Bad Debts Assessing China's Financial Influence in Great Power Politics

Daniel W. Drezner

International Security, Volume 34, Number 2, Fall 2009, pp. 7-45 (Article)

Published by The MIT Press

Bad Debts

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China has challenged the United States on multiple policy fronts since the beginning of 2009. On the security dimension, Chinese ships have engaged in multiple skirmishes with U.S. surveillance vessels in an effort to hinder American efforts to collect naval intelligence.[1] China has also pressed the United States on the economic policy front. Prime Minister Wen Jiabao told reporters that he was concerned about China's investments in the United States: "We have lent a huge amount of money to the U.S. Of course we are concerned about the safety of our assets. To be honest, I am definitely a little worried."[2] The head of the People's Bank of China, Zhou Xiaochuan, followed up with a white paper suggesting a shift away from the dollar as the world's reserve currency.[3] China's government has issued repeated calls for a greater voice in the International Monetary Fund (IMF) and World Bank. To bolster this call, Beijing helped to organize a summit of the leaders of Brazil, Russia, India, and China (BRIC) to better articulate this message.[4]

The initial reaction of President Barack Obama's administration to many of these policy disputes has been muted.[5] Some commentators have suggested that American dependence on Chinese credit acted as a constraint on the U.S. ability to resist China's foreign policy advances. As one commentator noted following a March 2009 naval incident, "The U.S. might have decided to press its case. But it would then have to face the reality that its defense is crucially supported by the very country it wanted to confront."[6]

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The author is grateful to Anu Bradford, Jonathan Caverley, Gregory Chin, G. John Ikenberry, Charles Lipson, Douglas Rediker, Justine Rosenthal, John Schuessler, Herman Schwartz, Anna Seleny, Brad Setser, Duncan Snidal, Felicity Vabulas, and the anonymous reviewers for their feedback.

1. "Naked Aggression," *Economist*, March 12, 2009.
2. Quoted in Michael Wines, Keith Bradsher, and Mark Landler, "China's Leader Says He Is 'Worried' over U.S. Treasuries," *New York Times*, March 14, 2009.
3. Zhou Xiaochuan, "Reform the International Monetary System," People's Bank of China, March 23, 2009, http://www.pbc.gov.cn/english//detail.asp?col?6500&ID?178.
4. Philip Bowring, "China Tests the Waters," *New York Times*, June 17, 2009.
5. Bruce Stokes, "Dousing the Dragon Fire," *National Journal*, May 9, 2009, pp. 40–43.
6. Peter Hartcher, "China Flexes, and the U.S. Catches a Chilly Reminder," *Sydney Morning Herald*, March 17, 2009.

International Security, Vol. 34, No. 2 (Fall 2009), pp. 7–45

In the wake of the 2008 financial crisis, policy analysts are taking a hard look at the geopolitical implications of the United States' debtor status vis-à-vis its sovereign creditors. America's ballooning budget deficit and persistent trade deficit have required corresponding inflows of foreign capital. In recent years, official creditors such as central banks, sovereign wealth funds (SWFs), and other state-run investment vehicles have dominated these inflows. The United States owes an increasing amount of money to authoritarian capitalist states.[7] China has risen to special prominence as a creditor to the United States. In September 2008 China displaced Japan as the largest foreign holder of U.S. debt; according to one estimate, Chinese financial institutions owned $1.5 trillion in dollar-denominated debt in March 2009.[8]

What are the security implications of China's creditor status? If Beijing or another sovereign creditor were to flex its financial muscles, would Washington buckle? Many analysts believe the answer to be yes. In December 2008 James Rickards, an adviser to U.S. Director of National Intelligence Mike McConnell, observed that China possessed "*de facto* veto power over certain U.S. interest rate and exchange rate decisions."[9] Similarly, Gao Xiqing, the head of the China Investment Corporation (CIC), recently warned, "[The U.S. economy is] built on the support, the gratuitous support, of a lot of countries. So why don't you come over and . . . I won't say *kowtow,* but at least, *be nice* to the countries that lend you money."[10] Whenever sovereign creditors appear to lose their appetite for dollar-denominated assets, it becomes front-page news.[11]

If lending states can convert their financial power into an instrument of statecraft, the implications for the United States would be daunting. As Brad Setser recently concluded, "Political might is often linked to financial might, and a debtor's capacity to project military power hinges on the support of its

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7. Azar Gat, "The Return of Authoritarian Great Powers," *Foreign Affairs,* Vol. 86, No. 4 (July/August 2007), pp. 59–69; and National Intelligence Council, *Global Trends 2025: A Transformed World* (Washington, D.C.: U.S. Government Printing Office, 2008), pp. 7–14.
8. Brad Setser and Arpana Pandey, "China's $1.5 Trillion Bet: Understanding China's External Portfolio," Working Paper (New York: Center for Geoeconomic Studies, Council on Foreign Relations, May 2009).
9. Quoted in Eamon Javers, "Four Really, Really Bad Scenarios," *Politico,* December 17, 2008, http://www.politico.com/news/stories/1208/16663.html.
10. Quoted in James Fallows, "'Be Nice to the Countries That Lend You Money,'" *Atlantic,* December 2008, p. 65.
11. See, for example, Keith Bradsher, "U.S. Debt Is Losing Its Appeal in China," *International Herald Tribune,* January 8, 2009; Michael Mackenzie, "Foreign Investors Slash U.S. Holdings," *Financial Times,* March 17, 2009; Keith Bradsher, "China Slows Purchases of U.S. and Other Bonds," *New York Times,* April 13, 2009; and Keith Bradsher, "China Grows More Picky about Debt," *New York Times,* May 21, 2009.

creditors."[12] As the United States continues to run large deficits, many other commentators believe that its power is another bubble that will soon pop.[13]

The use of credit as an instrument of state power in great power politics has received surprisingly little scholarly attention in recent years. Setser observes, "Rising U.S. imports of capital—and the displacement of private funds by state investors—has not produced a comparable literature examining whether state-directed financial flows can be a tool for political power."[14] A perusal of major security journals reveals no recent discussion of this issue.[15]

This article appraises the ability of creditor states to convert their financial power into political power, drawing from the existing literature on economic statecraft. It concludes that the power of credit between great powers has been exaggerated in policy circles. Amassing capital can empower states in two ways: first, by enhancing their ability to resist pressure from other actors and, second, by increasing their ability to pressure others.[16] As states become creditors, they experience an undeniable increase in their autonomy. Capital accumulation strengthens the ability of creditor states to resist pressure from other actors.

When capital exporters try to use their financial power to compel other powerful actors into policy shifts, however, they run into greater difficulties. As the

