



## Sino-US relations

May 17, 2010

### Economic deterrence & asymmetric vulnerability

- China may emerge as the world's largest economy by 2025 and it may be twice the size of the US by 2050. However, China faces various actual and potential challenges: increasing natural resource dependence and rising geo-political competition with "status quo" powers, weakening political legitimacy of current governance structures, environmental degradation, political and economic limits to the current investment- and export-oriented growth strategy.
- China's increasing economic and financial weight, while very significantly enhancing its role in international affairs, will not translate into greater leverage vis-à-vis Washington for now.
- The Sino-US economic-financial relationship is best described as one of "asymmetric interdependence" skewed in Washington's favour. Both sides have an interest in avoiding a broader economic conflict. However, should push ever come to shove, China would incur far greater economic and financial costs than the US.
- The balance of economic and financial power will only shift once China reduces its dependence on the US market (or US dependence on the Chinese market increases).

### China vs. US – rising dragon, falling eagle?

According to a recent Pew poll, 41% of people believe that China is the world's leading economic power, tied in first place with the United States. More revealingly, a recent Gallup poll showed that 44% of Americans believe that China is the world's greatest economic power (only 27% named the US). The fact that the US was at the epicentre of the very global crisis that China appears to have weathered largely unscathed is bound to have contributed to this perception.

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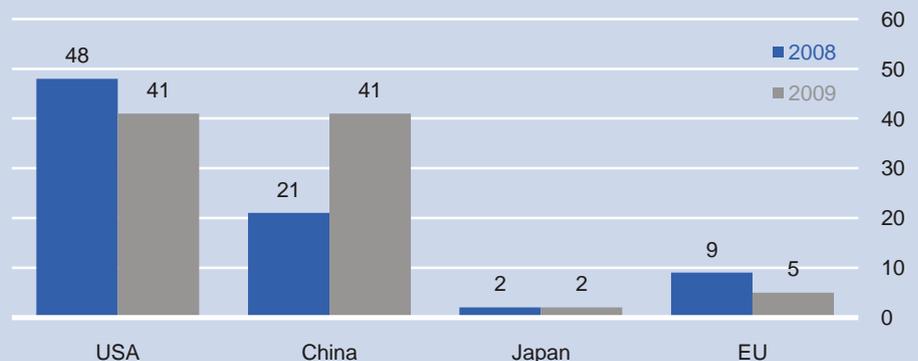
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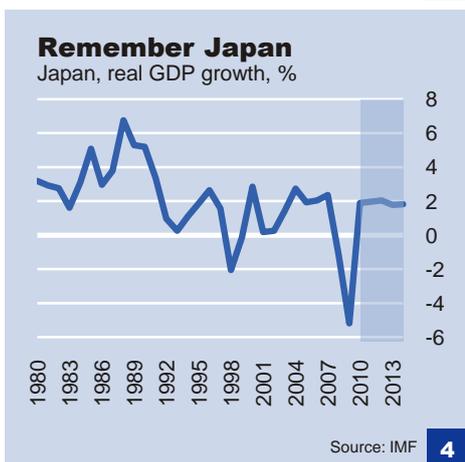
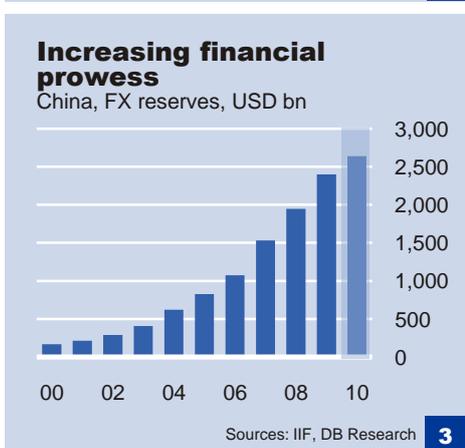
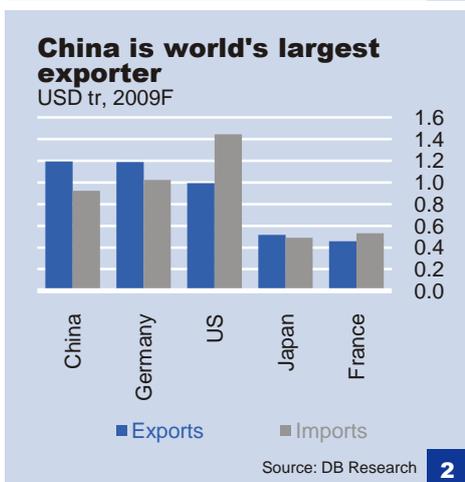
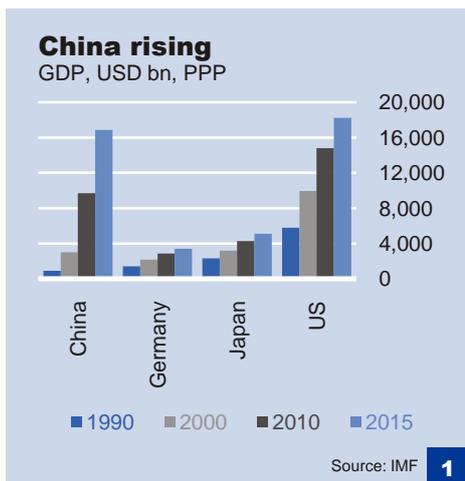
Thomas Mayer

