Virtual Event | Is China Headed for an Economic Crisis?

TRANSCRIPT

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Nadia Schadlow:

Well, it's great to be here today with two of the country's really preeminent experts on the Chinese economy. One is my colleague, Tom Duesterberg, who is a senior fellow here at the Hudson Institute. And another is Leland Miller, who I had the pleasure of just meeting today. Tom is an expert on trade manufacturing, economics and foreign policy. He leads a project at Hudson on trade with Europe and China, reform of the World Trade Organization, global competition in advanced technology, such as 5G and the strength of the U.S. manufacturing sector. I've had the pleasure of working with him on several of these projects.

Leland Miller is a leading authority on China's economy and financial system. He's the co-founder and CEO of the China Beige Book International. He was a capital markets attorney based out of New York and Hong Kong. He has a law degree from the University of Virginia. Leland is an elected member of the National Committee on U.S.-China Relations and the Economic Club of New York.

So I'll start with some high-level observations about Tom's new report, which you can find on the Hudson Institute website. That report is called Economic Cracks in the Great Wall of China: Is China's Current Economic Model Sustainable? I'll describe some of my takeaways from the report and then turn to Tom to go in depth on some of his findings and Leland to respond to Tom's analysis, and then we'll get into a discussion of policy options and some questions.

First, overall Tom's report argues that fundamentally there are several long-term structural problems and various short-term policy initiatives that are undermining China's long-term economic [inaudible 00:01:46]. He argues that China's growth will likely be weakened by a combination of increased control by the state, a focus on older population, less innovation, and the deliberate undermining of some of China's faster growing sectors, which we can get into during the discussion.

In addition, Tom challenges the common assumption that growth in the PRC will continue. He argues that most analysts are not understanding the extent of the danger of economic crises in China today. Fundamentally he asks whether President Xi's vision of reinventing and imposing a state directed CCP dominated model can actually happen, will it succeed? And by better understanding these weaknesses, the crux of his report is looking at policy options that we have so that we can identify where and how the United States can develop and craft targeted tools to support U.S. policy objectives.

So I'll turn now to Tom, he'll do a much better and more detailed explanation of what's in his report and his findings. And then as noted, I'll turn to Leland. Tom, please take it away. Thank you.

Tom Duesterberg:

Okay. Thank you, Nadia, for being with us today, and to Leland as well for taking the time to go through this long paper and give his vast body of knowledge to take a close look at my arguments. So as Nadia, you pointed out, I see some longer-term structural problems and some acute political and economic problems that make it difficult I think for anyone, let alone an authoritarian leader like Xi Jinping to manage what I think is a looming crisis. So let me go quickly over what I think are some of the structural problems. Some of these are well-known, so I'll glide over them without too much detail.

First is the demographic issue, which has been widely noted. Population is about to start to decline or perhaps is already started to decline. It's severely aging, falling by over 15% in the next 15 years. The
working age population is falling by about 15% over the next 15 years. By 2050, it’s estimated that about half a billion people will be over the age of 60 and require extensive support through the social welfare system.

Second, the social welfare and medical systems in China are underdeveloped, especially in comparison to Western models, but also are underfunded. This issue drives up the precautionary savings among the Chinese people and undermines the attempts by Xi Jinping to shift the economy to a consumer-oriented self-sufficient model, which Xi seeks to guide China into.

Third, there’s an unequal distribution of income, both vertically and geographically. The IMF noted in a paper a few years ago that from being one of the most equitable economies in 1990, China now has inequality that is higher than in most regions, with inequality in urban regions rising more sharply. This inequality extends to also the education system to job opportunities and opportunities for women.

A noted China scholar at Hoover Institution, Elizabeth Economy, notes that this could cause what she calls social fragmentation. She says discrimination based on gender and ethnicity is rampant and severe urban-rural inequality persists. Women only represent 5% of the Central Committee of the Chinese Communist Party, and wages are well below the average for men by women in China. So this is all a potential source of social unrest in a slowing economy, especially.

Fourth, I note there’s environmental degradation. Air, water, ground soil, this undercuts agricultural self-sufficiency, water shortages leading to tension with South Asia as China seeks to control major river systems from the Himalayas.

Fifth, there’s a lack of raw materials. China lacks the ability to be self-sufficient in food, energy, and minerals that are needed for its industrial powerhouse. The Belt and Road Initiative tries to compensate for these shortages, but results in tensions with the rest of the world.