12. Brad W. Setser, *Sovereign Wealth and Sovereign Power: The Strategic Consequences of American Indebtedness* (New York: Council on Foreign Relations Press, 2008), pp. 3–4.
13. National Intelligence Council, *Global Trends 2025,* pp. 7–14; Frederick Kempe, "Why Economists Worry about Who Holds Foreign Currency Reserves," *Wall Street Journal,* May 9, 2006; Heidi Crebo-Rediker and Douglas Rediker, "Capital Warfare," *Wall Street Journal,* March 28, 2007; Parag Khanna, *The Second World: Empires and Influence in the New Global Order* (New York: Random House, 2008); James Fallows, "The $1.4 Trillion Question," *Atlantic,* January/February 2008, pp. 36–48; Flynt Leverett, "Black Is the New Green," *National Interest,* No. 93 (January/February 2008), pp. 37–45; Joshua Kurlantzick, "A Fistful of Dinars," *Democracy,* No. 8 (Spring 2008), pp. 59–71; Gal Luft, "Selling Out: Sovereign Wealth Funds and Economic Security," *American Interest,* Vol. 3, No. 6 (July/August 2008), pp. 53–56; Setser, *Sovereign Wealth and Sovereign Power;* John B. Judis, "Debt Man Walking," *New Republic,* December 3, 2008, pp. 19–21; Michael Mastanduno, "System Taker and Privilege Taker: U.S. Power and the International Political Economy," *World Politics,* Vol. 61, No. 1 (January 2009), pp. 121–154; Mathew J. Burrows and Jennifer Harris, "Revisiting the Future: Geopolitical Effects of the Financial Crisis," *Washington Quarterly,* Vol. 32, No. 2 (April 2009), pp. 27–38; Nouriel Roubini, "The Almighty Renminbi?" *New York Times,* May 14, 2009; and David Leonhardt, "The China Puzzle," *New York Times Magazine,* May 17, 2009.
14. Setser, *Sovereign Wealth and Sovereign Power,* p. 17.
15. Beyond security studies, recent work includes David M. Andrews, ed., *International Monetary Power* (Ithaca, N.Y.: Cornell University Press, 2005); Helen Thompson, "Debt and Power: The United States' Debt in Historical Perspective," *International Relations,* Vol. 21, No. 3 (September 2007), pp. 305–323; Gregory Chin and Eric Helleiner, "China as a Creditor: A Rising Financial Power?" *Journal of International Affairs,* Vol. 62, No. 1 (Fall/Winter 2008), pp. 87–102; and Herman Schwartz, *Subprime Nation: American Power, Global Capital, and the Housing Bubble* (Ithaca, N.Y.: Cornell University Press, 2009).
16. Benjamin J. Cohen, "The International Monetary System: Diffusion and Ambiguity," *International Affairs,* Vol. 84, No. 3 (May 2008), pp. 455–470.

economic statecraft literature suggests, the ability to coerce is circumscribed. When targeted at small or weak states, financial statecraft can be useful; when targeted at great powers, such coercion rarely works. There are hard limits on the ability of creditors to impose costs on a target government. Expectations of future conflict have a dampening effect on a great power's willingness to concede. For creditors to acquire the necessary power to exert financial leverage, they must become enmeshed in the fortunes of the debtor state.

More often than not, the attempt to use financial power to exercise political leverage against great powers has failed. Looking at recent history, what is surprising is not the rising power of creditors, but rather how hamstrung they have been in using their financial muscle. To date, China has translated its large capital surplus into minor but not major foreign policy gains. To paraphrase John Maynard Keynes, when the United States owes China tens of billions, that is America's problem. When it owes trillions, that is China's problem.

To test the ability of foreign creditors to exercise political leverage, this article looks at cases in which sovereign creditors implicitly or explicitly tried to use their financial power to influence the foreign economic policies of targeted governments. Such disputes represent an "easy" test, in that financial power should be at its most potent in this arena. In the realm of foreign economic policy, other dimensions of power—such as military capabilities—are less likely to come into play. Because economic policy disputes are less likely to attract front-page levels of attention, the audience costs for all actors should be lower—increasing the efficiency of coercion attempts. If financial power does not work in altering target government policies on economic policies, then linkage strategies are far less likely to affect the foreign and security policies of the target government.[17]

The rest of this article is organized into five sections. The first section reviews policy and scholarly concerns about the rising power of official creditors. The second section surveys the existing literature on economic statecraft to see why these concerns are likely to be overstated. The next two sections look at instances when creditors would be expected to translate their financial power into political leverage. The third section reviews the bargaining over the regulation of cross-border sovereign wealth fund investments. The fourth section examines China's ability to use its creditor status to influence U.S. foreign

17. David M. Andrews, "Monetary Power and Monetary Statecraft," in Andrews, *International Monetary Power,* p. 9.

economic policy in the first year of the 2008 financial crisis. The final section discusses future scholarly and policy implications of China's financial muscle.

Scholarly and Policy Concerns about Financial Power

Fear of the political power of creditors has a long intellectual pedigree. Thucydides concluded that "the possession of capital enabled the more powerful to reduce the smaller cities into subjection."[18] Political theorists as diverse as Niccolò Machiavelli, Immanuel Kant, and V.I. Lenin cautioned against reliance on foreign sources of credit.[19] John Maynard Keynes argued after World War I that cross-border indemnities would foster insecurity in debtor countries and interventionist temptations in creditor countries: "Entangling alliances or entangling leagues are nothing to the entanglement of cash owing." During World War II, Albert Hirschman warned that "the power to interrupt commercial or financial relations with any country . . . is the root cause of the influence or power position which a country acquires in other countries."[20] During the 1980s, many Americans expressed anxiety about the rapid increase in Japanese holdings of U.S. assets.[21]

The growth and persistence of macroeconomic imbalances have rekindled these concerns. Over the past decade, the informal "Bretton Woods II" system enabled the United States to amass significant foreign debts.[22] Under this arrangement, the United States ran a massive current account deficit, helping to fuel the export-led growth of other countries. To fund this deficit, official creditors—central banks and other government investment vehicles—

18. Robert B. Strassler, ed., *The Landmark Thucydides: A Comprehensive Guide to the Peloponnesian War* (New York: Simon and Schuster, 1996), p. 7.
19. Niccolò Machiavelli, *The Prince,* chap. 10; Immanuel Kant, "Perpetual Peace: A Philosophical Sketch," in Hans Siegbert Reiss and Hugh Barr Nisbet, eds., *Kant: Political Writings* (Cambridge: Cambridge University Press, 1991), p. 95; and V.I. Lenin, *Imperialism: The Highest Stage of Capitalism* (New York: International Publishers, 1990), chaps. 2–4.
20. John Maynard Keynes, *The Economic Consequences of the Peace* (New York: Harcourt, Brace, and Howe, 1920), p. 279; and Albert Hirschman, *National Power and the Structure of Foreign Trade* (Berkeley: University of California Press, 1945), p. 16.
21. Eric Helleiner, "Money and Influence: Japanese Power in the International Monetary and Financial System," *Millennium: Journal of International Relations,* Vol. 18, No. 3 (Fall 1989), pp. 343–358; and Robert Gilpin, *The Political Economy of International Relations* (Princeton, N.J.: Princeton University Press, 1987), pp. 328–340.
22. On Bretton Woods II, see Michael P. Dooley, David Folkerts-Landau, and Peter Garber, "An Essay on the Revived Bretton Woods System," NBER Working Paper, No. 9971 (Cambridge, Mass.: National Bureau of Economic Research, September 2003); Benjamin Bernanke, "The Global Saving Glut and the U.S. Current Account Deficit," Sandridge Lecture, Virginia Association of Economics, Richmond, Virginia, March 10, 2005; and Barry Eichengreen, *Globalizing Capital: A History of the International Monetary System,* 2d ed. (Princeton, N.J.: Princeton University Press, 2008), pp. 210–218.

purchased dollars and dollar-denominated assets.[23] These purchases contributed to the boom in asset prices, which further fueled American consumption, widening the trade deficit and reinforcing the cycle.[24]

The magnitude of these imbalances is stunning. During the Bretton Woods II era, consumption as a share of American gross domestic product rose to an all-time high of 72 percent, while China's consumption as a share of GDP plummeted to a global low of 38 percent. The personal U.S. savings rate turned negative, while total Chinese savings approached 50 percent of GDP.[25] The U.S. current account deficit peaked in 2006 at close to $800 billion, or 7 percent of GDP. This percentage vastly exceeded the previous peak of the current account deficit in the mid-1980s. By 2007 the U.S. current account deficit equaled approximately 1.4 percent of global economic output, while China's current account surplus approached 0.7 percent of global GDP.[26]

