*POLICY ESSAY*

# A Tale of Two American Factories:

# Lessons from Japan's Experience for China's Foreign Direct Investment

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# EXECUTIVE SUMMARY

This essay examines what China can learn from Japan's experience with foreign direct investment (FDI) in the United States to make Chinese FDI welcome, suggesting how the United States should reformulate the negotiating strategy with China.

**MAIN ARGUMENT**

Chinese FDI in the United States steadily increased from 2009 until peaking in 2016, but for the last three years it has plummeted. When Japanese FDI accelerated in the United States during the 1980s, Japanese factories in the United States alleviated the negative stereotyping of Japan, the "Japan bashing", by introducing Japanese quality management. The essay discusses what China can learn from the experience of Japanese FDI to make Chinese FDI welcome in the United States where "China bashing" is rising now. It argues that in order to earn public support, Chinese firms must emulate the quality management that Japanese firms have brought to U.S. manufacturing industries. Moreover, by analyzing the challenges facing Chinese investors, it suggests that the United States should encourage the Chinese government to commit to the state-owned enterprise (SOE) reform that would benefit both China and the United States.

**POLICY IMPLICATIONS**

- Japanese FDI raises American workers' productivity and sets wages for American workers at higher than the local average for similar work. Chinese FDI will never be appreciated if its factories rely on low wages and predatory pricing.
- China's state capitalist system subsidizes SOEs and allows them to export at lower prices. If the Chinese government advances the SOE reform, Chinese investment in the United States will bring mutual benefits to both China and the United States.
- The United States should accept Chinese investment if it creates well-paid jobs for American workers.

Japanese company Toyota and Chinese company Fuyao both took over closed-down General Motors (GM) plants—with very different results. In 1984, Toyota invested in the GM assembly plant in Fremont, California. After introducing Japanese-style quality management called *kaizen* (which literally means "improvement"), productivity at the once underperforming facility increased by more than 50 percent.[1] By contrast, Fuyao struggled after it took over the GM Moraine Assembly Plant in Dayton, Ohio, that had closed in 2008, as is shown in the 2019 American documentary "American Factory"—which won the best documentary feature at the Academy Awards. Fuyao invested millions of dollars and employed hundreds of local workers, but ended up with cultural clashes and workers' complaints.[2] Workers earned twice as much under GM and had been out of work for a few years before Fuyao took over the factory.

Chinese investment in the United States began steadily increasing in 2009, but it peaked in 2016 at $46 billion, and for the past three years it has plummeted—declining into $29 billion in 2017 and $5 billion in 2018—since distrust between the United States and China has risen due to the U.S.-China trade war under the Donald Trump administration.[3] President Trump's xenophobic Twitter rants have stoked a fear of foreigners and foreign companies, even as foreign investment continues to create manufacturing jobs for American workers.

This essay analyzes what lessons China can learn from Japan's experience with foreign direct investment (FDI) in the United States. Although China is a dominant player in world trade

[1] Mike Parker and Jane Slaughter, "Behind the Scenes at NUMMI Motors," *New York Times*, December 4, 1988, https://www.nytimes.com/1988/12/04/business/business-forum-management-by-stress-behind-the-scenes-at-nummi.html.
[2] Manohla Dargis, "'American Factory' Review: The New Global Haves and Have-Nots," *New York Times*, August 20, 2019, https://www.nytimes.com/2019/08/20/movies/american-factory-review.html.
[3] Alan Rappeport, "Chinese Money in the U.S. Dries Up as Trade War Drags On," *New York Times*, July 21, 2019, https://www.nytimes.com/2019/07/21/us/politics/china-investment-trade-war.html.

and the global economy, in order to gain long-term traction and to benefit from its position, it must work to become more appreciated and persuade other nations to follow its leadership. First, Chinese firms should make well-paid skilled and unskilled jobs by setting wages for American workers at higher than the local average for similar work, instead of relying on low wages of production. Japanese firms were able to raise American workers' productivity because their productivity was already high. For Chinese firms to create well-paid jobs, they first must raise their own productivity. Moreover, China's subsidized state-owned enterprises (SOEs) anger the United States because they allow companies to export a product below market price. Thus, the Chinese government should advance the SOE reform to raise the productivity of local companies in China, and to help its U.S. investment prosper. Furthermore, China needs to realize that as long as it is involved in trade based on global value chains (GVCs), Chinese investment will benefit all countries connected along the GVCs. The Xi Jinping administration's strategic plan Made in China 2025 is turning China away from the GVCs based trade and making it difficult for Chinese FDI to be appreciated. Analyzing the difficulties facing Chinese investors will help the United States reformulate a negotiating strategy with China.