Now, let me turn to Xi Jinping’s economic and political path that he’s gradually articulated and put into practice since came he to power almost 10 years ago. This new direction for the Chinese economy undermines growth. Despite the desire to become more self-sufficient and build world dominating industry, Xi’s returned to authoritarian rule is upending growth and discouraging creative entrepreneurship in China.

This new policy favors state own enterprises over the private sector, estimates are that the state-owned enterprises are some 30% less productive than those in the Chinese private sector and only 20% as productive, at least in the industrial sector as those in the advanced economies of the west. Xi is also increasing the role of the Chinese Communist Party officials in company management boards, often enhancing political rather than economic efficiency as the goals of management.

Next, Xi’s drive against successful new services in both digital and services-oriented firms and large successful firms in general. For example, he undercut Jack Ma’s Alibaba and other large successful companies, but also fast-growing digital marketplace companies, such as ride-sharing, video gaming, and innovative health providers and private education providers. Overall, China must now devote seven to nine yuan or units of currency to get one yuan of higher GDP, compared one to two yuan to achieve the same goal of advance of GDP of one yuan in the go-go years of the 1990s.

Now, let me turn to some of the acute problems in China, the diminishment of the capital output ratio, which I just referred to, along with the need for higher savings and low productivity growth contribute
to the need for taking on higher and higher levels of debt. These levels now total, and I'm including both public and private, and it is sometimes hard to make a distinction between public and private debt because the authorities at the central and local level often implicitly assume responsibility for private debt, because of this growing debt level which is now well over 300% of GDP, China increasingly is looking abroad to finance that debt, which is likely to be a problem because of the growing Western recognition that its own economies are harmed by China’s more countless model.

So the biggest short-term problem and as well-known is the real estate bubble. In the 1990s, Beijing began to allow sales of land and local government seize the opportunity to engineer in a boom in land development, which helps them meet their goals of ambitious growth goals set by Beijing. The self-reinforcing cycle of land sales development purchases by individuals as a form of savings and higher prices in the real estate has created a bubble much larger than that of the US and Europe in 2008 and comparable to the disastrous Japanese bubbles in the 1980s, up to one third of the economy, maybe as much as one half of the Chinese economy in the recent two decades has been attributable to the real estate sector. 80% of personal wealth now is tied up in real estate, but more importantly, I think one third to one half of local government revenues from land sales of development taxes are the underpinning of the solvency of local government finances.

Now in the last three or four years, the air is coming out of the bubble. Urban dwellers now have apartment ownership rate of about 90%, but also there are huge amount of vacant apartments in urban areas. This vacancy rate represents somewhere around 10 years of supply based on urban immigration patterns. Land sales and prices came steadily down in 2021 and many developers are defaulting, especially in dollar denominated or Euro denominated debt. This dynamic I think is undermining local government finance, a very dangerous matter at a time when local governments are expected to improve social welfare, pension shortages, education discrepancy, and environmental problems. Japan saw a weak economy for decades after the real estate bubble imploded. The U.S. and Europe saw slow growth for at least four to five years after the great recession. These were democratic nations with officials responsible to an electorate and private sector-driven economies.

So in summary, China's economy is already slowing and it looks very likely that it's going to slow a great deal more. Can Xi Jinping manage to maintain both high growth and social stability while returning to an authoritarian centrally planned model? He is still dependent on foreign sources of food, energy, capital, and minerals. Western countries have leverage if they decide to push back against Xi’s mercantilism and expansionist military and economic programs. It's unclear and short what the source of strong growth in the future will be. This could be a source of some considerable political instability. So let me stop there. I look forward to the observations of the commentators.

Nadia Schadlow:

Great, Tom. Thanks so much. That's a perfect segue into Leland and his comment. Some of the material I've read from Leland has actually offered some different viewpoints, that the Chinese economy has not been doing as poorly as commonly thought. And that in some sectors, I think, Leland, you put it, it's doing well enough. So I'd like you to comment a little bit, is Tom exaggerating? Looking at some of the structural weaknesses that Tom pointed out, do you agree with them or the extent of these weaknesses? Thanks so much.
Leland Miller:

Oh, my pleasure. Thank you, Nadia. Thank you, Tom. I have to say that I actually really agree very strongly with most of Tom’s points. I have articulated a view about the strength, the Chinese economy recently being a bit stronger than people think, at least into the last month or two. But I think that there’s a big difference between talking about the type of currents that I see, discussing these with financial clients, with corporate clients in terms of the ebbs and flows of the Chinese economy. And something very different, which is identifying the long-term trends, which policymakers and which others watching China have to identify in terms of the next three to five to 10 years. I very much identify closely with Tom’s view, the economy is slowing, that there are enormous challenges at hand and independent of the ebbs and flows we might see in the economy from month-to-month or quarter to quarter, there are severe challenges that are being completely underestimated by most people watching China today.