Government investment vehicles have been responsible for an increasing share of capital inflows into the United States. Russia, China, and the Gulf countries have been the primary sources of these official inflows into America—and these countries have, at best, an ambiguous security relationship with the United States. In 2007 alone, emerging markets accumulated roughly thirty times the amount of currency reserves that the IMF lent out during the Asian financial crisis.[27] Because these assets are controlled by states, it is much easier to envisage their use as a tool of financial statecraft.[28]

China stands out in particular, as figures 1–3 demonstrate. Officially, China declared $1.95 trillion in hard currency reserves at the end of 2008, but this sum does not include holdings beyond the People's Bank of China. In all, Chinese state investors were estimated to possess $2.3 trillion in U.S. assets in September 2008, with approximately $1.5 trillion invested in dollar-denominated debt. This represents roughly 30 percent of global currency

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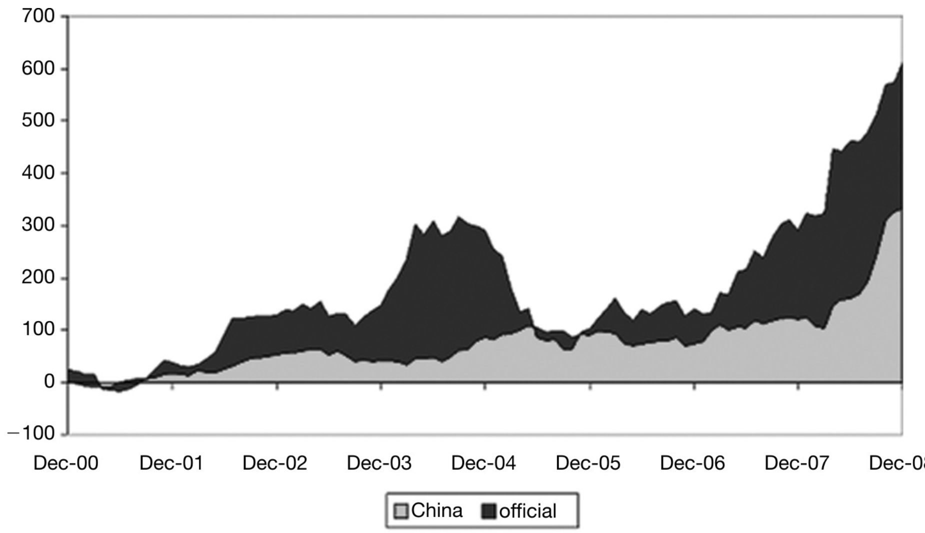
23. There are other reasons for foreign accumulation of U.S. assets, which we address in the conclusion. See Joshua Aizenman and Jaewoo Lee, "Financial versus Monetary Mercantilism: Long-run View of Large International Reserves Hoarding," *World Economy,* Vol. 31, No. 5 (May 2008), pp. 593–611.
24. Niall Ferguson and Moritz Schularick, "'Chimerica' and the Global Asset Market Boom," *International Finance,* Vol. 10, No. 3 (Winter 2007), pp. 215–239.
25. Nicholas R. Lardy, "China: Towards a Consumption-Driven Growth Path," Policy Brief, No. PB06-6 (Washington, D.C.: Institute for International Economics, October 2006); Barry Eichengreen, Charles Wyplosz, and Yung Chul Park, eds., *China, Asia, and the New World Economy* (New York: Oxford University Press, 2008), chaps. 10, 11, 14; and Stephen Roach, "A Wake-Up Call for the U.S. and China: Stress Testing a Symbiotic Relationship," testimony before the U.S.-China Economic and Security Review Commission, 111th Cong., 1st sess., February 17, 2009.
26. Steven Dunaway, "Global Imbalances and the Financial Crisis," Special Report, No. 44 (New York: Council on Foreign Relations Press, March 2009), pp. 15–16.
27. Setser, *Sovereign Wealth and Sovereign Power,* p. 13.
28. Helleiner, "Money and Influence."

Figure 1. Chinese and Other Official Purchases of Treasuries, Setser/Pandey Estimates from TIC data ($ billion)



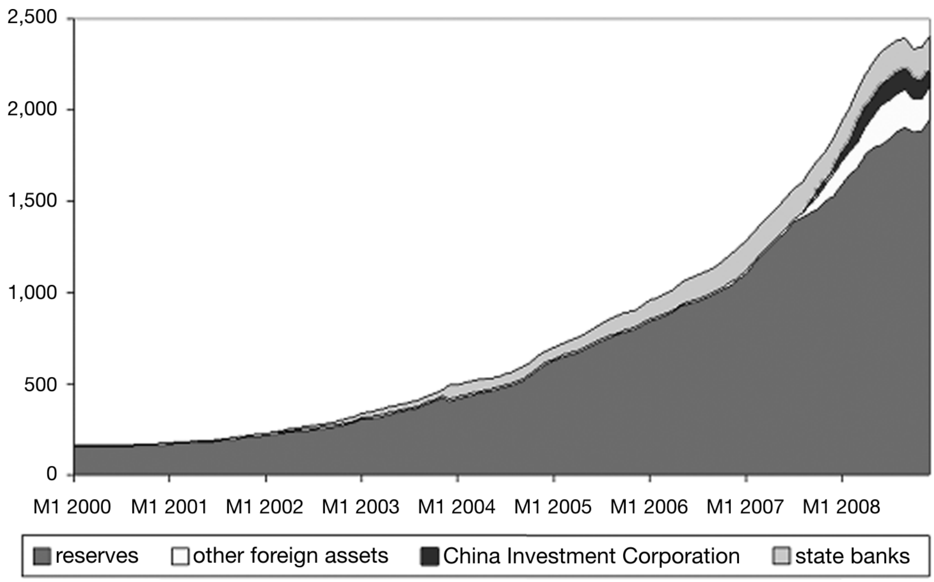
SOURCE: Brad Setser and Arpana Pandey, “China’s $1.5 Trillion Bet: Understanding China’s External Portfolio,” Working Paper (New York: Center for Geoeconomic Studies, Council on Foreign Relations, May 2009).

reserves, more than twice the reserve level of Japan, and four times the holdings of Russia or Saudi Arabia. In 2008 China purchased 46 percent of official U.S. debt. Between the fourth quarter of 2007 and the third quarter of 2008, China likely added more than $700 billion to its foreign portfolio. Setser and Arpana Pandey conclude, “Never before has the United States relied on a single country’s government for so much financing.”[29]

Dependence on foreign creditors alters the distribution of power through two theoretical pathways: deterrence and compellence.[30] In a deterrence scenario, lenders use their financial holdings to ward off pressure from debtor countries; in a compellence scenario, lenders threaten to use financial statecraft to extract concessions from the debtor states.[31] Creditors should be well

29. Setser and Pandey, “China’s $1.5 Trillion Bet,” p. 1. Other data in this paragraph come from Indira A.R. Lakshmanan, “Clinton Urges China to Keep Buying U.S. Treasury Securities,” Bloomberg, February 22, 2009.
30. For further exploration of these concepts, see Thomas C. Schelling, *The Strategy of Conflict* (Cambridge, Mass.: Harvard University Press, 1960).
31. Thomas C. Schelling, *The Strategy of Conflict* (Cambridge, Mass.: Harvard University Press,

Figure 2. Chinese Foreign Assets (Including Hidden Reserves)



