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Economics of the 2016-2017 Debate Topic:

U.S. Relations with China, Mixing Cooperation with Competition

Debate Backgrounder No. 9 by Doug Bandow December 2016

"Resolved: The United States federal government should substantially increase its economic and/or diplomatic engagement with the People's Republic of China."

Dallas Headquarters:
14180 Dallas Parkway, Suite 350
Dallas, TX 75254
972.386.6272

www.ncpa.org

Washington Office:
202.830.0177
governmentrelations@ncpa.org

NCPA National Center for Policy Analysis

There is no more important bilateral relationship than that between the United States and China. Yet the Congressional Research Service warns that ties have "become increasingly complex and often fraught with tension."[1] Relations appear likely to become even more fractious with the election of Donald Trump as president. Every four years the People's Republic of China (PRC) becomes a presidential election issue, but Americans deserve a better explanation of the importance of U.S.-China political and economic relations than candidates' sound-bytes.[2]

The Complicated Relationship with China. China is an emerging great power and perhaps eventual superpower that is challenging Washington in several key areas. The economic benefits for the United States of its relationship with China seem obvious, but many Americans wonder if the difficulties outweigh the benefits.

The PRC possesses the world's second largest economy and has become both commercial partner and competitor with the United States. Trade between the two nations is beneficial because of comparative advantage; that is, each country is relatively better at producing some items than the other. This economic concept is the foundation for trade throughout history.[3]

However, international commerce today is about politics as well as economics. Trade and investment disputes have multiplied between the two governments while China remains the fount of extensive cyber-espionage targeting U.S. business secrets. Continuing the relationship depends on the ability of the two governments to work through these often contentious disputes.

American interest in the theoretically illimitable markets of China can be traced back for more than a century, save for a pause after the Communist Revolution of 1949, when Americans had very little contact with the PRC. Following the 1972 China-U.S. opening and eventual economic transformation, however, the PRC turned into the world's most important trading nation. Combined U.S.-China trade was just $2 billion in 1979.[4] By 2015, bilateral commerce reached roughly $665 billion annually.

Trade Controversies Play Out in Numerous Forums. The United States continues to press Beijing for full implementation of its obligations under the World Trade Organization (WTO) — an intergovernmental agency responsible for regulating international trade. According to the U.S. Trade Representative, problems persist involving lack of transparency for trade rules, limits on trading and distribution rights, inadequate protection of international property rights (IPR), industrial policies that promote Chinese businesses, discriminatory health and safety rules, and limits on foreign trade and investment in services.[5] China has also yet to join the WTO's Government Procurement Agreement.[6]

As a result, the United States has launched numerous cases under the WTO and domestic American law against the Chinese government. (In turn, China has filed several cases against Washington.) Moreover, the United States has applied so-called countervailing duties in response to alleged Chinese "dumping" of products below cost. However, that exercise is highly political, given the difficulty of assessing actual production expenses, and primarily transfers wealth from consumers to politically well-connected producers. A unilateral 45 percent tariff, as proposed by Republican presidential candidate Donald Trump, would act as a huge regressive tax on U.S. consumers, as well as violate American obligations under the WTO.

Meanwhile, many in Washington have pushed the Trans-Pacific Partnership, which involves most of East Asia's most important economies, except China. Allowing China to join TPP would provide leverage to break down more of Beijing's trade barriers, including market restrictions on investment and services, and aid to state enterprises.[7] However, if Congress refuses to ratify TPP, Beijing's strategy of promoting bilateral free trade agreements will become more attractive to its neighbors and other countries.

The United States has always been a trading nation. Greater access to inexpensive products boosts the purchasing power of the incomes of U.S. consumers, especially those of modest means. Lower production costs also help U.S. firms compete around the world.

