

TESTIMONY

“What Growing Chinese Power Means for America”
by

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Madam Chairman and Committee Members:

You have asked me to address two profoundly important questions: “What are the security, economic, and diplomatic implications of China’s rise for America? And, “What U.S. policies are appropriate in light of those implications?”

China’s rise has implications for:

- *America’s competitiveness:* In the 1990s we seemed to have the notion that “globalization” was something that we did to others requiring them to reform. Americans have to get used to the notion that globalization also requires us to reform.
- *Asia’s security structures:* The post-World War II East Asian security structure, the “hub and spokes” system, is undergoing gradual and uneven change. U.S. allies are rebalancing their interests with America against their expanding interests in, and concerns about, a growing China.
- *The United States’ diplomatic toolbox and the mix of power:* There are three kinds of power—coercive, economic, and idea power. It is tempting to become fixated with the military dimensions of China’s rise, but it is the economic and intellectual dimensions that likely will be most important. China is leading with its growing economic and intellectual/cultural power in the region. America must rediscover and utilize its own economic, cultural, and intellectual power (soft power) assets in East Asia.

China’s rise need not be at America’s expense, even though we must be prepared for downside possibilities. If China’s rise can push America to make the internal and external policy

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and behavior adjustments we should make (out of consideration of our own interests), the United States will be stronger for this productive competition, East Asia will become more stable, and we will have a more prosperous and effective partner in addressing the region's humanitarian and developmental problems. Was China to move in less welcome directions and the United States to fail to make the needed changes, future prospects would be much more somber.

Uncertainties and the Dimensions of China's Growth and Change

The People's Republic of China (PRC) is the largest, most rapidly changing international actor on the world stage today. It is traversing enormous tracts of previously uncharted social, political, economic, and diplomatic real estate. Never before has such a large economy moved so rapidly from a planned structure toward market operation; opened up so speedily to the world financial and trade system; changed so dramatically from a rural to increasingly urban society; switched from energy self-sufficiency to import-dependence so quickly; and, gone from an information-starved to information-rich status so abruptly, the many controls on the Internet notwithstanding.¹ Given the magnitude of these changes, it is impossible to anticipate all the conceivable outcomes. A lot could go wrong in China, not the least being a rigid political system crumbling under the accumulated forces unleashed by reforms. Simply projecting past trends and successes indefinitely into the future is risky, indeed destined to be wrong along some important dimensions. If nothing else, as China's economy enlarges and exhausts the relatively "easy" gains that have produced spectacular growth thus far, the rate of economic expansion can be expected to slow. The straight-line projection of Japan's spectacular economic performance of the 1980s into the indefinite future is a cautionary tale.

Uncertainties aside, America must plan for a future in which China continues to make progress across a broad front. The dimensions of the PRC's emergence are everywhere apparent and the list below simply is suggestive:

- China's military modernization still faces enormous challenges, but the progress to date has exceeded expectations of a decade or so ago. We see this in China's

space program, its downsizing and professionalization of forces, its shift toward naval, air, and missile capabilities, and in its evolving force-use doctrines.

- The PRC's GDP growth has been in excess of 9 percent on average since 1990, after having averaged above 10 percent in the 1980s, according to the World Bank. India, by way of contrast, had growth rates a little more than fifty percent of China's throughout the 1980s and 1990s.²
- China's imports and exports have grown eight times as fast as world trade in the 1980-2003 period according to the IMF. In 1978, China's turnover trade accounted for .8% of world trade; by last year it accounted for 6.4%. Cumulative foreign direct investment in China has gone from negligible in 1982 to \$500 billion (2003), taking off in the early 1990s. There is a downside here for China, inasmuch as a large share of PRC exports (55% in 2003) comes from foreign-invested enterprises. This means that many of China's wholly owned domestic firms still are far from competitive internationally, though a few firms have emerged such as Huawei telecom and Haier appliances.
- China also is becoming a growing supplier of capital, particularly in Southeast Asia, as well as in the United States, Latin America, and elsewhere. The PRC's foreign exchange reserves (minus gold) were about \$659.1 billion in March 2005 and the PRC held \$174.6 billion in U.S. Treasury securities, second only to Japan (\$715.2 billion) in October 2004.
- In 1993, of China's total exports, 17.7 percent were machinery and electrical products; by 2003, 51.9 percent were in this category. The U.S. Census Bureau reports that in 2002 for the first time the U.S. trade balance in advanced technology products went negative, though we must acknowledge what constitutes "advanced" products is a broad category that includes items of comparatively modest technology.
- Since 2002, Japan, South Korea, and Taiwan have seen China become their number one export destination, replacing the United States, though this hides the fact that America remains a primary destination for intermediate goods sent to China, assembled there, and then exported.
- Intellectually, growing numbers of foreign students throughout Asia are studying in China. And, China's own students are achieving more internationally. In April of this year, "[T]he University of Illinois tied for 17th in the world finals of the Association for Computing Machinery International Collegiate Programming Contest."³ Shanghai Jiaotong University took first place.
- The OECD reports that Chinese R & D expenditures are growing rapidly now, from a low base, and a Stimson Center study by Kathleen Walsh⁴ reports on the growing number of foreign R & D facilities locating in China.

