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Transcript

CHINA IN THE WORLD PODCAST

Host: **Paul Haenle**
Guest: **Yukon Huang**

Episode 95: Common Misconceptions About China's Economy

Haenle: Welcome back to China In the World podcast. I'm glad to have with me today Yukon Huang. This is Yukon's fourth time on China and the World, making Yukon one of our most frequent guests. We always enjoy having him on the show, and we're glad to have him back, and we hope to have him back many times in the future.

Over the past few days, Yukon has been here in Beijing talking about his newest book called "Cracking the China Conundrum: Why Conventional Economic Wisdom Is Wrong". I look forward to talking to Yukon today. Yukon, thank you very much for joining us.

Huang: Really glad to be back, Paul.

Haenle: Yukon, since you joined the Carnegie Endowment after a long career in the World Bank, you have become known for taking the unconventional approach, being a contrarian on a lot of these issues regarding China's economy. I assume this was not a position you took while you were at the World Bank—it's a fairly traditional organization. How did you become a contrarian?

Huang: Well, the evolution surprised me. When I moved back to Washington after ten years in China, and Carnegie ask me whether I'd like to work and write on China, I wasn't quite sure whether I could find anything different or interesting to say, so I said let me think about this, let me look at what people think about and write about here in Washington, and let me come up with whether or not I can write something that is kind of interesting and different. After reading for a month or so, what surprised me is what people in Washington were writing and thinking about were quite different from the things I was thinking about in Beijing and vis-versa. That puzzled me, because this is a country that gets a lot of attention. You'd think that there would be a little more consistently in terms of the issues people look at. Then when I got deeper into it, I said to myself, you know, there's a lot of things here in Washington, in my view, that aren't quite right.

But then when I started thinking about what I thought about in Beijing, I realize that actually a lot of the things that I was thinking about in China was not quite right. So it was not just the so-called Western issue. It was actually a problem even for those of us in China, so that basically got me started. My views changed, so when I say conventional economic wisdom is wrong, I say in my book in the preface that I am part of that conventional economic wisdom. My views on China changed.

Haenle: So as you had the space and began to dig deeper, you started to think differently about these issues.

Huang: And what surprised me is the number of issues that this rethinking affected.

Haenle: The first one, if I remember correctly, was China's currency and the value of China's currency; the exchange rate.

Huang: Right, and that was probably the hottest topic in 2010. China's running huge trade surpluses. The West is basically saying 'your exchange rate is undervalued and needs to go up in value." S I basically looked at this issue very carefully and I spoke up in a seminar at Carnegie and I said to the Chinese who were in town that you should actually depreciate your currency—move it in the opposite direction—because your objective is to make the exchange rate more market driven.

Haenle: Which means it could go up *or* down.

Huang: Right, because if it only goes one direction, your policy is not sustainable. And the difficult job or task is trying to find the cases when it, logically, market driven, should go down in value, and today is the day because the Euro has collapsed. Now the Chinese government tendencies in the past is when international markets are unstable, they tend to hunker in and don't change anything.

Haenle: Keep it stable.

Huang: Stable. And I said you have to realize that you're trying to become more market oriented. When markets are, in fact, fluctuating, you can use this occasion to show more market driven forces and this is actually helpful to you.

Haenle: And what reaction did you get at that particular comment?

Huang: They liked it, actually. So within the next couple days, the Renminbi actually was allowed to fall in value, and I got quite the arc on the *China Daily* that reproduced and commented on my view which made me realize that somewhere and along the line, something thought that this might make sense. And part of the reason, frankly, was that in the audience at Carnegie that day was the Vice Minister of Finance. And my guess that somehow this particular argument filtered into the discussion in Beijing.

Haenle: What was the second issue in which you took a contrarian view?

Huang: Well the second issue was that everyone in China, everyone in the West, thinks China's statistics are manipulated and that growth is actually overstated for political reasons. Wall Street Journal had surveyed thirty economists. Twenty-nine said that China's numbers are manipulated to make it look better than reality. So I wrote an article and I sent it to Wall Street Journal, and I said China's statistics are a mess. There are lots of inconsistencies, things that aren't properly done.

Haenle: So you agreed with that?

Huang: I agreed that they were messed up, but I basically said that the bias in the end is the opposite. China's growth rates are actually understated. It is actually growing faster than people think. So, although you may get the point right about the quality of the data, the implication that it is manipulated in one direction is actually totally wrong.

Haenle: In your book, you talk a lot about international perceptions of China's economy and how different they are around the world, and this important because, of course, policies in countries, and the government approach to China's economy is often driven by these perceptions. How do you see these differ from region to region?

Huang: Well, I think that the biggest issue is U.S.-China trade, U.S.-China foreign investment relationships. This is going to become increasingly more sensitive or important because when Trump comes to China, he will probably have at the top of the agenda trade and foreign investment issues.