In fact, when I was looking at the paper, I was thinking to myself, what are the giant takeaways that come to me? I was soaking it all in, but as someone who was talking about solutions at the end and what the takeaways might be for people watching this, three big takeaways really jumped out at me. The first was the focus of the paper I think was right. So much of the talk about China now is about the hype of a rising China. If you’re in the policy-making community, then basically all you’re talking about is the rising China threat. Of course, China’s been rising for 20 years, and that has continued. It's certainly accurate. If you’re in the Wall Street world, then you’re talking about rising China, this land wealth opportunity where fortunes could be made. But there’s not enough commentary right now on the enormous challenges that China is looking at over the next two, five, 10, 20 years, the longer ones being of course related to demographics and environment and others, shorter term ones on the political side, and even just switching up the growth model. So I think that this is quite welcome in that it sheds the idea that China, just because it's risen for 20 years, is going on this linear path to world domination, but actually has enormous structural problems, enormous economic and political and social challenges ahead of it. And so by doing that, I think it takes a much more realistic view of the Chinese economic landscape to allow us to assess the solutions.

Second issue, and I'm not sure this is something that Tom took a strong take on into paper, but it's, what might an economic crisis in China look like? Most people who trade broadly or who don't spend a lot of time working on China often think that, well, United States had an economic crisis, we had Lehman. The Europeans then had a crisis. So the next crisis will probably look a lot like that. So we're just waiting for China's next Lehman moment. I think every question I was asked around the Evergrande crisis was "is this China's Lehman moment?" The answer for that was no, but the answer for "will China have a Lehman moment?" I think is no. The chances of an acute crisis hitting I think are actually very low in terms of what are the challenges that China will have in the coming years?

The idea of China having this one big moment where the system goes, boom, I don't think that's very likely at all. The reason for that is China is a non-commercial financial system. It's very different from the United States, very different from the European Union, very different from most of the world. What that means in a non-commercial financial system is that essentially China can swoosh large tidal waves of capital from one side of the other in order to plug up gaps. You have defaults, no problem. You order them closed. You have other issues. You have bank runs, you plug the gaps there. So the chances of there being one big boom moment, I think is very low for China, whether it's in the short-term, even the
medium-term. But I think that the consequences of these challenges that Tom has laid out very well is that you're looking at a future of long-term stagnation.

One of the things that you keep seeing is that with all this buildup of debt, which is talked about on just about every page in the paper, huge amounts of debt, so much of a non-performing. Where is this going? Well, the system is now geared to trying to chase this non-performing debt. More and more capital is going to non-productive uses instead of productive uses. What does that do? It slows the economy down dramatically over time, and it leaves in a state where you have a future of very, very low growth and very likely stagnation. So I think that when we talk about where these challenges lead us, there's a very interesting question on what would an economic crisis look like? And I very strongly feel that it's going to look like something very different than what we've seen in 2008 or anything in the last several decades.

The last thing that jumped out at me is the solutions. So much of the policy-making communities, and especially in Congress, where being loud on China is a huge electoral advantage right now regardless of your party, so much of it's about hitting China hard, hitting China everywhere. How can we just go all out, anything anti-China is bad? I think what these solutions did a very good job of is focus on the areas where we really should be aggressively pushing back on Chinese ill intent. So focusing on areas where China's misbehaving. There's talk about reciprocity, market access, unfair subsidies, central or local government subsidies. So areas where China's misbehaving, or areas where we may be giving them the means to best us in the long run. So what's happening on advanced technology? Are we providing them the means in order to give them an advantaged and threatening our national security as a result of that?

I think so many of the solutions at the end fall to those two categories, which really gives it a very strong thumbs up from me because they're very focused solutions. They'll get to the problem, but they're not broad in the sense of the problems that we looked at with across the board tariffs or other things where we're focusing on things that maybe is counterproductive to our own country as it is in terms of reeling China back. So I really enjoyed the paper. Structurally, I couldn't agree more with where Tom is saying that the economy is going, but I look forward to a discussion about anything we may have some differences on.

**Nadia Schadlow:**

Great, Leland. Thanks so much. So let me just jump in a little bit to your point about China's long-term economic stagnation essentially, a path of stagnation. I think Tom, you probably agree with that characterization, that's what your report says as well, but what are the implications of that for both U.S. businesses, as well as U.S. policymakers?