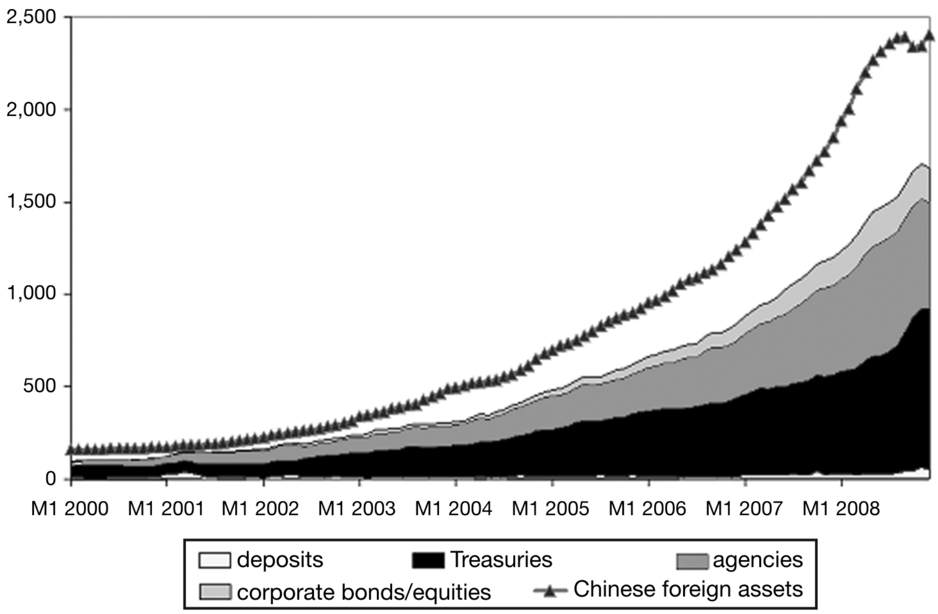
SOURCE: Brad Setser, "China's Record Demand for Treasuries (and All U.S. Assets) in 2008," *Follow the Money,* February 23, 2009, http://blogs.cfr.org/setser/2009/02/23/chinas-record-demand-for-treasuries-and-all-us-assets-in-2008/.

equipped to deter debtor nations from using coercion on other policy disputes. Even if creditors never explicitly brandish the threat to stop exporting capital, that possibility should constrain the ability of debtor countries to ratchet up tensions in a policy dispute. Countries possessing sufficient levels of reserves should therefore have greater autonomy of action and be better placed to rebuff foreign policy pressures from the debtor state.

Beyond deterrence, creditor nations could use their holdings as a tool of compellence. Leverage could be exercised most crudely through the threat of investment withdrawal. In response to public criticism of sovereign wealth funds, CIC President Gao warned, "There are more than 200 countries in the world. And, fortunately, there are many countries who are happy with us."[32] Beyond the "nuclear option" of dumping assets on the open market, creditor

1960); and Thomas C. Schelling, *Arms and Influence* (New Haven, Conn.: Yale University Press, 1967).
32. Quoted in Jamil Anderlini, "China Fund to Shun Tobacco, Guns, and Gambling," *Financial Times,* June 13, 2008.

Figure 3. Chinese Foreign Assets vs. Estimated U.S. Holdings



SOURCE: Brad Setser, "China's Record Demand for Treasuries (and All U.S. Assets) in 2008," *Follow the Money,* February 23, 2009, http://blogs.cfr.org/setser/2009/02/23/chinas-record-demand-for-treasuries-and-all-us-assets-in-2008/.

countries have subtler methods to pressure a debtor government. These options include slowing down the purchase of new debt, refraining from such purchases altogether, shifting the composition of foreign holdings, or talking down the debtor's currency.[33] Even implicit threats can have a coercive effect.[34] Creditor countries can also use their financial relationships to build up sympathetic domestic lobbies in debtor countries.[35]

The concerns about financial leverage are not purely theoretical: policymakers articulate fears about creditor compellence with increasing regularity. During the 2008 presidential campaign, Barack Obama stated, "It's pretty hard to have a tough negotiation when the Chinese are our bankers."[36] Director of

33. Setser, *Sovereign Wealth and Sovereign Power.*
34. Daniel W. Drezner, "The Hidden Hand of Economic Coercion," *International Organization,* Vol. 57, No. 3 (Summer 2003), pp. 643–659.
35. Andy Mukherjee, "Sovereign Wealth Funds a Boon for Asset Managers," Bloomberg, October 23, 2007; and Chris Larson, "Managers Eye Asian SWF Billions," *Financial Times,* August 3, 2008.
36. Quoted in David M. Dickson, "China's Economic 'Bargaining Chip,'" *Washington Times,* July 27, 2008.

National Intelligence McConnell declared in early 2008 that "concerns about the financial capabilities of Russia, China, and OPEC countries and the potential use of market access to exert financial leverage to achieve political ends represent a major national security issue." The U.S.-China Economic and Security Review Commission warned that "China appears far less likely than other nations to manage its sovereign wealth funds without regard to the political influence that it can gain by offering such sizable investments."[37] On the other side of the Pacific, Chinese officials and think tank analysts have suggested that Beijing use its dollar holdings to prevent American protectionism, acquire strategic assets, and ward off international pressure on the Tibet issue.[38]

Policy analysts have evinced similar concerns. Multiple books, essays, think tank reports, and op-eds stress the dangers of excessive dependence upon the financial largesse of foreign creditors.[39] Stephen Roach asserts, "Given America's reliance on China's funding of its external deficit—a reliance that will only grow in an era of open-ended trillion dollar budget deficits—the U.S. is in no position to risk reduced Chinese buying of dollar-denominated assets." Setser warns, "A Chinese or Russian decision to reduce holdings of dollars would probably inflict more pain on the United States than vice versa. Alternative sources of external financing would probably not be willing to lend to the United States on a comparable scale at the same terms." Helen Thompson observes, "What is important about the U.S.'s present net foreign debt is not so much that it has risen rapidly, but that the budget and current account deficits are now in significant part being financed by a state unlike those that have allowed the U.S. these opportunities at such a low domestic cost for four decades."[40]

Historically, governments have deployed the power of credit to advance

37. Mike McConnell, testimony before the Senate Select Committee on Intelligence, 110th Cong., 2d sess., February 5, 2008; and *U.S.-China Economic and Security Review Commission 2008 Report to Congress,* November 2008, p. 43, http://www.uscc.gov/annual_report/2008/annual_report_full_08.pdf. See also National Intelligence Council, *Global Trends 2025,* pp. 7–14. Congress created the U.S.-China Commission in 2000 to report on the national security implications of the economic relationship between the United States and China.
38. Dickson, "China's Economic 'Bargaining Chip'"; Ambrose Evans-Pritchard, "China Threatens 'Nuclear Option' of Dollar Sales," *London Daily Telegraph,* August 10, 2007; and "A Time for Muscle-flexing," *Economist,* March 19, 2009.
39. National Intelligence Council, *Global Trends 2025,* pp. 7–14; Rediker and Rediker, "Capital Warfare"; Fallows, "The $1.4 Trillion Question"; Leverett, "Black Is the New Green"; Kurlantzick, "A Fistful of Dinars"; Luft, "Selling Out"; Setser, *Sovereign Wealth and Sovereign Power;* Judis, "Debt Man Walking"; Mastanduno, "System Taker and Privilege Taker"; Burrows and Harris, "Revisiting the Future"; Roubini, "The Almighty Renminbi?"; and Leonhardt, "The China Puzzle."
40. Roach, "A Wake-Up Call for the U.S. and China," p. 7; Setser, *Sovereign Wealth and Sovereign Power,* p. 24; and Thompson, "Debt and Power," p. 314.

their geopolitical interests. In the sixteenth century, Genoese bankers used a debt ceiling to impose hard constraints on the military ambitions of Spain's Philip II, the most powerful monarch in Europe at the time.[41] The nineteenth century is replete with creditor nations forcing debtor states into line in order to secure their investments, using means ranging from trade sanctions to military intervention.[42] Nazi Germany built up dependent allies in central and eastern Europe by using blocked accounts of foreign exchange from its cross-border trade with those countries.[43] The United States resolved the 1956 Suez crisis by denying the United Kingdom's access to the International Monetary Fund, forcing the British to withdraw forces before allowing the British to use their IMF quota to defend the pound.[44] The power of IMF conditionality to force recipient countries into structural adjustment programs has been dissected for thirty years. In the past decade, the United States threatened financial sanctions to force countries to ratchet up their anti-money laundering practices.[45] Three years ago, China used its hard currency reserves as a carrot to encourage developing countries to stop recognizing Taiwan.[46]