Haenle: And the idea is that the trade deficit is huge and that's really creating imbalances in the relationship, and the notion that there's not enough U.S. investment, or there's too much U.S. investment into China, and that that investment should be in the United States.

Huang: Absolutely. So conventional wisdom as I describe in my book is that China's surpluses are the cause of America's trade deficits, and that too much of America's foreign investment is going to China, leading to job losses here back home in the United States. The reality is quite the opposite. There is actually no direct causation between China's and America's trade balances. This is a very hard issue to explain because most people have to explain with accounting or technical economic trade analysis.

In my book, I try to do it very simply by pointing out that America's trade deficits became very large in the late '90s and early 2000s and they stayed very large. But China's trade surpluses did not emerge until five or six years later around 2004 or 2005, so how could China be responsibility for America's trade deficits when they weren't even generating any trade surpluses that were significant? And on foreign investment, most people would say America cut major investment too much in China. How much is too much? Taiwan, Singapore, Hong Kong, Japan—they invest 15, 20, 30 percent of their foreign investment in mainland China. So how much do American companies invest in mainland China? The answer is 1.5 percent—it's almost negligible. Europe, however, invests multiples more. Fifteen years ago, it's interesting to note, the European and American investment in China were the same amount in dollars. Now Europe is multiples more. And the answer is very interesting. America's greatest strengths are in services. Their exports to China—agricultural, semiconductors, Boeing aircraft—they don't lead to foreign investment. European investment support exports and manufacturing products, machinery, all this requires FDI. So, the issue I think Trump and Xi need to discuss is why is there so little foreign investment coming from America and the reason is because China's very restrictive in imports of services, and it rightly should liberalize. But here's the point: If China liberalized foreign investment services, it's a win-win for both sides.

Haenle: But this doesn't seem to be an issue that the Trump administration is pushing

Huang: No, because they begin with the presumption that foreign investment leads to job loss at home, and they begin with the presumption that this is manufacturing oriented kind of foreign investment. In fact, U.S. strengths do you lie in manufacturing, they lie in services. So, it's not like a company is going to move a plant to China to produce. Actually, Europeans tend to do that a lot. American firms, they're most interested in investing in China because of services, and this is America's strength. So, American investment in China in services leads to more jobs, both in the U.S. and more jobs in China. It is really a win-win.

Haenle: Well, turning away from China external policies, let's look a little more closely at some of the issues China faces at home. One of the issues which you talk about extensively in your book is on innovation. China's trying harder than most countries, probably any country in the world, to

become innovative. Chinese leader think, obviously, that this will help China's growth rate. You argue that that's not the case.

Huang: It's much more complicated for China's situation because it's trying to become more innovative at what I call a relatively low-income level than the real, truly innovative countries who all tend to be high income. So this is quite unusual. China's also trying to leapfrog ahead, become more innovative than would normally be the case a middle-income economy—

Haenle: —And having success in some cases.

Huang: In some cases. Those cases tend to me in some industrial product lines where size matters a lot. Take solar cells, wind turbine engines, batteries for vehicles—China putting in a lot of money and they're having some successes. So, that has a payoff, but it's also very expensive. But if you look at China's production of services, the knowledge intensity and technological sophistication is not very great. So they're actually lagging behind what you would expect for a middle-income country. And I go back to a point that we made earlier, this kind of restriction, unwillingness to accept competition, has actually been harmful to China's interest.

Haenle: Let's talk a little bit about debt, because here's another area that Chinese leaders want to address. Along with China's rapid economic growth has come surging debt, leading to questions about whether or not there's a debt problem in China. Do you think the amount of debt in China is unsustainable or could it actually be a positive indicator of China's economy?

Huang: Well, China's debt levels have certainly surged, and it's certainly bears close scrutiny in dealing with, so it's not a trivial issue. Its surge almost doubled over the last ten years. If you step back and ask, first of all, what is its level—26 percent of GDP—how does this compare with other major economies? What's interesting is that China's actually right in the middle of the hundred largest economies. Its level of debt is higher than most developing countries; it's lower than most developed. When we ask, "What is China? Is it developing or developed?" We probably all agree that it's neither. It's probably somewhere in the middle. That level actually is exactly what you'd expect.

But the risk comes from the fact that it increased so rapidly in the last ten years, faster than any country we've ever seen, so the issue is somewhat different. How do we explain this? Was this increase logical or not logical? In my book, I say there's some logic to this, because a large amount of this debt essentially went into the financing of the value of property. So why did this happen in China? Why was this so large? The answer is in some ways very simple. Fifteen years ago, there was no private property market in China. Land was owned by the state. Now you can use it, buy it. It soars in value because it is extremely valuable. So 70 percent of the debt increase in China, directly or indirectly, essentially financed the increased value of land. If you look at other countries which have a debt crisis, that kind of financing of property never counted for more than 25-30 percent. This is largely the reason why China's debt surge was larger than one would have normally expected.

