Submitted Testimony for the Record by Ian Bremmer, PhD

Ways and Means Committee Hearing on China's Trade and Industrial Policies

June 16, 2010

Good morning, Chairman Levin, Ranking Member Camp, and all the Members of the Ways and Means Committee. Thank you for holding this hearing on China's Trade and Industrial Policies, a subject that I consider of vital importance for international politics and the future of both the US and global economies. For the record, though I am the president of Eurasia Group, a global political risk consulting and advisory firm, my testimony today reflects only my personal views.

Mr. Chairman, I will speak this morning about the steady growth in China of "state capitalism," a system in which the state dominates market activity primarily for political gain. This trend has important implications for the US government, for US companies hoping to profit from opportunities inside China, and for US companies competing with Chinese state-owned and national champion firms across the developing world.

The economic and financial turmoil of the past 21 months has hastened the transition from an international bargaining table dominated by heads of state of the G7 group of industrialized nations—all of them champions of a free-market brand of capitalism—toward a G20 model that acknowledges the need to allow relative free-market skeptics to join the policy debate. Today, we are living in a G20 world. When leaders of free-market democracies diagnose what ails the global economy and prescribe their respective remedies, they must now contend with those across the table who believe that the free market has failed and that the state should play a leading role in national economic performance.

Mr. Chairman, the friction inherent in these competing forms of capitalism will pose important challenges for US policymakers and the productivity of the global economy for the next several decades.

The Chinese government, the world's leading current practitioner of state capitalism, uses various kinds of state-owned companies to ensure long-term access to the oil, gas, metals, minerals, and other commodities needed to fuel continued growth and to create and maintain large numbers of jobs. They use select privately owned companies to dominate many other economic sectors. They use sovereign wealth funds to invest excess foreign reserves in ways that maximize the state's profits. In all three cases, the state is using markets to create wealth that can be directed as political officials see fit. In all three cases, the ultimate motive is not economic (maximizing growth) but political (maximizing the state's power and the leadership's chances of survival). This is a form of capitalism, but one in which the state acts as the dominant economic player for ultimately political purposes.

Chinese state officials watched the Soviet collapse and Russia's political and economic upheaval of the 1990s as if their survival depended on it, and they learned some important lessons. First, they recognized that if the Chinese Communist Party failed to generate prosperity for China's people, its days were numbered. Second, they accepted that the state cannot simply mandate lasting economic growth. Only by releasing the entrepreneurial energies and innovation within its vast population could China thrive and the party survive. In short, China needed to embrace markets. Third, they saw that once this growth potential was unleashed, the party could only protect its monopoly hold on political power by ensuring that the state controlled as large a share as possible of the wealth that markets generate.

The state-capitalist trend—now apparent in various forms in Russia, the Arab monarchies of the Persian Gulf, North Africa, and elsewhere—would matter much less for US interests if China were not its primary model. Beijing's growing geopolitical influence and its importance for future global economic growth give its state-owned companies, national champions, and investment funds enormous clout. Though state capitalism has developed gradually over several decades, the financial crisis and global recession have made it much more difficult for those who believe in free-market capitalism to make their case to those who do not.

Over the next several years, the growth of state capitalism will have three important implications. First, to take full advantage of globalization, companies and investors need access to global labor, capital, and consumer markets. Essential to their success is the freedom to hire workers and borrow money where they are least expensive and to sell in the fastest growing markets—even if this implies simultaneous operations in dozens of countries. But as many authoritarian governments look increasingly to favor domestic companies and investors at the expense of their foreign competitors, privately-owned Western companies will lose some of their access to all three. This problem is already becoming increasingly evident in China.

Second, as governments focus increasingly on political challenges at home and in their immediate neighborhoods, states will invest more heavily in domestic markets and in ways that increase their leverage with states along their borders. That represents a shift from the recent past when trade and investment flows reflected a desire for maximum efficiency and profitability by seeking opportunities anywhere in the world they could be found.

Third, hopes that the increasingly free flow of ideas, information, people, money, goods, and services can create a more prosperous and open global economy will face new skepticism. This is because the friction created by the collision of free-market and state-capitalist systems will drag on economic growth—and because China's strong economic rebound, America's relatively high unemployment, and financial volatility in Europe are discrediting the free-market model.

Unfortunately, Mr. Chairman, this is not merely a matter of incompatible economic systems but of increasingly divergent interests. Over the course of China's remarkable three-decade rise, Beijing had good reason to value American power and Washington's willingness to use it. Developing trade and investment relationships with potentially volatile emerging states in Africa, the Middle East, Southeast Asia, and Latin America—and ever-deeper dependence on tanker traffic through troubled waters—meant exposing China to unprecedented levels of political risk, a challenge that state-owned Chinese companies and political bureaucrats in Beijing had little experience managing. America's willingness to help maintain open trade routes and sea lanes served the needs of Chinese companies. Chinese companies looking to move up the value chain have benefitted from exposure to the management and marketing techniques of US, European, and Japanese firms—and the advanced technologies they bring with them. Expanded Chinese access to US consumers helped China's economy create millions of jobs. Washington's willingness to engage an increasingly open China created the makings of, if not a beautiful friendship, at least a profitable partnership. By allowing China to protect its hard-won gains and to build a capitalist future on a solid foundation, American power proved indispensable for China's expansion.

