Introduction

The global financial crisis (GFC) was born in the United States of too loose money and too lax regulation, aided and abetted by China’s willingness to provide credit to America seemingly without limit. What began as a Wall Street meltdown from securitized home loans turned bad metastasized into the Great Recession, spread around the world with pandemic-like speed by the twin forces of globalization, cross border trade and the international integration of financial markets.

The instant conventional wisdom was that the US must now reap what it has sown. British Prime Minister Gordon Brown said bluntly “the old Washington consensus is over”. German Finance Minister Peer Steinbrueck predicted “the US will lose its status as the superpower of the global financial system”. Former senior Clinton administration official Roger Altman told Americans “the United States' global power, as well as the appeal of U.S.-style democracy, is eroding”. Some speculate the purported post-American world will be characterized by a radically de-centred, and potentially chaotic and conflict ridden, global system along 19th century European lines. Others project a new “Beijing consensus” emerging around state-managed capitalism and benign authoritarianism.

To paraphrase Mark Twain, talk of the demise of the US is most likely exaggerated. The American brand of laissez-faire capitalism is tarnished. No return is in sight to the go-go growth rates of the roaring noughties. Step function increases in unemployment and poverty will remain grim reminders of the carnage. The spectre of public debt mountains and protectionism will haunt the West as emerging markets think again about their preoccupation with export led growth.

But none of this will be enough to move geopolitics off the big picture path it was already on, towards a world increasingly dominated by the US, still the world’s most powerful country, and China, its biggest and fastest growing rising power. China and the US will face their own economic demons, but these seem less insurmountable than those facing Europe and Japan. There are other coming major powers, led by India, but they are at least fifteen years behind China.

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Welcome then not to a post-American world, but to a post-GFC “Chimerica”—Niall Ferguson’s term for the preponderant global impact of the US and China, joined at the economic hip but wary of each other’s ambitions and with very different world views. What the two countries do—alone, together, in regional and multilateral forums, or in conflict with each other—will increasingly define the global bounds of the possible.

Sino-American relations are likely to be increasingly fraught after the GFC. Against the backdrop of unprecedented prosperity in both countries, what quickly became the most imbalanced bilateral economic relationship in history was the glue holding together China and the US. China was happy to buy up piles of dollars and Treasury bills so long as Americans used the money to buy unprecedented quantities of goods assembled or made in China. The US was willing to live with ever greater trade deficits with China so long as the low interest rates made possible by China’s hunger for dollars kept the consumer driven America economy humming.

What the two countries do—alone, together, in regional and multilateral forums, or in conflict with each other—will increasingly define the global bounds of the possible.

Now the “trade for Treasurys” global bubble has spectacularly burst, and Chinese and American leaders have joined the “never again” chorus. But undoing Chimerica will be very hard. In the short term, both countries’ GFC-fighting measures will exacerbate not lessen their imbalances. The Chinese government is driving production ever higher through public investment and bank lending with little priming of the domestic consumer pump. More exports is the easiest way out. The Obama administration is propping up demand through deficit spending, bailouts and loose monetary policy. As the American economy recovers, so will its appetite for imports.

In the longer term, the policy changes needed to get China to consume more and the US to consume less run against the grain in both countries. Politically popular regulation and tax breaks, most notably with respect to home ownership, have long boosted consumption in the US. The Chinese government’s focus on steering the economy has neglected the building of the social safety net and retail financial system needed to create a consumer society.

The longer the imbalances of Chimerica persist, the greater their potential harm not only economically but also politically. China and the US are already prominent parts of the rising protectionist tide around the world. The possibility of a spiral of dueling US-China economic nationalism cannot be ruled out, particularly given the suspicion with which both countries view the foreign investment ambitions of the other. The more economic disputes are couched in nationalist terms, the higher the risk that they might spill over into geopolitics.

China and the US have already committed to expanding their bilateral diplomacy. Presidents Hu and Obama have given the Strategic Economic Dialogue of recent years a new broader name, the Strategic and Economic Dialogue. Its leadership team has been doubled—US Secretaries of State Hillary Clinton and Treasury Timothy Geithner, Vice Premier Wang Qishan and State Councilor Dai Bingguo for China—and they will be accompanied by a phalanx of other cabinet-level participants from both sides.

But both countries want to embed their bilateral relationship in robust multilateralism. Among the myriad possibilities on the table, from Asia-Pacific groupings such as APEC and the East Asia Summit to root and branch reform of the Bretton Woods system, China and the US seem to have settled on the G-20 as the multilateral forum in which to invest most energy coming out of the global financial crisis.

The G-20 is the first important multilateral grouping in which China’s major power status has been recognized, and this has been done without asking China to play a leadership role it is not yet ready to embrace. The G-20 allows the US to further its agenda for encouraging China to become a “responsible stakeholder” on the global stage as well as to gain some global ballast to leaven European recalcitrance about taking America’s lead.