### Who's the world's leading economic power

% of respondents



Source: Pew



In reality, of course, China's economy is merely 1/3 the size of the US economy (measured at market exchange rates), but, admittedly, 2/3 measured at PPP exchange rates. While China is set to replace Japan as the world's second-largest economy this year, it will not overtake the US before 2025. China did, however, replace Germany as the world's largest exporter last year and it is both the largest holder of official FX reserves and the second-largest net international creditor.

China's economic and financial weight will continue to grow on the back of continued strong economic growth and (net) foreign asset accumulation. While enhancing its influence in international economic affairs (including IFIs), it will not translate into significantly greater bilateral leverage vis-à-vis Washington. This, despite the fact that the US will be running "super-sized" fiscal deficits for some time to come and that China – and primarily the Chinese government – is the single largest holder of US government debt.

### Remember "Japan as number one"?

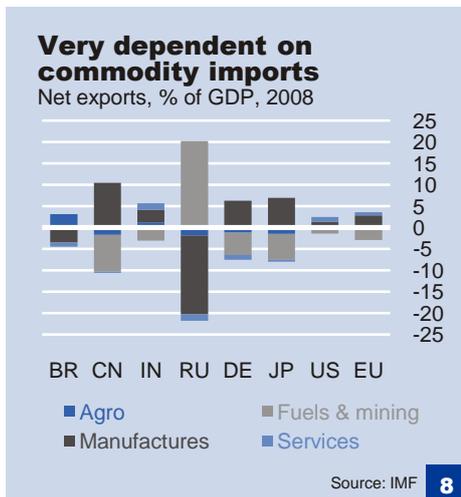
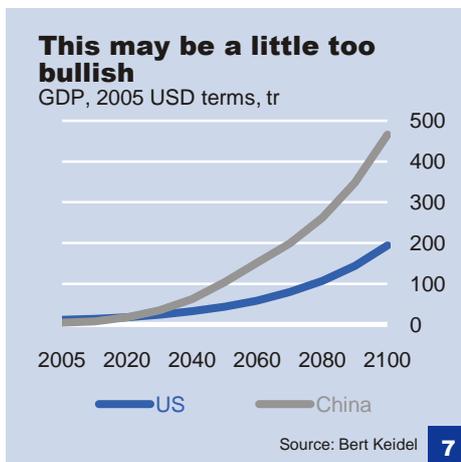
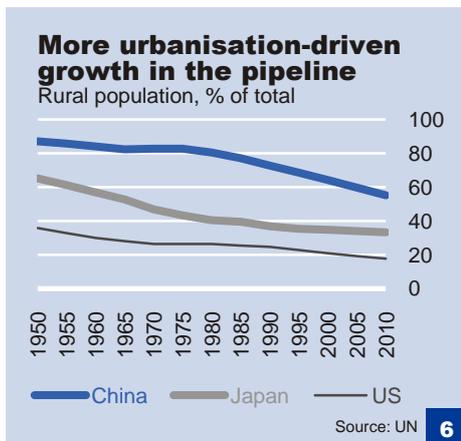
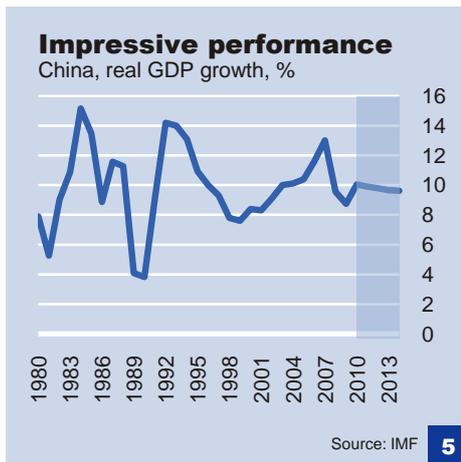
It is very tempting to regard the global crisis as the event that precipitated the decline of the US and the rise of China. The "rise and decline" school has gotten it spectacularly wrong before, however. During the 1970s, especially following the Vietnam War and during the economically challenging Carter years, the "declinists" – as incredibly as this may sound today – worried that US economic stagnation would lose Washington the Cold War against an increasingly assertive Soviet Union. It turned out that it was the Soviet Union that was experiencing decline, leading to its eventual economic collapse and political break-up a little more than a decade later.