## FROM JAPAN BASHING TO CHINA BASHING

During the 2016 U.S. presidential election, Trump's campaign drew heavily on opposition to trade, foreign investment, immigration, and racial diversity, promoting the nationalist slogan of "America First." As a result, American anti-internationalism has escalated from protectionism (economic nationalism) into xenophobia, nativism, and even racism, which have become the rallying cry of anti-globalists. The resurgence of economic nationalism targeting Japan in Trump's campaign has reminded Americans of Japan bashing caused by U.S.-Japan trade friction that culminated in the 1980s—of which Trump took part.[4] At that time, Japanese investment was taken as evidence of an economic invasion and the reference of the "yellow peril" was reintroduced, connecting the new wave of anti-Japan sentiment to its historical root of the U.S. war with Japan during World War II.[5] Political campaigns attempting to harness nationalism into trade protectionism pushed the "buy American" slogan and escalated economic nationalism into xenophobia and racism, and the U.S. economy often ended up paying the price with a less efficient economy brought on by protectionism.[6] In some of the cases, the buy-American programs only targeted Japanese auto companies such as Honda, Nissan, and Toyota while auto companies of other countries such as German BMW and Mercedes continued to export a lot of their products to the United States.[7] Some of the buy-American advertisements exploited nationalism and racism to sell their products with the message "remember Pearl Harbor" and by exaggerating accents and encouraging ridicule of the Japanese physique.[8]

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[4] Jonathan Soble and Keith Bradsher, "Donald Trump Laces into Japan with a Trade Tirade from the '80s," *New York Times*, March 7, 2016, https://www.nytimes.com/2016/03/08/business/international/unease-after-trump-depicts-tokyo-as-an-economic-rival.html.

[5] Narrelle Morris, *Japan-Bashing: Anti-Japanism Since the 1980s* (London: Routledge, 2010).

[6] E. J. Dionne Jr., "Economics and Patriotism: A Revised Dukakis Theme," *New York Times*, April 30, 1988, https://www.nytimes.com/1988/04/30/us/economics-and-patriotism-a-revised-dukakis-theme.html; Robert Reinhold, "'Buy American': Remedy or Tunnel Vision?", *New York Times*, January 27, 1992, https://www.nytimes.com/1992/01/27/us/buy-american-remedy-or-tunnel-vision.html.

[7] Matthew L. Wald, "The New Buy-American Auto Sweepstakes," *New York Times*, January 24, 1992, https://www.nytimes.com/1992/01/24/business/the-new-buy-american-auto-sweepstakes.html.

[8] Stuart Elliott, "Anti-Japan Auto Ads May Backfire," *New York Times*, January 30, 1992, https://www.nytimes.com/1992/01/30/business/the-media-business-advertising-anti-japan-auto-ads-may-backfire.html; Randall Rothenberg, "Ads That Bash the Japanese: Just Jokes or Veiled Racism?", *New York Times*, July 11, 1990, https://www.nytimes.com/1990/07/11/business/the-media-business-ads-that-bash-the-japanese-just-jokes-or-veiled-racism.html.

But by the late 1980s, Japanese FDI accelerated in the United States. Since then the distinction between "American" and "Japanese" has become blurred and Japan bashing has waned now that Japanese companies are making American jobs.[9] Japanese automakers used to be criticized for lower local content rates, as American journalist James Fallows wrote in 1992: "the Big Three are all much more 'American' than any Japanese brand. The average North American content for Chrysler vehicles is more than 85 percent…[but] it remains an open question whether the [Honda] cars are even 50 percent North American."[10] However, in 2016 Toyota was the automaker that used the most made-in-U.S. parts with the Toyota Camry ranking highest, while the Big Three—nowadays sometimes ridiculed as the "Detroit Three"—was not listed at the top five.[11]

How could Chinese investment prove beneficial to the United States? Japanese automakers originally strategized their FDI as response to the voluntary export restraint imposed due to U.S.-Japan trade friction in the 1980s. Japanese firms introduced their corporate governance, corporate social responsibility (CSR), cultural outreach, job training, and labor relations, as well as their quality management. The experience of Japanese FDI suggests that to build public support for FDI, economic interdependence alone is not sufficient; it is also necessary for firms to adopt proactive social engagement strategies targeted at the host country's workforce and general public at large.[12]

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[9] Doron P. Levin, "A Patriotic Pitch: Honda is American," *New York Times*, November 6, 1994, https://www.nytimes.com/1994/11/06/business/a-patriotic-pitch-honda-is-american.html.
[10] James Fallows, "A Plea for Truth-in-Bashing," *New York Times*, February 10, 1992, https://www.nytimes.com/1992/02/10/opinion/a-plea-for-truth-in-bashing.html.
[11] "Toyota Tops 'Most American Made' Car List," *Industry Week*, June 28, 2016, https://www.industryweek.com/the-economy/competitiveness/article/21974235/toyota-tops-most-american-made-car-list.
[12] Kristin Vekasi, *Risk Management Strategies of Japanese Companies in China: Political Crisis and Multinational Firms* (New York: Routledge, 2020), 107–39.