Of course, some American jobs have migrated to China as a result of imports from that country. By one estimate, 2.4 million jobs have disappeared due to Chinese imports. However, trade economist Phil Levy warns that it is difficult to disentangle the impact of technological change as well as the rise of domestic competition to established firms.[8] For instance, rising productivity, allowing more goods to be made with less labor, rather than production shifting to China, accounted for 90 percent of U.S. manufacturing job losses between 2000 and 2010.[9]

Moreover, the alternative to imports from China for many products is imports from other developing countries. Indeed, rising wages in the PRC have begun to drive manufacturing to lesser-developed nations. In any case, the loss of specific jobs does not reduce employment overall because the economy benefits from lower prices, which generate new opportunities. The number of jobs in America has risen along with the increase in Chinese imports.

Nevertheless, the trade deficit has become a political issue. In 1990 the United States ran a $10 billion merchandise deficit. In 2015, the gap was $366 billion ($336 billion including services, in which America ran a surplus).[10] However, no system of free trade could yield balance for everyone, whether bilaterally or in aggregate. Germany, with a very different economy, ran a $75 billion merchandise surplus with the United States in 2015, second only to China.[11]

The Trade Deficit Is an Accounting Fiction. The U.S. trade deficit is inflated by goods shipped to the PRC for assembly. For instance, trade attorney Scott Lincicome points out that Apple earns hundreds of dollars for every iPhone sold. Yet, when sent to America, each device technically adds about $300 to the trade deficit, even though China's contribution to it is barely $6.[12] Though assembled in China, much of the iPhone is made in the United States and other countries [see the table].

Where the Components of an iPhone Are Made (iPhone 5 and 6; software not included)
Accelerometer: Germany and United States
Audio Chipsets and Codec: United States
Baseband processor: United States
Batteries: South Korea and China
Cameras: Japan and United States
Chipsets and Processors: South Korea, Taiwan and United States
Controller Chips: United States
Display: Japan and South Korea
DRAM: Taiwan and South Korea
eCompass: Japan
Fingerprint sensor authentication: China and Taiwan
Flash memory: Japan and South Korea
Gyroscope: France and Italy
Inductor coils (audio): Japan
Main Chassis Assembly: China
Mixed-signal chips: Netherlands
Plastic Constructions (for the iPhone 5c): Singapore
Radio Frequency Modules: Taiwan and the United States
Screen and Glass (for the display): United States
Semiconductors: United States
Touch ID sensor: Taiwan
Touchscreen Controller: United States
Transmitter and Amplification Modules: United States
Source: Christopher Minasians, "Where are Apple products made? How much does the iPhone cost to make? A comprehensive breakdown of Apple's product supply chain," *Macworld (UK)*, November 24, 2016.

In any case, Chinese accumulate dollars only to use them. For instance, the PRC currently is the third largest buyer of American exports: $116 billion in goods and $45 billion in services last year.[13] Private consumption is still low, but increasing far faster than in the United States. As more Chinese enter the middle class they will purchase more imports: McKinsey & Co. predicts China will have 630 million middle class households by 2022.[14] The congressionally chartered U.S.-China Economic and Security Review Commission observed that China's "focus on services and technology may create one of the world's largest consumer markets, generating up to $6 trillion of new market opportunities" for American firms.[15]

Moreover, the PRC held $1.24 trillion in U.S. federal debt as of July 2014, the most of any foreign nation. This has sparked concern that Beijing may use its financial holdings to influence U.S. policy or hurt the U.S. economy.[16] However, so far there have been plenty of other buyers of federal debt. Further, any attempt at economic war would cost the PRC dearly.

A wealthier China also invests in American businesses, with this year's total running around $30 billion, twice that of 2015. More than 1,900 Chinese-affiliated firms are located in the United States, employing roughly 90,000 people. Many of these enterprises export to the PRC.[17]

Security Concerns in the U.S.-China Relationship. Proposed investments that involve technology transfers are subject to review by the interagency Committee on Foreign Investment in the United States (CFIUS). An area of particular concern is American business involvement with Chinese enterprises tied to the People's Liberation Army. Transfers of even civilian technology to such companies may aid Chinese military capabilities, some analysts warn.[18] There is general agreement that such transactions should be regulated, though exactly how remains a matter of dispute.

Unfortunately, some transactions are targeted more for political reasons rather than security purposes, leaving some Chinese companies pressured to abandon purchases that pose no conceivable threat to U.S. security. For instance, in early 2016 the Chinese insurer Angbang dropped its offer for Starwood Hotels, which ultimately punished Americans rather than making them more secure. Even still, some legislators want to enact even more rigorous standards.