Not everyone is concerned about the specter of financial statecraft hanging over the United States. Another school of thought argues that the size of capital and trade flows creates mutual interdependence rather than asymmetric dependence, making it difficult for China to credibly threaten or use its financial leverage.[47] Nevertheless, the chorus of concerns about financial leverage appears to be growing louder by the day. Kenneth Rogoff, who has largely dismissed concerns about U.S. foreign debts, nevertheless testified in June 2007 that "the United States' continued dependence on foreign borrowing is a

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41. James Conklin, "The Theory of Sovereign Debt and Spain under Philip II," *Journal of Political Economy,* Vol. 106, No. 3 (June 1998), pp. 483–513.
42. Charles Lipson, *Standing Guard: Protecting Foreign Capital in the Nineteenth and Twentieth Centuries* (Berkeley: University of California Press, 1985); Kris James Mitchener and Marc D. Weidenmier, "Supersanctions and Sovereign Debt Repayment," NBER Working Paper, No. 11472 (Cambridge, Mass.: National Bureau of Economic Research, June 2005); and Michael Tomz, *Reputation and International Cooperation: Sovereign Debt across Three Centuries* (Princeton, N.J.: Princeton University Press, 2007).
43. Hirschman, *National Power and the Structure of Foreign Trade.*
44. Diane B. Kunz, *The Economic Diplomacy of the Suez Crisis* (Chapel Hill: University of North Carolina Press, 1991); and Jonathan Kirshner, *Currency and Coercion: The Political Economy of International Monetary Power* (Princeton, N.J.: Princeton University Press, 1995), pp. 63–82.
45. Gary Clyde Hufbauer, Jeffrey J. Schott, and Barbara Oegg, "Using Sanctions to Fight Terrorism," Policy Brief, No. 01-11 (Washington, D.C.: Peterson Institute for International Economics, November 2001); and Sue E. Eckert, "The Use of Financial Measures to Promote Security," *Journal of International Affairs,* Vol. 62, No. 1 (Fall/Winter 2008), pp. 103–111.
46. Jamil Anderlini, "Beijing Uses Forex Reserves to Target Taiwan," *Financial Times,* September 11, 2008.
47. See, for example, Chin and Helleiner, "China as a Creditor"; Jonathan Kirshner, "Dollar Primacy and American Power," *Review of International Political Economy,* Vol. 15, No. 3 (August 2008), pp. 418–438; and Schwartz, *Subprime Nation.*

significant vulnerability in the event of shock, such as a collapse in U.S. housing prices."[48] It is safe to say that this shock has arrived.

The Limits of Financial Leverage in Theory and Practice

There is a surprising conceptual divorce between the geopolitical fretting and the extant literature on economic, financial, and monetary statecraft. This literature contains diverging opinions on the relative utility of financial leverage, but there are a few hypotheses that do generate significant amounts of consensus. These hypotheses suggest that China will not be able to wring much geopolitical bang for its bucks.

ALTERNATIVE SOURCES OF CREDIT

The scholarly literature concludes that financial sanctions work only under a limited set of conditions. The first necessary condition is that the debtor state cannot access alternative sources of credit. If debtors can find other lines of credit—through public or private sources, domestic or foreign investors—then the material impact of financial statecraft is severely circumscribed. Without significant costs, coercion yields little in the way of political concessions.

This is why, in explaining the variation in the success of financial statecraft, one of two conditions must hold. If the target state is in such desperate straits that no other actor is willing to bear the risk of extending credit, then financial statecraft can be a powerful form of leverage. The reason why the international financial institutions (IFIs) traditionally possess leverage in their lending programs is that state recipients have exhausted every other recourse. This explains Great Britain's decision to acquiesce in the Suez crisis—the IMF was its lender of last resort. For much of this decade, emerging markets had the option of tapping private capital flows or receiving unconditional loans from creditors such as China. Not surprisingly, the ability of the World Bank and the IMF to attach conditions to loans declined markedly during this time.[49]

The other condition is that the primary creditor is able to gain institutionalized multilateral cooperation in the execution of any kind of coercive threat.

48. Kenneth Rogoff, "Foreign Holdings of U.S. Debt: Is Our Economy Vulnerable?" testimony before the U.S. House of Representatives Committee on the Budget, 110th Cong., 1st sess., June 26, 2007, p. 9.

49. Ngaire Woods, "Whose Aid? Whose Influence? China, Emerging Donors, and the Silent Revolution in Development Assistance," *International Affairs,* Vol. 84, No. 6 (November 2008), pp. 1205–1221; and Gregory Chin, "China's Creditor Power and the World Bank: Reshaping Multilateral Institutions," in Alan Alexandroff and Andrew F. Cooper, eds., *Can the World Be Governed? Rising States, Rising Institutions* (Washington, D.C.: Brookings Institution Press, forthcoming).

The greater the number of actors that agree to sanction, the greater the opportunity costs of finding alternative sources of credit. Institutionalized cooperation significantly increases the likelihood of sanctions success.[50] Historically, Spain's Philip II was at the mercy of Genoa because Genoese bankers enforced a lending cartel. In the case of Suez, the United States was able to use its veto power in the IMF to ensure a de facto embargo of foreign reserves against Great Britain. Similarly, the United States acted through the Group of Seven (G-7) and the Financial Action Task Force on Money Laundering to enforce its anti-money laundering efforts.

LOW COSTS OF RETALIATION

There are additional requirements for financial leverage to yield tangible political concessions. Most obviously, the target country cannot be able to retaliate with its own costly sanctions. This is why, historically, economic statecraft between the great powers has had a dismal success rate. There is little precedent for great powers being able to asymmetrically punish other great powers; by definition, these countries possess either mutual vulnerabilities or no vulnerabilities. Indeed, there is little evidence that complex interdependence acts as a policy constraint between the great powers during times of geopolitical tension.[51] The economic globalization of a century ago did little to prevent the outbreak of World War I.[52] The U.S. seizure of Japanese assets in the late 1930s did carry significant economic bite—and, in response, Japan attacked Pearl Harbor.[53]

LOW EXPECTATIONS OF FUTURE CONFLICT

Expectations of future conflict also affect the likelihood of coercive pressure yielding significant concessions.[54] A sanctioning state will be more eager to apply financial pressure against an actor when it anticipates frequent conflicts with the target. Paradoxically, these same conflict expectations will reduce the willingness of the target to make significant concessions. If targets anticipate

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50. Lisa L. Martin, *Coercive Cooperation: Explaining Multilateral Economic Sanctions* (Princeton, N.J.: Princeton University Press, 1992); and Daniel W. Drezner, "Bargaining, Enforcement, and Multilateral Economic Sanctions," *International Organization*, Vol. 54, No. 1 (Winter 2000), pp. 73–102.
51. This is distinct from the claim that complex interdependence acts as a systemic constraint to prevent the emergence of crises.
52. David M. Rowe, "World Economic Expansion and National Security in Pre–World War I Europe," *International Organization*, Vol. 53, No. 2 (Spring 1999), pp. 195–231.
53. Edward S. Miller, *Bankrupting the Enemy: The U.S. Financial Siege of Japan before Pearl Harbor* (Washington, D.C.: Naval Institute Press, 2007).
54. Daniel W. Drezner, *The Sanctions Paradox: Economic Statecraft and International Relations* (Cambridge: Cambridge University Press, 1999).

frequent disputes, they will be reluctant to make material concessions in the present that undermine their bargaining position in the future. Targets will also worry about reputation effects: making concessions today encouraged the sender to expect acquiescence in the future as well, which will encourage future coercion attempts.

