

## Friend or Foe? How the Pandemic is Shaping U.S.-China Relations

**Host:** Porter Schutt

**Guests:** Andy Rothman and Linda Yueh, Ph.D.

- 00:00:02 **Ken Stuzin:** This is Ken Stuzin. I'm a partner at Brown Advisory. Welcome to our NOW 2020 podcast. NOW stands for Navigating Our World. We are simply trying to understand the world better, to navigate some of the most pressing questions that are shaping our lives, our culture and our investment challenges. How will we navigate the future of capitalism, climate change, our geopolitical relationships, and, perhaps most importantly, how will the coronavirus pandemic affect these questions and so many others. NOW 2020 is the place where we'll bring together thoughtful experts and people who are trying to make a difference. As we look to the future, the one thing we know for sure is that none of us can figure this out on our own. At Brown Advisory, we are focused on raising the future, and we hope these NOW conversations will help do just that.
- 00:01:03 **Porter Schutt:** I've been fascinated with China for 28 years, since I first went there in 1992 and started working in Hong Kong. The story of China is about human potential and about power. And right now, it also represents the most important contest of ideas in the world. When China began to open up and grow, many people assumed it would become more like a Western democracy. Instead, it's gone its own way. It offers a different economic and political model and alternative values. That's why this coronavirus moment matters so much. Some big waves of change are likely to hit China.
- After the pandemic, the rest of the world may think differently about global supply chains and how much we rely on China to make essential equipment and supplies. That could leave China weaker. On the other hand, if China can manage the impact of the crisis and emerge relatively stronger, it'll take another leap forward on the road to becoming the world's biggest economy. And even more importantly, perhaps, China may be able to say to its people and to everyone else who is watching around the world, "Look, our system works." What would that mean for the balance of power in the world?
- 00:02:21 **MS1:** There are millions of American workers whose jobs depend on the sale of our goods abroad, making industrial sewing machines or trucks.
- 00:02:29 **MS2:** The meeting between the leaders of China and the United States is to seek the normalization of relations between the two countries.
- 00:02:38 **MS3:** With America and China going forward, hand in hand.
- 00:02:42 **MS4:** What we have said to the Chinese, and we've been firm consistently about this, is you have to recognize that with increasing power comes increasing responsibilities.
- 00:02:53 **Porter Schutt:** I'm Porter Schutt, and I'm a partner at Brown Advisory. It's my great pleasure today to welcome two people who really understand Chinese economics, politics and culture. Linda Yueh is a fellow in economics at the University of Oxford and a professor at the London Business School, and Andy Rothman, who I've known for 25 years, is an investment strategist at Matthews Asia. So let's get started.
- Well, welcome Andy Rothman, Linda Yueh. It's so nice to have you here with us today.
- 00:03:27 **Linda Yueh:** Thank you, Porter. It's a real pleasure.

