industry, new energy, next-generation IT, biotechnology, high-end machinery, new materials, and electric vehicles. These sectors were chosen because they were expected to become globally important and there was no dominant global leader yet.²⁷ This could allow China to leapfrog to the technological frontier, or “pass on the curve.”²⁸

These sectors have received support from government-linked investment funds, tax incentives for research and development, and support for basic research. The Center for Strategic & International Studies estimated that China spent 1.7% of GDP on industrial policy in 2019 whereas every other country in the study spent less than 1% of GDP on such activities²⁹. That figure has likely risen since.

In practice, however, China’s industrial policies tend to be less coordinated and less targeted than the centralized plans suggest. Most industrial support comes from local governments, primarily through three channels. First, local governments compete to lure industrial firms to their jurisdictions with tax incentives and other benefits³⁰. Second, industrial land-use rights are sold at a substantial discount. On average, industrial land sold for ¥260/sq. meter in 2023 compared to ¥4090/sq. meter for residential land-use rights. Third, 47% of local government special-purpose bonds, roughly equivalent to project bonds in other countries, were used to build industrial parks, which are then rented out to firms at a discount.³¹

These measures have substantially reduced the cost of manufacturing in China but have also contributed to its excess capacity due to the duplicative nature of local support.

This is a vulnerability. The on-going property market collapse threatens to undermine local governments’ ability to support manufacturers. Their total fiscal revenues, including transfer payments and bond issuance, fell from 31% of GDP in 2019 to 27% in 2023, mostly due to a ¥1.5 trillion decline in land sale revenues.³² If land sales continue to decline, as seems likely, local governments will eventually be forced to reduce their subsidies.

This, too, is a reason to think that China’s pivot back to manufacturing will eventually fail. In the meantime, however, China’s economic slump is contributing to its rising global export share.

²⁶ “Premier Wen Jiabao: Let science and technology lead China’s sustainable development (国务院总理温家宝：让科技引领中国可持续发展)”, Xinhua, November 3, 2009. https://www.gov.cn/ldhd/2009-11/23/content_1471208.htm

²⁷ Naughton, Barry. 2021. *The Rise of China’s Industrial Policy 1978 to 2020*. Universidad Nacional Autónoma de México.

²⁸ Yao, Yong, translated by David Ownby. “China’s economic future is bright,” Reading the China Dream, October 16, 2022. <https://www.readingthechinadream.com/yao-yang-on-chinas-economy.html>

²⁹ DiPippo, Gerard, Ilaria Mazzocco, Scott Kennedy. “Red Ink: Estimating Chinese Industrial Policy Spending in Comparative Perspective.” Center for Strategic & International Studies. May 2022. <https://www.csis.org/analysis/red-ink-estimating-chinese-industrial-policy-spending-comparative-perspective>

³⁰ Ang, Yuen Yuen. 2016. *How China Escaped the Poverty Trap*. Cornell University Press.

³¹ Land and bond data were accessed from Wind.

³² Data are from the Ministry of Finance and National Bureau of Statistics, accessed via Wind.

Weak domestic demand supports Chinese exports

Weak domestic demand has exposed excess capacity, weighed on industrial margins, and contributed to producer price deflation. In 2023, 22% of industrial companies posted a loss for the year, a record high going back to 2002, and industrial profit margins narrowed to 5.6%, a 13-year low³³. The producer price index (PPI) had fallen on an annual basis for 16 consecutive months as of January 2024³⁴, a streak that looks likely to continue in the months ahead. Tight margins and falling prices have reduced the cost of Chinese produced goods in the global market.

This has been reinforced by a depreciation in China's exchange rate. Based on purchasing power parity, China's deflation should have translated into a stronger nominal exchange rate to prevent real currency depreciation. Instead, capital outflows caused the nominal exchange rate to depreciate, too. Foreign investors have pulled some of their investments from China, with foreign claims falling in four of the last five quarters through Q3 2023.³⁵

As a result, the renminbi is as cheap as it was in the mid-2000s based on some measures of the real effective exchange rate (Chart 4). This was not due to government policy, at least directly. The PBoC has leaned against renminbi depreciation by setting its fixing rate, or the center of the USD/CNY trading band, at stronger levels than the market-based spot rate. State-owned banks have also sold foreign assets to support the exchange rate.³⁶

Whether intentional or not, China's pivot back to manufacturing will likely lead to a further decline in its product prices and exchange rate, which will tend to increase its global export share.