MONETARY REGIME

The use of monetary statecraft faces an additional hurdle if the target government maintains a floating exchange rate regime.[55] In a fixed rate regime, sender countries can try to provoke a run on the currency, forcing the government to expend its reserves to defend par value. In a floating regime, however, this kind of pressure will work only if markets sense an extreme overvaluation of the target currency. In this scenario, all the target has to do is guard against excessive volatility. This constraint on the use of economic statecraft holds with particular force if the target state's foreign debts are denominated in its home currency. If a country borrows in its own currency, any financial attack on the debtor's currency simultaneously punishes the sender, by eroding the value of outstanding debt payments.

In sum, for financial leverage to yield tangible concessions, the target state must be unable to find alternative creditors, lack the capability to inflict costs on the sanctioning country in response to coercive pressure, anticipate few conflicts with the coercing state over time, and try to maintain a fixed exchange rate regime. In looking at the current relationships between the United States and its sovereign creditors, none of these criteria is met. I will focus on the Sino-American bilateral relationship for now, because as the descriptive statistics from the previous section demonstrate, China is the best placed of the capital exporters to exploit its supposed financial leverage.

DOES CHINA HAVE FINANCIAL LEVERAGE?

The United States still possesses alternative sources of credit—both foreign and domestic. The yields on U.S. government debt, after falling to historic lows in early 2009, remain well below the historical mean—because the United States is still perceived as a safe haven compared with the alternatives. Although U.S. debt has doubled since 2000, it is still estimated to be 37 percent of GDP—a far smaller ratio than those of either Japan or many of the Eurozone economies. To be sure, the 2008 financial crisis dramatically increased the U.S. government's need to borrow. At the same time, the crisis also caused con-

55. Kirshner, *Currency and Coercion.*

sumption levels to decline and personal savings rates to increase dramatically from the beginning of 2008. The aggregate effect is to reduce the current account deficit while increasing the budget deficit. These trends imply a persistent need for financing, but blunt the need for foreign financing.

The United States is also well placed to impose significant costs on the Chinese economy if Beijing were to try to use its currency reserves to execute the nuclear option. If China scaled back its purchase of U.S. assets, the dollar would inevitably depreciate against the renminbi. Any dollar depreciation triggers capital losses in China's external investment portfolio. A 10 percent appreciation of the renminbi translates into a book loss of 3 percent of China's GDP in its foreign exchange reserves.[56] The United States possesses significant monopsony power in the issuance of liquid assets; in 2006, for example, roughly 45 percent of all liquid debt instruments originated from the United States. Because such a large fraction of liquid reserves in the world are issued by the United States, creditor countries cannot easily diversify away from holding the dollar.[57] The importance of the American market to Chinese exporters—and the threat of trade retaliation in the face of Chinese financial statecraft—highlights the mutual dependency of the two economies. This interdependence makes it difficult for China to credibly threaten any substantial exercise of financial muscle.

Short of the nuclear option, China will likely pursue subtler tactics—but expectations of future conflict will reduce U.S. willingness to accede to this kind of pressure. Beyond economic frictions, China's rise has exposed policy disagreements over questions of nonproliferation, humanitarian intervention, global and regional governance structures, and security in the Pacific Rim.[58] These conflict expectations might whet Beijing's appetite for financial statecraft, but they should also limit its ability to extract meaningful concessions from the United States. Although one should expect to see efforts at financial statecraft, those efforts should not yield much in the way of concessions.

Finally, the United States does not maintain a fixed exchange rate regime, and it issues debt denominated in its own currency. Indeed, China is the country that maintains a tightly managed peg against the dollar. Although this peg

56. Gregory Chin and Eric Helleiner, "Calling China's Bluff," *Foreignpolicy.com,* January 2009, http://www.foreignpolicy.com/story/cms.php?story_id?4646.
57. Schwartz, *Subprime Nation,* chap. 6.
58. Christopher Layne, "China's Challenge to U.S. Hegemony," *Current History,* January 2008, pp. 13–18; and Elizabeth Economy and Adam Segal, "The G-2 Mirage," *Foreign Affairs,* Vol. 88, No. 2 (May/June 2009), pp. 14–23. For a dissenting view, see G. John Ikenberry, "The Rise of China and the Future of the West," *Foreign Affairs,* Vol. 87, No. 1 (January/February 2008), pp. 23–37.

weakened somewhat between 2005 and 2008, it tightened up again as the financial crisis unfolded.[59] The United States' debt to China remains denominated in dollars and not another currency. China still faces its own dilemma in managing its foreign reserves. It cannot maintain its trade surplus while allowing its currency to appreciate vis-à-vis the dollar.[60]

The limited ability to exercise financial power over the United States is consistent with the empirical record on financial coercion. Without multilateral support, most efforts to use financial statecraft have fallen short.[61] In general, such cases are successful in extracting concessions only when the target state is a vulnerable ally of the primary sender. Benn Steil and Robert Litan surveyed recent efforts by the United States to use capital market access to force policy changes in China, Russia, and Sudan, and found that all the targeted entities were able to find alternative sources of financing at minimal cost. They conclude, "Rarely has so powerful a force been harnessed by so many interests with such passion to so little effect."[62] In 1995 Jonathan Kirshner reviewed past efforts to use financial power and concluded, "There have not been any significant episodes of subversive disruption, and, not surprisingly, floating rate 'systems' have not been disrupted."[63] A more recent collaborative effort to examine attempts at monetary statecraft reached a similar conclusion: "Among the central findings of our study are the substantial impediments to the efficient exercise of monetary power as a deliberate instrument of economic statecraft. . . . The tools of monetary statecraft . . . are often too blunt to be effective when they would most be desired and too diffuse to be directed at particular targets without incurring substantial damage."[64] Statistical analyses of sanctions reveal that financial statecraft or similar kinds of "smart sanctions" are no more likely to yield concessions than traditional trade sanctions.[65] More optimistic assessments of financial statecraft focus on the

59. Jeffrey A. Frankel, "New Estimation of China's Exchange Rate Regime," *Pacific Economic Review,* Vol. 14, No. 3 (August 2009), pp. 346–360.
60. Paul Bowles and Baotai Wang, "The Rocky Road Ahead: China, the U.S., and the Future of the Dollar," *Review of International Political Economy,* Vol. 15, No. 3 (August 2008), pp. 335–353, especially pp. 348–350; and Dunaway, "Global Imbalances and the Financial Crisis," pp. 10–12.
61. For other cases, financial statecraft was not the causal mechanism through which the sender influenced the target. In most cases of debt collections in the nineteenth century, for example, financial dependence was the excuse for exercising influence, not the causal mechanism through which creditors altered the policies of debtors. The British Navy, rather than British financial power, caused a change in the target policies. On this point, see Robert A. Pape, "Why Economic Sanctions Do Not Work," *International Security,* Vol. 22, No. 2 (Fall 1997), pp. 90–136.
62. Benn Steil and Robert E. Litan, *Financial Statecraft: The Role of Financial Markets in American Foreign Policy* (New Haven, Conn.: Yale University Press, 2006), p. 77.
63. Kirshner, *Currency and Coercion,* p. 175.
64. Andrews, "Monetary Power and Monetary Statecraft," p. 25.
65. A. Cooper Drury, "Revisiting Economic Sanctions Reconsidered," *Journal of Peace Research,* Vol.

ability of these sanctions to impose significant costs on rogue regimes in Pyongyang or Tehran. In neither case, however, have these costs translated into political concessions.[66]

None of this evidence proves conclusively that the United States can resist creditor compellence. The scholarly literature has barely considered the possibility of the United States being the target country. It is possible that the Chinese government's financial leverage is categorically different from other kinds of capital market sanctions. The sheer size of U.S. indebtedness might allow more subtle uses of financial pressure to force American concessions.[67] Through the examination of policy disputes that emerged in 2008, the next two sections test the relative vulnerability of China and the United States.

