

Article

# Are We Beating China Economically?

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It's widely accepted that the U.S. should compete economically with China, even though it sometimes still feels as if only one side is competing. What's not settled is how to win or who is likely to do so. As the impact of China's "zero Covid" mistake fades, that nation's economy will recover in 2023 and 2024, to cheers from Wall Street and American technology firms. When that happens, it may seem that America is failing to keep pace.

But the longer term looks much better for the United States. Economic fundamentals and, to a lesser extent, the policies tied to them show America outperforming China on a durable basis. The main question is not who will win the competition but whether the U.S. will take advantage of a clearly superior situation and put the People's Republic of China (PRC) well into the rearview mirror.

Economic comparisons typically start with the national economy's size and individual citizens' prosperity, as seen in part in gross domestic product (GDP). But size and prosperity are outcomes, flowing from development policies and four fundamental features of the economy: labor, capital, land, and innovation. Those are the sources of growth no matter how it is measured.

The U.S. and the PRC are by far the world's largest economies. Yet both have serious defects in a vital area: the need for a skilled, productive workforce. A young and growing labor force can be frightening in a society without enough jobs for the prospective workers. The PRC faced that challenge in the 1990s and 2000s and largely met it, but now it has an older and

shrinking labor force. Indeed, China's labor force has been shrinking for a decade. Not coincidentally, its GDP growth has slowed considerably. And the problem will get much worse.

While China's data can be dubious, even its tightly controlled National Bureau of Statistics admits the labor force peaked in 2015 at 801 million and dropped steadily in size to 780 million in 2021. The age structure of the population indicates about another 100 million departures from the labor force over the next 20 years, with the exits accelerating in the 2030s. The view is the same through another demographic lens. Japan's lost economic decades date back to the early 1990s, when its median age was 37. China's median age is now 38. Japan's current median age is near 49; China will reach that in 20 years.

The coming of a much smaller and older Chinese labor force will present an opportunity for the U.S. to bring back some of the production it has lost to the PRC since the latter joined the World Trade Organization in 2001. But there will be a major obstacle. It's not that all the jobs will go elsewhere. Mexico, and nearly every other country, is too small to absorb them. Even India, which theoretically can create that many jobs, has a labor-force participation rate far below that of the PRC or the U.S., in fact below the world average, and it has been falling for years.

The obstacle is us. From 2001 through 2022, the total number of American employees increased 16 percent. Not bad? In the previous 22 years, it rose 49 percent. The reasons for the slowdown deserve their own article, but an ageing American population is one of them. Another is unwillingness to work. The Chicago Fed found declining willingness to work during the pandemic, but also before.

This is well known as a societal problem. It's less well known as an economic-security problem in the many industries, from aerospace to computing to pharmaceuticals to shipbuilding, where the U.S. wants to re-establish its independence from the PRC.

Both "near-shoring" of jobs to other countries in North America and "friend-shoring" of jobs to allies elsewhere must therefore supplement the "re-shoring" of jobs to the U.S. But since there's no way to know which partners will ultimately be reliable in which industries, or how they will maintain their own relations with China, the best long-term option for the U.S. is a larger, more skilled labor force to make extensive re-shoring possible.

Both sustained long-term growth and supply-chain resilience are crucial to national security and require high labor-force participation and a skilled workforce. These needs call for government action to incentivize working, hiring, and training, or at least for the cessation of high payroll takes and other disincentives to work, hire, and train.

Capital is similar to labor in that America is doing better than China, but neither is doing especially well. Perhaps the most valuable tool — economic, military, political, or cultural — that the U.S. has in international affairs is the dollar. It's the world's "reserve currency," overwhelmingly. Of payments made around the world through the Society for Worldwide Interbank Financial Telecommunications, the dollar's share is above 40 percent; of international foreign-exchange reserves, it's almost 60 percent. The Chinese yuan's shares are below 2.5 percent and below 3 percent, respectively.

