

The Role Of China And The United States In The Global Economy Of The 21st Century

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The world is characterized by brutal global competition. When talking about competition during much of the 80s and 90s, we generally refer to the triage of Western European, Japanese, and U.S. firms. Today, we have to add firms from Brazil, Chile, China, and India to this elite bunch. This competition is good for the consumer -- prices of manufactured goods have been kept in check, and there is a general feeling of economic prosperity around the world. According to a recent article in *The Economist* global output has grown by over 4.3 % annually. The growing middle class in India and China has recorded the sharpest increase in the number of billionaires in the last decade; therefore the world has every reason to feel optimistically euphoric, even if China and India will reap a bigger share of the economic pie. In the words of Drucker, India and China are "...rapidly transforming their economies...they can now produce technologically sophisticated and financially rewarding offerings that are diminishing American standards." (Drucker, 2004) The concern with the advent of China has prompted more protectionist oriented legislation against China: textiles. The U.S. Congress also blocked a recent attempt by China's China National Offshore Oil Corporation (CNOOC) to acquire Chevron. A recent Harris Poll indicated that 40% of the people surveyed believe that China will be stronger than the U.S. within a decade, and over 50% believe that China will have a negative effect on the U.S. economy.

However, if we dig a little deeper under the surface, there are many signs that the global economic outlook is not as rosy as it may seem. For instance, there is real concern of a renewed emergence of higher inflation -- something that was not much of a factor for much of the last decade. The Chairman of the Federal Reserve in the United States was concerned enough about this reemergence of inflation to raise interest rates. In addition, the increase in fuel prices coupled with the increased uncertainty in future fuel prices due to potential supply disruptions induced by the Iraq war, and increased demand due to economic growth in India and China have decreased consumer confidence in the ability of our global economy to sustain these growth figures. On a different level, gold prices have soared to over \$680 an ounce, which lends credence to the notion that global uncertainties with the global economy, global currencies, and the increased levels of political uncertainty have driven investors and hedgers to seek gold in their portfolios. Finally, the U.S. suffers a current account deficit of over 6% of GDP vis-à-vis the rest of the world, whereas most of the wealthy countries enjoy a current account surplus. It is debatable whether this status quo can be maintained in the 21st century.

In light of these developments, a logical question to ask is: What roles can we expect China and the United States to play in the redefined global economy of the future? This question is not trivial, since global policy makers have to confront more issues with the following questions: Would China have a bigger economic role (and hence a bigger political role) in the new economy? Will the United States' economic and political influence diminish in the future? What specific policy measures should each of these countries adopt to ensure continued survival in the redefined economy? In this paper, we will attempt to provide a perspective on these questions that is designed as "food for thought" rather than provide specific answers to these important questions. In the next section, we provide a synopsis of the Chinese economy, its strengths and weaknesses. This synopsis is followed by similar reviews for the economy of the United States. The conclusion includes our thoughts on what the future roles of each country should be.

CHINA: AN ECONOMIC SYNOPSIS

Over the last decade, China has evolved from a “sleepy giant” into one of leading global manufacturing centers of the world. Reports suggest that China currently manufactures a substantial proportion of the world’s manufacturing output, and there are suggestions that this percentage will increase even further. China enjoys a current account surplus of approximately 5% with the rest of the world. In particular, China enjoys a trade surplus of approximately \$ 200 billion (2005 figures) with the United States. This is a large trade account deficit that the United States has with the rest of the world (reported in a recent New York Times article to be a record U.S.\$617 billion in 2004) and a third to a half of this deficit is with China. This deficit (particularly with China) has been touted as a matter of concern for its residents.¹ Experts have suggested that this deficit is partly responsible for the U.S. dollar’s continuing decline in value which can lead to higher interest rates in the future with negative repercussions for the U.S. economy, and by extension, for U.S. consumers and businesses. Since the 1980s, China is increasingly dependent on external demand for domestic economic development. On the other hand, global wages, profits, prices, and interest rates are increasingly influenced by events in China. It enjoys foreign exchange reserves of over \$750 billion (2005 figures). To understand the impact that China has on global currency values, there is some speculation that if China takes only 3% of this amount and buys gold with it, then gold prices will soar to \$1000 or higher. On the negative side of China’s emergence as a consumer nation, global prices of resources have gone up significantly since China’s admittance into the WTO. For instance, many mines in South America such as, in Peru, have entered into long term contracts to supply resources to China. In addition, other resource rich nations like Canada have enjoyed prosperity in part due to signing long term resource related contracts with China. In fact, Canada’s exchange rate (relative to the U.S. dollar) is at its highest level since 1976.