Manufacturing is less labor intensive than construction, so shifting resources away from building houses and infrastructure toward manufacturing high-tech products may lead to net job losses during the transition. Plus, changes to the household registration system and rural land-use rights, which are key parts of the factor market reform plan, could lead to a reduction of agricultural employment. The potential boost to the non-agricultural labor force could be substantial. When Japan and Korea were at a China's current per-capita GDP level, agriculture accounted for less than 15% of employment. In China, it accounted for 24% in 2022.³⁷ Both factors will weigh on wage growth, which could allow producers to further cut product prices.

³³ Data are from the National Bureau of Statistics' "Main Economic Indicators of Industrial Enterprises" database. <https://data.stats.gov.cn/english/easyquery.htm>

³⁴ Tan, Clement. "China producer prices dip in January for a 16th month; consumer prices see biggest drop since 2009," CNBC, February 7, 2024. <https://www.cnbc.com/2024/02/08/china-producer-prices-dip-in-january-for-a-16th-month-consumer-prices-slip-again.html>

³⁵ Based on the balance of payments data from the State Administration of Foreign Exchange. <https://www.safe.gov.cn/en/2019/0329/1496.html>

³⁶ "China state banks selling dollars for second day to support yuan – sources," Reuters, December 6, 2023. <https://www.reuters.com/markets/currencies/china-state-banks-selling-dollars-second-day-support-yuan-sources-2023-12-06/>

³⁷ Data from national sources and the Penn World Tables, accessed via LSEG Datastream.

The pivot in practice: how China became the top auto exporter

Looking at how these dynamics are unfolding at the sector-level can help to clarify the global consequences. This section describes how China became the world's largest auto exporter.

China's auto exports surged from 724 thousand cars in 2019 to 4.08 million in 2023, making it the top exporter of passenger cars globally.³⁸ Some of this increase was due to the government's support for new energy vehicles (NEVs) under its Strategic Emerging Industries initiative. Local governments have also been keen to establish NEV factories in their jurisdictions, resulting in duplicative efforts and excess capacity that has put downward pressure on prices. Meanwhile, reforms to boost domestic competition – cutting purchase subsidies, allowing Tesla into the market without a joint-venture partner, etc. – also helped to improve the quality of Chinese NEVs. NEV exports rose from 31 thousand cars in 2019 to 1.15 million in 2023, of which 27% were Chinese-made cars from Tesla.

Yet most of the increase in China's auto exports came from traditional, internal combustion engine (ICE) cars, which rose from 693 thousand units in 2019 to 2.94 million in 2023 (Chart 5). Two factors explain this spike. First, passenger car exports to Russia rose from \$440 million in 2019 to \$11.7 billion in 2023 as producers from other countries abandoned the market due to international sanctions. But this only explains a small share of the surge. Exports of cars to the rest of the world rose from \$8.2 billion to \$66 billion over this period.³⁹

The second factor has been more important. Declining demand for ICE cars in China resulted in chronic excess capacity. Producers, most of which are joint ventures with foreign firms, dumped their excess capacity on the global market, a process that was helped by a cheap exchange rate.

This combination of excess capacity, technological advancement, and a cheap currency may lead to similar export surges in other higher value-added products in the coming years. China's lagging-edge semiconductors are a particular concern. Increased government support has helped the industry to expand its capacity.⁴⁰ Meanwhile, sanctions on Huawei have turned it into a large, price-insensitive buyer of domestic chips with high quality standards.⁴¹ This will help the industry get up to scale and improve its competitiveness. After which, a cheap currency and excess capacity could see China flood the market with lagging-edge chips by undercutting global prices. This could weigh on margins for chip producers in the rest of the world, including those in the US.

The US has not de-risked its supply chains

US policymakers should not assume that efforts to de-risk the country's supply chains will offer much protection from a surge in higher value-added Chinese exports. For one, US import data likely understate the country's actual imports from China by nearly 25% due to systematic tariff avoidance.

³⁸ All data in this paragraph are from the China Association of Automobile Manufacturers, accessed via Wind.

³⁹ Data are from China Customs for exports of HS code 8703. <http://stats.customs.gov.cn/indexEn>

⁴⁰ Strumpf, Dan. "China Chases Chip-Factory Dominance—and Global Clout," Wall Street Journal, July 24, 2022. <https://www.wsj.com/articles/china-bets-big-on-basic-chips-in-self-sufficiency-push-11658660402>

⁴¹ Wang, Dan. "China's Sputnik Moment?," Foreign Affairs, July 29, 2021. <https://www.foreignaffairs.com/united-states/chinas-sputnik-moment>

Before 2018, the US regularly recorded imports from China worth 15-20% more than China reported sending to the US. About 10-15 percentage points seems to have been due to China recording a portion of exports that were ultimately bound for the US as going to Hong Kong. The rest was due to different global standards for recording imports and exports. But since 2020, the US has recorded fewer imports from China than China reported sending to the US. This should not be possible.