The common idea that the yuan is challenging the dollar is silly. Nor will it, since that would require the PRC to let money freely leave the country (making it more attractive to hold assets in yuan). But the Communist Party has been terrified of doing this ever since ordinary Chinese people started to have some money. Its terror is justified.

Long-term debt is a measurement of capital that did not contribute to growth after being allocated. It has thus been wasted. One comprehensive indicator of this waste is credit extended to the nonfinancial sector, expressed as a share of GDP, a statistic compiled by the Bank of International Settlements (BIS). At the end of 2008, this kind of credit in China was 139 percent of GDP. The figure for Germany, to compare, was 199 percent. China had kept its debt small, and debt had been no obstacle to growth. By the end of 2021, that had changed. The German figure was 204 percent. The Chinese figure was 286 percent. In particular, the PRC's financial performance has weakened sharply since the 2008 global financial crisis. China has thereafter been more vulnerable to capital flight and has needed capital controls more than before. Looking ahead, we can predict that fiscal support for an ageing population will lead to more debt and frighten the party, again, into confining capital. The yuan will remain a junior currency.

As long as the dollar is king, the U.S. can win any international economic battle because it controls so much of the money used in international transactions. Data may be the new oil, but money is always money. Securing the dollar's status are American financial markets unmatched in their ability to attract participants.

The American problem is also the public-sector policies in place since the global crisis. From the standpoint of preserving the dollar's status as the reserve currency, the Federal Reserve's recent interest-rate increases look long overdue. Real interest rates had been near zero for more than a decade, a sign of an unhealthy system that discouraged saving for the future.

Now it's fiscal policy that is of greatest consequence to the dollar. The Biden administration projects years of deficits well in excess of \$1 trillion, not because it anticipates an economic downturn but just as the norm. The BIS 2021 outstanding-credit level for the U.S. is 278

percent, barely better than China's. The risk is not that the yuan will replace the dollar but rather it's that the dollar will just fail, with nothing to replace it. There will be no reserve currency and a critical U.S. advantage will be lost.

Until recently, American policy-makers seemed to have forgotten the importance of land and physical resources to economic security in general and to the rivalry with the PRC specifically. In 2022, local officials and members of Congress remembered land but in unhelpful fashion, treating Chinese firm Fufeng's purchase of land for corn-milling near Grand Forks Air Force Base in North Dakota as far more momentous than it was. That deal has been blocked by local officials, and bans on land ownership are properly decisions for individual states. But on a national scale there has been no substantial acquisition by any sort of PRC entity of U.S. land since 2018, and Chinese entities currently own less than 1 percent of American farmland.

Much more consequential than Chinese ownership of our land are our land advantages over China. Yet these are being only partly exploited. The best illustration is shale. Competition in resource sectors and a secure right to private ownership of land enabled the "shale revolution" of hydraulic fracturing and horizontal drilling to start in 2009, reversing decades of declining crude-oil production. Output then doubled in a decade. This has helped turn the U.S. from dangerously energy-dependent to largely independent. Now America, not Russia or Saudi Arabia, is the world's biggest petroleum and biofuel producer, at something like three times China's level. The PRC imports about ten times more petroleum and biofuel than the U.S. does. China begins with less petroleum reserves and then makes things worse with prohibitions on private ownership of land.

It's not just energy. America is by far the world's largest net exporter of food products. In dollar terms, the PRC is a net exporter (at one-fifth the U.S. level) of all food, but it is a large net importer of the basics, such as meat, cereals, and soybeans. It lacks the land to support its population, and it restricts private agricultural development. On top of this, China has a serious dependence on imports of metals, chiefly iron ore, to the tune of more than \$200 billion annually.

These dependencies are the primary motivation behind China's Belt and Road Initiative. It's defense, not offense: trying to get as secure a guarantee of commodity supplies as possible. This is evident in Chinese investment and construction patterns around the world, which heavily emphasize energy and give supporting roles to metals, food, and transportation. In general, state control of land — in China, in India, in the oil states — warps development. The state mismanages land the same way it mismanages financial capital.