During the 1980s, when the US was running record-high fiscal and current account deficits, Japan was going to emerge as "number one", only to crash financially and burn economically before the decade was over. It has experienced economic malaise ever since. During the 1990s and early 2000s, the US, supposedly, "re-emerged" again as the most powerful economy with no serious challengers on the horizon, despite attempts to cast a German-led Europe and a possibly rebounding Japan as potential challengers. Following the 2008 financial crisis, strengthened in their belief by apparent US geo-political setbacks in Afghanistan and Iraq, the "declinists" are once more predicting US decline. This time, it is China's turn to rise and challenge US pre-eminence.

### Dragon rising

China does indeed look set to overtake the US in terms of economic size. Not only has China weathered pretty much unscathed the very crisis that has pushed the US economy "off-course". But China has been growing at an average annual rate of nearly 10% since the beginning of economic reforms in the late 1970s. On current trends and at PPP GDP, China will replace the US as the world's largest economy within the next decade. Chinese GDP measured at market exchange rates should reach US levels by 2025 or so. Some well-respected China analysts, like Bert Keidel, even forecast the Chinese economy potentially to be twice the size of the US by 2050.

While Chinese growth may slow down from double-digit levels, the medium-term growth outlook appears solid. A low degree of urbanization and a low per capita capital stock provide conditions conducive to continued strong growth. When Japan slipped into crisis, it had already reached the "technological frontier". The Soviet



economic model, based on “extensive” rather than “intensive” growth, was not sustainable, especially in the context of strong geo-political competition that forced Moscow to keep defence expenditure at ultimately ruinous levels. By contrast, China is generating both intensive and extensive growth. So if China manages to avoid geo-political competition by way of a “peaceful rise”, it is likely to enjoy continued solid growth for the foreseeable future. This is the “consensus China story” as seen through the eyes of the “extrapolators”.