Mapping the US and Chinese data to the US's Section 301 tariffs by HS code helps explain how this happened.⁴² The gap between US-recorded imports and Chinese-reported exports only reversed for the goods subject to the higher tariffs, although it narrowed somewhat for non-tariffed goods (Chart 6). This suggests that tariff avoidance was the primary driver behind the reversal of the discrepancy.

In this instance, the Chinese data are likely more reliable since US-based firms have a financial incentive to understate their imports to avoid paying higher tariffs. As a result, US imports from China may have been understated by \$100 billion or more each year since 2020. China's share of US imports probably only fell from 21% in 2017 to 17% in 2023, not the 14% share officially recorded.⁴³

Moreover, while the final assembly of some goods has moved from China to India, Mexico, Vietnam, and other locations, the Chinese value-added embedded in these products does not appear to have declined significantly. Instead, a BIS analysis using firm-level data found that US supply chains have lengthened by an additional step, without any additional diversification.⁴⁴

This means that the impact on the US economy from a surge in cheap Chinese exports of higher-value products will be similar to that of the rest of the world. This could undermine US industrial policies aimed at boosting the domestic production of electric vehicles and batteries, green energy, and semiconductors. Even with government subsidies, US firms in these sectors may find it difficult to make a profit if China's excess capacity weighs on global prices.

Policy recommendations for Congress

The US should coordinate with other countries to resist a further rise in China's global export share. China's pivot back to manufacturing may benefit the US in some ways. It could lead to lower inflation and help to make the transition to green energy faster and cheaper. But most countries share similar concerns about the potential for deindustrialization and dependence on Chinese goods.

A coordinated response would be best. The Indo-Pacific Economic Framework for Prosperity is a positive but insignificant step. Multilateral free-trade agreements with tight product, environmental, and labor standards would more effectively level the playing field with China. Congress should approve the Comprehensive and Progressive Agreement for Trans-Pacific Partnership and encourage the executive branch to open negotiations with other regions for similar high-standard agreements.

⁴² This was done using the bilateral trade data from the UN Comtrade database, which was mapped to the US Trade Representative's Section 301 tariff lists.

⁴³ The calculation uses Chinese-reported exports to the US, adjusted to match the pre-2018 relationship with US-record imports from China. National data accessed via LSEG Datastream.

⁴⁴ Qiu, Han, Hyun Song Shin and Leanne Si Ying Zhang. "Mapping the realignment of global value chains," BIS Bulletin no 78, October 3, 2023. <https://www.bis.org/publ/bisbull78.pdf>

The US should not increase its tariffs on Chinese goods any further. The tariffs haven't reduced US dependence on China or harmed China's economy in any significant way. Instead, US-based firms are now engaged in systematic tariff avoidance, and US supply chains have lengthened. Higher tariffs probably wouldn't generate more revenue for the Treasury. Instead, they would likely lead to further efforts to conceal the origin of Chinese produced goods. This would only increase the fragility of US supply chains and make them more difficult to monitor.

Chinese investment into the US should be encouraged, especially in clean energy technologies, as should cooperation between US and Chinese scientists. There are legitimate security concerns about Chinese investment and scientific research. Screening tools should be strengthened. But China is well ahead of the US in several technologies that will be critical for avoiding a climate catastrophe, and Chinese scientists are leaders in several areas of research.

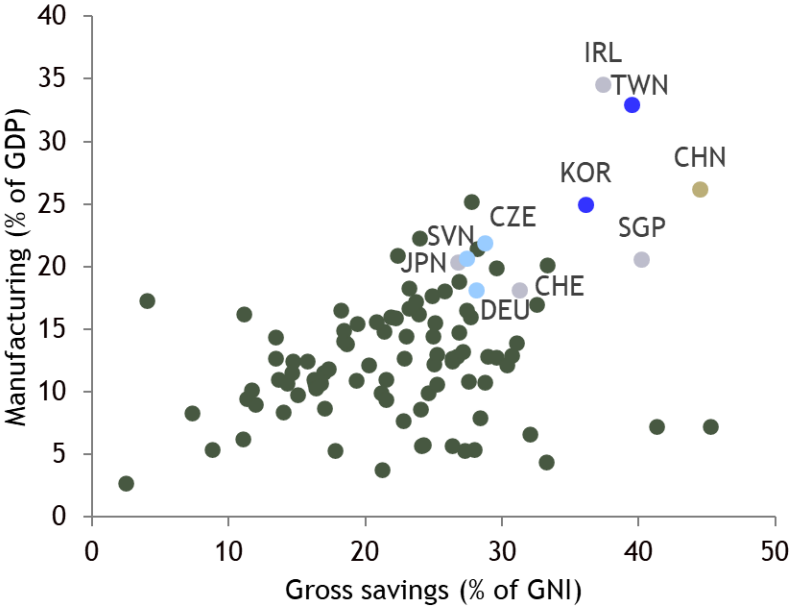
It's time for the US to steal a page from Japan, the Asian Tigers, and China itself by leveraging China's knowledge and knowhow in these sectors by encouraging foreign direct investment in the US, licensing agreements with US firms, and collaborative research with US scientists. It's not too late for the US to catch up and surpass China in these sectors. The best way to do that may be to follow the learning-by-doing process that underpinned the East Asian Miracle.