So in one sense, does this mean we can kind of sit back and worry less over time? The long-term strategic threat posed by China may be not as great as we've been thinking, or what does this mean time-wise? But implications for U.S. businesses and U.S. policymakers, and how would that interpretation of what's happening maybe shift in both of those areas? Tom, what do you think? And then I'll turn to ...
Tom Duesterberg:

Okay. Well, let me start by, Nadia, your point about should we worry less or is the threat not as great as we might have thought. I don't think I would totally agree with that. The leadership is very determined, and they've shown over the course of the last 40 plus years that they're willing to pursue their long-term goals very aggressively and use whatever means they see necessary to achieve those goals.

So I guess I would put the emphasis on, do they have the resources to pursue those goals? I'm somewhat skeptical that they can continue, for instance, with the massive and aggressive military build-up and with programs of expansion into the rest of the world through the Belt and Road program, where they're providing a fair amount of aid and to help those countries develop, but also often to acquire assets that are useful to their own economy.

So I guess my larger point, and I'll try to turn to addressing Leland's suggestions as well here. My larger point is, it's such an accumulation of problems that I doubt whether or not they have the resources to accomplish everything they want to accomplish. There's always been a question. And Leland is probably much more an expert on this than I am, but throughout Chinese history, there are these problems of social unrest, the so-called Mandate of Heaven.

In my paper, I gave a few statistics on what we can see about social unrest, but I guess my larger point is that some of these structural problems, environmental degradation, demography, inequality, they contribute to the weakening, I think, of at least the strong growth path, and maybe even worse than that, but also there is a potential for some social unrest. I don't think any of us know where that might go, but I raise that as a question. It would be very difficult for any world leader faced with that conglomeration of problems to manage everything.

Now, with regard to Leland's point about a Lehman moment, I can't argue with that. I shied away from taking a firm stand in my own paper on that because I don't think it's predictable. I sometimes think of Hemingway's famous utterance about bankruptcy happening slowly over time, then all of a sudden. That's sort of what happened in the United States in 2008, but being able to predict that I think is difficult.

I think the question is, do they have the financial resources internally? Leland made reference to the ... It's a non a non-market system, it's an authoritarian system, but if they keep printing money, there's some chance that it would lead to some sort of inflation, even hyperinflation in the worst case scenario, which again, would contribute to some social unrest. I mean, the Chinese people putting so much of their wealth into real estate, for instance, if the bubble bursts there and their resources that they have available to them to meet the shortages of the pension and medical system in their old age, that could cause some unrest.

I guess the other question is, and they seem to realize this, but there's a need for foreign capital. Some of that acquisition of entry into foreign markets for stock bonds and venture capital funds is designed to acquire technology, but some of it's just because they want to diversify their funding base.

The part of the other general thrust of my paper is that a lot of their policies antagonize their biggest trading partners, and even some of the countries in the Belt and Road Initiative that they're trying to help at some point or another sometimes realize that they're being exploited. So if Western economies and other economies push back, then this ability to both export their excess product and to acquire
financial help, I think is diminished. So all of this just flows into some skepticism on my part about whether or not in the sort of the medium term, they're going to be able to handle all of these issues.

Nadia Schadlow:

Thanks Tom. Leland, I'd like you to go back and answer specifically the relationship between longer term economic stagnation and implications for U.S. businesses, especially given BlackRock and the companies that have been quite bullish on staying in China, more in China, going into China amidst most of that currently human rights, ESG issues.

But this issue of longer term stagnation, how does that affect their positions and really what you think they're thinking. And then I would like to get into BRI, but let's wait a little bit, because I'd like to then talk about some of the policy points that the paper is talking about. Thanks.

Leland Miller:

Sure. You asked the question earlier, if Tom is right, if I'm right about all the things we're saying today, is this reason to worry less? No, I think it's a reason to worry more particularly on the policy making side. You asked about Wall Street. I think when the corporate community, when the financial firms are looking at China, they have always been way too bullish. They continue to be way too bullish, but as the realization of this sort of long-term stagnation sinks in, and this may not hit stagnation, something to take a few years to get in, you're going to see precipitously declining growth in a few years. But stagnation will take a little bit longer to recognize.

But I think when you look at China as a market, there are still fantastic opportunities. There are still ways to make money. There are still places that they could open up in which individuals and firms and companies could do very, very well. So is this mean it's not a land of opportunities, it's something that the business community is going to turn away from? I don't think that at all. I think that there's still going to be very distinct opportunities in ways to make money for the Chinese consumer, although that has been overhyped from day one, but there's plenty of opportunities there. It just can't be based on the idea that there is this rising China monolith that's going to grow at 8% or 7% or 6% or 5%, or even 4% going forward. It's going to be a Chinese economy that's going to slow down dramatically.