### Cautionary voices of the bears

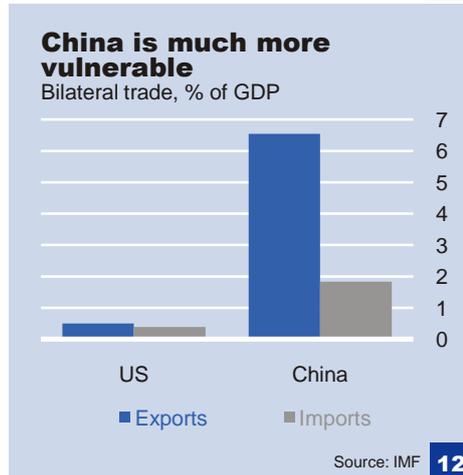
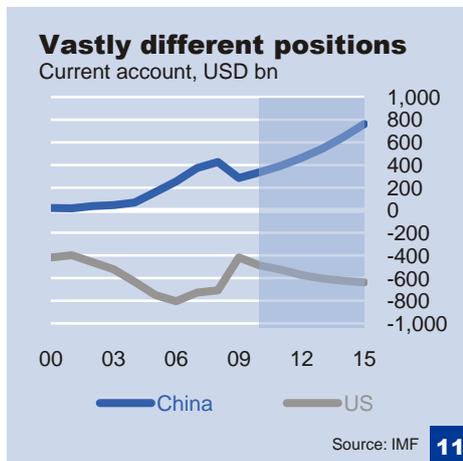
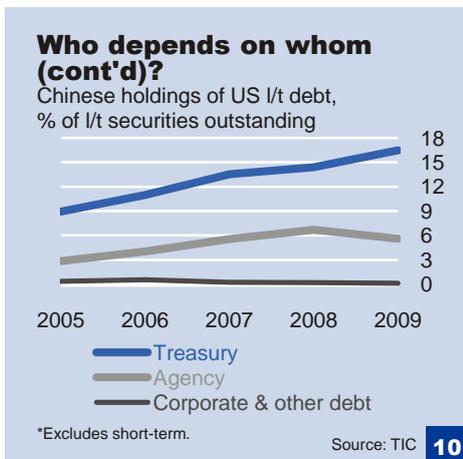
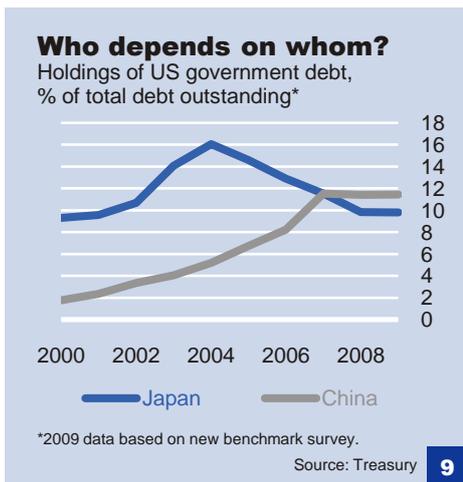
The China bears, on the other hand, not only expect Chinese growth rates to decline substantially. But they also see other, potentially dangerous speed bumps on China’s road to economic pre-eminence. To stick with this metaphor, a speed bump can slow one down; but if one hits it at top speed, it may throw one off-course, and may even land one in the ditch. These “bumps” include, among others, the following: increasing natural resource dependence and rising geo-political competition with “status quo” powers (Friedberg), a “trapped (economic) transition” (Pei), a crisis of political legitimacy potentially coinciding with political instability (MacFarquhar), political and economic limits to investment-heavy and (supposedly) export-oriented growth (Goldstein/Lardy).

One does not have to be a China bear to believe that the risks are biased to the down- rather than the upside. But it is equally important to recognise that a reasonable “downside” scenario is likely to mean 5-7% annual growth rather than economic stagnation. China is unlikely to be thrown off-course in the way the Soviet and Japanese economies were. Structurally speaking, China’s medium-term growth potential is very significant. China is located far from the technological frontier (unlike Japan in the 1980s). China’s development model is also based on a relatively high degree of economic openness and is hence much better suited to generate total factor productivity growth than the economically closed Soviet Union, which lacked access to advanced Western/global technology.

The Soviet and Japanese examples, nonetheless, suggest the need to critically re-examine the economic and political sustainability of China’s growth strategy given China’s rapid progression from low- to middle-income economy. In Rumsfeldian parlance, China faces quite a few “known unknowns” and, one must assume, a non-negligible number of “unknown unknowns”, though this can, of course, not be known. History, in any event, would seem to counsel some caution when it comes to simply extrapolating current trends a decade or more out into the future.

### China’s financial prowess & Sino-US relations

China’s increasing economic size will provide Beijing with greater political, economic and financial influence. China is in a radically different position from where it was a decade ago. Political, economic and financial influence comes in many guises. But over the medium-term, it requires a strong economy and a solid financial position. On both scores, China compares favourably to the US. While China is the world’s second-largest net creditor (after Japan), the US is the world’s largest debtor. While the US is running the largest current account deficit, China is running the largest surplus. Arguably this has thus far provided Beijing with little in terms of bilateral influence. It may have made Washington more reluctant to pursue a confrontational policy towards Beijing, but it does not



provide Beijing with a lever of direct influence vis-a-vis Washington, mainly because of the US's reserve-currency country status and China's dependence on the US as an export market.

China's most direct lever of influence vis-a-vis the US is the threat to sell off its estimated USD 880 bn worth of US treasury securities (as of February) – and another USD 450 bn worth of agency debt (as of June 2009). Such a move would be quite costly for Beijing, however. First, economically and financially, China would shoot itself in the proverbial foot. The value of its holdings would decline and higher US interest rates would weigh on the US growth outlook, hurting Chinese exports. Furthermore, China would have to find other dollar assets to invest in, unless it is willing to accept RMB appreciation – and too rapid a RMB appreciation is hardly in China's interest in terms of exports and dollar-denominated US debt holdings. If it does re-invest in dollar-denominated assets, this would presumably help ease financing conditions in other parts of the US economy, potentially offsetting the negative effect of higher rates in the treasury market. But these assets would be less liquid and carry higher credit risk. A Chinese threat to divest US debt may therefore not be considered very credible by Washington.