In turn, China limits American investment. The PRC has the most restrictive framework for foreign investment of any major industrialized nation. Beijing uses foreign investment to promote its economic ends, breaking sectors into “encouraged,” “restricted” and “prohibited” categories. The Congressional Research Service points to “a number of challenges, including local protectionism, lack of regulatory transparency, [international property rights] theft, and discriminatory license practices.”[19] Furthermore, China’s antimonopoly law, approved in 2007, has been employed disproportionately against foreign firms.[20]

U.S. investors have often been required to transfer technology as a condition of doing business in the PRC, contrary to Chinese promises made under the WTO. Meanwhile, foreign companies have been forced to set up local research and development operations. Inconsistent enforcement and pervasive corruption have long troubled American firms, some of which recently found themselves under legal attack for what appear to be political purposes. In mid-October 2016, China’s State Council, or cabinet, promised to streamline rules governing foreign direct investment. Although a step forward, Jake Parker of the U.S.-China Business Council complained that “these measures clearly fall short of the significant liberalizations needed to reinvigorate foreign investors’ moderating confidence in the China market.”[21]

More broadly, President Xi Jinping’s ideological crackdown has taken on a xenophobic edge, chilling international cooperation and discussion. Chinese women have even been warned against dating Westerners who might be prowling for state secrets. A survey this year found that almost four of five U.S. businesses felt less welcome in China.[22] U.S. investment in the PRC has slowed.

The two governments have pledged to limit reviews to genuine national security concerns. They also promised to speed negotiations on a bilateral investment treaty, which would enhance protections for U.S. investors. The implementation of such a plan remains a challenge.

Compromise of Intellectual Property and Cyber Threats. The protection of Intellectual Property Rights (IPR) remains a serious problem. Under U.S. pressure the PRC has strengthened legal protections, but piracy continues. In 2013, for instance, China was believed to account for as much as 80 percent of global IP theft, potentially costing U.S.-based businesses more than $240 billion.[23] Although Beijing blames the problem on inadequate enforcement resources, some American analysts view IP theft as China’s conscious appropriation of Western technology for its own development. Despite improvement in Chinese laws, regulations and judicial procedures, Beijing still appears to tolerate if not encourage IP infringement.[24]

A related issue is cyber-warfare, which some have termed the “great brain robbery.”[25] In a July 2016 report, James Scott and Drew Spaniel of the Institute for Critical Infrastructure Technology contend that cyber-war is intended “to not only steal but to economically interrupt and cripple.”[26] Chinese hackers thought to be acting with government support extracted employee information from the federal Office of Personnel Management in 2015.[27] Cyber-attacks on private firms have become routine.

In 2015 the United States forged an agreement with Beijing to forswear use of cyber-attacks for commercial advantage, while recognizing that state-to-state spying is inevitable. Neither government is to “conduct or knowingly support cyber-enabled theft of intellectual property.”[28] Since then, Chinese hacking, as measured by the security firm FireEye, has fallen substantially.[29] But Chinese cyber-attacks have not ceased, and efforts might have become more focused and sophisticated, and thus, better hidden.

Countermeasures remain paramount. American companies should be the first line of defense against foreign cyber-attacks and federal law should be changed to encourage U.S. enterprises to vigorously defend themselves, retaliating when appropriate and "hacking back" to erase stolen data. Moreover, government agencies need to coordinate their defenses.

Increased international cooperation is also necessary. Last year, the president instructed the Treasury Department to penalize any businesses complicit in cyber-attacks; Congress should empower the president to impose appropriate commercial sanctions against any foreign entity found to have benefited from cyber-espionage. The best approach to China would be persistent diplomatic pressure backed by better private security and credible threats of official retaliation.

The Issue of Currency Manipulation. Chinese economic growth has been based on an export-oriented economic strategy. For years Beijing pegged the yuan to the dollar, preventing the exchange value of the yuan from rising relative to the dollar. Though Beijing finally allowed what has been called a "managed float" for the yuan, it has used various techniques, including purchasing U.S. dollars and dollar-denominated assets, to hold down the yuan's value. This was intended to spur exports, encouraging the growth of domestic firms and employment.