If the leadership does it right, it'll be slower but healthier growth. There will be industries in which there is enormous opportunity for foreign companies. The green universe is the most obvious one, but private healthcare, other things. So it's not that Wall Street and the corporate community are wrong across the board on this, they just have to understand that they're going to have a nuanced view, they're going to have to understand their slowing growth overall, and they're going to have to be very picky on their opportunities instead of jumping in with both feet and eyes closed, which is what a lot of firms have been doing for the last 20 years.

I think the challenges for policymakers is much more significant, because when we're talking about a rising China and the threats there, I think something's more dangerous than a rising China. That is a China that's realizing that it's coming close to peaking. Because a China that's coming close to peaking is going to look at itself, look at its goals and say, we have a narrowing window here. We don't have all the time in the world. This idea that we've got 5,000 years of history or another 50 or 100 years to claim Taiwan, some of these things aren't true. We may have a limited window to this. So does that speed up
China’s aggressiveness in the South China Sea or in terms of Taiwan? Does it mean it's going to have to act more aggressively because of all these economic challenges pouring down, will it have to rally around the flag by being aggressive towards its neighbors?

The demographic challenges you have, there's far too many old people in China, but there's also a major gender imbalance. So will there be so many men in China that they’re wreaking havoc on neighbors, in terms of seeking marriage mates across the borders. There's a lot of things that a suffering or a slowing or a peaking China can ... A lot of problems that it can pose that are more serious even than a China that continues rising for another five, 10 or 15 or 20 years. So I think this is such an important conversation because there's a tendency to see a rising China and just assume that China's going to rise forever.

You certainly read the headlines and that's what everyone in the financial media thinks. But it's the arguments in this paper talking about the structural challenges to continued high growth, the structural challenges to continued social stability that are really the things weighing on the leadership in Beijing. And this should be the mindset. This should be the lens through which U.S. policy makers are looking at the Chinese economy and the Chinese leadership, because they may a deal with a China in five or 10 years it looks very, very different than what they're reading in the newspapers.

Nadia Schadlow:
So planning for instability associated with stagnation and weakness.

Leland Miller:
A narrowing window for a China that thinks that maybe our advantages have been increasing up to a certain point, say 2030, 2035, but a slowing economy and demographic challenges. Another means that the opportunity window for aggressive action say Taiwan or something else may be limited going forward. And so we have to prepare sooner rather than later to do something.

Nadia Schadlow:
So Tom, do you agree, specifically on Taiwan, sort of a sense that the window may be closing that there is a danger of a more aggressive China vis-à-vis Taiwan. Not to put you on the spot, but that's sort of basically what Leland saying. So I put you on spot.

Tom Duesterberg:
No, I think that's a real danger that we have to think about quite deeply. Nadia, I'd like to hear your view on that. Let me-

Nadia Schadlow:
The beauty of the moderator is, I don't have to answer any questions. But I would like to go into some of the policy implications, because Tom, you talk about, you have 16, pretty specific, very interesting kind of policy recommendations. Leland, what I found interesting about your points was that essentially, not to put words in your mouth, but what I interpreted your comments were that we should actually be pretty narrow in our policy toolkit and focus in certain areas. I think it's fair to say Tom's were much
broader—everything from rejoin TPP to just working with European allies—a much broader set of recommendations. Is that fair? Is there maybe some difference between the two of you on those?

Leland Miller:

Look, I actually agree with Tom’s recommendations. On the top level, the way to approach, what are the best solutions, I think they have to be looked at from a narrow rather than broad view, rather than just anything bad for China is good for the United States, which clearly hasn't proven itself true over time that you have to look at, how do we address Chinese malfeasants? How do we address Chinese misbehavior? How do we prohibit or restrict the Chinese leadership from getting access to advanced tech that’ll cause this pain down the road.

Those are the sort of the threshold questions. But when you talk about working with allies and joining trade packs that make sense and other things, I couldn't agree more. I mean, it's a broad based strategy, but it has to come from an idea that you have to really go at things that are in America's interest and not just anti-China because that'll bring you down a dark road.

Nadia Schadlow:

Tom, what do you think?

Tom Duesterberg:

Yeah. My perspective is that partly that we have to focus on what our larger overall goal is with China. I mean, for the first 20, 30 years of the modern regime, if you will, since Deng Xiaoping, we had hope. Let’s put it that way, that they would gradually be more integrated into the sort of economic system and geopolitical system that had served the world fairly well since it was set up after the Second World War.