Secondly, even if Beijing were to sell large holdings of US debt, it is unclear how sizeable an impact this would have on US yields. In the very short run, it might disrupt financial markets, but the medium-term impact would likely be manageable, as other foreign (official) buyers would step in, albeit at higher interest rates (e.g. Japan, Gulf countries). Last but not least, any politically motivated fire sale of US debt would trigger a very severe political backlash – and not just from the US. A fire sale (as opposed to a gradual unwinding of holdings) would also undermine China's standing as a reliable financial investor and economic partner in the eyes of many other countries.

### Deterrence & asymmetric interdependence

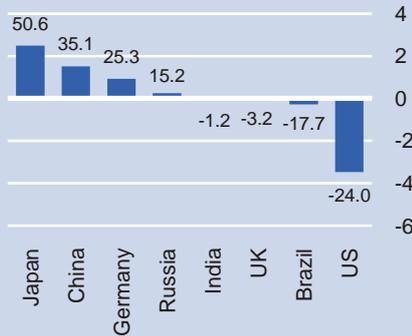
Financially, economically and politically, Beijing would pay a high price for pushing up US borrowing costs and, in all likelihood, a much higher price than Washington would end up paying. First, the US has access to a more diversified investor base (with parts of which it maintains close political relations) than Beijing has markets to invest in – at least as long as Beijing seeks to maintain a stable USD-RMB exchange rate. Second, in the short run, the US market is also substantially more important to China in terms of both exports and imports than vice versa (chart 12) – and the Chinese export sector is relatively more employment intensive! Last but not least, Beijing's concern about maintaining near-double-digit growth rates would diminish the credibility of any action that risks triggering an outright economic conflict with the US, or a severe US economic slowdown on the back of financial instability.

In short, China's holdings of US debt do not lend themselves as a coercive instrument. They may act as a sort of limited deterrent. Naturally, rising cross-border asset holdings and trade have increased interdependence, raising the costs of economic conflict for both sides – but the potential costs of a conflict due to China's trade dependence are substantially higher for Beijing than for Washington. The Sino-US economic-financial relationship is therefore best described as one of "asymmetric interdependence" (or "asymmetric vulnerability"), skewed in Washington's favour for now.



### Only trailing Japan

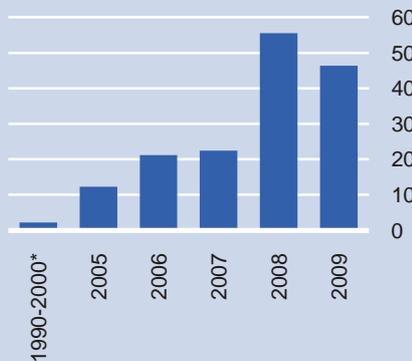
Net IIP, USD tr, 2008; data label in % of GDP



Source: IMF **13**

### Becoming a player

Chinese outward FDI flows, USD bn



\*Annual average

Sources: UNCTAD, DB Research **14**

## Washington continues to hold a stronger hand – for now

None of this means that China's financial and economic power is not a force to be reckoned with. China's growing international financial resources, rising outward investment, increasing prominence as a trade partner and importance as a location for global FDI have materially increased its influence (and interests). Nonetheless, as regards Sino-US relations, China will – for the foreseeable future – derive only limited bilateral influence from its meteoric economic and financial rise.

By the same token, Beijing will have a greater incentive to avoid a broader bilateral economic confrontation than Washington given the substantially greater economic and financial costs China would incur in the event of such a conflict. None of this is meant to suggest that a Sino-US economic conflict will never occur. Domestic political considerations do sometimes result in "miscalculated" government policies. However, if *raison d'état* and pragmatism prevail in both Beijing and Washington, inevitably recurring economic tensions will remain manageable.

Last but not least, if and when China reduces its export dependence on the US market relative to US dependence on the Chinese market, the balance of economic and financial power will change dramatically in Beijing's favour. Until then, Beijing will have a far greater interest in preventing a wider economic-financial conflict than Washington.