JAPAN AS NUMBER ONE

Four decades ago, when sociologist Ezra Vogel wrote *Japan as Number One: Lessons for America*, he did not mean that Japan was number one in the world for its military or economic power.[13] He said that Japan was not number one in "gross national product, standard of living, political power, and cultural influence."[14] However, he argued that Japan was number one in other aspects such as quality management of manufacturing companies. In *Japan as Number One*, Vogel analyzed how Japan had been successful in achieving educational standards, efficient bureaucracy, economic productivity, social welfare services, environmental regulations, and crime control.

*Toyota's Success in the United States*

By the time Japanese FDI in the United States increased in the 1980s, Japanese multinational corporations (MNCs) had brought their quality management to U.S. manufacturing industries. When in 1984 Toyota invested in the GM-Toyota assembly plant in Fremont, California—which was called NUMMI (New United Motor Manufacturing, Inc.)—labor productivity of Japanese Toyota plants was more than 50 percent higher than that of American GM plants, and the labor productivity of the then 20-year-old GM Fremont Assembly Plant—which the NUMMI took over—had been one of the lowest among the GM plants.[15] By taking half-ownership of the NUMMI plant, "Toyota learned how to adapt its famed Toyota Production System to work with U.S. suppliers, U.S. government regulations and, most importantly the UAW

[13] Ezra F. Vogel, *Japan as Number One: Lessons for America* (Cambridge, MA: Harvard University Press, 1979).
[14] Ibid., 21.
[15] Author's personal communication with a Toyota executive in Dallas, TX, April 19, 2018.

[United Automobile Workers]."[16] Two years after the NUMMI started operation, Toyota invested in its first wholly-owned plant in the United States and opened a new plant in Kentucky. Now approximately 40,000 people are directly employed by Toyota's 10 engineering and manufacturing plants in the United States, and almost 200,000 people are working for Toyota across the United States if including dealer employees.[17] In sum, contrary to former Labor Secretary Robert Reich's concern with the breach of intellectual property rights, as seen in Toyota's contribution to the U.S. economy, Japanese investment has proven beneficial to the United States by introducing the Japanese "secret" to quality management.[18]

In the United States, for the last three decades, FDI by MNCs has been creating American manufacturing jobs that had been lost by American companies.[19] Despite the economic reality, however, American politicians conveniently place blame for manufacturing job losses on foreign based MNCs. For example, in January 2017, then President-elect Trump picked a fight with Toyota on Twitter accusing it of building a new plant in Guanajuato, Mexico.[20] He tweeted: "Toyota Motor said will build a new plant in Baja, Mexico, to build Corolla cars for U.S. NO

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[16] Benjamin Gomes-Casseres, "NUMMI: What Toyota Learned and GM Didn't," *Harvard Business Review*, September 1, 2009, https://hbr.org/2009/09/nummi-what-toyota-learned.

[17] The number will increase if including supplier employees. The data is provided by Toyota during the author's personal communication with a Toyota executive in Tokyo, Japan, July 18, 2019.

[18] Robert B. Reich and Eric D. Mankin, "Joint Ventures with Japan Give Away Our Future," *Harvard Business Review*, March, 1986, https://hbr.org/1986/03/joint-ventures-with-japan-give-away-our-future.

[19] Patricia Cohen, "When Foreign Companies Are Making, Not Killing, U.S. Jobs," *New York Times*, August 6, 2017, https://www.nytimes.com/2017/08/06/business/economy/chattanooga-foreign-investment.html.

[20] Motoko Rich, "Trump's Twitter Warning to Toyota Unsettles Japanese Carmakers," *New York Times*, January 6, 2017, https://www.nytimes.com/2017/01/06/business/trump-toyota-mexico-twitter-threat.html.

WAY! Build plant in U.S. or pay big border tax" (grammatical errors uncorrected).[21] Trump is not the only politician who has criticized MNCs; many American political leaders, including those of the Democratic Party, have joined in on the anti-MNCs chorus. For example, Senator Sherrod Brown, Democrat of Ohio, said: "Any trade proposal that makes multinational corporations nervous is a good sign that it's moving in the right direction for workers."[22]

GVCs of MNCs have spread all over the world, and it has become common practice for different stages of manufacturing production to be located in different countries.[23] Thus, in reality, Toyota's new assembly plant in Mexico would increase high-skilled parts-supplying jobs in the United States. GVCs connect the United States and Mexico, and Mexican assembly plants use American-made parts, thanks previously to the North American Free Trade Agreement, and now to the United States–Mexico–Canada Agreement. Toyota's investment in Mexico would increase manufacturing jobs in *both* Mexico and the United States. In fact, under GVCs based international trade, foreign based MNCs are making, not killing, American jobs.

*Investment in Research and Development for American Workers*

Like Japanese firms, Chinese investors pay wages and benefits for workers in the United States. However, while the intensity of research and development (R&D) activities is notable in

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[21] https://twitter.com/realDonaldTrump/status/817071792711942145. Trump's Twitter post was not accurate. Trump said that Toyota would build a new Corolla factory in Baja, but the company is planning to build a new plant in Guanajuato and it already has a factory in Baja. The new plant in Guanajuato builds Tacoma pick-up trucks, not Corollas. Perhaps most importantly, it will not replace any of Toyota's 10 factories in the United States.