I think what we have learned especially in the last 20 years is that China is not going down that path. I take seriously the Chinese expressions of long term goals of things like self sufficiency and through the Made in China 2025 program of being the world leading firms and the leading to technologies of the future. So one can interpret that, and I am closer to this interpretation that China really wants to actually fulfill those ambitions, be the world leader, become more self-sufficient.

So then that leads back to what should the business community think. Leland is certainly right, that at the moment in the last 20 years, a lot of American and European firms especially have done quite well in the Chinese market. Tesla is I think the leading seller of EVs in China. Apple overtook Huawei again as leading seller of advanced phones in China this year. But I think that window is going to continue to narrow as China tries to develop their own indigenous technology and win themselves from dependence on the west.

So I think the business community needs to take that into consideration. Now, with regard to the policy prescriptions I sort of have tried to think of this in terms of the dual goals, one protecting national security and challenging China’s misuse or disregard for its obligations that it’s entered into, for instance, in the World Trade Organization, things like subsidization theft of intellectual property. It's pretty clear that we can fight back against that. What I'm a little bit more ambiguous about is going forward is China tries to achieve the goal of self-sufficiency.
I think Xi calls it the dual circulation economy. They want to retain access to South Asian markets for that matter. But can our policies induce them, incent them to back off from that drift away or sprint away in some cases from the standards of the World Trade Organization of the Bretton Woods Institutions that we had thought they might embrace. So I think we do have tools. I think access to foreign capital is somewhat underestimated as a tool and since the Chinese adamantly refuse to use Western accounting standards for issuing both equity and debt on our markets, a simple thing to do would be to require them rigorously to meet the disclosure transparency requirements that Western firms have to meet.

We can use trade policy. As I tried to emphasize in some of my remarks, I think it's not just the United States that is increasingly aware of China's abdication of its responsibilities of World Trade Organization and World Health Organization for that matter. Others are fighting back, all of these actions if we took them, could do I think significant harm to the Chinese economy. So it sort of depends on how one interprets China's long term goals. I guess I'm a little bit more on the pessimistic side and in the sense that I think they're moving towards self-sufficiency and want to keep moving that way.

Nadia Schadlow:

Yeah. Do you agree with that Leland on the interpretation of self-sufficiency, the objectives dual circulation, essentially what Tom is saying is that China's driving decoupling and actually has been for a long time. And then also, if you could comment on obstacles too, are efforts of people out there trying to get more transparency into Chinese companies and why it's been four years of some really smart people arguing for that. What's stopping that? Thanks.

Leland Miller:

Yeah. I agree with what Tom has been saying. If your initial question was on which point, I was just writing [crosstalk 00:43:04].

Nadia Schadlow:

Oh. So do you agree with the ... Well, what are the objectives of China vis-à-vis? Its dual circulation policy, its drive for decoupling. Decoupling is coming from China, really much more than from the U.S.

Leland Miller:

Yeah. Look, I agree with that. And I think that because it's such an important goal for China, I think that should be the focus of U.S. policy. A way to look at this, I think if we just take a step back, is that, the U.S. has got its problems, but it has a innovation economy. It drives technological advancement. It drives innovation. The Chinese economy is not terribly good at that. There's some big champions that want to undermine the great tech giants they have. But in a one-on-one even playing field, the U.S. model, this innovation economy model will beat this non-market authoritarian model 95% of the time.

The problem is, is that when you have a system like China's, you have the ability for the state to put very firm finger on the scales in very specific ways. What we've seen used to be called, Made in China 2025 until the Chinese banned the term a few years ago, was this extraordinary drive for self-sufficiency, for self-reliance on all the things that are going to make up this next industrial revolution. We're talking
about artificial intelligence, 5G, robotics, quantum, biotech, all these very, very important top elite tier level manufacturing issues.

The problem with the U.S. competing on an even playing field with China is that it's of course not an even playing field. And so the focus of U.S. policies should be to make sure that these backdoor subsidies are being combated. If Huawei is receiving, I remember The Wall Street Journal did this exposé on all the subsidies, the tens of billions of dollars of subsidies Huawei's gotten over the years, how part of China's foreign policy was pushing Huawei into other countries so that their 5G would be run by a Chinese company.