Haenle: Yet Chinese leaders are looking to address this problem, and you don't see it as so urgent?

Huang: It is a problem in the sense that the property market developed so suddenly, and it varies so much between the major cities and the smaller cities, and they've overbuilt in some places and they don't have enough in some places. So, market forces actually have not been able to fully reflect the changing property market because it's such a recent phenomenon. So, I think the government is correct in saying this is potentially risky, but it's not actually a so-called debt risk. The problem is the merges of different kinds of markets and credits and property, and trying to make sure they function smoothly. And that's a big issue, because in the West, our property markets have been around for generations. In China, this is really a function of the last decade.

Haenle: Last sort of issue Yukon and I want to talk about, which you talk about in your book, is what you identify as one of the biggest challenges between the United and China: the area of tech transfer. China is very, very good at adapting technology. China, of course, has also been accused of stealing technology through cyber theft and other means. This was an issue that came up when President Xi did a state visit to Washington a couple years back, and he said in the Rose Garden that China was not going to engage in cyber theft of intellectual property going forward. He gave the impression to a lot of people that this will not be as big of an issue going forward, but you think that this issue will continue for at least the next ten to fifteen years. Explain what you mean by this.

Huang: Well, historically, theft of technology, effective ideas, for economic reasons has always been there. You go back two hundred years, U.S. borrowed, transferred, or stole technology from England or Germany. European countries stole from each other. This has occurred. You go back thirty, forty years, Japan was accused of theft, South Korea, Hong Kong, Singapore. So, when you look at the history, you realize that theft has been there. The interesting thing is that the countries that are growth rapidly and dynamically tend to steal. Countries that don't have the capacity usually don't steal, so it's a kind of ironic situation. China's been accused of theft over the last fifteen, twenty years in a serious way, very much like South Korea, Taiwan, Japan, Singapore did twenty, thirty years ago.

Cyber security is a particular issue because it was mixed up not only just with economic technology transfers but security. So I think it's quite right, actually, that the U.S. government had a serious discussion with China to try to differentiate between cybersecurity for security reasons as a different category and cyber theft of commercial. What is interesting is that other the last couple years, accusation about cyber theft for economic reasons has moderated a bit. But there still theft of these other forms that we're talking about. So, what is it that America should actually do? The first thing should be that if legal remedies exist, the American firms should pursue them. WTO offers a means, but from the American perspective it is seen as too slow of cumbersome. Should the U.S. resort to some of these other frameworks that they've developed, including a Section 301 Charter that allows American companies to claim a country is not performing fairly? What the U.S. needs to do is to get China to enter an agreement into which both countries sign on to so that then you make it legally binding if you want to accuse China of unfair practices. And there is a means for address this—this is the Bilateral Investment Treaty. And this has actually been put on the back burner.

Haenle: This was a top priority for the Obama administration, and it has hardly been discussed under the Trump administration.

Huang: Yes. It was very much on the agenda. It's been put on the back burner because this current U.S. administration is saying to itself, "Why do I want to encourage more foreign investment to go to China?" As we talked about earlier, if one understands that foreign investment coming from the U.S. is coming from services, it doesn't lead to the kind of job loss possibilities that manufacturing has, that kind of worry is not there.

Haenle: Is anyone making that argument in the administration?

Huang: It's not prevalent enough. There's too much of a sense that any foreign investment going overseas is bad—no differentiation of the type, no differentiation as the advantages it serves America. So, this is an area to address issues not of jobs and growth, but it also is the best vehicle for talking about theft, because then you start to talk to each other about the rules of the game and, if there's a problem, how to actually mediate it. Now we have no means of doing so.

Haenle: Well that's a point I completely agree with you. I wish the administration was talking more about some type of bilateral investment treaty between the U.S. and China, and how do we open up more markets in China to U.S. and other foreign competition. I think this would be an area where you would see win-win as well. Chinese companies would become more efficient and have to compete. Over the long term this would be good for China, and frankly, China's now arguing that it is going to be a champion for global economics and trade. If it's going to be a champion, it seems to me it has to open its markets more. They're quite closed.

Huang: Right. If you're a globalization champion, you're a champion across a wider spectrum of economic activities, not just trade of manufactured good, but into services and ideas and the flow of information. This, I think, is an issue that should be address by China because of its interests in the long run.

Haenle: Well Yukon, I've enjoyed hearing you talk about your book this week, "Cracking the China Conundrum: Why Conventional Economic Wisdom Is Wrong." I'd encourage our listeners to go out a buy it, and we're looking forward to the next book that put out. Can you give us a hint?

Huang: It's going to be about innovation technology transfer. I think that frankly the most sensitive issue between China and the U.S. in the coming decade.

Haenle: We look forward to it. Thank you again for being on the China in the World podcast.

Huang: Thank you. Take care.