- 00:03:27 **Andy Rothman:** Thanks, Porter. Looking forward to the conversation.
- 00:03:30 **Porter Schutt:** There's a lot to unpack here. Let's start with the big picture before we drill down. Today, China accounts for one-third of all global economic growth. They account for more global growth than the U.S., Europe and Japan combined. How did we get here? Andy, let's start with you. You've been paying attention to China for a long time. How have you seen China and the U.S.-China relationship evolve?
- 00:04:00 **Andy Rothman:** When I first went to China as a student in 1980 or went back to work there as a very junior American diplomat in Guangzhou in 1984, the place was pretty dismal from every aspect and showed few signs of becoming better. So I think that my optimism today is in part due to having seen how bad things were for so many years and then how it turned around in the 1990s. But if you go back to when I started doing this, it would have been impossible to imagine how much the role of China in the world from a political or an economic or a social and cultural perspective has changed over the last four decades. And even when we were negotiating the WTO entry of China in the 1990s when I was in the U.S. Embassy in Beijing --
- 00:04:57 **MS5:** I think it would be a very good thing for the world and a very good thing for the Chinese if China were in the WTO. But the reason it would be a good thing is that it would give them participation in a rural-based system where you could have more and more open trade on fair and balanced terms. So the entry has to be a decision --
- 00:05:19 **Andy Rothman:** And, for example, I worked on the financial services part. We didn't anticipate that American investment banks and brokerage firms were really going to be eager to get into China, because what would you possibly be wanting to do there in terms of making money in the financial sector? So we really underestimated how fast things would move on those fronts, but we were also encountering then people who were saying that getting China into the WTO was going to be a disaster for China. It was going to destroy their agricultural economy, and that was going to be the end of China. So it was really polar opposites back then -- just like today, polar opposite views on what's going on with China now and its role. But the politicization of it harkens back to the way Americans thought about China maybe in the 1950s.
- 00:06:10 **Porter Schutt:** Linda, could you set the context of your time and how you've seen China change over your career?
- 00:06:19 **Linda Yueh:** The China that began to open up in the '80s and '90s, it was a, you know, remarkable period. Studies basically show that the majority of China's poverty reduction actually happened in those two decades. But I think the 21st century has heralded something somewhat different. As China has become middle income and as it was moving out of a kind of catch-up phase and more establishing itself as a player on the international stage, its economic development started to have a lot more impact on the global economy. The China of the 21st century wants to have a role in the international system. So, for instance, emerging economies like China setting up its own Asian infrastructure investment bank -- so basically setting up its own supernational funding organization, you know, setting rules. So to me, that's probably been the biggest change of China in the 21st century. And I haven't even mentioned the Belt and Road Initiative, where China's become a net capital exporter. So its investments in the New Silk Road, East Africa, Southeast Asia, all of that has had an economic as well as a geopolitical effect.
- 00:07:42 **Porter Schutt:** I guess I'd like to dig in just a little deeper on what do you think the role that they want to have is, and maybe, Andy, I'd turn to you and say, what do you think the long game is for Xi Jinping?
- 00:07:57 **Andy Rothman:** Well, before we look ahead, I think it's useful to look back for a moment because I think one of the biggest problems in U.S.-China relations right now is hardly anybody seems to recall how bad things were across the board in China and between the U.S. and China, and how much they've improved for Chinese people and for the rest of us over the last four years of engagement. So we hear U.S. officials talking all the time about how engagement, including bringing China into the WTO, has been a failure because, hey, China's not a liberal Western democracy like us right now. But I think this is a mistaken view on a number of scores. If you think about for Chinese people how poor they were. You know, when I first went to China, you'd drive in from the airport, and you'd help the farmers thrash their rice because they would put the rice out on the

road and you'd drive over it on your way in from the airport, which then meant when you got the restaurant, you ate a bowl full of rice with lots of little rocks in it. There were no fresh vegetables during the winter, even in southern China. The standard of living was just really poor. Back then, if you were a Chinese person with relatives coming to visit from overseas, you hoped when they came to visit, they might bring you a radio or an electric fan or a bicycle. This is now the population that accounts for one-third of global luxury sales.

I think also that Chinese people's lives are a lot less repressed than they were back then. Back then, the party would tell people where to live, where to go to school, what to study. When you finished school, they'd assign you to a job -- serious abuses of human rights and no political freedom. But for most Chinese people, life has improved dramatically over a few decades, both in a material sense and in terms of personal, if not political, freedom. It's also worked really well for Americans. One of the reasons that we enjoy the lifestyle that we do here is we've had the benefit of inexpensive labor and supply chains in China. We would not all be able to afford mobile phones without that, for example.

Where the problems have come have largely been of our doing, I think, whereas we knew once we started those Bretton Woods organizations that Linda was talking about that there was going to be disruption. When GATT, the predecessor to the WTO, was signed into law, Kennedy noted that globalization was going to have an impact on employment in the United States, but we really didn't do anything to help workers adjust to that, and we still have that problem.

So I think we need to take a step back before we think about what's going to happen next with China and really think about what we've done over the last 40 years. Has it achieved the objectives that we legitimately set out at that time, including opening up markets for us? U.S. exports to China since they joined the WTO are up over 500%, whereas our exports to the rest of the world are up 100%. Yeah, they have problems with market access and IP [intellectual property], but they've opened up enough that until the virus came around, Nike had 22 consecutive quarters of double-digit revenue growth with an EBIT higher in China than in North America. GM sells more cars in China than it does in the United States. So some things have worked. And then we have to stop and ask ourselves if we did not engage at this level with China over the last several decades, what would China look like today, and what would our relationship with them look like?

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**Porter Schutt:** I think it's a good chance to turn as we think about the virus and the coronavirus and the impact on globalization. A statistic that jumped out to me [from] a quote that I read was China's pharmaceutical firms manufacture more than 90% of the antibiotics, ibuprofen, hydrocortisone and vitamin C that's sold in the United States. How will the coronavirus shape this globalization or this de-globalization that is in front of us at the moment?

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**Linda Yueh:** I think it's going to cause quite a lot of countries to think about supply chain diversification. And I think what this coronavirus has shown is the extent to which you do rely on China, or East Asia, or a set of countries for supplies. And even before the virus traveled west, the effects were being felt in the first few months of this year in Europe and in the United States because of supply disruptions of things that were produced in China but obviously were not being produced because production had been shut down. So I think for both of those reasons, there will be another look at the extent to which there is enough supply chain diversification.