On the other hand, China’s prosperity has caused some headaches for itself. Since China was admitted into the WTO as a full fledged member on December 11, 2001, it has pegged its currency to the U.S. dollar. This has the benefit of shielding the global prices of Chinese manufactured goods from currency fluctuations. China’s emergence as the world’s manufacturing center has caused its wealth to increase, and consequently allowed a perception that China’s currency should be properly aligned to reflect its new economic stature. Many feel that China’s Yuan should be appreciated considerably. If so, this action may arguably make Chinese goods less competitive in the United States but make U.S. manufactured goods more competitive in China. In theory, this would reduce the U.S. trade deficit with China, mitigating the potential problems related to the continuing trade imbalance. With a monetary policy perspective, this places China between a rock and a hard place. If it appreciates its currency significantly, then this move hurts domestic export dependent firms (who are primarily responsible for the new jobs created in China), or may create a domestic banking crisis since many domestic banks have lent money to these firms. On the other hand, devaluation (or pegging the Yuan to the U.S. dollar) helps exports, but invites external wrath. In response to external pressures, China adopted a middle-of-the-road policy: on July 21, 2005, China decided to peg the Yuan to a basket, revaluing its currency by 2% with a possible daily upward adjustment of 0.3 % per day. There have been concerns expressed that the new currency policy does not do the job; the percentage weight to currencies other than the dollar is minimal.

Ironically, despite its global economic might, China continues to suffer from high unemployment. *The Economist* reports that the number of unemployed is in excess of 15 million in cities, which compared to its population is miniscule, but still significant. There is also a perception that economic growth is occurring only in 2 cities -- Shanghai and Beijing. This growth has led to the classic problem faced by many developing countries: migration of workers from rural areas to urban areas. This problem has become so critical that the Chinese government has decided to encourage economic development in areas outside of the 2 major cities. Finally, as reported in a recent issue of *The Economist*, the Chinese are facing a collapsing health care system, and a falling life expectancy. Part of this problem may have been induced by their economic prosperity: the World Bank reports that pollution in China is at “scandalous proportions,” and that 16 of the 20 most polluted cities in the world are in China, estimating that it costs over \$70 billion a year in direct and indirect costs. Recently, recognizing that

¹ More discussion on this topic can be found in Madison, Tom and Prasad Padmanabhan. “The Trade Deficit is not all Bad News” *The China Daily*. 10 June 2005.

pollution in China can impact neighboring countries, Japan paid over \$2 billion to clean up Chinese pollution in China, knowing that it would have cost much more to clean it up when it reaches Japan.

Another global complaint against China is that of a blatant disregard for respecting the intellectual property rights related to foreign innovations. While WTO membership will force China to take adequate steps to safeguard against intellectual property theft, one must consider the Chinese culturally based view on this matter: the Chinese consider that to “copy” the invention of others is a sign of “respect” for that individual or company; they preach the philosophy that “...you should be flattered that I am copying you...” Clearly, the Chinese government is taking steps to “beef-up” enforcement of intellectual property rights, but there is still some concern that enough is not being done in this regard. If China is to be recognized as a viable economic player, then it should strengthen its attempts to enforce property rights. Doing so serves its interest in two ways: one, it lends credence to China’s claim to be a global economic player, and second, that its entrepreneurs will be emboldened to develop new innovations, knowing full well that they will be able to extract the maximum benefits from their innovations.