In short, America should plan on dealing with an increasingly capable China in the military, economic, intellectual, and cultural realms. The United States should not go into the

defensive crouch of containment-like thinking. Instead, we must think seriously about how to *cooperate and compete more effectively*, and play a central role in the emergence of new patterns of economic, intellectual, and security interaction.

The Building Blocks of National Competitiveness

The PRC is becoming an increasingly able competitor on the global playing field America did so much to build. China wants to play ball with America. The question is: “Will America perform well in a game and on a field it long dominated?”

The building blocks of national power and competitiveness are national investment and savings; education; health; energy; and sound, legitimate governance. Though China has significant problems in each area, it is doing comparatively well in the first three—and less well in energy and legitimate governance.

In 2003, the Chinese had an investment to GDP ratio between 32% and 42%. Looking at domestic savings alone, the IMF says China’s “gross national savings” rate that year was 47.6%. These rates make continued high economic growth very likely.

Chinese performance contrasts sharply with America’s. Harvard’s Larry Summers was right when he said:

In the last year [2003], the net savings rate of the United States has been between 1 and 2 percent...It represents the lowest net national savings rate in American history...In fact, net investment has declined over the last four to five years in the United States, suggesting that all of the deterioration of the current account deficit can be attributed to reduced savings and increased consumption rather than to increased investment.

The United States cannot long compete when it borrows for current consumption while China invests using its own savings. America must rebalance its saving, investment, and consumption priorities. If we do, Beijing’s competition will have done us a big favor. Such action would help us resolve our twin budgetary and trade deficits.

Examine the second building block—education. U.S. higher education is excellent. Nonetheless, considering its low current income levels, and the many severe education problems in China’s rural areas, the PRC has brought primary school education to 93% of the nation’s

population; the percentage of secondary school-age children enrolled has risen rapidly in the last decade; and the percentage of China's population in tertiary education has more than quadrupled since 1991/92. Many people say China is attracting foreign manufacturing investment because of cheap labor. In fact, the attraction is the combination of relatively inexpensive *and* relatively skilled labor, though we ought not to forget the millions of educationally deprived in rural areas.

Take as an example a field that is highly germane to economic modernization—engineering. China and the United States in 2002 granted approximately equal numbers of graduate-level engineering degrees, though China granted almost 3.5 times as many undergraduate engineering degrees. Moreover, U.S. engineering schools have substantial enrollments of non-citizen students. More startling, entering class sizes in engineering schools in China are growing rapidly. Looking to the future, and even discounting for quality differences, China will have enormous and growing human resources in technology. The National Science Foundation predicts that by 2010 China could well be turning out about four times the number of engineering doctorates as the United States.⁵

Go to most U.S. graduate schools in the hard sciences and you will see highly capable students from China in profusion. And, while the number of Americans studying in the PRC is in the low thousands each year, China for well over a decade has had about 60,000 students matriculated in American institutions of higher learning studying science, technology, as well as business, economics, and international affairs. China is turning out language proficient, culturally adept, and scientifically and technically capable people at home and abroad in ever-greater numbers. We must do the same thing. If Chinese competition motivates us to do what we should be doing, this is positive.