The challenges in front of the G-20 of course are immense, from tackling climate change to fixing finance, from resisting protectionism to coordinating fiscal policy. But these are the same challenges facing China and the US. The global community will do well to support the multilateral instincts of its two most important countries as they come to grips with the sobering realities of the post-GFC world.
A de facto G-2

The World Bank’s American President Robert Zoellick and its Chinese Chief Economist Justin Yifu Lin spoiled the multilateralist celebrations at April 2009’s G-20 summit in London to tackle the global financial crisis, saying “without a strong G-2, the G-20 will disappoint”. In the months leading up to the summit, both Zbigniew Brzezinski and Henry Kissinger both endorsed the idea of a China-US G-2. Soon after the summit, British Foreign Secretary David Miliband warned his European colleagues later that they would have to work hard to expand the nascent G-2 into a G-3.

No American or Chinese official is ever likely to call the relationship between their countries “G-2”. On the eve of the first Strategic and Economic Dialogue in July 2009 Secretaries Clinton and Geithner signaled the US’s intention to dovetail intensive Chinese diplomacy with a strategy of global engagement, saying “few global problems can be solved by the US or China alone. And few can be solved without the US and China together.” Chinese Premier Wen Jiabao went further at May 2009’s Sino-European Union summit in Prague, saying ”it is totally ungrounded and wrong to talk about the dominance of two countries in international affairs”.

But no matter how their relations are prosecuted, Geithner’s June 2009 assessment of the centrality of China and the US to the post-GFC world was surely correct:

A successful transition to a more balanced and stable global economy will require very substantial changes to economic policy and financial regulation around the world … How successful we are in Washington and Beijing will be critically important to the economic fortunes of the rest of the world.

There is no denying that both countries have been hard hit by the crisis. The US increasingly resembles more dirigiste France than Reagan revolution America. After decades of ever greater global reach, the US will want to make its foreign policy, like its economy, more solvent. China’s faith in development by export has been shaken. Its government must also confront mounting social problems against a backdrop of apparently increasing questions about its legitimacy.

Yet there can be little doubt that the US will continue to be the world’s dominant geopolitical force well into the new century, its economy still driven by unparalleled American verve for Schumpeterian “creative destruction”, its military hegemony enduring, and its cultural and political reach dwarfing that of other countries. The immense capacity of the Chinese state coupled with the insatiable drive among its people for a better life and their innate business acumen make it foolhardy to bet against the country’s continuing global ascent. Before the crisis, Goldman Sachs BRICs team brought forward by almost two decades to 2027 the date by which it predicted China would pass the US to become the world’s largest economy. That still seems a reasonable projection today.

In 2007, BRICs projections had China passing both Germany and Japan by 2011 to move into second place behind the US in terms of total economic size, measured at market exchange rates. Using the PPP comparisons favoured by many development economists, China is already clearly the world’s number 2 economy. If anything the GFC is likely to reinforce this change in the global economic guard.

The GFC has exposed Japan’s economic recovery from the lost decade of the 1990s as more apparent than real, built on booming exports to the US and China rather than the reforms so desperately needed at home. The leading Japanese global brands like Toyota and Sony may continue to thrive, but they are the exception rather than the rule for the Japanese economy as a whole. The suffocating legacies of massive public debt, sclerotic regulation and an aging and shrinking population will likely consign Japan’s next decade to a painful process of managing long term economic decline.
Plummeting exports, burst housing bubbles and toxic bank assets, coupled with piecemeal policy responses have exposed the fragilities in the past two decades of rapid European integration. Though the full 27-member European Union will remain the world’s largest economic bloc long after the crisis (far bigger than the US), size should not be mistaken for strength. Europe’s fundamental post-GFC tasks will likely be shoring up foundering domestic economies and repairing its creaking union rather than projecting its influence on the global stage.

The latest IMF global economic forecast expects the drop in economic growth between 2007 and 2009 to be less in the US than any in any other major G-20 economy (see Table 1). Germany, because of its export dependence, and the UK in virtue of its own housing woes and bank failures, are mired in downturns far deeper than that in the US. Things look even worse in Japan, where the crisis has halved its exports with catastrophic effects for economic growth.

Among the BRICs, India has been relatively less affected by the crisis than China because notwithstanding the global successes of its software industry, much of the Indian economy remains inward looking. But still China will be the world’s fastest growing major economy in 2009. In contrast, Brazil and dramatically Russia are mired in recession.

Most forecasters believe the US and China will lead the path to global recovery, in no small measure because of the speed and scale of the GFC-fighting measures they have both enacted. As Table 2 shows, they lead the world in terms of fiscal stimulus measures, not only in total size but also when measured relative to the size of national economies.