And I would just stress the other driving factor of it is there was always the case that there was greater reshoring back to the United States of advanced manufacturing. So all of that was already happening, and I think what this virus has done is added a geopolitical lens to it as well as a diversification, more of a pressing need to say we can't be reliant on one set of countries for things which we're going to deem essential.

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**Porter Schutt:** Andy, how has your thinking changed around this topic of globalization, given the virus?

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**Andy Rothman:** Well, I agree with a lot of the points that Linda just made, including that this is an acceleration of a process that's been underway for a while. What I worry about is not the diversification, so that if there's, for example, a typhoon or an earthquake in Japan, you don't have all of your manufacturing there, all of your supply chain there. That makes sense to me. What doesn't make sense is governments asking their businesses to move supply chains based on the governments' political relationship with the government in China. That, I think, is doomed to fail. And I think that the reshoring argument doesn't hold up

much weight.

I don't think there's been a considerable or a significant reshoring of jobs back to the United States for a variety of reasons, including that how many of us want our kids to work in factories assembling iPhones? If you've been in these kinds of factories in China, it's not something that you want to aspire to come back here. So I think we need to be careful to allow the economics and demographics and supply chain security for natural disasters to work without overlaying too much politics on it.

00:15:13 **Porter Schutt:** As I think about the China of the past, it was manufacturing of shoes and toys and assembly of products. But today and going forward, there is a large initiative by the government to boost their higher-tech capabilities, particularly around artificial intelligence. I was struck by a comment that artificial intelligence deployment will add more than \$15 trillion to global GDP by 2030. And China's share is projected to be almost half of this and double the United States'. When it comes to artificial intelligence, Linda, should we think of China as a partner, which is often the view from Silicon Valley, or as an adversary, which seems to me the typical policy view from Washington, D.C.?

00:16:15 **Linda Yueh:** I think on some things they are partners, and I think on other things, Chinese companies will be competitors. That, as far as I know, is not unusual in the tech world. You have some things you partner on and then other things you're fiercely competitive about. I think some of the advances in terms of Chinese AI, in terms of the kind of cutting-edge technology -- you do see some companies who are outside of China demonstrating perhaps some of that. I'm thinking of Pony.ai, the autonomous car company. It's one of the Chinese-based companies invested in by, you know, global automakers is just one example. But I think in general, it's quite hard to gauge how cutting-edge Chinese technology is, and this has been an issue for quite some time, because you can be a very big company and never have left China because the market is so large. So some of the names that will be known to the rest of the world, like Alibaba or Tencent -- well, let's take Alibaba, for instance. It doesn't do a great deal of business outside of China, but it's absolutely massive. So there's an element of Chinese policy, which basically wants its big companies to test themselves on the global market to see if they are truly competitive. The other reason why it's very hard to gauge how innovative Chinese tech companies are is that China lacks some of the metrics that you would use, say, for American companies. For instance, if you file an intellectual property right, a patent, you would track the number of people who pay you a licensing fee to license your technology, and that is how you economists would, for instance, [know] how innovative a particular patent was. So you don't really have that kind of data within China. So I find these forecasts on tech really hard to judge. But what I am sure of is one of the big policies in China is the Made in China 2025 policy. This policy is to ultimately, in five years' time, have 70% of inputs into key Chinese high-tech sectors be domestic. It's a reflection of a lot of the factors we're discussing now, but there is certainly a push to develop the sector and to have it be driven by domestic, innovative suppliers into the industry. So that is one example of supply chain localization. But I find this area to be one of the ones that it won't probably make a massive difference to where China is headed, but it is still very hard to know how to measure it.

00:18:55 **Porter Schutt:** Andy, you're based in California, but you spend a lot of time across the Pacific as well. What are your thoughts on this artificial intelligence race between these two countries?

00:19:08 **Andy Rothman:** Well, I hope you can use AI to tell me when I'm going to be able to go back to China again. My last trip there was in December, and this is now, I think, the longest period of time that I haven't either lived or visited in China for 30-plus years.

I think AI, to a certain extent, is a good example of how important collaboration between the United States and the U.K. and China and the rest of the developed world on China is. We hear people getting very excited about AI in China as if it's racing ahead separately from the United States, when, according to the tech guys that I speak to here, it's really a very collaborative effort. There are certain elements of AI that the United States is far ahead. And being far ahead actually in the United States includes a lot of Chinese students who came here, studied here, and are now working here and helping develop all elements of innovation and technology in the United States, as immigrants have done since the start of our country. China has some advantages. They've got a lot of data, and they have less qualms there in society and in the government

about deploying that. So in certain elements, they're ahead, but do we really want to envision a world where it's, I don't know, VHS versus Betamax; everybody's developing their own? That doesn't seem like it would make a lot of sense to folks.