[22] Ana Swanson, "Trump's Tough Talk on NAFTA Raises Prospects of Pact's Demise," *New York Times*, October 11, 2017, https://www.nytimes.com/2017/10/11/business/economy/nafta-trump.html.

[23] Richard Baldwin, *The Great Convergence: Information Technology and the New Globalization* (Cambridge, MA: Belknap Press of Harvard University Press, 2016).

Japanese investment, "Chinese R&D is thus far a much smaller fraction of value-added than Japanese R&D, but it is much higher than R&D spending of other emerging-market firms, including those from India, Brazil, Russia, and Mexico."[24] Thus, one of the lessons Japanese experience provides for China is that it should invest in R&D and create high-skilled jobs, for which Americans have comparative advantage.

For example, in 2015 Toyota founded the Toyota Research Institute (TRI), inviting Dr. Gill Pratt who led R&D of robotics technology at the U.S. Defense Advanced Research Projects Agency to be its founding chief executive officer.[25] The TRI researches how to apply innovative technology to build a new approach to mobility and refine the interaction between human and machine—such as artificial intelligence, automated driving, and robotics. Its three offices are all located near universities: i.e., Ann Arbor near University of Michigan, Boston near Massachusetts Institute of Technology, and Los Altos, California, near Stanford University.[26] And perhaps most importantly, all the employees are locally recruited. In short, R&D investment provides well-paid jobs for those who have invested in higher education.

*Jobs for American Workers*

The documentary "American Factory" suggests another lesson that Chinese firms could learn from Japanese experience. Fuyao's investment in a former GM plant led to workers'

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[24] Theodore H. Moran and Lindsay Oldenski, "Japanese Investment in the United States: Superior Performance, Increasing Integration," *Peterson Institute for International Economics Policy Brief*, February, 2015, https://www.piie.com/publications/policy-briefs/japanese-investment-united-states-superior-performance-increasing.

[25] Nagata Osamu and Takeuchi Hiroki, "Grōbarizeshon o Darasu kara kangaeru" [Globalization from the Dallas Perspective]. *Koken* 668 (April 2019): 34–51.

[26] For another instance, the Uber Advanced Technologies Group, the R&D division of Uber, locates its headquarters in Pittsburgh, Pennsylvania, to conduct joint research with Carnegie Melon University.

complaints about the company's high demands because the workers' salaries were cut in half. One of the workers who appeared in the film said that he used to earn $29 per hour with GM but his current wage with Fuyao was $13 per hour. By contrast, Toyota Motor North America sets the workers' wage standard at 50 percent higher than the local average wage for similar work. For example, the average wage of the Toyota Motor Manufacturing Texas (TMMTX) in San Antonio is $26, and the TMMTX provides job training for their employees to raise their productivity.[27] The plant is located in one of the lowest income areas of San Antonio and almost 8,000 people are employed by the TMMTX's assembly line and the 22 onsite suppliers.[28] When I visited the TMMTX in 2017, I observed a computer class teaching Excel. The job training does not have to require workers to learn a complicated new skill such as writing code—although Democratic presidential candidate Joe Biden suggests that laid-off coal miners should learn computer programming.[29] Updating workers' skills through job training will be critical to making the workforce more competitive and productive.

For another instance, Toyota's new joint plant with Mazda in Huntsville, Alabama—which will start operation in 2021—also aims to set the workers' wage standard at 50 percent higher than the local wage for similar work.[30] Alabama's state government provides generous subsidies for investors when they implement job training programs. When Honda decided to open a new assembly plant in Lincoln, Alabama, in 1999, it chose Alabama because of the subsidies for job training, even though it did not expect to employ experienced workers because there had not been

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[27] Author's interviews with Toyota executives in San Antonio, Texas, November 2, 2017.
[28] The number of jobs created by the TMMTX will increase if including employees for parts suppliers located outside the plant.
[29] Alexandra Kelley, "Biden Tells Coal Miners to 'Learn to Code,'" *Hill*, December 31, 2019, https://thehill.com/changing-america/enrichment/education/476391-biden-tells-coal-miners-to-learn-to-code.
[30] Author's interviews with Toyota executives in Huntsville, Alabama, January 16, 2019.

an auto plant in Alabama before.[31] Since then, however, supply chains in the Midwest—including Indiana, Kentucky, Michigan, Ohio, Pennsylvania, and West Virginia—have been extended into Alabama, and the extension of the supply chains was one of the reasons why Toyota chose Huntsville as a site of the new joint plant with Mazda.[32]

In short, Toyota is making well-paid unskilled jobs while its Toyota Production System demands a higher level of creativity to each worker—even to unskilled workers—and raises American workers' productivity by job training. If the productivity of better-paid American workers is the same as that of less-paid developing countries' workers, American workers will face downward pressure on their wages. Unfortunately, the job training policy that has been instituted by the U.S. federal government has not been successful at adjusting American workers to the global economy.[33] The malfunctioning of the federal government's job training programs has been even more problematic as technological change happens faster.[34] Thus, intra-firm job training is increasingly important to raise the productivity of American workers in the age of automation and globalization.