The Regulation of Sovereign Wealth Funds, 2007–09

The issue of sovereign wealth funds represents an excellent test for the ability of debtors to resist creditor preferences. SWFs are commonly defined as government investment vehicles that acquire international financial assets to earn a higher-than-risk-free rate of return. They emerged because capital exporters, including China, wanted to expand their investment opportunities. Despite U.S. dependence on imported capital, however, Americans grew increasingly uneasy about the size, state origin, and opacity of SWFs. In 2008 the combined heft of sovereign wealth funds was estimated to range between $2 and $3 trillion—larger than the value of all private equity or hedge funds. They had grown at an annual rate of 24 percent over the previous five years. Prior to the 2008 financial crisis, analysts predicted an annual 20 percent growth rate over the next decade.[68]

The most prominent sovereign wealth funds come from authoritarian capitalist states in the developing world. Of the top-twenty SWFs as measured by asset size in 2007, seven were based in the greater Middle East and nine were

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35, No. 4 (July 1998), pp. 497–509; Drezner, *The Sanctions Paradox*, chap. 3; and David Cortright and George A. Lopez, eds., *Smart Sanctions: Targeting Economic Statecraft* (New York: Rowman and Littlefield, 2002).

66. Rachel L. Loeffler, "Bank Shots: How the Financial System Can Isolate Rogues," *Foreign Affairs*, Vol. 88, No. 2 (March/April 2009), pp. 101–110; and Eckert, "The Use of Financial Measures to Promote Security."

67. Setser, *Sovereign Debt and Sovereign Power.*

68. The estimates in this paragraph come from Stephen Jen, "How Big Could Sovereign Wealth Funds Be by 2015?" in Currencies, Morgan Stanley Global Economic Forum, May 4, 2007; Steffen Kern, "Sovereign Wealth Funds—State Investments on the Rise," Deutsche Bank Research, September 10, 2007; Lyons, "State Capitalism"; Brad Setser and Rachel Ziemba, "Understanding the New Financial Superpower—The Management of GCC Official Foreign Assets," RGE Monitor, December 2007; and Jan Randolph, "Sovereign Wealth Fund Tracker" (Lexington, Mass.: Global Insight, April 28, 2008).

based in the Pacific Rim economies.[69] The fastest-growing funds (though not the largest) were based in China and Russia. The growth of these funds provoked a variety of policy concerns, ranging from worries about their effects on corporate governance to fears of excessive foreign influence over domestic industries.

THE PUSH FOR TRANSPARENCY

By the fall of 2007, sovereign wealth funds had moved to the forefront of financial governance issues. SWF investments in preeminent financial institutions such as Barclays and Blackstone heightened public anxiety and triggered proposals for regulation.[70] At the urging of both the United States and France, the G-7 finance ministers called on the IMF to draft a code of conduct for sovereign wealth funds.[71] The IFIs were requested to devise a code for the SWFs themselves; the Organization for Economic Cooperation and Development (OECD) was tasked with designing best practices for recipient countries.

The home countries of sovereign wealth funds reacted coolly to the G-7 pronouncement. Developing country representatives at the G-20 finance ministers meeting were wary about the G-7 request for standards. The G-20 communiqué praised the virtues of SWFs and then merely stated that they "noted the work" of the IFIs without any positive affirmation.[72] At the Davos Economic Forum in January 2008, SWF representatives across the board rejected criticisms of their activities. Some SWF representatives began to highlight their financial bargaining power. At one point, Norway's finance minister, Kristin Halvorsen, said, "It seems you don't like us, but you need our money."[73]

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69. Marko Maslakovic, "Sovereign Wealth Funds 2008" (London: International Financial Services, April 2008).
70. Edwin M. Truman, "Sovereign Wealth Funds: The Need for Greater Transparency and Accountability," Policy Brief, No. 07-6 (Washington, D.C.: Peterson Institute for International Economics, August 2007); Jeffrey Garten, "We Need Rules for Sovereign Funds," *Financial Times*, August 8, 2008; and Doug Rediker and Heidi Crebo-Rediker, "Foreign Investment and Sovereign Wealth Funds," Working Paper, No. 1 (Washington, D.C.: Global Strategic Finance Initiative, New America Foundation, September 25, 2007).
71. Laura Badian and Gregory Harrington, "The *Politics* of Sovereign Wealth: Global Financial Markets Enter a New Era," *International Economy*, Vol. 22, No. 1 (Winter 2008), p. 53; and statement of G-7 Finance Ministers and Central Bank Governors, meeting of G-7/8 Finance Ministers, Washington, D.C., October 19, 2007, http://www.g8.utoronto.ca/finance/fm071019.htm.
72. See G-20 communiqué, meeting of Finance Ministers and Central Bank Governors, Kleinmond, South Africa, November 17–18, 2007, http://www.g8.utoronto.ca/g20/g20-071118.html.
73. Mohammed al-Jasser, quoted in Natsuko Waki and Clara Ferreira-Marques, "Wealth Funds Bristle at Rich Country Wariness," Reuters, January 24, 2008; and Kristin Halvorsen, quoted in Daniel Gross, "SWF Seeks Loving American Man," *Slate.com*, January 24, 2008.

The IMF effort was a contentious process. Following initial consultations in November 2007, the IMF asked representatives from Abu Dhabi, Norway, and Singapore to develop benchmarks for best practices.[74] As the global credit crunch deepened, however, IMF officials reported pushback from some SWF officials at the very idea of voluntary best practices. Beyond the public complaints aired at Davos in January 2008, officials from SWF home countries expressed their opposition directly to IMF officials.[75]

The IMF issued a paper at the end of February to establish a work agenda.[76] The paper concurred with SWF officials that many of the stated concerns about sovereign wealth funds were exaggerated. It also argued, however, that there were valid regulatory concerns with regard to financial stability and transparency, justifying IMF involvement. The paper proposed an international working group (IWG) to draft a set of best practices by August in the hopes of receiving approval at the World Bank/IMF meetings in October.

The biggest issue for IMF officials was transparency on a variety of dimensions. They argued that if sovereign wealth funds were more explicit about their objectives, organizational structure, and investment portfolio, it would assuage anxieties about their cross-border investments. The IMF paper acknowledged that transparency on the last point was "likely to generate considerable discussion."[77] Sovereign fund officials argued that there were sound commercial reasons for keeping their portfolio composition a secret.