So, yeah, there aren't very many Nobel Prize-winning research projects being done on the ground in China right now, but that doesn't mean that it's not become incredibly innovative, even if that means taking a technological breakthrough that happened elsewhere but figuring out how to commercialize it and make it profitable.

00:21:11 **Porter Schutt:** I read that despite China's well-documented aging population, in raw numbers, China has more millennials than North America, Europe and the Middle East combined. What are the social and cultural economic implications of all those millennials, especially post the coronavirus, Linda, in your mind?

00:21:39 **Linda Yueh:** I think one of the fascinating things about the Chinese consumers and what's happening with COVID-19 is it was already the case before the pandemic that the Chinese bought a lot of things online. They have very good payment systems. But essentially, it was already a society that was very comfortable with being cashless and buying things online. So it looks like the pandemic has accelerated that trend. Some of the consumer surveys that have come out over the past, you know, few days/few weeks have essentially seen a spike in online shopping. And so I think it's going to maintain accelerate, consuming behavior, which is very digitally driven. I think the millennial generation also has different savings behavior than their parents. They tend to spend, whereas a lot of their earlier generations -- probably because of the history -- they do tend to save a bit more. And another driver of savings behavior is, of course, not just income, but pensions and the better developed social security system compared to where China was a few decades ago. It still has obviously a lot of issues.

So I think for all those reasons, I think that Chinese millennials are going to accelerate, and that you'll see companies cater to it, being more online, e-commerce, digitally orientated. But I think this is one of the one stories of China, which is the new middle class that's emerged. A lot of the kind of weight of their consumption, their tourism at home and abroad, you know, that's really caused China to become a significant market, a large market for a lot of multinational companies, including Apple, who I believe always says they sell more iPhones in China than they do elsewhere.

00:23:38 **Porter Schutt:** Andy, when you and I were getting to know each other 20-plus years ago, I was relying on your groundbreaking surveys that you had implemented in China to really get an understanding across the country of what the consumer and what was happening on the ground. Given that quote that I just gave from a Bloomberg article around that millennial -- the size of that millennial generation -- what are you seeing today?

00:24:10 **Andy Rothman:** The development of that population in China illustrates a couple of things about the country that most people outside of China aren't aware of. Let me give two examples. The first is how China's becoming -- has become already a domestic demand, consumer-driven economy and society just like ours. So last year was the eighth consecutive year in which the tertiary part of China's GDP -- that's the consumer and services part -- was the largest part, bigger than manufacturing and construction. Last year, almost 60% of China's GDP growth came from consumption. So for over a decade now, I've been calling this the world's best consumer story, and that's why, as Linda alluded to, a lot of American companies are doing really good business there.

The consumer story's origins come from the Chinese government allowing private companies to start existing. And now small, entrepreneurial, privately owned companies are the engine of China's growth. They employ almost 90% of urban workers, account for pretty much all of the net new job creation because the state sector is still shrinking. So that's the economics and investment angle of it. The other kind of social and political aspect of it is when people join the middle class in China, or in Eastern Europe, or in Africa, or in Latin America, their wants and desires and ambitions tend to be pretty similar to those people in the middle class in the United State or in Western Europe. And I think that brings people closer. And so they're not done yet. Things need to improve a lot more, but investing in companies that are helping drive this economic change is, I think, helping drive more personal freedom and a less repressive government.

