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

Hearing: "*U.S.-China Relations in 2020: Enduring Problems and Emerging Challenges*"

- 1) How do CCP leaders view their prospects for achieving the economic modernization goals they set for 2020? What is the state of the social contract and the CCP's ability to keep providing economic growth approaching the end of 2020?

China's leaders are feeling confident they will meet their centennial goal—to be accomplished by 2021 or the 100th anniversary of the founding of the Chinese Communist Party—to build what they call a "moderately prosperous society" or in Chinese *xiaokang shehui*. As part of a "moderately prosperous society" they have pledged to eliminate absolute poverty by the end of this year and double the size of the economy and per capita disposable income from 2010 to 2020, all three of which look reachable. According to China's official figures, some 93 million people have been lifted out of poverty since 2013, more than ten million annually, and only a little over five million remained in absolute poverty at the beginning of this year. China has already met its target of doubling GDP and looks set to narrowly accomplish its goal of doubling per capita disposable income, despite the challenges posed by COVID-19. In the short term however, in order to keep growth from falling too precipitously due to the pandemic, China's policymakers have had to push more credit into the economy, and once again encourage rapid industrial growth. That helped China achieve the highest quarterly growth of any major country in the second quarter, but also at least for now has meant abandoning deleveraging efforts which aimed to reduce the economy's alarmingly high debt levels. It also has slowed progress on moving to a more consumption-driven economy.

- 2) Describe the policies China's leaders have used to respond to economic fallout from the COVID-19 pandemic, as well as the "dual circulation economy." What is the interaction between these policies and mitigation of trade tensions? Where do they fit in with the overall strategic direction of China's economic planners?

During COVID-19, China's policymakers have supported smaller enterprises through tax breaks and social security payment deferrals rather than giving significant sums of money directly to the population, in contrast to the response here in the US with stimulus checks. That has exacerbated inequalities in the economy to where today wealthy consumers are doing well, reflected in strong sales for high-end goods including Louis Vuitton handbags, smart phones and luxury vehicles, while middle-income and lower-income people have suffered from job losses and slower income growth, and mass market sales have stagnated.

Meanwhile in response to the pandemic-induced collapse in global growth, as well as growing tensions with more than half its top twenty trading partners, China's leaders have announced their intention to double down on their long term goal of rebalancing China away from its reliance on export manufacturing and investment and accelerating the shift to a more domestic consumption-driven economy. Earlier this year top leaders even created a slogan for it when they coined "dual circulation" to describe their new growth model. While the new policy refers to dual reliance, a nod to the fact their leaders know China will always trade with the world, the clear emphasis now is on an economy much more self-sufficient that can grow based on the spending power of its own people. China's leaders today look around and sees what they believe is a global environment openly hostile to China's future, with US-led efforts to slap tariffs on its exports, cripple its national tech champions including Huawei, Tencent, and ByteDance, the parent company of TikTok, and sanction its officials in Hong Kong and Xinjiang. Its leaders clearly feel China can no longer rely as much on the world to meet their ambitious development goals. Indeed, over the last year we have heard president Xi Jinping refer with ever more frequency to the need for self-reliance, or *zili gengsheng*, a key goal and phrase of the autarchic Mao-era.

- 3) What are the consequences of the policies described in the previous question for the domestic economy, and what does this outcome say about the strengths and limitations of China's economic management? How do they impact Beijing's ability to act on its geopolitical vision and meet its international obligations, for instance through the Belt and Road Initiative?

This focus on building up a much more self-reliant economy does not mean abandoning national priorities like the Belt and Road Initiative. It will continue as China aims to extend its influence and find new markets in Southeast and Central Asia, Africa, and Latin America even as it tries to lessen its reliance on the U.S., European Union and Japan. China's leaders have talked of the need to strengthen domestic consumption, in part in response to the continuing drop in export competitiveness due to rising wages, going back at least to a key party plenum in 2013. They however have struggled to lift the proportion of the economy made up by domestic spending, which has remained stuck at around only forty percent for years now, and is far lower than the global average of sixty-plus percent. The inability to grow consumption is directly connected to the rapid growth in income and wealth inequality in China today, and the tendency of less well-off Chinese to engage in so-called "pre-cautionary savings" or not spend because they feel uncertain about their future economic prospects. Inequality and the lack of confidence in the future now prevalent in China, in turn have much to do with the lack of progress in reforming and ultimately ending two Mao-era legacy policies that still today ensure some one-half of the Chinese people, migrants and their relatives in the countryside, are treated as second-class citizens.