Table 1. IMF Global Economic Forecast, July 2009 (select G-20 countries)

<table>
<thead>
<tr>
<th>Economic Output (annual % change)</th>
<th>2007</th>
<th>2008</th>
<th>2009 forecast</th>
<th>2007-2009 forecast slowdown</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>2</td>
<td>1.1</td>
<td>-2.6</td>
<td>-4.6</td>
</tr>
<tr>
<td>India</td>
<td>9.3</td>
<td>7.3</td>
<td>5.4</td>
<td>-4.8</td>
</tr>
<tr>
<td>France</td>
<td>2.1</td>
<td>0.7</td>
<td>-3.0</td>
<td>-5.1</td>
</tr>
<tr>
<td>China</td>
<td>13</td>
<td>9</td>
<td>7.5</td>
<td>-5.5</td>
</tr>
<tr>
<td>Italy</td>
<td>1.6</td>
<td>-1.0</td>
<td>-5.1</td>
<td>-6.7</td>
</tr>
<tr>
<td>Brazil</td>
<td>5.7</td>
<td>5.1</td>
<td>-1.3</td>
<td>-7</td>
</tr>
<tr>
<td>UK</td>
<td>3</td>
<td>0.7</td>
<td>-4.2</td>
<td>-7.2</td>
</tr>
<tr>
<td>Japan</td>
<td>2.4</td>
<td>-0.6</td>
<td>-6.0</td>
<td>-8.4</td>
</tr>
<tr>
<td>Germany</td>
<td>2.5</td>
<td>1.3</td>
<td>-6.2</td>
<td>-8.7</td>
</tr>
<tr>
<td>Russia</td>
<td>8.1</td>
<td>5.6</td>
<td>-6.5</td>
<td>-14.6</td>
</tr>
</tbody>
</table>

Table 2. Fiscal stimulus and financial bailouts, % GDP (select G-20 countries)

<table>
<thead>
<tr>
<th>IMF estimates, 18 February 2009</th>
<th>Fiscal stimulus</th>
<th>Financial assistance</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>6.3</td>
<td>0.5</td>
</tr>
<tr>
<td>US</td>
<td>4.9</td>
<td>73.7</td>
</tr>
<tr>
<td>Russia</td>
<td>3.9</td>
<td>7.1</td>
</tr>
</tbody>
</table>
Barack Obama signed into law a nearly $US 800 billion fiscal stimulus package after less than a month in office. The Chinese government announced their own massive fiscal injection in late 2008, almost as big as Obama’s in terms of total dollars at market exchange rates. In contrast, critics continue to point to the relatively desultory efforts of the major European countries.

The scope of financial sector assistance has varied greatly across countries, in large measure mirroring differences in the scale of toxic assets problems. Direct financial bailouts have been more dramatic in the US and western Europe where major banks were very highly leveraged before the crisis and dangerously exposed once it hit to plummeting prices for mortgage backed securities and other housing based derivatives.\textsuperscript{xiv}

In the US, cash injections, asset purchases and guarantees by the Treasury and Federal Reserve are estimated by the IMF to total fully three-quarters of US GDP. President Obama has added more than a trillion dollars on top of the Bush administration’s $700 billion bailout. Unprecedented activism by the Federal Reserve had added a trillion dollars to its balance sheet since the crisis began, with more likely to come.\textsuperscript{xv} Guarantees yet to be cashed in are measured in the multiple trillions of dollars.

Banks in the major emerging markets have been sufficiently resilient to the GFC not to require big bailouts, a profound irony given years of trenchant IMF criticism. Belying this general emerging markets trend, however, the Chinese government has paired its fiscal stimulus with a lending spree by state-controlled banks, with new loans in the first quarter of 2009 alone in excess of the entire government fiscal stimulus plan for three years and greater than total banks loans for all of 2008, which were already the largest in Chinese history.\textsuperscript{xvi}

When all these government interventions are compared side by side, China and the US stand out as global first and biggest responders to the crisis. But what will be the effect of this costly activism after the crisis? IMF projections for public debt are telling. Three features of Table 3 stand out.

Table 3. IMF Public Debt Forecasts, % GDP (select G-20 countries)

<table>
<thead>
<tr>
<th>Country</th>
<th>2014</th>
<th>increase from 2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>Japan</td>
<td>222.3</td>
<td>27</td>
</tr>
<tr>
<td>Italy</td>
<td>118</td>
<td>11.1</td>
</tr>
<tr>
<td>US</td>
<td>99.5</td>
<td>37.6</td>
</tr>
<tr>
<td>France</td>
<td>79.4</td>
<td>15.8</td>
</tr>
<tr>
<td>Germany</td>
<td>77.2</td>
<td>11.2</td>
</tr>
<tr>
<td>UK</td>
<td>76.2</td>
<td>32.9</td>
</tr>
<tr>
<td>India</td>
<td>71.6</td>
<td>-10.4</td>
</tr>
<tr>
<td>Brazil</td>
<td>54.1</td>
<td>-9.6</td>
</tr>
<tr>
<td>China</td>
<td>18.6</td>
<td>2.1</td>
</tr>
<tr>
<td>Russia</td>
<td>6.4</td>
<td>-2.7</td>
</tr>
</tbody>
</table>

IMF, The State of Public Finances, 6 March 2009
First, Japan’s public finances, already in a parlous state before the crisis, will be even worse afterwards. Japan is facing the prospect of having to deploy significant portions of GDP just to repay interest on its public debt into the indefinite future, crowding out public investment and making major tax increases almost inevitable—against the backdrop of an aging and shrinking population. It is hard to be optimistic about Japan’s economic prospects.