There is now mounting evidence that some within the Chinese leadership view the continued value of US power and wealth with increased skepticism. Leading Chinese officials have argued publicly that their country's resilience in the face of a crisis triggered by Western financial institutions has vindicated China's state-capitalist model of development. The Chinese leadership no longer appears to believe that American power can remain indispensable for China's economic expansion—and, therefore, for the Communist party's political survival. Nor does it accept that access to US capital or commercial know-how is quite so important for the next stage of China's development.

As a result, there appears to be strong consensus at the top of China's policymaking circles that the government's highest priority—ensuring long-term political stability—requires a concerted and massive effort to shift China's growth model away from reliance on exports to the United States, Europe, and Japan toward one based more heavily on domestic consumption of Chinese-made products. As a result, Mr. Chairman, we are likely to see continued gradual progress in raising Chinese consumption rates in coming years. That process will proceed by fits and starts, but the financial crisis has persuaded many within the Chinese leadership that excessive exposure to Western economic volatility and long-term dependence on the purchasing power of Western consumers comes with unacceptable levels of economic (and, therefore, political) risk. In addition, Beijing is now pushing more aggressively to diversify its exports away from the West and into Southeast Asia, South America, and Africa. The slew of currency swap agreements and bilateral and multilateral trade deals that Beijing has pursued in recent years is emblematic of this larger trend.

Yet, we must recognize, Mr. Chairman, that Beijing faces overwhelming challenges on execution. Attempts to reorganize political and economic incentives to increase domestic consumption will run headlong into deeply entrenched domestic political and commercial interests. Here again, state capitalism will play an enormous role: China's finance ministry recently reported that state companies produced $3.3 trillion in sales in 2009. That accounts for approximately 70% of China's gross domestic product—and it reveals just how well entrenched some of China leading interest groups will prove to be.

In addition, a move toward reliance for growth on higher levels of domestic consumption in China will require not only an expansion of social safety nets, but reform of the country's entire industrial structure. Preferences for the state-led corporate sector, and state monopolies over key industries, are inefficient and siphon money from Chinese citizens. Dismantling this state support, especially when the financial crisis has prompted the government to move in the opposite direction by vastly expanding support for domestic companies, will require unprecedented political will. It is not yet clear that this political will exists.

Mr. Chairman, a new generation of Chinese leaders—those who will rise to the top of China's political elite in 2012—will face the challenge of pushing the Chinese economy into its next phase of consumption-led growth. Beijing's next two five-year economic plans, running through 2020, will likely contain a much heavier focus on policies that address income distribution, services, social welfare, education, climate change, and incentivizing citizens to spend their money. We will know much more about the contours of the 12th five-year plan at the end of this year.

In the meantime, the global economic slowdown has only intensified the drive among some within the Chinese leadership to ensure that wealth and wealth generation in China remain under heavy state dominance, that many increasingly capable Chinese firms enjoy important advantages over their foreign competition, and that state-owned Chinese enterprises and sovereign wealth funds increase China's political and economic leverage on the global stage.

Biography

Ian Bremmer is the president of Eurasia Group, the leading global political risk research and consulting firm. In 1998, Bremmer founded Eurasia Group with just $25,000. Today, the company has offices in New York, Washington, and London, as well as a network of experts and resources around the world. Eurasia Group provides financial, corporate, and government clients with information and insight on how political developments move markets.

Bremmer created Wall Street’s first global political risk index, and has authored several books, including the national bestseller, *The End of the Free Market: Who Wins the War Between States and Corporations?*, which details the new global phenomenon of state capitalism and its geopolitical implications. He also wrote *The J Curve: A New Way to Understand Why Nations Rise and Fall*, which was selected by *The Economist* as one of the best books of 2006, and *The Fat Tail: The Power of Political Knowledge for Strategic Investing*. Bremmer is a contributor for the *Wall Street Journal* and writes "The Call" blog on ForeignPolicy.com; he has also published articles in the *Washington Post*, the *New York Times*, *Newsweek*, *Harvard Business Review*, and *Foreign Affairs*. He is a panelist for CNN International's "Connect the World" and appears regularly on CNBC, Fox News Channel, National Public Radio, and other networks.

Bremmer has a PhD in political science from Stanford University (1994), and was the youngest-ever national fellow at the Hoover Institution. He presently teaches at Columbia University, and has held faculty positions at the EastWest Institute and the World Policy Institute. In 2007, he was named a Young Global Leader of the World Economic Forum. His analysis focuses on global macro political trends and emerging markets, which he defines as “those countries where politics matter at least as much as economics for market outcomes.”

Bremmer grew up in Boston, and now lives in New York and Washington, DC.