

# Engaging China and India: An Economic Agenda for Japan and the United States

A BINATIONAL STUDY GROUP REPORT

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## **Executive Summary**

The economic rise of the world's two most populous countries, China and India, will be a defining feature of the twenty-first century. Japan and the United States must resist the temptation to view the emergence of these two economic powers as a zero-sum game, potentially creating new geopolitical rivalries. Instead, Japan and the United States should strengthen their economic engagement with China and India to create long-term partnerships for peace and prosperity that will benefit the whole world.

This report by a binational team of American and Japanese academic, business, and government leaders makes specific recommendations about how Japan and the United States can work together to develop new initiatives with China and India in trade and capital flows, technology and innovation, and energy and the environment.

### **Evaluating the Economic Trajectories of China and India**

Chinese annual economic growth has averaged almost 10 percent for the past twenty-five years. India's boom began more than a decade later, with average annual growth rates of 6 percent since. Some analysts project that China will pass Japan in a decade to become the world's second largest economy. Others forecast that the Chinese and Indian economies will be the two largest in the world by around 2050, surpassing even the United States.

Nevertheless, these developing giants face very real challenges to robust and sustainable development. Chinese growth is currently driven by very high levels of government investment in infrastructure. In marked contrast, private capital markets are underdeveloped, contracts are hard to enforce, and the banking system is shackled by nonperforming loans. Growth in demand comes more from exports than domestic consumption. Inequality is high and rising between urban and rural areas, between coastal China and the interior provinces, and between those participating in the global economy and those who are not.

India's economy is less export dependent and has better debt and equity markets. The Indian economy, however, faces its own challenges. Chronic, large, public-sector deficits divert government funds from much-needed public investment in roads, railways, ports, electricity, education, and health care. Bureaucratic inefficiencies constrain entrepreneurship. Just like in China, large gaps between

the rich and poor, urban and rural areas, and India's booming southern cities and the north of the country create concern about social unrest and political instability.

Japan and the United States should work with China and India to help them deal with these challenges, while also adjusting policies at home to ensure that we enjoy the full benefits of this economic engagement.

### **RECOMMENDATIONS:**

- 1.1 Japan and the United States should provide technical assistance to help China strengthen domestic financial markets, the rule of law, and social security systems.
- 1.2 Japan and the United States should increase loans and aid to India for physical infrastructure, schools, and health care and encourage India to address its fiscal and structural problems.

## **Reducing Global Economic Imbalances**

The U.S. bilateral trade deficit with China, which ballooned to \$194 billion in 2005, is by far the largest bilateral deficit in history. The United States is also running a trade deficit of over \$800 billion with the rest of the world. While these imbalances are currently being offset by the willingness of foreigners to buy U.S. assets, the China-U.S. imbalances threaten to destabilize the global economy and cannot be sustained.

The United States cannot continue indefinitely to import more than it exports, spend more than it earns, and borrow internationally to make up the difference. China cannot indefinitely rely on ever-greater trade surpluses to absorb the output of its rapidly expanding factories. Some financial bears worry that if both China and the United States break these patterns by cutting back on spending (on investment in China; on consumption in the United States) at the same time, the result could be a return of early 1980s-style, worldwide "stagflation" (stagnant economic growth plus inflation). The prospect of such dire outcomes, however, can be mitigated by coordinated policies among the world's major economies. This report calls for China to increase domestic economic activity through financial reform and for the United States and Japan to support infrastructure investments in India. But further American and Japanese action is warranted.

## **RECOMMENDATIONS:**

- 2.1 The United States should increase national saving, first by reducing the size of the federal budget deficit.
- 2.2 Japan should boost personal consumption by reassuring workers and citizens that pension, health, and unemployment insurance programs are fiscally sound.
- 2.3 Japan and the United States should work to increase the involvement of China and India in the deliberations of multilateral economic organizations such as the G-8 and IMF to facilitate the coordination of macroeconomic policies to sustain global growth.

## **Promoting Free Trade throughout the Asia-Pacific**

Japan and the United States have tried to maintain the momentum for freer international trade despite the stalling of trade negotiations in the WTO's Doha Round. Japan has enacted free trade agreements (FTAs) with Singapore, Mexico, and Malaysia. The United States has FTAs with Singapore and Australia in addition to NAFTA and has begun talks with South Korea and Thailand.

Regional economic integration is also being advanced through ASEAN Plus Three (the ten countries of the Association of South East Asian Nations plus China, Japan, and South Korea), which facilitated the signing of the ASEAN-China free trade agreement in goods. In 2005 this group was expanded to include India, Australia, and New Zealand in the new East Asia Summit with the lofty ambition of creating an "East Asian Community" along European Union lines.