Public health is a tricky third building block. There are millions of people in China with virtually no medical care, the system is vulnerable to infectious diseases as the world saw with SARS in 2002-2003, and maladies once reduced to very low levels are increasing in incidence—not to mention a looming HIV/AIDS catastrophe. Nonetheless, China had a life expectancy in

2002 of 71 years, which compares favorably with the life expectancy in a much richer United States—77 according to the World Bank. And yet, in 2002 China only consumed about 5.5% of its still modest GNP on health expenditures while the United States consumed 13.3%; by 2004, this figure had risen to 15.4% and the rate projected for 2014 is a whopping 18.7%. The point is not that Americans should prefer Chinese health care, but rather that if the United States is to remain competitive it must control health expenditures. Germany, France, and the UK each have longer life expectancy rates than the United States, and they have about half the per capita health costs of America according to OECD data. The U.S. Bureau of Economic Analysis reports that “Before the first energy shock [1973], Americans spent \$1.56 on health care for every dollar they spent on energy...Now, even with oil prices up, every dollar spent on energy is matched by \$3.81 on health care.”⁶

And this brings us to energy policy, about which little need be said, other than the United States needs to get away from excessive reliance on imported petroleum and unstable regions of the world. Whatever nation first escapes the petroleum trap will achieve economic dominance for the next era; indeed, such liberation would define a new era. China is becoming rapidly energy-import dependent and this accounts for the near obsession Beijing has with securing sources of energy supply irrespective of the attributes of the supplying regimes. Energy is one of the principal Achilles heels of the PRC—along with water.

The Challenge of Building New Security Structures in Asia

Turning to the security implications of China’s rise, the trends merit vigilance. China’s official, non-inflation adjusted defense budget has increased in the double-digit range every year from 1990 through 2004. Most outside estimates place China’s military expenditures in a league with Russia, Japan, and the United Kingdom. Second, China has an active space program, the dimensions of which would surprise most Americans, and emphasis is on modernizing air, missile, and naval forces, as well as enhancing cyberspace, communication, guidance, and reconnaissance capabilities. Beijing is developing these forces and capabilities to have military

options if it determines Taiwan is moving unalterably toward independence; to deter Washington from entering a Taiwan Strait conflict; to safeguard China's nuclear deterrent; and to secure its resource lifelines. There is a non-trivial chance that Washington and Beijing could end up in conflict in the Taiwan Strait if the situation there is not handled well. Since early this year, however, there have been positive developments in cross-Strait relations—we must watch carefully and actively encourage positive moves.

Beyond Taiwan, however, the U.S. security situation in Asia is changing less as a consequence of China's growing military power than its economic growth. America's post-World War II allies in East Asia (Japan, the Republic of Korea [ROK], Australia, Philippines, and Thailand) increasingly depend on exporting to China and/or receiving increasing investment from it. Consequently, most U.S. allies will not allow themselves to be drawn into what they view as unnecessary friction with Beijing. Japan is the ally most tightly aligned with Washington. As China's economic power grows, the United States can decreasingly count on allies marching in lockstep. In some cases, such as the ROK, that day already is gone. The amorous effects on U.S. allies of China's economic aphrodisiac are nowhere more apparent than in NATO's contemplating arms sales to China in the face of Washington's opposition.

China's rise, therefore, is forcing many of our traditional allies in the region and farther afield increasingly to balance their interests with Beijing against their interests with Washington. Most Asian countries do not wish to be forced to choose between the two. As China becomes a bigger security and economic player, and if it continues with its trade and smile diplomacy, alliances that initially were directed against the PRC, and more recently designed to maintain balance and reassurance in the region, will become progressively less effective unless they adapt.

Institutions need to be developed that incorporate China into the Asian structure of peace. America needs to take the lead in developing this structure. The most critical strategic challenge in this respect is how to foster security cooperation between China, Japan, and the United States, a structure not premised on a "two-against-one" triangular logic that inevitably has one party

feeling left out and vulnerable. No major regional challenge in Asia can be effectively addressed without cooperation among Beijing, Tokyo, and Washington. The recent surge in Japanese and Chinese nationalism and Chinese hostility directed at Tokyo signal the dangers.