Secure private property means that land works greatly in America's favor, but the advantage can be larger. Much more important than the PRC's ownership of U.S. farmland at a level under 1 percent is the federal government's ownership of 28 percent of all land. Stemming from that is the failure to identify valuable resources. The U.S. lacks a proper inventory of our reserves of lithium and many rare earths because so much area is not surveyed. Is it really true that Canada has more than six times the rare-earth reserves of the U.S.? It's easier to win when you know what you have.

Finally, innovation is more difficult to assess than are the other three sources of economic growth. The U.S. has a role for government in the economy, but it emphasizes private-sector initiative, spending, and competition. The PRC does the opposite, limiting private-sector innovation. China's government sets most goals and throws a massive amount of resources at them in the form of both direct spending and financial incentives.

The American advantage over the PRC in gross research-and-development spending has therefore declined, but spending is a somewhat misleading measure. Because the private sector leads, must compete to survive, and seeks profit, most American research spending will have some sort of payoff. Large quantities of Chinese research spending have been badly misdirected by the state. This happened in failed efforts to simply command advanced semiconductors into existence, for example, which wasted tens of billions of dollars and saw one-time premier firms such as Unigroup needing bailouts.

More important than raw spending is the effect of innovation on economic growth. Just a few innovative industries can be the engine of a small economy, as has been the case in Israel. But a larger economy requires a broader base. Japan has tried for a generation to offset its ageing and indebtedness with innovation but largely failed. Japan's economic size means it needs a large number of innovative industries to propel growth, and it's difficult and rare for a country to sustain such widespread innovation.

China has Japan's problems plus a restrictive authoritarianism. The PRC can certainly innovate in some sectors, including military applications such as hypersonics. But the party has never wanted an open system, for obvious political reasons, and it has become more oppressive under Xi Jinping. The state simply cannot anticipate all opportunities and needs in an economy of China's size. In contrast, self-generated innovation by way of the trials and errors of private actors, along with property rights enabling successful innovators to benefit from their work, has contributed significantly to American growth for at least 40 years.

Of course, the PRC is not constrained by "self-generated" innovation. For the same 40 years, it has thrived on absorbing foreign technology by legal and illegal means. The benefits of

doing this were huge at first but have shrunk as China has advanced and the added value of foreign technology has declined. With self-imposed constraints on its own private sector, the PRC must work harder to absorb foreign innovation.

Beijing has a plan. Some American firms claim they need revenue from China to innovate. In fact, it's *surviving* American firms that may need the PRC. Beijing's strategy is to acquire the intellectual property of foreign innovators, create and heavily subsidize competitors, and kill off the foreign companies. While the dead firms cannot testify, the result is that China has harmed American innovation. American corporate R & D grew much faster before China joined the World Trade Organization in 2001 than it did for the 15 years thereafter, recovering only as the nature of the PRC's trade practices became better recognized.

Federal-government research can be vital, but government attempts to pick technological winners and losers can harm truly innovative firms. This danger applies equally in Beijing's distortion of technological development here by stealing from and driving out of business American firms that do not cooperate with China. The way to win in labor, capital, and land is for the U.S. to take care of its own house; the way to win in innovation is for the U.S. to shield itself against the PRC's predatory practices.

So the U.S. wins land easily, will win labor almost by default, and can continue to win in capital and innovation. Why is China catching up, then?

In fact it may no longer be. The once-consensus view that China would inevitably surpass the U.S. economically has turned into projections that China will surpass the United States in GDP later than expected, or never. The gap in GDP per capita is of course much larger in America's favor. More important, GDP and especially GDP per capita are not the only or even the best measures of size and prosperity.