The first of those policies is the household registration or *hukou* which ties social welfare provisions to the place where one, or one's parents, were born; that in effect bars China's roughly 300 million migrant workers from accessing affordable healthcare and education for their children, in the cities where most of them work. The second is the dual land policy which prevents rural Chinese from renting or selling their land at market rates. This stands in direct contrast to the cities, where there has been an explosion of wealth as urbanites have profited from buying and selling apartments; indeed the dual land policy is probably the key driver of China's rapidly expanding wealth gap, which now has reached levels comparable to those in Russia. And it is the reason that China will struggle to continue to grow its middle class and lift the domestic spending power of its people.

- 4) Is China's science, technology, and innovation ecosystem able to prosper independently if access to international talent and the technology supply chain is constrained, either through external limits such as U.S.-imposed export controls or internal constraints such as limiting foreign investment?

China also faces the real risk that the continued development of its science and technology ecosystem stalls as U.S.-led export controls and its own renewed focus on pursuing a go-it-alone approach to development, limits its access to international talent and technology. The leadership's goals of developing China's own domestically-produced technology has a long history and decoupling must be seen as a two-way street: driven both by countries concerned with excessive reliance on China's supply chain and the Chinese leadership's own longtime desire to break its reliance on global technology. This emphasis on technological self-reliance goes back even earlier than the policy of "indigenous innovation" pursued by the previous administration of Hu Jintao, and continues as a top priority today as evidenced by the national strategy of "Made in China 2025". China's policymakers for years have had specific targets to reduce China's reliance on the imported technology and produce their own technology, in areas ranging from robotics to aerospace.

Despite the rhetoric, China's technological progress to date-like countries around the world-has relied on a robust exchange of people and knowledge from outside its borders; there is no reason to think that openness is no longer necessary. The demographic challenge of a rapidly aging population also is likely to be a constraint; an older workforce is typically less likely to be innovative research has shown. And China's deeply unequal education system, with huge gaps in quality between its showcase cities and the interior of the country where a large proportion of its young people still study, will be a hindrance to its ability to continue to move up the technology value chain.

- 5) What is next for the U.S.-China economic relationship? The Commission is mandated to make policy recommendations to Congress based on its hearings and other research. What are your recommendations for Congressional action related to the topic of your testimony? Does the United States government have adequate policy tools to address a redefined economic relationship after the events of 2020?

China's policymakers could respond to the economic challenges their country now faces by accelerating reforms of the household registration and dual land policies which would allow more people to enter the middle class and help China transition to a more domestic consumption-driven economy. They could do this while continuing to engage with the world. Unfortunately, the signs so far are not encouraging with little progress on liberalizing *hukou* or giving rural people more control over their land, while localities across the country are making it even more difficult for China's migrants to settle down. The response to the pandemic may make China even more restrictive in controlling where its large lower-income migrant population live long term, to the detriment of economic growth and vitality.

Meanwhile, China under Xi Jinping appears to be adopting an ever stronger "politics in command" ideological approach to manage society, including through invasive technological monitoring of its people, and to manage its economy. Xi has made clear that private entrepreneurs must, as he put it, "love the Party"—meaning they must focus not just on making profits but also ensure their broad corporate goals align with that of the CCP, especially as they become larger and more successful. Political pressure on entrepreneurs and growing inequality could spark pushback from disgruntled citizens, a prospect that already clearly worries the party. One possible response from China's leadership could be to lash out in places like the South China Sea and Taiwan to distract its people from problems at home.

To stem the rapid deterioration in the bilateral relationship and avoid the real possibility of an eventual military conflict with China, the U.S. should work to restart some of the more than 100 government-to-government forums that have been used to manage the day-to-day relationship between the two countries, but that have been discontinued since 2017. It is also critical that the Congress find ways to strengthen relations with countries that share concerns with the U.S. about China's chosen model; working together with others would be far more effective in countering China's mercantilist economic strategy and its coercive style of diplomacy than the current administration's unilateral approach. At the same time the U.S. must work to build up the tattered people-to-people exchanges with China which can help counter that country's leaders' efforts to portray the U.S. as a threat to the Chinese people. And while being mindful of the real danger of technology theft, the U.S. government should stop singling out Chinese students with visa restrictions and work to once again make America the top global choice for all international students going abroad.

Finally, the U.S. must also get its own house in order, including by ensuring adequate funding for education and for innovation and technology development; only then will the U.S. be able to maintain the competitiveness of its economy and be better positioned to manage the growing rivalry with China, including for global soft power influence. That too will allow the U.S. and China to avoid full decoupling and continue to have a mutually beneficial if often contentious relationship, one that both countries' economies and companies depend on, and one that is crucial to confronting global challenges including climate change, nuclear proliferation and pandemics.