

“The China-U.S Strategic Economic Dialogue: America Looks Stronger but China Can Take the Initiative Next Time”

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We have just ended another China-US Strategic and Economic Dialog (SED). Last time we judged it a failure with both sides performing badly. What's the scorecard this time? Strangely enough, better this time, but the two participants have changed roles in many ways.

Let's not forget that the SED is not just about economics, it's about security too. And just as the summit was about to start, the situation on the Korean peninsula erupted.

Guns Before Butter?

In some ways that actually worked to the summit's advantage since the top priority from the US side changed. Previously it had been the value of the yuan and China's policy of indigenous innovation. Now it switched quickly to the Korean issue. In order to attempt to get Chinese support, the US downplayed both the yuan and the indigenous innovation issues. This was fortunate since the Chinese side was always unlikely to move on these anyway.

However this did result in a bonus from the US' perspective. Although during the summit, China would not commit on the Korean issue, afterwards it softened its stance. From the perspective of the US this was a win, although not a big one. But, from the American side, better than nothing. And, as a bonus, China also softened on the Iran issue, again a small win for the US.

Why the move by China? Well, firstly, because it was obviously a quid pro quo for the US not pushing either the yuan or the indigenous innovation issues. But there is a more fundamental reason.

A Day is a Long Time in Diplomacy.....

In the US, there is a saying: what a difference a day makes. In this particular case the difference was since the last summit. In the last summit the US looked weak. Its economy was in tatters and the reputation of its policy-makers was also pretty much in shreds.

But this time around, the US economy was in the process of strengthening quite rapidly. In contrast the Shanghai stock market was almost in bear territory and there has been a growing chorus of economic commentators, both overseas and in China, who are concerned about the possibility of an economic slowdown or even worse in China. So this time around the US economy looked stronger and the Chinese economy more risky.

Europe Revalues the Yuan!

So the economic fundamentals favored the US this time, not China quite so much. There was yet another reason for this. The crisis in the European economies has led to the Euro dropping

significantly in value against the dollar and therefore against the yuan. So the yuan has been effectively revalued, something China did not want.

Ironically the yuan issue has been at last partly resolved by the global market, not by Chinese policy-makers, and not in China's favor, at least not from the viewpoint of its leaders. The US still sees the yuan value as being a problem, but no doubt the Europeans no longer do or at least much less so.

And China Starts Rebalancing Anyway...

And even on the yuan issue, China has effectively moved, although not in a way that had been anticipated by the rest of the world. China has stuck with the current parity between the dollar and the yuan. However it has changed its domestic wages policy to encourage pay rises for workers in manufacturing enterprises. This will lead to some stimulation of domestic demand for overseas goods and goods sold by foreign companies in China. In effect this helps meet the goal of the US which is to help stimulate demand for its own exports.

This is a creative move by China which it can now present to the other countries as being a better alternative than a yuan revaluation to achieve the goals of rebalancing. The US in particular may not see it quite this way (because much of this additional demand will be for locally-produced commodities such as food rather than for more expensive foreign goods). However it is clear that this is a credible measure that helps to achieve the aim of foreign countries that China rebalance its economy towards more consumption, thus helping the exporters in foreign countries.

Indigenous Innovation

China did not really move at all on this issue, although it made some apparent concessions. But China has already won on this issue although its policy-makers do not understand this yet.

Europe has effectively devalued against the yuan. This will make it harder for Chinese exporters in Europe. In response we can be sure that China's exporters will become more innovative, just as Japanese exporters did when faced with the situation of having to increase exports even as the Japanese yen increased in value.

In fact, again although the Chinese policy-makers do not understand this yet, this effective revaluation of the yuan will do far more to spur indigenous innovation in China than will the new regulations on Chinese government purchasing that are making foreign exporters so concerned. The likelihood is that this issue will go to the World Trade Organization for resolution and China will then likely lose. But in any case, the effective revaluation of the yuan in Europe will do the innovation job far more effectively anyway. On this particular issue it would help China to let the market take its natural course.

A Bold Initiative for China?

Policy-makers in all countries are usually short-term focused and we can be sure that the SED missed one hugely important development in the area of energy independence. At the time of the summit, a major US oil well had blown out in the Gulf of Mexico. This is already having the impact of leading the US to slow down oil exploration. On its own, this is likely to push up the global price of oil.

But in the past year there has been a massive change in the global energy equation. This is the massive finds of natural gas in shale deposits in the US. The Gulf of Mexico crisis will certainly lead to the US moving much more quickly to transitioning its energy use from oil towards natural gas. This will lead to lower global oil demand in the next few years. This will help China but hurt the oil producers in the Middle East in particular. But this transition in the US to using more

natural gas will take time since the US has to make massive investments to beef up natural gas distribution systems in the US, especially pipelines.

If I was advising the Chinese mission to the next SED, I would advise them to offer to invest some of the Chinese reserves in expanding natural gas distribution systems in the US. This would be a blue-chip investment for China which would also accelerate the US move to natural gas and therefore reduce the price of oil to China, thus helping its own national development. This would provide huge long-term benefits to both parties.

Who's Up, Who's Down?

This was a better summit than the last one. This time the US looked in better shape than last time, China in not quite as good shape. China has had its yuan revalued even though it has not become fully aware of the implications. The European situation is an enormous economic challenge for it, but it will probably benefit long-term through becoming more innovative as a result.

On the other hand, China looked much less confident on the security side of things than on the economic side. If it is to continue its march towards becoming truly one of the two or three great powers, - which it will become – it has to increase its capabilities in the diplomatic area and in the area of global analysis. Only by doing this can it portray the necessary level of confidence needed to participate at the appropriate level in world affairs.

Finally China is probably still trying to work out how to handle the problem of profligate developed countries, what I call the Over-Developed Countries (ODCs). This summit merely demonstrated the problem from the perspective of the European countries.

However the long-term problem of US fiscal profligacy has still not gone away. It just looks a little less pressing given the even greater-immediacy of the European fiscal problem. China has a role to play in helping to address this issue. Like the developed countries themselves, it just hasn't figured out how to do it yet. But it needs to learn.

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