The PRC is not alone in following what C. Fred Bergsten of the Peterson Institute for International Economics called an "economically distortive and protectionist" policy.[30] Even Washington has done so at times. However, this policy punished Chinese consumers and firms dependent on imports by making foreign goods more expensive. Moreover, a cheap Chinese currency acted as a subsidy for American buyers.

It might not even put U.S. producers at a disadvantage. The Cato Institute's Dan Ikenson points out that "with the proliferation of global supply chains and cross-border investment, the overwhelming majority of trade flows today are intermediate goods, so the effect of currency values on final prices cuts in different directions."[31] This may explain why both China's trade surplus and the yuan's value have increased in recent years.

In fact, official Chinese support for a cheap yuan may have waned. As China's competitive edge declined, some economists argued that the yuan was appropriately priced or perhaps even inflated in value. Forced devaluation would harm Chinese workers, who are demanding higher pay, and firms that have taken on foreign debt. These groups represent a growing middle class that remains essential to political stability. Beijing also hopes to turn the yuan into a global standard, perhaps someday challenging the dollar as the world's reserve currency.[32]

The United States could retaliate against a "cheap yuan" policy with tariffs, countervailing duties, or counter-intervention in currency markets. But it is impossible to know the "right" value of the yuan. Last year, a month after the U.S. Treasury declared the yuan to be "significantly undervalued," the International Monetary Fund concluded that it was "no longer undervalued."[33] Moreover, many domestic policies, such as the Federal Reserve's quantitative easing, affect the value of a nation's currency, especially in international exchanges.[34] It likely would be best for Washington to allow any currency problem to correct itself.

China's International Presence. Beijing is using its added economic resources to expand control of natural resources, make business deals and win political influence in developing states, sometimes at American expense. Beijing has launched a high-profile "Silk Road" initiative (officially called One Belt, One Road, or OBOR) to link Asia with Africa, the Middle East and Europe. Already, almost a trillion dollars has been committed, and Beijing expects total investment to hit $4 trillion. Moreover, the PRC has invested in a number of nations under Western sanction, such as Burma/Myanmar, Sudan and Zimbabwe.

These efforts have raised concern in Washington. However, China's tight embrace has triggered backlash in nations as diverse as Burma, North Korea, Sri Lanka and Zambia, suggesting that Chinese overreach is sometimes the most effective counter to Chinese influence.

Beijing has been pressing for a greater say in established multilateral development banks, such as the World Bank and International Monetary Fund. Over American opposition, the PRC orchestrated establishment of a new multilateral development bank, the Asian Infrastructure Investment Bank.[36] The economic value of such institutions is overstated, but Beijing's move was a major political victory over the United States.

Centralized Chinese Economy Affecting Bilateral Trade Relationship. Though an estimated 60 percent of the Chinese economy is market-driven, the government influences economic decision-making in many different ways, distorting investment and trade. The Congressional Research Service points to "subsidies, tax breaks, preferential loans, trade barriers, FDI restrictions, discriminatory regulations and standards, export restrictions on raw materials (such as rare earths), technology transfer requirements imposed on foreign firms, public procurement rules that give preferences to domestic firms, and weak enforcement of IPR laws."[37]

In 2011, Beijing reported there were 144,700 public enterprises, or state-owned businesses.[38] The banking sector is dominated by government entities. Despite promises of reform, they have grown in importance in recent years. China's economy has been investment-driven rather than consumption-driven but, as private sector investment slowed dramatically, the government stepped in with public spending funneled through state enterprises to maintain growth. Many public firms are economic "zombies," operating at a loss and only through continued state support and cheap credit. A 2016 report from China's Renmin University estimated that more than half of steel firms, nearly half of real estate developers and a third of construction companies, most state-owned, were among the walking dead.[39] These inefficient, money-losing enterprises suck up resources that could be better employed elsewhere, hindering economic growth. In fact, the productivity of China's labor force is less than a third, perhaps substantially less, than the average among developed countries in the Organization for Economic Cooperation and Development.[40] Warned Chief Greater China Economist Harrison Hu of the Royal Bank of Scotland: "China's growth model has thus become more costly."[41]