THE U.S. PERSPECTIVE

As with the rest of the world, the United States is primarily concerned with its trade deficit with the world, especially with China. Of interest is the loss of manufacturing jobs in the United States associated with the trade imbalance with China. What are some of the realities of this merchandise trade deficit? Should the United States be worried about this problem? What solutions should policy makers put in place to combat the potential erosion of economic wealth in the United States? First, it is true that U.S. companies have exported jobs to China. U.S. companies operating multi-nationally have taken advantage of the abundant supply of less-expensive labor in China in order to produce and market goods internationally. Although the manufacturing wage income now flows into China, if the cost structure based on Chinese manufacturing operations creates a competitive advantage for American companies, then profits from these companies flow to U.S. investors. As a result, lost wage income to China is somewhat offset by increased investment income in the United States. In addition, manufacturing operations in China supply both the U.S. market and the burgeoning consumer market inside of China. Thus, the flow of profits to U.S. multinationals and their investors is further enhanced by U.S. multinationals' presence in the Chinese domestic market. Second, even if U.S. public policy does change to discourage U.S. firms from investing in Chinese manufacturing operations, this act may do nothing to reverse U.S. job losses to China. Foreign direct investment in China totaled almost U.S. \$50 billion in 2002, up from U.S. \$430 million in 1982, and some of this is induced by U.S. firms outsourcing manufacturing operations to China, but multinational corporations from all over the world are doing the same. Without draconian import controls in the United States, Chinese manufactured goods are going to enter the country. It is a matter of whether they enter through U.S. multinationals or through the multinational corporations of other countries. Additionally, should U.S. firms exit the Chinese market, foreign multinational firms will have greater access to the Chinese markets. Their increased profits in China may well subsidize foreign multinationals' penetration of U.S. domestic markets.²

Given the interdependencies inherent in today's global economy, it would be myopic to focus only on the trade deficit with China and ignore the larger picture. As a recent *New York Times* article reported, American companies with foreign operations accounted for 48 % of the nation's imports. In fact, there is a growing trend for parts and components imported into the United States to be used in finished products that become U.S. exports. Thus, low-cost imported components actually make U.S. exports more competitive.

WHAT SHOULD THE U.S. DO?

We believe that continued pre-eminence -- and perhaps the survival -- of the United States as an economic superpower will depend largely on its strategic ability to develop real innovations. A large part of the economic challenge that the U.S. faces *vis a vis* China and India is one of differences in growth rates -- their economies are growing much more rapidly than ours. If these current rates of growth are sustained, their economies may surpass ours in the foreseeable future. To the extent that global innovators continue to feel that they should *commercialize*

² See Madison and Padmanabhan (2004), op. cit., for more details.