The Implications for American Diplomacy and the Mix of Power Used

Presidents Bush and Hu Jintao both traveled to Australia in late 2003 and it is widely asserted that China's president was more warmly received by our ally's legislature than our president, reflecting the success Beijing has had in its dollar and smile diplomacy, the most notable features of which were signing two energy deals with Canberra each of which ranged well over fifteen billion dollars. China also is seeking to reduce tensions in the region by shelving most territorial issues, signing agreements to reassure neighbors, promoting free-trade agreements, engaging in military-to-military exchanges, establishing large and long-term investment relationships, and promoting its "early harvest initiative" that promises some agricultural producers in the region more favorable access to China's domestic market. Beijing is doing the latter to win support on Taiwan as well. This tightly coordinated diplomatic and economic strategy in the region is leading serious analysts of the East and Southeast Asian system to talk about a "power shift," though Asia is by no means sinocentric.⁷

The United States needs to react more effectively to these developments and possesses enormous resources to do so if it employs the appropriate mix of economic, intellectual and cultural, and military power. Washington has talked too much about military issues and done too little on the economic and cultural/educational fronts. This problem began under the Clinton Administration when Washington reacted too feebly to the Asian Financial Crisis. Nonetheless, the United States still is more trusted to be an honest broker, and power balancer, than anyone else in the region. Moreover, America is still the most important "end market" for most everyone in the region. Washington needs to be more active in multilateral diplomacy in the region and more active in expressing interest in multilateral free-trade possibilities.

China's integration into vital regional and global production chains has an important implication for the use of economic sanctions. For many Chinese exports the value added in the PRC is 30 percent or less, meaning that 70 or more percent of the value is added in other countries or regions, most of which are friendly to us. To inflict sanctions against nominally "Chinese exports," therefore, is to inflict the bulk of the pain on others. This is bad economics and bad international politics.

Policy Implications for the United States

Americans believe in competition; China's emergence is providing it. There are two categories of policy responses—those involving fundamental American domestic systems and those that more directly pertain to relations with China and East Asia.

- 1) China's rise forces Americans to reexamine fundamental systems in the United States, challenges we ought to address even if China weren't in the picture. The issue is, "Are we going to be competitive?" If so, we need to:
 - A) Increase our national savings rate. The solutions to our trade and budget deficits do not principally rest in Beijing, they lie principally in Washington. It may be emotionally satisfying to rail against foreigners, but this alone will not be economically effective. Having said this, *Beijing now should modestly revalue the RMB out of its own, as well as U.S., interests* (more below).
 - B) Improve our schools--increase math and science training. Bill Gates has noted our high schools are broken overall, and one needs only look at foreign student enrollments in higher education science and technology programs in the United States to know that we are not producing sufficient numbers of our own citizens proficient in the hard, mathematical, and engineering sciences. As Gates put it in recent remarks:

By obsolete, I don't just mean that our high schools are broken, flawed, and under-funded – though a case could be made for every one of those points. By obsolete, I mean that our high schools – even when they're working exactly as designed – cannot teach our kids what they need to know today.⁸
 - C) Get more of our students into first-rate language and area studies programs and put the same emphasis on being effective with other peoples that the Chinese do. Mainstream social science departments in major U.S. research universities have lost interest in area studies—this is a national security issue and should be taken as seriously in the 21st century as it was in the second half of the twentieth.

- D) Find a way to stop the steady increase of health expenditures as a percentage of GDP. The American auto industry, for example, cannot be competitive when its overhead includes \$1,525 of health costs on each car rolling off the assembly line as is the case at GM.⁹ And be assured, China is emerging as an international competitor in this most American of industries.
- E) Reduce U.S. dependence on external supplies of energy, contain costs, and decrease negative environmental consequences of energy use.

These are alterations that the United States can and must make--they do not particularly depend on Beijing's cooperation but will have great bearing on how effective we are in competing with the PRC. If we fail to do these things, even effectively pushing Beijing to alter its unhelpful practices (which we should do) will only marginally improve things.