Jingzhou Tao, managing partner of the Dechert law firm in China, criticized Beijing's failure to reduce centralized controls, support for uneconomic mega mergers and push for an expanded role for the Communist Party, saying "China is retreating from market-oriented reforms in order to pursue old-fashioned Soviet-style central economic planning."[42] President Xi once promised to "proceed with reform and opening up without hesitation."[43] However, more recently he called for "stronger, better, bigger" state enterprises.[44] The simplest explanation may come from Premier Li Keqiang, who in March 2016 said: "we have to prevent massive unemployment."[45]

Such policies have made the United States and Europe reluctant to grant China market economy status under the WTO. Of course, the United States uses many of these tools at both the state and federal levels. Nevertheless, government plays a much larger and more malign role in China. Many of these policies violate WTO rules and disadvantage American competitors. For instance, earlier this year Uber conceded the Chinese market to Didi, which received support from the PRC's sovereign wealth fund.[46]

Also of concern are China's high indebtedness, fragile banking system and real estate bubble.[47] A dramatic stock market crash in 2015 demonstrated that the Chinese economy would not always rise. Yet the government's clumsy efforts to prop up stock prices — including halting trading, prohibiting larger investors from selling, forcing brokerages to purchase shares and punishing journalists who reported pessimistic assessments — demonstrate that Beijing is ill-prepared for the economic crises that could come. The impact of such a meltdown would inevitably leap the Pacific.

Of course, the PRC retains important economic strengths, and so far has confounded pessimists. But fear of public opposition today stalls desperately needed reforms. With economic agencies disagreeing over policy ends and a major political shake-up coming next fall at the 19th Communist Party Congress, dramatic change is unlikely during the coming year. Even a so-called soft landing could have destabilizing consequences, since economic stasis would undermine a Communist Party whose legitimacy is down to providing a steady increase in living standards.

Diplomacy Remains the Key to a Beneficial Relationship. While Chinese-U.S. economic relations concern private firms and individuals, the issue remains political. Diplomacy helped create the relatively stable international order, which has enriched China and forced the PRC to accept international rules, such as through the WTO. Diplomacy, obviously important for resolving the many geopolitical issues between the two nations, will remain an important aspect of the commercial relationship as well. Resolving trade disputes, negotiating economic treaties, managing international organizations, addressing investment controversies, encouraging domestic economic reforms and reaching a degree of cyber-peace all require serious and intense diplomatic effort.

Handling this relationship will remain a challenge. Both countries would gain from further liberalizing the bilateral trade and investment regimes, though America has the most to gain from breaking down the PRC's higher barriers. Chinese firms already have easier access to and operation in the U.S. market, though they must undergo CFIUS review. (Chinese consumers and workers, too, would benefit from increased American investment in the PRC.) The two nations maintain several important bilateral contacts, including presidential summits, the U.S.-China Strategic and Economic Dialogue, the Joint Commission on Commerce and Trade, and ongoing investment and trade talks. These could be expanded by offering the PRC membership in TPP and even negotiating an omnibus free trade agreement with Beijing, though the latter steps would face significant political opposition at home.

Conclusion. Americans should not fear the future: The United States is likely to remain wealthier and more technologically advanced than China for many years, if not decades to come. The PRC's passage to national greatness could be rough, given its extensive economic and political problems. Said one Chinese businessman who has been investing in U.S. real estate: "The price of property in Beijing is very high, the stock market is crashing, and the real economy is not stable."[48]

Washington must exercise skill and nuance to work through current controversies. American officials must move beyond the sort of soundbites which characterize most presidential campaigns. Washington would do well to improve its own economic and budget policies while polishing its diplomatic skills.

Doug Bandow is a Senior Fellow at the Cato Institute. He also is a former Special Assistant to President Ronald Reagan and author of Foreign Follies: America's New Global Empire.

Notes

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