Second, despite its massive stimulus package and state bank lending, China will exit the crisis with very little debt by western standards. Among other things, this demonstrates the size of the fiscal war chest the Chinese still has to deploy as it sees fit in its ceaseless striving for more growth, more jobs and more prosperity.

Third, the US will look increasingly European when it comes to public debt. However, the US is in a better position to manage its public debt than many European. The reserve currency status of the dollar reduces the interest rate premium attached to American public debt and gradual inflation in the US will likely have less downward pressure on the exchange rate than would be the case for other countries. This has been exemplified during the crisis itself when unprecedented government spending and increases in the Federal Reserve balance sheet coupled with near zero interest rates have been associated with a strengthening of the dollar as Americans have repatriated capital back into the country and global investors have looked for a safe haven in the storm.

Putting all that we know about the economics of the crisis together, the world does appear to be moving towards a de facto G-2, almost by default as the other major economies are being hit even harder by the crisis. The problem is that China-US relations are likely going to be more difficult to manage after the crisis than they were before.

**Stubborn Chimerica**

The headline statistics concerning the mushrooming of Chinese government purchases of American Treasury bonds and American consumption of Chinese goods before the global financial crisis are by now well known (see Figure 1). China increased its holding of US Treasury bills more than fivefold to well over $US 500 billion from 2000 to 2008. Over the same period, American imports of Chinese goods more than trebled to over $US 300 billion. By 2008, the US-China economic relationship was quite simply both the largest and least balanced bilateral relationship in history.

Figure 1. Trade and Treasurys Co-dependence
The co-dependence inherent in these imbalances is equally well understood. China kept its currency weak against the dollar by buying dollars and dollar-denominated paper, which kept US interest rates low and American debt-financed consumption booming. American red ink kept Chinese exports flying off the shelves and made possible year after year of extraordinary and even accelerating growth in China.

Economists decried Chimerica as “unsustainable”. But neither China nor the US wanted to stop the party while the music was still playing. Then the music stopped, Now both sides have made solemn declarations about how they will change—China by increasing consumption, the US by reducing it. Secretaries Clinton and Geithner were transparent in July 2009 about what needs to be done:

As we move toward recovery, we must take additional steps to lay the foundation for balanced and sustainable growth in the years to come. That will involve Americans rebuilding our savings, strengthening our financial system and investing in energy, education and health care to make our nation more productive and prosperous. For China it involves continuing financial sector reform and development. It also involves spurring domestic demand growth and making the Chinese economy less reliant on exports. Raising personal incomes and strengthening the social safety net to address the reasons why Chinese feel compelled to save so much would provide a powerful boost to Chinese domestic demand and global growth.

Translating these lofty aspirations into action will be a herculean task, as the rise and rise of Chimerica imbalances since the crisis hit attests. In the first five months of 2008, the US trade deficit with the rest of the world (excluding China) was $US 236 billion (see Table 4). In the first five months of 2009, the corresponding deficit was $92 billion, a drop of 60% in one year—and something many have pointed to as the GFC’s silver lining. But over the same period, the US trade deficit with China only declined by 13% to $85 billion—now almost as big as the US deficit with the rest of the world combined.

Between May 2008 and May 2009, Chinese holdings of US Treasury bills grew by three hundred billion dollars to just over $US 800 billion, an increase of 58% in one year. Over the same year, Treasurys holdings by the rest of the world increased by four hundred billion dollars or 19%. Today, China holds one quarter of all Treasury bills.

These statistics bely the notion that the crisis itself will remove the imbalances of Chimerica and instead underscore its likely persistence. It is thus perhaps not surprising that the first half of 2009 witnessed unprecedented public mudslinging between the two countries.

Table 4. Trade and Treasurys during the GFC (all figures are billions of US dollars)

<table>
<thead>
<tr>
<th>US Trade Deficit with:</th>
<th>Jan-May 2008</th>
<th>Jan-May 2009</th>
<th>% decrease</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>96.8</td>
<td>84.6</td>
<td>13%</td>
</tr>
<tr>
<td>Rest of World</td>
<td>236.0</td>
<td>92.2</td>
<td>61%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>US Treasurys Holdings by:</th>
<th>May-08</th>
<th>May-09</th>
<th>% increase</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>506.8</td>
<td>801.5</td>
<td>58%</td>
</tr>
<tr>
<td>Rest of World</td>
<td>2090.7</td>
<td>2491.6</td>
<td>19%</td>
</tr>
</tbody>
</table>

On the US side, Geithner let slip in his confirmation hearing that China “manipulates” its currency. Understanding that this could trigger a legislative process requiring US retaliation against China, President Obama quickly sought to recover the situation by saying his Treasury Secretary had misspoken. But the Obama administration is well aware of the pent up demand in America to get tough with China. The reason was amply clear in the job statistics when American unemployment was less than 5%.

The simple inference Americans politicians, particularly Democrats in Congress, draw from the statistics in Figure 2 is that cheap Chinese imports have cost millions of good American manufacturing jobs.