This is the type of thing in which U.S. policy will need to step up and push back on in order to ... You say the compete, compete, compete, but sometimes you have to push back against the Chinese finger on the scales. That's where this is a particular problem, it's in the high level advanced tech Made in China 2025 issues. That's the reason, again, why I think export control should be a word that everybody's talking about in their kitchens, policy makers are not. Because you can talk about all these other tools, but at the end of the day if we're allowing China to get access to certain advanced technologies, and then they use those advanced technologies to beat us, then who's at fault here? I think people need to understand the importance of export controls and take them a lot more seriously as a fundamental alternative of U.S. policy.

**Nadia Schadlow:**

Tom, did you want to comment on that? Among your policy recommendations, I think you agree with that point of view, correct?

**Tom Duesterberg:**

I sure do.

**Nadia Schadlow:**

So I want to give everyone a chance to wrap as we end our hour. I did want to ask a couple more questions, a quick questions. I mean, Belt Road Initiative, Tom, in your report, you talk about that essentially as a liability for China down the line. Leland, quickly, do you agree with that that assessment?

**Leland Miller:**

I do. I think Belt and Road was created at a very different era. When Xi Jinping first adopted it as his own his, the market talk was about how China's forex reserves were approaching four trillion, and there was too many and they'd have to figure out a way to get them down and we're going to send all this money abroad, we're going to cycle Chinese surplus is abroad, that's not the world we live in anymore.

I think the leadership over there realizes that they've gone too big on this that doesn't make sense with their current priorities at home. It's also a bad idea overall. So for all the soft power and advantages that this might have, and certain, I guess, hard power advantages, there's one thing that Chinese leaders have never been good at, and that is striking deals that are economic. I mean, most of the stuff you look at what happened in Venezuela and Central Asia and South Asia, and they're money losing enterprises. There's money that's being just lost abroad.
And so Belt and Road never really made sense, but at least it made sense a little bit in the context of when it was five plus years ago when it was being developed. Now, I think it's a liability that the Chinese can't completely walk away from because Xi Jinping associated himself personally with it. But I think they're very happy to have this play a smaller and smaller role in Chinese foreign policy going forward, because it's not paying off, it's a money pit.

**Nadia Schadlow:**

So related to that [crosstalk 00:48:26].

**Tom Duesterberg:**

Can I comment on that?

**Nadia Schadlow:**

Yeah, sure.

**Tom Duesterberg:**

Just quickly. One of the interesting things I came across in doing this work was a lot of research on the efficiency of infrastructure development, both internally in China and externally through Belt and Road. And most of the economic studies that I came across indicated that, by and large, these things weren't as productive. The return on investment was generally a lot less than what they had anticipated.

So a large part of the Chinese thinking at about growth over the last 40 years has been building infrastructure. They've done a great job internally in China, but they're continuing to put money into that and into foreign markets as well for infrastructure. It's another example of how it's really a misallocation of capital, I think at this point in time. Again, it undermines their ability to have strong growth going forward.

**Nadia Schadlow:**

Related to that often part of the U.S. discussion of the Belt and Road Initiative has been a discussion of the Trans-Pacific Partnership. I noticed in your recommendations, you advocated that the U.S. should rejoin. And that's actually been a controversial view. It's been bipartisan controversial. So could you comment a little bit more about that, and then Leland, I'd like your view on that, on rejoining and the advantages or disadvantages to the U.S. And then we really will wrap. Thanks.

**Tom Duesterberg:**

Okay, Nadia, thanks. I know it's been a controversy between myself and some of my best friends in the policy making community for a long time. Much of the reason for rejecting the TPP as you know yourself was the potential impact on the U.S. manufacturing sector, which has been over the last 25, 30 years hard hit by the competition from China. Some of it, as Leland mentioned, heavily subsidized, but some of it just their ability to produce things at a better price than we are able to do.
I've come to the conclusion though that China is now such a big economy, and they've managed to build up relationships sometimes under some duress, but trading relationships, for instance, with ASEAN or with Europe where there's enough mutually beneficial trade at the moment for them to not want to take on China. I think we need to gradually whittle away at this advantage that China has. And we can't do that unless we're in some sort of a more constructive trading agreement on trade, especially with our Asian partners. And I would put India into that basket, even though they're not a member of the successor to the TPP.

Also, many have argued, we need to gradually try to convince the Europeans if the Chinese are more of a threat to their economy than they are an advantage. So it's for a lot of those reasons that I think we do need to get back into what was used to be called the TPP. The Japanese, the Australians are really very hard to try to convince us to do that. And it's a sign that they don't want become too dependent on trade with China.

Nadia Schadlow:

Thanks, Tom. So Leland, what's your view on CPTPP?