their innovations in the United States, then the U.S. will do well economically. The U.S. consumer has been touted as being the most discriminating, and the U.S. domestic market continues to reward global innovators. However, will this situation last for ever? At some point in time, global innovators may shift their attention to the Asian market to commercialize their innovations, and relegate the United States to a secondary status. Clearly, there is the potential of economic wealth shift from North America to Asia, particularly to China and India. The combined population of China and India is over 2.33 billion, and wealthy Chinese and Indians may rival the United States for the attention of global innovators. Given this scenario, what should the United States do to retain its premiere global economic status?³ Innovations -- real innovations or “new-to-the world” products -- can be a strategic source of economic growth for a firm or a nation. However, not all innovations have strategic impact. For example, artists may innovate and develop new creations, which are “new-to-the-world” -- but may have little economic impact. Therefore, a strategic innovation, is one that is both new-to-the-world and has economic impact. Policy makers in the United States should recognize that technological innovations (as opposed to gains from trade, etc.) remain as one of the main source of U.S. growth. First, the U.S. should rigorously defend the intellectual property (patents) of U.S. firms and seek penalties against infringing foreign firms who seek to export to the U.S. Second, we must encourage and fund increased emphasis on science and technical education at all levels. Math and science teachers should be paid much more than what they are paid now, and at the same time, the quality of math and science teaching should receive closer scrutiny. Third, the U.S. should leverage its funding for basic research -- the research that underlies real innovations -- by aggressively partnering with U.S. firms. Entities such as the National Science Foundation could offer to match corporate funds for research conducted in independent settings, such as university laboratories, allowing the corporation to retain exclusive use of the resulting innovations for some period of time. Fourth, governmental policy should play an active role in encouraging global competition between firms, which creates the motivation for strategic innovation. The degree of competition and the resulting drive for strategic innovation is a function of both the product market as well as market structure. A monopolist may be induced to innovate only if there is a perception of a threat to its market power, perhaps as a result of the presence of a band of “marauding” entrepreneurs, domestic or foreign. A firm in a perfectly competitive market, even though the means with which to innovate may be limited, may still be forced to do so in order to avoid being forced to the bottom of the barrel. A firm in a monopolistically competitive industry may feel compelled to innovate when facing external pressures and an oligopolistic firm may decide on strategic innovation only when the rival makes inroads into the firm’s market share. An example is the U.S. governmental policy to allow a few major players in the broadband industry. The large size of each firm in the industry affords them the economic wherewithal to innovate and the scale to compete globally, yet the existence of multiple players prevents them from becoming complacent with respect to innovation because of the competition between them. In addition, in a dynamic economy with global competition, job losses will be routine. In this regard, the policy focus should be on creating re-training programs for displaced workers, funded through tax credits or perhaps through private investment, in order to help workers transition to new, high-wage jobs. Ideally, these programs could be designed to work in smaller entrepreneurial firms. Companies with an entrepreneurial focus create the majority of new jobs, and we believe will be far more effective in re-training workers for new skills that are in demand. We would broaden the opportunity provided by existing programs to educate and retrain workers, and to foster entrepreneurial dynamism in the U.S.

WHAT SHOULD THE CHINESE DO?

The Chinese enjoyed unprecedented economic prosperity during the last decade. Although *The Economist* reports that GDP growth in China is expected to slow down in the next 2 years, it still represents levels significantly higher than global levels. China enjoys increased clout in the political arena as well, and the Chinese currency is growing in stature as an important regional currency.

Despite these developments, China needs to solve its outstanding problems if it expects to continue to prosper. It needs to come to grips with its currency problem, particularly with the impact of an appreciating Yuan on domestic, growth oriented firms. Failure to do this can lead to economic problems. The growing income gap

³ More on this topic can be found in Madison, Tom, Karl Kampschroeder, and Prasad Padmanabhan. “Outsourcing, jobs weave tangled web,” *San Antonio Business Journal*, Print edition, 3 December 2004.

between Beijing/Shanghai and the rest of China is another source of concern, and the Chinese government is correctly encouraging new foreign investments in regions other than these two cities. Recent reports of new Chinese government initiatives to seek and to develop local resources (for example, coal, which allows for coal based energy) will allow for lesser dependence on foreign sources for key resources.

On a different front, the WTO membership is a double edged sword for China. On the one hand, it opens up the global market for Chinese manufactured goods. On the other hand, this increases the responsibility on the part of the Chinese government to ensure compliance with international trade and patent protection rights. For any nation to be a serious player in the international economy, strict enforcement of international economic rules is critical. Interestingly, as Chinese entrepreneurs develop new commercializable innovations, they will be the first to demand that copyright rules be enforced! The Chinese government is on the right path to ensure that patent rights are protected, and that existing rules are adequately enforced.

Finally, many have suggested that China and India are rivals in this economic war to the top. For instance, in an issue of the *Wall Street Journal*, it has been suggested that India is viewed as a “less successful economy” than China, and that policy initiatives taken by the Indian government could “narrow the gap with China” (*Wall Street Journal*, 2003). We feel that India and China will (and should) remain competitors, but both will benefit if they adopt a strategy of selective collusion. For instance, instead of placing competing bids for offshore natural resources (e.g.: oil), they could agree to collaborate in the bidding process when placing bids. In fact, this is exactly what they did recently in relation to an oil contract. We suggest that India and China can collaborate economically in more sectors for mutual benefit. China’s strength lies in manufacturing, and India’s strength lies in software. These comparative advantages can be mutually beneficial to both countries.

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