The symbolic importance of manufacturing jobs far exceeds their number. Americans still look back fondly on the 20th century ideal of stable high paying manufacturing jobs with generous health care and retirement benefits that spread prosperity to the middle class. And manufacturing is concentrated in the Midwest whose swing states invariably hold the balance in presidential elections. It is much easier politically to blame foreign competition for job losses than to look harder into the domestic dynamics such as technological change that most studies show have had much more to do with manufacturing jobs losses than trade does.

This is why congressional representatives from the rustbelt draw a straight line between lost good jobs at home and unfair Chinese competition. Here is how Ohio Senator Sherrod Brown painted the picture in March 2009:

The Ohio manufacturer has a minimum wage to pay his workers. He has clean air and workplace and product safety standards by which to abide, helping to keep his workers healthy and productive and his customers safe. The Chinese manufacturer has no minimum wage to maintain and is allowed to pollute the local water sources and let workers use dangerous and faulty machinery. The Ohio manufacturer pays taxes, health benefits, and social security. He typically allows family leave and gives WARN notices when there is a plant closing. The Chinese manufacturer often allows child labor. The Ohio manufacturer receives no government subsidies, and the Chinese manufacturer often receives subsidies for the development of new technologies, or for export assistance. The Chinese manufacturer benefits from China’s manipulation of its currency, which gives up to a 40 percent cost advantage.xviii

Figure 2. Chinese imports and American job losses
It is thus not surprising that Chinese reaction to Geithner’s diplomatic faux pas was sharp and swift. Wen Jiabao worried out loud about China’s dollar based holdings, saying that in light of the GFC “of course we are concerned about the safety of our assets”. A week later, the Governor of the Bank of China Zhou Xiaochuan proposed a new global reserve currency “that is disconnected from individual nations and is able to remain stable in the long run, thus removing the inherent deficiencies caused by using credit-based national currencies”.

American profligacy and Chinese dollar asset purchases have long been at the heart of Chimerica imbalances. Before the crisis, they soothed frictions between the two countries. Now they are the source of irritation. The problem is that there are both short and long term impediments to transforming Chimerica into more balanced Sino-American interdependence.

The US is compensating for large scale deleveraging by consumers and firms in response to the crisis with unprecedented government spending to revive American demand. Even though the Obama administration has talked about reforms in education, energy and health as investments, significant increases in America’s productive capacity remain uncertain and a long way off. In the short term more American demand will mean more imports from China.

The Chinese government is trying to offset the slump in global demand with large scale investments and bank lending for public infrastructure projects and to large state owned or state controlled companies. The rate of investment in China is slated to rise this year from an already very high 40% of GDP to an even higher 45%. Unless and until Chinese consumers start buying more of what Chinese firms produce, exports, above all to the US, will be the principal way to translate investment into economic growth.

When it comes to the longer term, reducing the imbalances of Chimerica entails changing the economic DNA of both countries, with Americans needing to become more Chinese by consuming much less and Chinese needing to be more American by saving much less.

For the foreseeable future, the biggest domestic challenge for the US will be what Obama has taken to calling “fiscal sustainability”. But just stabilizing US public debt after the full effects of Obama’s spending are felt would require tax cuts or spending increases of nearly one-third of central government spending (7-9% of GDP). Americans have repeatedly shown that they will punish politicians for smaller increases in taxes or cuts to spending than the US’s crisis generated debts demand—just remember George HW Bush’s betrayal of his “read my lips, no new taxes” pledge. Beyond identifying inefficiencies in current spending (and hence potential savings), it is hard to see how the US could cut expenditures by this much. Retirement and health care liabilities are the two biggest ticket items. Social Security has long been the third rail of American politics. The last Democrat in the White House Bill Clinton was transformed from bold progressive to triangulating centrist by a painful defeat on health care reform proposals that are not so different from Obama’s.

What about tax increases, focusing on measures that would also reduce incentives to borrow money? The volume of home mortgages in the US is about as big as the entire economy, but every dollar spent on servicing mortgage debt on residential real estate (including second homes) is fully tax deductible. As housing prices ran up in the 2000s, American’s added another ten percent of GDP to housing debt, this time in the form of credit card equivalent home equity lines of credit secured against homes, with much lower interest rates than regular credit cards—and with all debt interest fully tax deductible. It is doubtful even President Obama has the political capital to wean Americans off the motherhood and apple pie of government subsidized borrowing to realize the American dream of home ownership.

China’s challenge is the mirror image of America’s. Whereas Americans borrow because they are confident about the future, Chinese citizens save for a rainy day. Members of close knit extended families save because it is family rather than the state that will look after them when they get sick, old or lose their jobs. Even if Chinese citizens wanted to spend and borrow more, the retail financial sector needed to service a consumer society is at best rudimentary in China.
The Chinese government has the capacity to build an effective social safety net and to change the regulatory environment to favour the growth of retail banks, credit cards and insurance targeted at consumers. But the government has preferred to invest in infrastructure and SOEs and state controlled companies, with state-owned banks a preferred intermediary.

This strategy makes political as well as economic sense for the Chinese government. Focusing on driving productive capacity ever higher allows the Chinese government to deliver on its implicit guarantees of full employment and higher living standards for all its citizens. The government also knows that the history of democracy runs through the development of a large consumerist middle class. Chinese leaders learned well the lessons of Gorbachev’s glasnost and perestroika, and they will not lightly walk down what might be considered the former Soviet Union’s naïve path to openness.