"American Factory" also shows that Fuyao struggles with responding to the pressure of unionization. Chinese firms will be better able to confront this challenge if they learn from the Japanese enterprise union system. Most Japanese labor unions are not industry-wide unions but enterprise unions, which means that the typical Japanese labor union collects the employees of a

[31] Author's personal communication with a Honda executive in Washington, DC, February 24, 2017.
[32] Author's interviews with Toyota executives in Mexico City, April 9, 2018; in Toyota City, Japan, June 22, 2018; and in Fukuoka, Japan, March 15, 2019.
[33] Edward Alden, *Failure to Adjust: How Americans Got Left Behind in the Global Economy* (Lanham, MD: Rowman & Littlefield, 2016).
[34] Edward Alden and Laura Taylor-Kale, *The Work Ahead: Machines, Skills, and U.S. Leadership in the Twenty-First Century* (Washington, DC: Council on Foreign Relations, 2018).

single firm, not employees of different firms in the same industry. Thus, for example, the Toyota employees in Japan belong to the Federation of All Toyota Workers' Unions while the GM employees in the United States belong to the UAW. Under the enterprise union system, strikes are less frequent and labor relations are more cordial.[35] A strike is a means to fill the gap of asymmetric information about the employer's true willingness to pay for the labor and the union's true demand for their wages and compensations. If the information gap is smaller, a strike is less likely. In other words, the enterprise union system gives both the employer and the union less incentive to bluff, makes both sides' commitments more credible in the negotiation, and enables both sides to reach an agreement more easily than the industry-wide union system.

In sum, one lesson that Chinese investors should learn from Fuyao's experience—as a comparison to Toyota's experience—is that Chinese FDI will not earn public support if its success relies on low wages of production, which means that Chinese firms need to raise their productivity. Foreign firms cannot bring what they do not have in their home country. Thus, to set higher wages for American workers Chinese firms need to raise the productivity of their factories in China. Otherwise, Chinese FDI would lead to exporting the "race to the bottom" in labor standards. Overall, the productivity of SOEs is lower than that of private firms in China.[36] If the Chinese government implements SOE reform, the productivity of Chinese firms will rise and Chinese FDI will be received better in the United States.

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[35] David Flath, *The Japanese Economy*, third edition (Oxford: Oxford University Press, 2014), 363–70.

[36] Nicholas R. Lardy, *The State Strikes Back: The End of Economic Reform in China?* (Washington, DC: Peterson Institute for International Economics, 2019).

Perhaps most importantly, China should advance its domestic economic reforms for its FDI to be appreciated in the United States. In what aspect is China number one? In fact, China is notoriously number one in low prices of its exported products. Economic research shows that trade with China has been responsible for a significant part of the decline in U.S. manufacturing employment in the last two decades, but there is no evidence that trade with other developing countries is responsible for job or wage losses of U.S. workers. In short, *China is different*, because of its state capitalist system. One study estimates that U.S. trade with China from 1999–2011 led to net job losses of 2.0–2.4 million in the United States.[37] Another study finds that people who work in parts of the United States most affected by import competition from China tend to have greater unemployment and reduced lifetime income.[38] Subsidized Chinese SOEs have strong incentives to over-invest, and as a result they have excessive productive capacities and are able to export a product at a price below market price. Thus, the Chinese government's commitment to domestic economic reforms would affect the reception of Chinese investors in the United States. That the SOE reform has stalled under the Xi administration is cause for concern.

### *Obstacles to the State-Owned Enterprise Reform*

Xi originally advocated greater market reform to diminish the role of SOEs when his administration started in 2013. Having observed that China had maintained rapid economic

[37] Daron Acemoglu, David Autor, David Dorn, Gordon H. Hanson, and Brendan Price, 2016. "Import Competition and the Great US Employment Sag of the 2000s," *Journal of Labor Economics* 34, S1 (Part 2) (2016), S141–98.
[38] David H. Autor, David Dorn, and Gordon H. Hanson, "The China Shock: Learning from Labor-Market Adjustment to Large Changes in Trade." *American Review of Economics* 8 (2016), 205–40.

growth since 1978 primarily because of private firms, he had a good reason to expand the private sector and shrink the state's role in the economy, although SOEs still played major roles in the Chinese state capitalist economic system.[39] However, his SOE reform has made no progress and has instead intensified the role of the Chinese Communist Party (CCP) in the decision-making of SOEs. Following Xi's deviation from the SOE reform, economist Nicholas Lardy, who contended in 2014 that markets had driven China's economic growth, now argues that resurgent state dominance has begun to diminish the vital role of the market and private firms in the Chinese economy.[40] Political scientist Wendy Leutert shows that there are at least three obstacles facing the SOE reform: difficulty to determine the timing and method of reform, mismatched executive incentives, and the complexity of intra-firm obstacles.[41] Indeed, SOEs play a central role in China's industrial policy both at home and abroad such as in the Belt and Road Initiative (BRI), and as a result companies have developed a symbiotic relationship with the state.[42]