The flurry of bilateral and regional activity in Asia may strengthen the broader liberal trade regime by stimulating "competitive liberalization" not only in the region but across the Pacific and potentially globally. But in the short term, regional groupings distort trade. Japan and the United States will face higher tariffs with ASEAN and with China. Even though both Japan and the United States are leading trading partners for most Asian nations, China is currently more centrally placed in the Asian trading regime.

Further, the United States does not have a seat at the table in these new Asian regional groupings. The Asia-Pacific Economic Cooperation (APEC) forum, which includes the major Asian nations as well as the United States, Canada, Mexico, and Latin America, has

lost its 1990s' momentum. Accordingly, Japan and the United States should become more actively involved in building free trade in the Asia-Pacific.

### **RECOMMENDATIONS:**

- 3.1 Japan and the United States should continue to support WTO multilateral trade liberalization, but they should simultaneously promote regional economic integration and openness in the Asia-Pacific that is compatible with WTO.
- 3.2 A Japan-U.S. FTA should be developed to take the lead on difficult issues plaguing broader trade liberalization such as agriculture, services, investment, intellectual property rights, antidumping, and migration.
- 3.3 The United States should try to gain a seat in pan-Asian trade negotiations (the "ASEAN plus" groupings) and work with Japan to broaden these discussions to create an APEC-wide FTA.
- 3.4 Japan and the United States should support openness at home by empowering those dislocated by globalization through education and training.

## **Promoting Technological Diffusion and Economic Innovation**

Exports from China and India are "moving up the value chain" from low-cost production of standardized goods and services to the development, design, marketing, and distribution of high-tech products. China and India together currently graduate twice as many engineers each year as Japan and the United States. While many Chinese and Indian degrees are not up to Western standards, the increasing skill levels available in China and India cannot be denied. The knowledge base for these economies is further enhanced by the return of Chinese and Indian graduates from American and Japanese universities in greater numbers than ever before. Tighter U.S. immigration rules since 9/11 exacerbate these problems.

American and Japanese firms have responded by conducting an increasing share of research and development (R&D) in China and India in sectors such as software, semiconductors, mobile telephony,

and pharmaceuticals. This accounts for up to one-third of all R&D for American multinationals according to a recent study. At the same time, piracy of intellectual property is rampant, especially in China. This extends beyond the well-known cases of Hollywood movies, music CDs, and computer software to include a growing range of manufactured products from automobiles to consumer electronics.

Japan and the United States, world leaders in economic innovation for decades, should embrace and encourage the growing competition in the innovation economy. This must be coupled with vigilant intellectual property rights protection and improved math and science education at home.

### **RECOMMENDATIONS:**

- 4.1 The United States and Japan should promote cross-border movement of highly skilled people in science and technology among their two countries and China and India.
- 4.2 Japan and the United States should improve the quality and efficiency of primary and secondary science education.
- 4.3 The United States and Japan should encourage and assist China's and India's efforts to streamline and strengthen their systems of intellectual property rights protection.

## **Managing Energy Competition and Reducing Environmental Degradation**

Rapid economic growth in China and India has been powered by fossil fuels. To feed their enormous needs for electricity, the two nations are projected to account for 75 percent of the entire increase in world coal demand over the next twenty years. China and India are also forecast to generate 30 percent of the growth in global demand for oil over the same period. Both countries are making concerted efforts to expand their gas infrastructure and to develop the capacity to import large quantities of liquefied natural gas.

Chinese and Indian demand for fossil fuels is an increasingly important factor in global energy markets. Both countries are trying to "lock up" long-term energy deals by paying top prices and are willing to sign agreements with countries like Iran, Kazakhstan, Russia, Syria, and Venezuela to do so. At the same time, environmental deg-

radation, particularly in China, is already a major problem because electricity is largely generated using old, “dirty coal” technologies.

Yet China and India are still consuming relatively low quantities of energy per capita. As the middle classes in both countries continue to grow, driving cars and using central heat and air conditioning at home, energy demand and environmental degradation will only increase. If the world’s energy producers cannot boost output fast enough, upward pressure on fossil fuel supplies and prices will continue.

Japan and the United States, both world leaders in energy conservation and renewable technologies, should cooperate with China and India to address these issues. The opportunities for American and Japanese firms to benefit from improved energy efficiency and environmental quality in China and India are immense, but it will require government leadership to make this possible.

### **RECOMMENDATIONS:**

- 5.1 Japan and the United States should work with India and China to build multilateral and regional institutions that enhance energy security through risk-sharing and market-based mechanisms.
- 5.2 Japan and the United States should encourage China and India to adopt domestic energy reforms that increase the role of market forces.
- 5.3 Japan and the United States should share with China and India new energy technologies for conservation and renewable energy.
- 5.4 Japan and the United States should work toward a post-Kyoto global warming regime that ensures steady reductions in carbon emissions.
- 5.5 Japan and the United States should work with current members of the International Energy Agency to establish a formal relationship with China and India with a view to their eventual membership in the organization.