**The spectre of economic nationalism**

For all its intrinsic economic problems, Chimerica has been for a decade the glue holding together stable Sino-American relations, keeping a lid on potential geopolitical frictions in the name of short term economic wins for both sides. Now China and the US say they want to undo their economic imbalances. But the likely stubborn persistence of Chimerica creates risks for both countries as well as temptations to engage in blame game recriminations.

America’s growing public debt mountain creates incentives for the Obama administration to let inflation to creep back into daily life, allowing the government to reduce the real value of what it owes China and its other creditors. The bond markets are already pricing inflation into the US’s long term borrowing. Over the past six months, the Federal Reserve has kept its key short term interest rates near zero. But over the same period, the yield on 10 year Treasury bonds has almost doubled to nearly four percent.

The spectre of the US’s inflating away its public debt is that the centre of Chinese criticisms of the American economy, particularly since it would only add to upward pressure on the RMB against the dollar in nominal terms, decreasing in the short term at least the competitiveness of Chinese exports to the US. For its part, the Chinese government knows that there are diminishing returns its ever higher rates of investment. China has been able in recent decades to fight the classic communist foes of over capacity and inefficiency through booming exports. But this will be harder to do in the future.

The last time there was anything approaching such a politically volatile bilateral economic was in the 1980s when the US claimed that unfair Japanese trade competition was destroying American jobs—the last time US unemployment was over 10%. Ronald Reagan did something about it, engineering via the then G-6 Louvre and Plaza accords a doubling of the value of the yen against the dollar. The US trade balance with Japan improved markedly and the American economy recovered. Japan used the stronger yen to buy iconic American assets such as Rockefeller Centre and to turn the most visible Japanese imports, Toyotas and Hondas, into products made in America.

But there was a downside to all this international change. It took years for Americans to become comfortable with large scale Japanese investment in the US. The appreciation of the yen and the decline in Japanese exports laid the foundation for the country’s disastrous lost decade of the 1990s.

The challenges facing post-GFC China-US relations are considerably more formidable. Japan was democratic, capitalist, and an ally of the US. China is none of those things, raising American suspicions on each count. Japan was a partner, acquiescent if not willing, in the US plan to drive up the value of the yen. China continues to assert its sovereign autonomy where the exchange rate is concerned.

The international face of the Chinese economy is sovereign wealth funds led by the China Investment Corporation and para-statal industrial firms with apparently close but frustratingly opaque connections to the central government such as CNOOC and Chinalco. The barriers to foreign investment in China remain high for American firms, and these may only grow given China’s commitment to creating a large number of global champion companies in markets US multinationals currently dominate.
On top of this, the US is a much more unequal society today than it was in the early 1980s. The political incentives to feel the pain of ordinary people is high, and getting tough on globalization is an effective way to do it. On the campaign trail and even before the economy was a real issue, candidate Obama insisted that fair trade was more important than free trade.

Globalization is considered in much of the world a process of Americanisation. But for most Americans, China represents the leading edge of globalisation’s darker side.

Even before the crisis, Americans were growing tired of globalisation. Gallup has been asking Americans for a decade: “Do you see foreign trade more as an opportunity for economic growth through increased U.S. exports or a threat to the economy from foreign imports?”. In 2000, 56% of respondents thought trade was an “opportunity”, whereas 36% viewed it as a “threat” (a +20 point opportunity-threat score). In 2008, only 41% thought of trade as an opportunity for America, with 52% considering it a threat—a swing of 31 points against globalisation in eight years.

The Obama administration has said repeatedly that it will forsake the protectionist temptation, with dire memories of Smoot-Hawley tariffs deepening the Great Depression etched in policymakers’ minds. But buy American, hire American and lend American provisions crept into the US’s GFC-fighting fiscal stimulus and bank bailout packages. Government bailouts cum de facto nationalization of the GM and Chrysler auto companies—now running to well over $50 billion—have the explicit goal of propping up ailing domestic companies to keep their workforces in jobs, and in the process hurting international competitors and violating the level playing field norms underpinning the global trading regime.

American financial bailouts have focused on domestically-owned institutions like Bank of America, Citigroup and AIG and there heat on these institutions, now with sizable government ownership stakes, to will privilege domestic clients over foreign ones. The large scale infrastructure projects at the core of the Obama stimulus package initially contained explicit provisions mandating that work be done using American iron, steel and manufactures—all core parts of the Chinese export machine.

The climate change bill passed by the House of Representatives in June 2009 adds another new protectionist barrier to the, promising to impose heavy tariffs on countries with less stringent regulation of carbon emissions than the bill would mandate for the US. China, the world’s largest emitter and without anything akin to the Obama administration’s bill, looms as the largest target for climate change tariffs.