Moreover, the SOE reform has stalled because it would undermine the vested interests of the collusive and corrupt rent-seeking scheme that thrives under the state capitalist system. The Tiananmen democratization movement in 1989 reminded Deng Xiaoping that a market economy would lead to increasing popular demands for democratization. In the 1990s, the new President Jiang Zemin employed the cooptation strategy, encouraging former officials and former SOE managers to start businesses by using their political connections, and this strategy prevented the

[39] Nicholas R. Lardy, *Markets over Mao: The Rise of Private Business in China* (Washington, DC: Peterson Institute for International Economics, 2014).
[40] Lardy, *Markets over Mao*; Lardy, *The State Strikes Back*.
[41] Wendy Leutert, "Challenges Ahead in China's Reform of State-Owned Enterprises," *Asia Policy* 21 (2016): 83–99.
[42] Min Ye, *The Belt Road and Beyond: State-Mobilized Globalization in China, 1998–2018* (New York: Cambridge University Press, 2020).

market economy from threatening China's one-party rule.[43] Those who benefit from the state capitalist system do not want to see the SOE reform that would diminish the benefit of the revolving door built between the CCP and SOEs. In short, since the 1990s the CCP has used the state capitalist system to maintain popular support for one-party rule by distributing economic rents. The power struggle over distributing these economic rents became especially severe after Deng's death in 1997, when China lost its last charismatic leader who had participated in the Communist Revolution. Such a severe intra-party power struggle over distributing rents among the collective leadership was a necessary consequence of maintaining one-party rule while advancing a market-oriented economy.

Furthermore, these vested interests are rooted in patron-client relationships between businesses and bureaucrats in various departments of municipal governments that manage SOEs.[44] By competing in offering businesses government funding and tax breaks, local bureaucrats have been able to attain political achievements under the cadre evaluation system, gain authority over policies, and consolidate patron-client relationships with businesses. As a result, many of these firms, which found their own bureaucratic patrons, are not motivated to upgrade and raise their productivity, and are instead competing in a "race to the bottom" for predatory pricing. Moreover, confronting the reality that China has less secured property rights protection, as do other authoritarian countries, private entrepreneurs have a strong incentive to form collusive

[43] Jie Chen and Bruce J. Dickson, *Allies of the State: China's Private Entrepreneurs and Democratic Change* (Cambridge, MA: Harvard University Press, 2010); Kellee S. Tsai, *Capitalism Without Democracy: The Private Sector in Contemporary China* (Ithaca, NY: Cornell University Press, 2007).

[44] Ling Chen, *Manipulating Globalization: The Influence of Bureaucrats on Business in China* (Stanford, CA: Stanford University Press, 2018).

relationships with local bureaucrats to protect their wealth against state predation.[45] Consequently, since the 1990s the major source of economic growth in China has shifted from rural entrepreneurship to state capitalism, even though there has been continuous growth of private capitalism in urban areas.[46]

Many of the nominally private entrepreneurs are successful because of their political ties with local bureaucrats that were established during their previous professional experience as an SOE manager or as a government official.[47] Not surprisingly, those who have strong ties to local bureaucrats do not demand democratization but support the current one-party rule.[48] Because the CCP successfully created the collusive and corrupt vested interests of its business class, nominal privatization of the SOEs in the 1990s formed the basis of the CCP's cooptation strategy under state capitalism. Financial backing from the Chinese government allows Chinese SOEs to take extra risks and make them less interested in raising workers' productivity.[49] China's outbound investment is dominated by SOEs, which take advantage of better access to credit and monopolistic power in the domestic market, and then find it difficult to compete globally.[50] In short, the Chinese economy needs structural reforms such as the SOE reform to increase productivity in the long run, but Xi has prioritized political control over economic efficiency.

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[45] Yue Hou, *The Private Sector in Public Office: Selective Property Rights in China* (New York: Cambridge University Press, 2019).

[46] Yasheng Huang, *Capitalism with Chinese Characteristics: Entrepreneurship and the State* (New York: Cambridge University Press, 2008).

[47] Chen and Dickson, *Allies of the State*.

[48] Teresa Wright, *Accepting Authoritarianism: State-Society Relations in China's Reform Era* (Stanford, CA: Stanford University Press, 2010).

[49] Weiyi Shi, "The Political Economy of China's Outward Direct Investment," Ph.D. Dissertation, University of California, San Diego, 2015.

[50] Xiaojun Li and Ka Zeng, "To Join or Not to Join? State Ownership, Commercial Interests, and China's Belt and Road Initiative," *Pacific Affairs* 92, no. 1 (2019): 5–26.