US policymakers should continue to pressure their Chinese counterparts to boost domestic demand and curtail excess capacity through bilateral dialogue. These conversations do not have to be antagonistic. China's pivot back to manufacturing seems destined to fail as an economic development strategy anyway. But the government may cling to the strategy for longer than it should due to its own security concerns about its supply-chain exposure to the US and its allies.

The US should instead encourage policies that would steer economic resources to the household sector and flatten the distribution of household income. This could provide a boost to consumption, which could lead to higher Chinese demand for US goods.

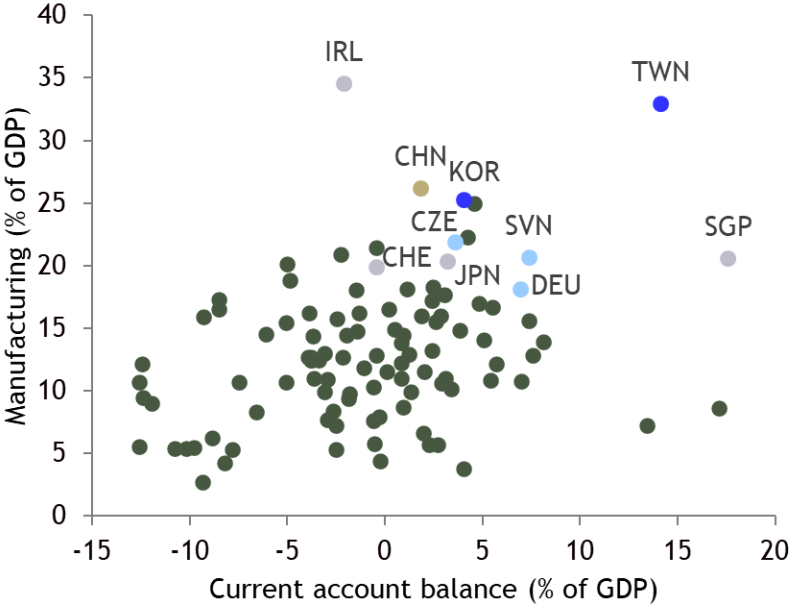
Charts

Chart 1: Manufacturing-oriented economies have high savings (2019)



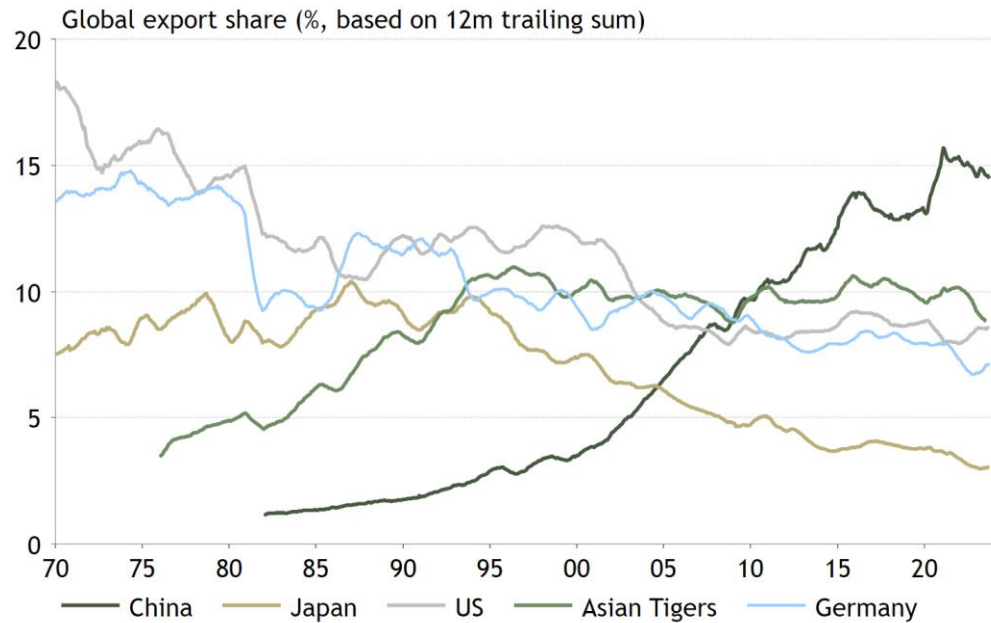
Source: World Bank

Chart 2: Manufacturing-oriented economies have large current account surpluses (2019)