Add to these new forms of American trade protection what is likely to be rising nationalism surrounding foreign investment. China’s sovereign wealth funds and its large para-statal companies wanted to buy American firms before the crisis. But the backlash in America was intense—most vividly in the congressional firestorm in the summer of 2005 that led CNOOC to withdraw its bid for the small American oil and gas company Unocal. Since then, China has kept a low profile in the market for corporate control in the US, opting for minority stakes in shadow banks like the private equity firm Blackstone over more visible acquisitions of manufacturing firms and their quintessentially American middle class jobs.

With American asset prices battered by the crisis, China worried about the security of its T-bill holdings because of American public debt, and the Chinese currency likely to continue appreciating against the dollar, the economic incentives are high for China to go on a foreign direct investment buying spree in the US. But it is hard to imagine that the reception in the US would be favourable.

For its part, China was one of the seventeen countries named by the World Bank for erecting new protectionist barriers after the November 2008 G-20 meeting—in the form of bans on some imports and, more importantly, new tax breaks for exporters. The Chinese government apparently chose to slow the appreciation of the RMB against the dollar as the full effects of the GFC began to be felt in the last quarter of 2008. The Wall Street Journal has also reported that the Chinese government has included its own buy Chinese mandate in the regulations governing the use of its GFC-fighting fiscal stimulus measures: "Apart from engineering goods or service that cannot be obtained under reasonable business conditions inside China, domestic products should be purchased for the government investment program."
Beyond trade protection, tight Chinese government control of its domestic market has always created high hurdles for American firms wanting to establish footholds in China—with the ability to void potential foreign investments if they threaten “national economic security”.²⁵ American firms salivate at the prospect of satisfying the needs of China’s growing middle class, and they have been willing to go to great lengths to get inside the Chinese market. Wal-Mart is now China’s biggest retailer, but the infamously anti-organized labour firm was willing not only to let its Chinese workers unionize but also to hold meetings of the Chinese Communist Party on Wal-mart premises.²⁶ GM is China’s biggest car maker, but its joint venture is still controlled by its Chinese partner. American banks continue to expend immense effort trying to open branches in China, but getting anything more than a small minority stake has proved impossible.

The spectre of rising economic nationalism in China and the US is real. Trade disputes are already on the rise. China is poised to ban chicken imports from the US, in retaliation to an American ban on Chinese chicken. The US International Trade Commission has recommended that America impose tariffs of up to 55% on tire imports from China by arguing that they are being unfairly dumped on the American markets, hurting US producers.²⁷ In late June 2009, the US joined the EU in initiating proceedings against Chinese restrictions on raw material exports, which they claim hurt unfairly hurt countries and companies wanting to export to China. US Trade Representative Ron Kirk said that the Obama administration would insist “on the rights of American businesses and workers to a level playing field.”²⁸

Things threaten to get more heated as China and the US stare each other down over climate change in the run up to the Copenhagen Summit. The Obama administration is committed to changing the US from skeptic to leader on climate change. But the US insists that this will entail a global agreement that includes binding Chinese commitments. China is also taking climate change seriously, but it insists that given its stage of development China should not have to pay via deep emissions reductions for problems caused by almost two hundred years of western industrial production.

Tensions in the China-US economic relationship will play out against the backdrop of mutual national security anxieties that may increase as the US reassesses the limits of its global engagement and China continues to expand its external reach and military capacity. China insists is security objectives are wholly defensive, and principally focused on securing its land borders with its nearly twenty neighbours. But security hawks in the US Pentagon continue to pore over China’s defence spending, which they believe is rising too rapidly and too focused on blue water naval power to be only about securing the mainland.
US military expenditures are roughly half the global total, dwarfing those of China. But as Figure 3 shows, China’s military spending has been rising much more quickly than America’s, not only because China’s economy is growing more quickly but also because it is increasing the portion of GDP it spends on the military.

The pace of China’s military “catch up” will only increase if the Obama administration sticks to its defence spending plans. After a dramatic increase in spending to support the Af-Pak troop surge in 2009-2010, the administration projects a reduction in the US Defense Department budget of more than $US60 billion by 2012, with the total defence budget not returning to its 2010 levels until 2018.Obama’s plan is to devote one-third less of the US budget to defence in a decade’s time than it does today—a similar scale to the post Cold War “peace dividend” but in less benign international conditions.

Potential flash points that could trigger military confrontation between the US and China are few and apparently decreasing. Taiwan’s economic integration with China continues to build stronger linkages between the island and the mainland. The US and China have cooperated more closely over curtailing North Korea’s nuclear ambitions in recent years than many predicted.

Nonetheless, mutual suspicions about each other’s world views and long run ambitions will probably remain in China and the US. On top of the persistence of Chimerica and the temptations to economic nationalism generated by the GFC, there are clearly big challenges facing Sino-American relations.

The G-20 option
The launch of their new Strategic and Economic Dialogue amply shows that China and the US will devote considerable resources to their bilateral relationship. But both countries have also gone out of their way to signal that their relationship should be embedded in broader global forums. But what form might these take?

The first place to look might be regional groupings in the Asia Pacific. Australian Prime Minister Kevin Rudd has proposed the creation of an Asia–Pacific Community (APC) on European lines including most countries on both sides of the Pacific including China and the US—a revival and upgrading of what in recent years has been a decreasingly active APEC process. In his June 2009 confirmation hearings for US Assistant Secretary of State for East Asia and the Pacific, Kurt Campbell said that “Asians hate to be compared with Europe” and that if the APC idea is to succeed “it has to have deeper roots”.