*Global Value Chains and the State-Owned Enterprise Reform*

The development of GVCs over the last three decades has brought a new international division of labor between developed and developing countries, as well as between democratic and authoritarian states.[51] Closely associated with the growth of GVCs is the growth of intra-industry trade, in which components and parts are traded across national borders when moving from one production stage to another. GVCs based intra-industry trade requires a different kind of rule-making for international trade. As more international economic interactions have become GVCs based trade, the focus on trade negotiations has shifted from lowering tariffs—and other trade barriers imposed at the national border—into building rules on domestic regulations such as rules of origin, customs administration, FDI, SOEs and government procurement, intellectual property rights, labor and environmental conditions, regulatory coherence, anti-corruption measures, and dispute settlement, to name a few. Thus, if a country benefits from GVCs based trade, as China does, it would have a strong incentive to be committed to the politically sensitive domestic economic reforms that would promote GVCs based trade—such as the SOE reform. These domestic economic reforms would undermine collusive and corrupt rent-seeking schemes—such as the vested interests based on the SOE system in China. Therefore, GVCs based trade empowers reformists vis-à-vis those who benefit from the rent-seeking.

At the same time, in developed countries, GVCs based trade has made it increasingly difficult to protect domestic producers with protectionism because restrictions on trade may hit the domestic firms that use imports as inputs under GVCs based trade. The path toward intra-industry trade means that interests in trade may be industry-specific. For example, the U.S. imposition of

[51] Fukunari Kimura, "How Have Production Networks Changed Development Strategies in East Asia?", in *Global Value Chains in a Changing World*, ed. Deborah K. Elms and Patrick Low (Geneva: WTO Publications, 2013), 361–84.

tariffs on auto parts under the Trump administration has hurt domestic auto producers that use imported components and parts, even though Trump and his mercantilist cabinet members have argued that tariffs will protect them. Car tariffs—presumably designated to protect the jobs of U.S. autoworkers—have raised production costs of car manufacturing in the United States. As a result, for example, in 2018 GM announced that it would close four plants in the United States and one in Canada, cutting 14,000 jobs—although GM denies that the Trump administration's protectionist policy is the reason for the job cuts.[52]

As Chinese and Japanese FDIs are both involved in GVCs based trade and the American economy benefits from GVCs based international economic transactions, Japanese experience suggests that Chinese FDI in GVCs connected manufacturing sectors would be more beneficial to both the U.S. and Chinese economies than investment in other sectors such as real estate. When a Japanese manufacturing company opens a new affiliate abroad, that company's employment in Japan tends to *increase*, because a certain stage of new production in a foreign affiliate also *creates* another stage of new production in Japan.[53] Thus, as long as China is involved in GVCs based international economic transactions, Chinese investment will benefit all the countries connected by GVCs.

However, the Xi administration's strategic plan Made in China 2025 is turning China away from the GVCs based international trade. Made in China 2025 is the government's ten-year plan aiming to achieve 70 percent self-sufficiency in high-tech industries by 2025 and to seek a dominant position in the global markets by 2049—the hundredth anniversary of the People's

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[52] Martin Sandbu, "Tariffs Are Bad for GM and Bad for America," *Financial Times*, November 28, 2018, https://www.ft.com/content/db323146-f24d-11e8-ae55-df4bf40f9d0d.

[53] Mitsuyo Ando and Fukunari Kimura, "Evolution of Machinery Production Networks: Linkage of North America with East Asia," *Asian Economic Papers* 13, no. 3 (2014), 121–60.

Republic of China.[54] To achieve this goal, the strategic plan includes localizing and indigenizing technologies and brands, substituting foreign technologies, and capturing global market share. It is a means for the state to protect the domestic industry—especially SOEs—from foreign competition and to control the market to determine winners and losers. As long as Xi gives a priority to political control over economic efficiency with Made in China 2025, it is more difficult for the United States and its allies to manage China's economic rise and stay competitive in the globalized economy.

*Is China a Responsible Stakeholder?*

Although China is eager to expand its influence in the world, it is not clear whether China's rise is appreciated. The outsized presence of SOEs in Chinese overseas investment has provoked concerns in host countries. In addition, Xi's nationalist slogans, such as "Chinese dream" (*Zhongguo meng*) and the "great rejuvenation of the Chinese nation" (*Zhonghua minzu weida fuxing*), make other nations doubt whether China will behave as a responsible stakeholder for regional stability and security. As a result, while the BRI has emerged as the most important foreign strategy in China since 2016, foreign observers have become extremely concerned with the nationalist nature of its geostrategic implications.

In order to lead the world, China would have to persuade other states to follow its leadership. However, China does not seem to feel any responsibility for regional stability and security. Thus, so far China has found it difficult to play the leadership role in international relations. While Xi tightens his political control at the cost of economic efficiency to manage

[54] James McBride, "Is 'Made in China 2025' a Threat to Global Trade?" Council on Foreign Relations, https://www.cfr.org/backgrounder/made-china-2025-threat-global-trade.

domestic politics, he tries to project China's power in whatever way he can in international relations.[55] Backed by newly acquired economic power, China seems interested in breaking the ties between the United States and its allies, lowering U.S. influence, and expanding its own influence in the Asia-Pacific region.

