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China: Rising Noise, Sharper Focus

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While there appears to be a collage of ideological and policy conflicts between China and the United States, it would be useful to ponder just how much of this angst is actually new.

Arms sales to Taiwan, receptions for the exiled Dalai Lama, concern over human rights, a command and control economy that favors local interests and protocols, Internet censorship and hackings, allegations of currency manipulation, warnings to the United States about fiscal recklessness, disagreement over perceived climate change, differences over intellectual property rights, opposition to sanctions against Iran and support for Iran's ballistic missile manufacturing capability, and the rise of a blue water navy in the Pacific are examples of those divisive issues between China and the U.S. These differences have for the most part been continuing for many years, but in some cases the intensity appears to be increasing. Because the noise level is now higher, it is especially critical to maintain a well-focused sense of U.S. priorities.

Against this array of conflicts, it is very difficult to envision a more important relationship than that of the world's first and second largest economies, based on purchasing power parity. Were it not for the United States and its vast consumer economy, China would not have lifted hundreds of millions from poverty to the middle class, in a country which in January the *Telegraph* estimated had 350 million Internet users. Further, and thanks in large part to the U.S., with its export driven development model China has become the world's largest exporter, with exports now more than twice those of Japan (*CIA World Fact Book* 2009 estimate). Its factories are kept in business by the U.S., allowing China to achieve a miraculous economic transformation since the late 1970s.

With foreign currency denominated assets estimated at $2.5 trillion, China is indeed America's banker – with almost $900 billion of U.S. Treasury securities, plus other U.S. dollar currency holdings and investments. China's appetite for U.S. Treasury instruments keeps our cost of debt capital low and supports a high standard of living through the use of debt – which, as we have seen in the global economic meltdown, has been badly abused. It is hard to imagine in modern history when two nations have been so addicted to each other.

The most recently announced $6.4 billion weapons sale of helicopters, telecommunications gear and Patriot air defense systems to Taiwan is not a game changer in strategic terms – Taiwan has been a U.S. client state for decades. And President Obama's recent meeting at the White House with the Dalai Lama is part of a presidential tradition going back nearly twenty years – human rights in China's repressive culture have been an issue of disappointment and contention for some time, embracing more than suppression of dissident Uighurs in western China. To attract foreign investment, for many years China has permitted moderate foreign control but has issued decrees preventing too much concentration of influence. However, of increasing concern should be the climate in China for foreign companies, as reported by the *Wall Street Journal*: A recent survey taken by the American Chamber of Commerce in China states that 38% of over two hundred U.S. companies questioned now believe that they are not welcome in the Chinese market – and that they feel disadvantaged, particularly in state sector procurements.

Of further note, hacking activity believed to emanate from China has been a serious concern for the U.S. government and private sector a number of years. However, the more recent travails of the iconic Google enterprise, which charges extreme local censoring and hacking into accounts of Chinese dissidents, are demonstrating just how authoritarian China can be when it wants to suppress dissidents and those who criticize its ways. Fearful that Google is an instrument of U.S. foreign policy with the ability to destabilize, it is doubtful that the Chinese will yield. At this writing, Google has rerouted its China searches to Hong Kong.

As for currency manipulation, the real issue, as explained recently in the *Wall Street Journal* editorial pages, is not the rate at which the Yuan is pegged to the U.S. dollar by the Chinese government, but rather the lack of external convertibility of that currency, which is not freely tradable in private markets to establish its value. While there is a very understandable populist cry to revalue the Yuan to create U.S. jobs, the World Bank's chief economist, Justin Lin, has pointed out in the same newspaper that from 2005 to 2008, the Yuan appreciated 21%, but the U.S. current account deficit actually increased in that period. Continuing, Mr. Lin said that China contributes to only one-third of the total U.S. trade deficit – and it is well-known that much of this is derived from U.S. companies that now manufacture in China for export to the U.S.

Long term, the trade and treasury deficits of the U.S. must be moderated to avoid future imbalances, asset bubbles, and concentrations that imperil a stable economic order. And China will have to do its part to balance what has been an export led economy with one that favors more local consumption, with liberalization of its currency policy to establish free market value.

China's opposition to Iran sanctions is less understandable. As a principal supplier of oil, a world commodity market that is fungible, Iran can be gradually replaced as the source of an estimated 15% of China's imports of oil and gas. The Uighurs of western China, while Muslims, are Sunni with limited affinity for Iran's Shi'ites with more cultural linkages to central Asia. To China, however, there is value in a situation that makes the U.S. uncomfortable.

As a rising global power, China's dedication to building a modern navy is yet another issue of concern. While experts would argue that it is presently no match for the U.S. going head to head, this does not address the intimidation value of its navy in the region, as well as reported efforts to develop an anti-ship medium-range ballistic missile with a speed of Mach ten for potential use against Carrier Strike Groups, as reported by the U.S. Naval Institute a year ago.

U.S. priorities with China must embrace nuclear non-proliferation, a stable world economic and investment order, and avoidance of game changing military technology, if possible. The U.S. cannot engage with China on all issues of difference at once, and timing is important. When the U.S. needs China to reform its currency policy, and more immediately endorse sanctions for Iran, it is not wise to contemporaneously announce arms sales to Taiwan and host the Dalai Lama in Washington; those legitimate and traditional opportunities can always wait.

There is no short term fix. And China may well be overplaying its hand by alienating U.S. multinationals and Google, an enterprise that enjoys broad global admiration, ranking fourth among the *Fortune* top fifty most admired companies in the world, with a youthful, entrepreneurial image in a country with a young technology savvy population.

We should be cognizant that China, when it wants to, still considers itself a developing country. While it has achieved economic superpower status in a couple of generations, per capita GDP, one accepted measure of national wealth, is yet another story. China undoubtedly has an opportunity to assert itself now that the Soviet Union is defunct and American power is diluted by a weakened financial system and two protracted wars. We should be prepared for these challenges – from a country that is a trading partner, global competitor, and potential adversary.

While we are going to have to live with a lot of noise and divisiveness, we should avoid distractions, with unrelenting focus on defining and ordering priorities and appropriate future tradeoffs.