Try buying a house with GDP per capita. What matters is actual income, which the U.S. and PRC report. According to Chinese-government data, personal disposable income was \$2,806 in 2012 and \$5,472 in 2022. The U.S. levels are \$41,436 and \$56,761, respectively. The ratio of Chinese to American income rose sharply, but the absolute gap widened by more than \$12,000 — which is better? Go ask an average Zhou.

The accumulation of income over time is national wealth. Credit Suisse has numbers for the U.S. close to the Federal Reserve's, nearly \$66 trillion in 2011 and nearly \$146 trillion in 2021 (latest). Credit Suisse has repeatedly and dramatically revised Chinese wealth higher over time. Its most recent figures put the PRC at \$31 trillion in 2011 and \$85 trillion in 2021. Again, the ratio to the U.S. rises, but the absolute gap widens in America's favor, from \$35 trillion to \$60 trillion. Would policy-makers rather have a higher ratio or an extra \$25 trillion?

For decades to come, the PRC will be America's chief rival, far more formidable economically than Russia, North Korea, and Iran combined. But there's a good case to be made that over the last ten years the U.S. has already been winning the economic competition with China. As Chinese fundamentals deteriorate, America can win more decisively, especially if policy improves.



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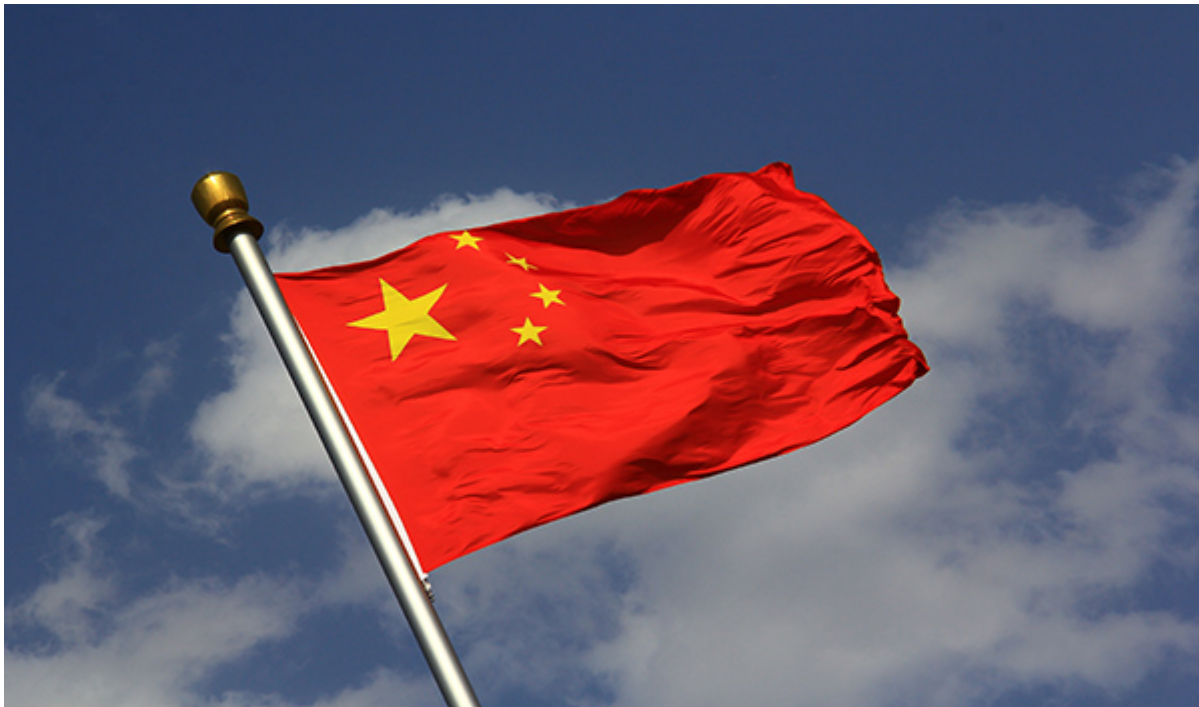
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