## IMPLICATIONS FOR U.S.-CHINA RELATIONS

Should the United States accept Chinese investment? The argument developed in this paper implies that the answer would be affirmative *if* the investment creates well-paid jobs for American workers. The SOE reform is essential for Chinese FDI to meet this condition, but the Xi administration would have to face the backlash from those who have vested interests rooted in the SOE system. The stagnation of SOE reform suggests that Xi is not strong enough to be fully committed to the reform even though he has more concentrated power than any Chinese leader since Mao Zedong.

Thus, the United States should encourage the Chinese government to commit to SOE reform, which would benefit both China and the United States. Returning to the Trans-Pacific Partnership (TPP)—which was originally a U.S.-backed trade agreement but is now led by Australia, Canada, Japan, and Mexico—would be the first step. When the international negotiation of the TPP was concluded in October 2015, U.S. President Barack Obama said that "we can't let countries like China write the rules of the global economy."[56] The TPP was expected to play an important rule-making role to further develop GVCs based trade in the Asia-Pacific region,

[55] On this point, see Elizabeth C. Economy, *The Third Revolution: Xi Jinping and the New Chinese State* (New York: Oxford University Press, 2018).
[56] "Statement by the President on the Trans-Pacific Partnership," The White House Office of the Press Secretary, https://obamawhitehouse.archives.gov/the-press-office/2015/10/05/statement-president-trans-pacific-partnership.

requiring the participating nations to be committed to domestic economic reforms. Thus, after the Trump administration withdrew the United States from the TPP, Japan—the third largest economy that benefits from GVCs based trade following the United States and China—took the initiative to conclude a new agreement with the other 10 nations now named the Comprehensive and Progressive Agreement of Trans-Pacific Partnership (CPTPP): that is, almost the same set of rules agreed upon by the original 12 signatories but not requiring U.S. participation.

The CPTPP should be open for China's participation in the future. The option to opt into the CPTPP would push the Chinese government to commit to the SOE reform, even if China is not an immediate signatory of the CPTPP. If China implements the SOE reform, the CPTPP including China would further deepen regional economic interdependence. If China does not implement the SOE reform, the CPTPP would give its signatories an advantage to help them confront China's challenge to the current rule-based liberal international order. While the CPTPP would serve this purpose, the Chinese-led trade agreement Regional Comprehensive Economic Partnership would not.

The Trump administration should pressure China to advance the SOE reform; however, abandoning the TPP was the wrong approach to take to achieve this goal. Chinese government leadership is divided between reformist internationalists and anti-reformist nationalists. The hardliner stance taken by the Trump administration has empowered the anti-reformist nationalists vis-à-vis the reformist internationalists, making it more difficult for the Xi administration to gain support for committing to the SOE reform. By contrast, if the United States returned to the TPP (now the CPTPP), the United States would have leverage to pressure Xi into implementing his reform agenda transforming China's economic structure. Most importantly, this pressure would benefit both the United States and China—and it would benefit U.S. workers, too.

*Implications of the COVID-19*

COVID-19 threatens both the U.S. economy and Chinese economy because both economies are connected to each other and to the global economy through GVCs based trade and FDI. However, there is concern for long-term damage to the Chinese economy. The Chinese economy had already slowed down *before* the pandemic as the SOE reform stalled under the Xi administration. By contrast, in the long run the fundamentals of the U.S. economy will be strong as long as foreign investment continues to create jobs for American workers. Foreign companies—especially German, Japanese, and Korean companies—invest and create jobs in the United States thanks to GVCs.

Over the last two decades, China has become an economic powerhouse in the international arena through its involvement with GVCs. China has shown its intention to replace the United States as the leader of the global economy, a role the United States has played since the conclusion of World War II. For example, President Xi gave a clear statement opposing protectionism in the 2017 World Economic Forum in Davos. However, for China to lead the global economy, it first must commit to the SOE reform and Xi must face the backlash from anti-reformist nationalists. Now that the United States and China are turning to nationalism, Japan and Germany—the third and fourth largest economies—have the potential to take the leading role to maintain the international economic order.

China also has ambitions to become a political leader in the international arena. Many have seen China's rise as a threat to U.S. leadership in Asia and beyond. Contrary to conventional wisdom, a "weak China" is not good news for the world, because China is already strong enough to destabilize the Asia-Pacific region and to influence economic and political affairs worldwide.[57] This does not change with the pandemic of COVID-19. China is nowhere near powerful or responsible enough to be considered a global competitor of the United States—unless the United States itself abandons the leadership role. As the Trump administration lowers the credibility of U.S. commitment to regional security in East Asia, the possibility of the United States abandoning its role is of growing concern.

[57] On this point, see Thomas J. Christensen, *The China Challenge: Shaping the Choices of a Rising Power* (New York: W. W. Norton & Company, 2015).