Another possible regional option would be to include the US more formally in an expanded East Asia Summit, comprising the members of the Association of Southeast Asian Nations, the northeast Asian powers including China, and Australia, India and New Zealand. But China has already expressed its reservations about extending the grouping beyond its natural geographic meaning—and implicitly about including more democratic allies of Japan in an East Asian context where Beijing’s model of managed capitalism and benign authoritarianism remains the regional norm. Moreover, the whole ‘ASEAN plus’ process of regional institution building was born of Asian disillusionment with what was considered America’s malign neglect during the Asian financial crisis a decade ago.

Even though the scale and scope of multilateralism is obviously greater, there is more hope for embedding Sino-American relations at the global level. The US now accepts China’s claim that the Bretton Woods system is outmoded, in particularly because it does not reflect the rise of China and other emerging powers. While a Bretton Woods 2.0 might well soon be remembered as nothing more than a GFC pipedream, there is room within the existing system for consequential reform. In particular, using the IMF’s weighted voting formula to increase China’s role seems a plausible way to accommodate China’s rise without requiring new treaties or new treaty revisions. In addition, the US wants China to play more by global rules in finance (a central element of its “responsible stakeholder” agenda), and China wants more confidence that IMF will not abandon them and Asia, as it was seen to in Asian financial crisis a decade ago.

But IMF reform will not be on the multilateral table until at least 2011, and it would be naïve to expect that the process will be fast and painless. Between now and then, the G-20 is likely to be the crucial innovation in global governance, and one that both China and the US are already invested in.

For China, the G-20 represents the leading edge of worldwide recognition of its status as a global power, draped in the less threatening cloth of a broader balancing between the old powers of the 20th century and the rising powers of the 21st century. The G-20 is also big enough for the spotlight not to shine too brightly on China, allowing it to grow slowly into a global leadership role it remains uncomfortable about.

For the US, the G-20 represents a tangible reaching out to the new powers while also serving to lessen the influence of the big countries of old Europe, which seem increasingly not to see eye to eye with the US on a range of global issues. Both China and the US will have de facto vetoes in the G-20 without ever having to appear heavy-handed.

The short-term agenda for the G-20 is also very consistent with American and Chinese goals. Reforming the international financial institutions to give China a bigger role would also increase China’s confidence that it doesn’t need to accumulate such a large reserve of dollars to insure against the next financial crisis. For the US, greater Chinese involvement in the IMF would increase the pressure on China to reduce restrictions on its currency and on its capital account.
Even after the Copenhagen Summit, the G-20 is likely to play a vital role in brokering Sino-American agreement on an effective and binding international climate change agreement. Both sides may be willing to accept a deal in which China’s reduction targets are smaller and phased in later and in which China is given international aid to green its industrial base and economy. But given that Europe and India will also be essential to any such deal, using the G-20 as the framework for negotiation seems the prudent way forward.

The same is probably true both for the Doha Round and what comes next on global trade, and for empowering global financial regulation through the recently renamed Financial Stability Board. China and the US are the prima inter pares players, but the major European and other emerging economies must be included—without adding the complexity of inevitably cumbersome global treaty making.

The G-20 leaders meetings vaulted onto the global stage in the eye of the global financial storm. There is every chance, however, that its impact will only increase as the world emerges from the crisis. If it does, this will have been made possible in no small measure by the support of China and the US. The other members of the grouping will want to take advantage of the support of the de facto G-2 to embed their relations in a broader multilateral forum.

Conclusion

Before the global financial crisis, the US National Intelligence Council expressed the consensus view about global transformation, the forging a new international system that “will be almost unrecognizable by 2025 owing to the rise of emerging powers, a globalizing economy, an historic transfer of relative wealth and economic power from West to East”. After all the dust settles from the crisis, this transformation will continue. But it will increasingly focus on China and the US.

Sino-American relations are likely to be more difficult after the crisis than they were in the decade before—a decade of prosperity for both countries. With no return to the roaring noughties in sight, and with no easy path to “balancing” China-US economic relations, the Chimerica of the past decade is likely to be an increasing irritant to both sides, rather than the emollient to tensions it provided over the past decade.

Leaders in both China and the US know how important their bilateral relationship is. But neither country has a G-2 world view. Instead, both China and the US have shown that they want to pair a supersized bilateral relationship with a redoubled commitment to multilateralism. China seeks tangible status as a great power; the US wants China to be a responsible global stakeholder. Over time, this multilateral commitment may take the form of significant revisions to the Bretton Woods architecture, probably beginning with the IMF where the correlation between contributions and voting power facilitates the incorporation of China’s rise into an existing institutional structure.

In the meantime, the G-20 looms as the most likely global forum in which China and the US will play leading roles. In turn, their interrelations will be a defining feature of the G-20. Climate change, financial reform and free trade will be the big issues for China, the US and the world in the coming years. How well the G-20 deals with them will likely be a vital feature of the post-GFC world.

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