Leland Miller:

Yeah. It's unfortunate that the political discourse is what it is and TPP has become this job killing boogieman. TPP was probably never as important as some of its advocates push. It certainly was never as bad as its detractors try to sell it for. I wish the way people would look at these agreements would be more as who do we want to control the rules of the road? Whose rules do we want? Do we want to be established in the relationships and having our rules control the international bodies standards, trade agreements, or do we want to see that ground to others, most obviously China.

I think that part of this has been missing the last several years. I think we're just at a very politicized moment on this that when people turn around and they ask themselves, are we going to want to get in a good trade agreement with our allies and Asia and abroad? Particularly, if the opposite outcome is for China to be controlling these relationships. Certainly it pushes us to be in bigger, stronger trade agreements going forward. So I'm hoping that this politicized atmosphere of trade, which has happened off and on for decades, centuries, I guess, clicks back off after a while, and we can actually look at agreements for their merits alone and not based on the discourse, most of which is wrong.

Nadia Schadlow:

Thank you both. So we'll wrap now. I think if I had to identify sort of one takeaway from the discussion or met someone and said, "Well, Tom's report is really about essentially shifting our frame of reference from one of China's strength to the implications of growing Chinese weaknesses." And ultimately, the policy implications of that and the implications for the United States and its allies down the line. So that would be sort of my big takeaway. Hopefully it's somewhat accurate, Tom. And Leland what's yours, and then we'll turn to Tom and we'll say goodnight.
Leland Miller:

All right. I think Tom hit the nail on the head in terms of identifying all the big challenges that China has, and many more than I think people understand because they're so used to the rhetoric of arising China. China has some very severe challenges over the coming years that it's going to have to deal with. Where does this bring us? I think one of the problems with, again, the narrative that people are pushing is people just say a slowing China, and they don't know what that means. And so everybody's going to be right, because there's almost nobody saying China's going to speed up. So everyone just sort of says on the side of their mouth, oh, China's slowing, and everyone's predictions going to be right. So what does that mean?

Well, I found it very interesting because time and time again, people are I think underestimating the severity of the slowdown that is coming. 2022 is a political year, so I don't expect to see this during the year of Xi's recoronation. But 2023 and beyond, I think that the pressures on the Chinese economy from moving away from property and reckless credit expansion, and a lot of the things that the Chinese economic model has stood for, but I don't think is going to stand for going forward.

I think you're going to see a much more precipitous fall growth. I don't think this is going to be a matter of a 10th of a percentage point or something you may read in a Wall Street pamphlet just tweaking down the growth numbers. I think you're going to see growth numbers fall quite dramatically over the coming years. It's going to shock a lot of people if they're not identifying the types of problems that Tom has in his report and understanding that this is what Beijing's worried about. This is the lens to which Beijing is looking at their challenges going forward. And I think we need to be a bit more realistic on the US side of what's going on.

Nadia Schadlow:

Thanks, Leland. Tom, to summarize your own report.

Leland Miller:

Well, let me thank both of you for your incisive comments about the report and thank you for taking the time to discuss this today. I thought it was a great conversation. I do agree with Leland that 2022 is probably not the year we're going to see anything like an acute crisis, although it continues to build. I guess my final comment would be, I think we in the United States and hopefully, if we can convince some of our allies, especially the Europeans to begin to think like us about China, we need to think about how we can use the tools that are available to us. And I tried to elaborate them in the report to achieve goals that we agree on we in the west.

I don't know. I'm not sure if any of us know, if we can convince the Chinese, but Xi Jinping who's likely to be there for a lot longer, to back off a little bit on their threats on Taiwan and their military aggressiveness. We have to think very deeply about that, but we do have some tools that could possibly dissuade them by hurting them. And then to reflect on how much we think we can induce the Chinese to take a slightly different path at least in terms of their economic model.

I think that model is headed for long-term slow growth, which will be not in the interest of Chinese political stability in China. We also have to recognize if we push too hard, China, and there isn't a real Japan like crisis or Lehman moment in China, that's going to affect our economy as well. So it's very
delicate stuff, but we have to think about that I think a lot more clearly and try to understand both Chinese motives and what we can do to try to induce them to go on a path that leads to a little bit more global stability.

Nadia Schadlow:

Thanks, Tom. We could clearly actually have a whole nother conversation about whether or not that could actually happen. I'm probably more skeptical. Another area we didn't talk about enough was really technology and how dominance and key tech sectors could actually maybe counteract some of these developments. So clearly we will have to meet again hopefully live over a meal or something. And thank you both and best wishes for the new year. And thanks to those watching.