- 00:26:14 **Porter Schutt:** Let's step back and think about environmental implications, and I want to think about it as well from a big picture perspective. China accounts for 28% of global CO2 emissions, about twice the U.S. share, according to the latest statistics from December of last year. What role will China play in global climate action going forward, Linda?
- 00:26:42 **Linda Yueh:** China's approach to the environment is, in many ways, similar to the United States'. It's very focused on using innovation. For instance, really investing in renewables, and probably that is the main focus. And then, as we all know, it's also about behavior that needs to change to protect the environment. But I think, you know, some of the investments that China has done in the renewable space [are] considerable. It is actually by far the largest investor in some of the areas. So thinking of, for instance, solar PV cells. It doesn't change the fact that China is still reliant on coal-fired power plants. So China's often described as having a number of paradoxes, and I think this is one of them. As it tries to transition, it is investing a lot in alternative renewable sources, but at the same time, it is continuing to use fossil fuels in traditional production. And I think the kind of -- the paradox or the tug is between the fact that China remains a middle-income country. It still does have a big manufacturing sector, and transitioning it is going to be a considerable task.
- 00:27:56 **Porter Schutt:** Andy?
- 00:27:59 **Andy Rothman:** Well, the statistics you read about CO2 emissions illustrate why achieving any progress on climate change issues without strong cooperation and collaboration with China is going to be impossible. And this is just one of many issues where if the U.S. and the rest of the developed world can't work collaboratively and constructively with China, it's going to be impossible to solve issues like global health concerns, like fighting drug trafficking and money laundering and terrorism.
- 00:28:39 **Porter Schutt:** I want to drill down just a little bit on what's new now. What has changed now as a result of the virus in China? What are you seeing?
- 00:28:49 **Andy Rothman:** Oh, that's a great question. I don't know if it's too early in China or anywhere else to understand what the longer-term implications of this are going to be. On the positive side, we've seen a pretty fast rebound in consumer spending and confidence. So, for example, sales of property and cars during the height of the virus when everybody was locked down just stopped. And now those two are within 10% to 20% of the average sales rates for the last couple of years before this. We've seen a pickup in confidence for consumer spending that doesn't require being in a confined space. So it's going to take longer for restaurants and movie theaters. But in terms of how people are going to adjust their lives over the longer term, I think it's just too soon to really know. So what is it going to look like a year or two from now, I'm not sure.
- 00:29:56 **Porter Schutt:** Linda, how about you? What are you seeing right now?
- 00:29:59 **Linda Yueh:** I'd agree this is still very early because I think some parts of China -- for instance, along the Russian border -- have entered into a second lockdown. I think one of the areas that's just worth dwelling on for a moment is the fact that unlike Western governments -- Europe and the U.S., which have set up policies to help people directly, whether it's a coronavirus check, a stimulus check, or in the U.K. and Denmark, job retention programs -- China's response has not focused a great deal on people. They focused on firms. So the scale of the response, the spending, isn't as big as it was for the banking crisis 10 years ago. And it's very focused on giving liquidity, so cash being made available to small businesses. But I just wonder if that's going to solidify some of the, you know, systems that are already in place, where China, like other East Asian countries, [has] a fairly small social safety net, and people are not going to, as it were, change their minds if it means -- and this is a big if -- if it means they come through the pandemic with their employers intact and their small businesses intact because of the way the Chinese government has targeted the money.
- 00:31:18 **Porter Schutt:** Andy, do you want to just touch on that and your thoughts given that social contract, as it were?
- 00:31:25 **Andy Rothman:** Yeah. I guess I come at it a little bit differently than the way Linda described it. To me, I think we might see some Western countries moving more toward what China is already doing, although

China isn't funding those things adequately enough yet. So, for example, China basically has a basic living standard arrangement in rural China, where there is a subsidy paid to make sure that poor rural people have a minimum standard of living. They have universal health care coverage, although it's highly inadequate in terms of what it pays for and how good the coverage is. So to a certain extent, a lot of countries may come out of the virus looking more like China, but hopefully they'll fund programs better than the Chinese have done.

Another interesting factor is going to be how people feel about their government. The Chinese government made some horrendous mistakes, especially at the local level in Wuhan and Hubei Province, at the early stages of the outbreak. How are citizens in China and the rest of the world going to think about their government's response to all of this when we finally come out the other side of this, and what impact is that going to have on politics? If you look at the number of deaths due to COVID-19 in the United States, it's now surpassed the number of American deaths in the Vietnam War. And of course, the Vietnam War had a tremendous and long-lasting impact on our political system here. So these are all going to be really interesting things to watch, but probably too soon to make even an educated guess.

00:33:11 **Porter Schutt:** Well, Linda and Andy, thank you so much for taking the time to catch up together. All of us at Brown Advisory appreciate your insights.

00:33:22 **Andy Rothman:** Thanks, Porter. I enjoyed the conversation, and thank you, Linda.

00:33:24 **Linda Yueh:** Yeah, no, thank you, Porter. Thank you, Andy. So much to talk about. I'm glad that we got into quite a few of the very fascinating issues, which I'm sure will be with us for some time to come.

00:33:39 **Ken Stuzin:** Hello again. This is Ken Stuzin. Thank you for joining us as we continue this effort to seek out insights that help us better understand our rapidly evolving world. If you enjoyed listening, we encourage you to subscribe to the podcast. We will be back with another episode next week. Until then, be well and stay safe.