- 2) With respect to regional/bilateral policies, many things should be done:
 - A) Because U.S. competitiveness relies on innovation, and this depends on protecting intellectual property (IPR), my first priority with respect to economic/trade policy is IPR protection. I recently was in China with a group of your fellow senators and representatives and had a hard time finding any *genuine* foreign goods for sale by small vendors. I note that in recent congressional testimony Charles W. Freeman III, Assistant USTR, said that: "The Administration places the highest priority on stemming the tide of intellectual property rights infringement in China."¹⁰ I agree.
 - B) With respect to RMB valuation and exchange rate issues, we must distinguish between a flexible exchange rate system and a one-time revaluation. The former should be our longer-term goal, but a modest upward revaluation of the RMB now is warranted. This would assist the global monetary system in appropriately realigning exchange rates and help Beijing manage its current inflationary pressures. However, I doubt that any feasible (likely) Chinese revaluation would have great impact on the bilateral trade deficit and pushing precipitously for a fully market-driven exchange rate is risky given China's problem-plagued banking sector.
 - C) Washington should develop a means by which the United States, China, and Japan regularly consult about security concerns. The idea is to have "three-two talks" once or twice annually. These would be discussions where cabinet or higher-level security and diplomatic officers of the three governments get together to exchange views on common concerns. Such talks might evolve into something more formal, though we have the problem that Beijing may view such interactions as two against one as long as Washington has a bilateral alliance with Tokyo that it feels is directed against China. With respect to Northeast Asia, there were hopes that the Six-Party Talks might evolve into a more formal security structure. Those prospects seem dim now, but there is a role for five of those six parties to consult about regional security issues and perhaps something more formal could emerge. The main point is that bilateral alliances, with the Cold War patina of being aimed at China, are going to be decreasingly effective

as Beijing's power and attractiveness increase, assuming those trends persist. We must bring China into the regional security architecture.

- D) America needs to rediscover its soft power in the region. Washington should become more active in multilateral regional free trade discussions, talk about a broader range of issues than the global war on terror, and most immediately fix visa, exchange, and related policies so that businesspersons and students from the region have traditional access to America. The late-1999 move of the public diplomacy function from the stand-alone United States Information Agency to the Department of State was not wise inasmuch as public diplomacy suffered a relative decline in priority given the State Department's other responsibilities. We should increase the effectiveness and credibility of public diplomacy and restore America as a place people can expeditiously enter for education and business. The 2.4% decline in international student enrolments of 2003/4 is not in the national interest.
- E) And finally, China's rise has daunting implications for Taiwan. Taiwan has bet its economic future on financial, trade, and manufacturing integration with the PRC, but there are significant forces on the island that desire independence, a quest that basically is incompatible with the island's security and economic needs. To maintain this fundamentally inconsistent policy, Taipei will require increasing levels of security commitment from Washington, the cost of which will grow as Beijing's power increases. The security of a Taiwan that is highly integrated into the PRC's economy cannot be maintained by military means alone. Therefore, recent trends toward cross-Strait economic cooperation, cultural exchange, and political dialogue are logical, desirable, and to be encouraged. Getting back to a situation of cross-Strait dialogue that proved productive from 1992 until later in the 1990s should be a priority U.S. goal. For, if the Taiwan Strait were to erupt into conflict, our hopes for a pacific, Pacific region would be grievously set back.

ENDNOTES

¹ Michael Chase and James Mulvenon, You've Got Dissent: Chinese Dissident Use of the Internet and Beijing's Counter Strategies (Santa Monica: RAND Corporation, 2002).

² The World Bank, World Development Indicators (Washington, DC: The World Bank, 2004), pp. 182-183.

³ Thomas L. Friedman, "Soon, Just Showing Up Won't Even Take the Bronze," International Herald Tribune, May 14-15, 2005, p. 4.

⁴ Kathleen Walsh, Foreign High-Tech R&D in China (Washington, DC: The Stimson Center, 2003).

⁵ Data cited by Ernest Preeg, "The Emerging Chinese Advanced Technology Superstate," presentation at The American Enterprise Institute, May 13, 2005.

⁶ Floyd Norris, "Compared with Health Costs, Energy is Cheap," International Herald Tribune, May 14-15, 2005, p. 12.

⁷ See for example, David Shambaugh, ed., Power Shift: China and Asia's New Dynamics (forthcoming, University of California Press, 2005).

⁸ Bill Gates, "Remarks to National Education Summit on High Schools," www.gatesfoundation.org (accessed May 15, 2005), remarks delivered February 26, 2005.

⁹ Katie Merx, "Widening Burden: GM Confirms that Cost of Health Care is a Crisis," Detroit Free Press, April 20, 2005.

¹⁰ Charles W. Freeman III, "Testimony Before the Committee on Government Reform," May 13, 2005.