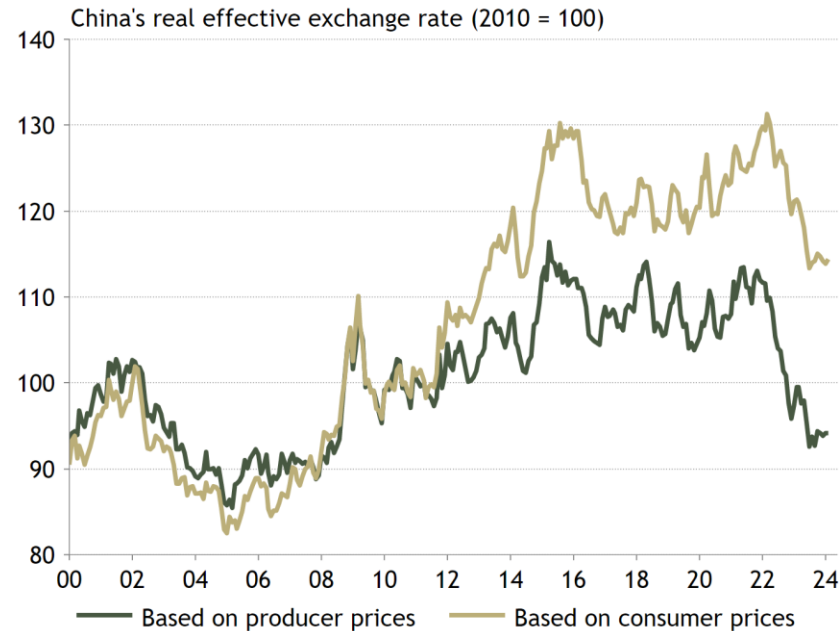
Source: World Bank

Chart 3: China's global export share has risen



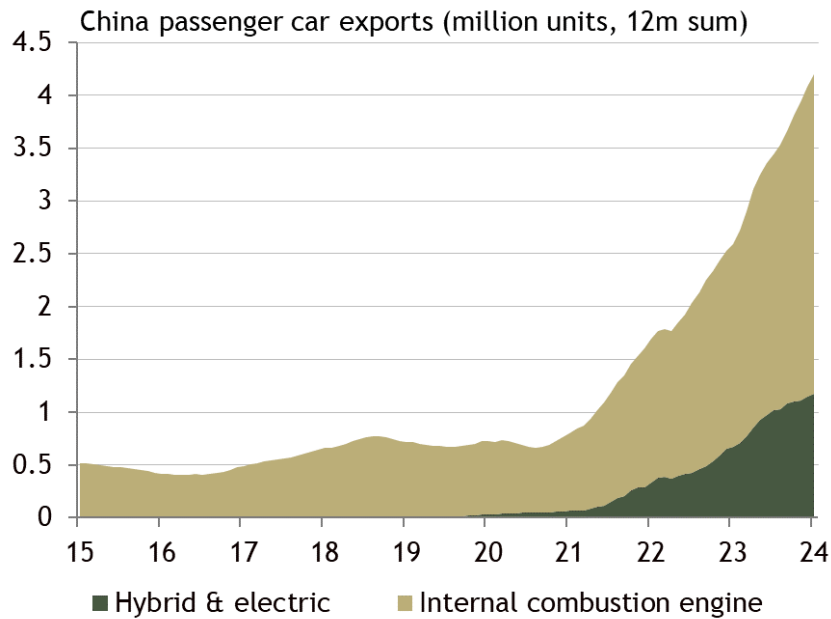
Source: IMF Direction of Trade Statistics, accessed via LSEG Datastream

Chart 4: China's real effective exchange rate has depreciated



Source: JP Morgan, accessed via LSEG Datastream

Chart 5: China's auto exports are mostly ICE cars



Source: China Association of Automobile Manufacturers, accessed via Wind

Chart 6: US imports from China are likely understated due to tariff avoidance



Source: Comtrade, US Trade Representative

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