

## Taming the Dragon

Written by Jacob Hershey

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JACOB HERSHEY, JUN 9 2011

The Third Annual US-China Strategic and Economic Dialogue (S&ED), a round of bilateral talks that are meant to improve relations and cooperation between the two largest economies in the world, was held on 9-10 May 2011 in Washington, DC.

For as much lip service as has been given to China as the nation to restore bipolarity to the world order, it seems more and more that the two countries are far too economically co-dependent to truly be opposite forces outside of their own bilateral relations. What was most interesting about this year's round of talks was China's open concern for its significant investment in the US Treasury, and how willing it is now to use its influence.

The US' debt has grown exponentially over the past decade, and its trade deficit, vis-à-vis China, has continued to expand almost uninterrupted for far longer. China had been happy to sit back for years and fill its coffers through export promotion and financing the US' extreme borrowing – that is until spring 2011, when the possibility of US debt default threatened to downgrade the greenback's creditworthiness. With two thirds of its estimated \$3 trillion currency reserves in US dollars, China had no choice but to raise its concerns and give the US a subtle economic slap on the wrist.

However, while China has historically been a bastion of non-intervention, its own concerns for US fiscal health make its already decreasingly tenable economic policy even less so. The export promotion model central to China's development has undercut the US' manufacturing sector for decades. When combined with the Communist Party's strict monetary and market access controls (which have kept those exports cheap), the US' economy has eroded both in terms of production and consumption. These policies have undermined China's economy by undermining its largest export market and debtor, the US.

At the Third S&ED China finally began to come around to the fact that they will be unable to have it all economically, and made major commitments to address a range of US concerns. The broad philosophical change that China has, at least nominally, committed to is a shift towards opening itself up to competition, something that government regulations have always tightly controlled. They have agreed to improve business transparency in finance and trade, partly as an anti-terror measure, and have also made commitments to higher government neutrality in markets where state-owned interests are concerned.

One of the biggest hurdles to foreign business in China has been an indigenous innovation procurement law that requires the Chinese government to show preference to businesses with holdings within China. Many have complained this creates an incentive for foreign corporations to export competitive advantage to Chinese subsidiaries in order to tap into its massive market. China has renewed President Hu Jintao's January commitment to end this practice, as well as agreeing to open a myriad of other financial and insurance markets to foreign competition.

A large number of the S&ED pledges from China are simply agreeing to enforce intellectual property laws that have long been flaunted. Anyone who has seen the flood of counterfeit media and luxury goods available both in the US and abroad, or pictures of knock-off Disney characters from Beijing's Shijingshan Amusement Park are aware that there is a lot of money being made in the Chinese market from copyright infringement. The Chinese government itself is not free from intellectual piracy, and in December had to recommit to weeding out counterfeit software from

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government computers.

All this would be moot, of course, if not for some agreement on currency valuation, the most popular drum to beat amongst US lawmakers. For years China's trading currency, the renminbi, was pegged at a fixed rate against the US dollar, before international pressure made China change to a floating rate against a basket of currencies in 2005. However, due to market fluctuations uncomfortable for the government, China re-pegged its currency to the dollar for about two years, ending last summer.

The pegged currency allowed China to keep the renminbi artificially undervalued, and thus kept exports cheap, despite inflationary side effects. China re-upped its commitment to allow currency appreciation against the dollar at the S&ED in May. This is not surprising as China continues to make efforts to make the renminbi an internationally traded currency, which will require market-based exchange rates and a more open Chinese market.

Of course these and other so-called "commitments" by China must be taken with a grain of salt. Besides the nature of these sorts of talks – grand statements with small, unobtrusive caveats – China historically has not been afraid to do what it will when it comes to piloting its economy. As seen with the currency re-pegging in 2008, if it sees greater stability for itself in tighter government controls, it will not hesitate to take action, regardless of whatever agreements it might have made. After all, from a state-centric realist's perspective, it has worked so far. Why rock the boat?

Therein lies the fundamental difference between US and Chinese economic discourse: where US economists speak almost singularly about immediate market correction, the Chinese outlook is much more slow-paced and deliberative. Politically and economically speaking, China has been moving towards a more open and free model since the 1970s, but it has usually been at a grinding pace. What will be interesting to see in 2012 is where these policies will lead and how they will be implemented when President Hu steps aside as Communist Party Secretary and a new leader comes into power, presumably Vice President Xi Jinping.

While real power becomes more diffused out into the vast government structure of China, the office of president, which would be fully ceded to Xi in 2013, is no empty figurehead. Considered by many in the media to be more personable and pragmatic than the current president, Xi has a daughter at Harvard and has a history of being open to policy experimentation, though he has worried a few US officials by taking small jabs at US criticism of Chinese policy. Though Xi's expected rise to power is unlikely to spur grand social reforms, it will be fascinating to watch as he and his party grapple with their new role as an equal economic partner to the US, with all the freedoms and responsibilities that it will entail.

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