The advanced industrialized states also took steps outside the multilateral process. Australia and the European Union (EU) issued their own voluntary guidelines for a code of conduct. The EU's guidelines consciously mirrored the IMF work agenda, providing guidelines for governance, accountability, and transparency. The president of the European Commission, José Manuel Barroso, warned that legislation was still a possibility: "We cannot allow non-European funds to be run in an opaque manner or used as an implement of geopolitical strategy."[78]

The United States also formulated guidelines that toughened the national

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74. John Burton and Chris Giles, "IMF Urges Action on Sovereign Wealth," *Financial Times,* January 24, 2008.
75. Steven Weisman, "Sovereign Wealth Funds Resist IMF Attempts to Draft Code of Conduct," *International Herald Tribune,* February 9, 2008.
76. International Monetary Fund, "Sovereign Wealth Funds—A Work Agenda," February 29, 2008, http://www.imf.org/external/np/pp/eng/2008/022908.pdf.
77. Ibid., p. 26.
78. José Manuel Barroso, statement on sovereign wealth funds, Oslo, Norway, February 25, 2008, http://ec.europa.eu/commission_barroso/president/pdf/statement_20080225_02_en.pdf; and Tony Barber, "Brussels Pushes Wealth Funds to Sign Code," *Financial Times,* February 27, 2008.

security review process for foreign direct investments by government investment vehicles, including SWFs. At the same time, the Treasury Department worked on gaining SWF acceptance of a voluntary code of conduct.[79] Treasury Secretary Henry Paulson met with more than thirty SWF representatives in the first quarter of 2008. As a way of signaling the desired outcome of the IMF process, the United States persuaded the Abu Dhabi Investment Authority (ADIA) and the Government of Singapore Investment Corporation (GIC) to jointly issue a set of policy principles regarding SWFs and recipient countries. These included commitments to governance and transparency standards, as well as a pledge to use commercial and not political criteria in determining investments.[80] This was significant for two reasons. First, ADIA and GIC ranked near the bottom of transparency scores on sovereign wealth funds.[81] Their commitment to these principles signaled a clear change of tack. Second, combined with sovereign wealth funds headquartered in the OECD, the G-7 members had de facto or de jure commitments to transparency from sovereign wealth funds controlling more than half of all SWF assets—including the three largest funds.

The other sovereign wealth funds responded to these steps on two parallel tracks. They continued to resist any effort to craft a set of best practices within the IMF process. China and Russia, in particular, expressed skepticism about the IMF work agenda even before the board of governors approved it. The first meetings of the IWG in April 2008 made little headway. In June EU Trade Commissioner Peter Mandelson characterized the IWG negotiations as "prickly."[82] Chinese officials were particularly belligerent. In April 2008 CIC President Gao told *60 Minutes* that an IMF code would "only hurt feelings" and called the idea "politically stupid." In June he was more blunt, characterizing the process as "political bullshit."[83] CIC began a concerted public relations effort to argue that its sole concern was maximizing its rate of return on overseas investments, making additional regulation unnecessary.[84] CIC officials refused to participate in any IWG deliberations for the first half of 2008.

79. Gillian Tett, "SWFs Face Growing U.S. Pressure," *Financial Times*, January 23, 2008.
80. Bob Davis, "Foreign Funds Agree to Set of Guiding Principles," *Wall Street Journal*, September 3, 2008. For U.S. policy principles, see U.S. Department of the Treasury, "Treasury Reaches Agreement on Principles for Sovereign Wealth Fund Investment with Singapore and Abu Dhabi," March 20, 2008, http://treas.gov/press/releases/hp881.htm.
81. Edwin Truman, "A Blueprint for Sovereign Wealth Fund Best Practices," Policy Brief, No. PB08-3 (Washington, D.C.: Peterson Institute for International Economics, April 2008).
82. Peter Mandelson, "The Politics of Sovereign Wealth," *Wall Street Journal*, June 7, 2008.
83. *60 Minutes*, transcript, http://www.cbsnews.com/stories/2008/04/04/60minutes/main3993933.shtml; and Anderlini, "China Fund to Shun Tobacco, Guns, and Gambling."
84. Bruce Stokes, "New Moves on Wealth Funds," *National Journal*, March 15, 2008, p. 54.

Despite resistance to the IMF process, the members of the G-7 continued to raise the issue of regulating SWFs. Host countries began to understand the linkage between accepting a code of conduct and access to developed markets. An OECD report explicitly linked the openness of developing country markets to the willingness of sovereign wealth funds to adhere to more stringent transparency standards.[85] In the bilateral Strategic Economic Dialogue talks between American and Chinese cabinet-level officials held in June 2008, Treasury Secretary Paulson indicated to his Chinese counterparts that a successful IMF process would help to keep barriers to investment relatively low in the United States and Europe.[86] The IMF process also received encouragement in the G-8 communiqué in Tokyo, Japan, in early July, which meant Russia had publicly signed on to the idea of the IMF code of conduct.[87]

These efforts yielded progress. The July 2008 IWG working session was more constructive than the April session in drafting generally accepted principles and practices (GAPP).[88] Agreement was reached on the institutional and governance issues, leaving transparency as the remaining sticking point.[89] The goal of codifying the GAPP by the World Bank/IMF October meetings was repeated. China joined the process, pledging to participate in the September meeting of the IWG in Santiago, Chile. At the Santiago session, according to an IWG cochair, "There was a very frank exchange between the sovereign wealth funds and the recipient countries on a whole host of topics." The primary drafter of the GAPP code noted that "there were many people in our group who did not think it was possible for us to get to the point where we could move to consultation with our governments."[90]

Despite these frictions at the September IWG meeting, the members reached consensus on the GAPP, also known as the Santiago Principles.[91] The GAPP

85. Organization for Economic Cooperation and Development Investment Committee, "Sovereign Wealth Funds and Recipient Country Policies" (Paris: OECD, April 4, 2008), p. 6.

86. U.S. Department of the Treasury, "Transcript of U.S. Delegation Press Conference at the Fourth Meeting of the U.S. China Strategic Economic Dialogue," June 18, 2008, http://www.treas.gov/press/releases/hp1048.htm.

87. See G-8 Information Centre, G-8 Summits, "Hokkaido Official Documents: World Economy," Hokkaido Tokyo Summit, July 8, 2008, http://www.g8.utoronto.ca/summit/2008hokkaido/2008-economy.html.

88. See International Working Group of Sovereign Wealth Funds, "Working Group Announces Creation of International Forum of Sovereign Wealth Funds," Press Release, No. 08/03, July 10, 2008, http://www.iwg-swf.org/pr/swfpr0803.htm.

89. John Jannarone, "Sovereign Wealth Group Aims to Improve Transparency," Dow Jones, July 10, 2008.

90. Both quotes from "Press Conference Call: International Working Group of Sovereign Wealth Funds," Transcript, No. 08/01, September 2, 2008, http://www.iwg-swf.org/tr/swftr0801.htm.

91. See International Working Group of Sovereign Wealth Funds, "Generally Accepted Principles

consisted of twenty-four principles addressing the legal framework, institutional framework, governance issues, and risk management of sovereign wealth funds. Pledges of transparency, compliance, and profit maximization were made explicit. GAPP Principle 15, for example, stated, "SWF operations and activities in host countries should be conducted in compliance with all applicable regulatory and disclosure requirements of the countries in which they operate." Principle 19 stated, "The SWF's investment decisions should aim to maximize risk-adjusted financial returns in a manner consistent with its investment policy, and based on economic and financial grounds." Press reports characterized the outcome as "a rare triumph for IMF financial diplomacy."[92] The IMF approved the Santiago Principles at the October 2008 World Bank/IMF meeting, finishing its work agenda on schedule.

EXPLAINING THE OUTCOME

Contrary to perceptions about the enhanced bargaining power of sovereign creditors, the capital importers got their way. Despite the extreme reluctance of key capital exporters, a code of conduct was approved, and the most powerful SWFs publicly pledged to adopt the Santiago Principles.[93] The expert consensus among financial analysts and regulators is that, if implemented, the Santiago Principles will address all of the recipient country concerns.[94] This result was sufficiently counterintuitive for some observers to explain away the outcome by asserting that SWFs were the victims of bad public relations and inexperience at international financial negotiations.[95]

Because of the newness of the GAPP code, it is possible that the governance process will produce a "sham standards" outcome in which principles are vaguely articulated but not codified or implemented.[96] Back in February 2008,

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and Practices: 'Santiago Principles,'" October 2008, http://www.iwg-swf.org/pubs/eng/santiagoprinciples.pdf.

92. Davis, "Foreign Funds Agree to Set of Guiding Principles."

93. "ADIA Sovereign Fund Says to Adopt New Rules Quickly," Reuters, October 12, 2008.

94. Deloitte Touche Tohmatsu, "Minding the GAPP: Sovereign Wealth, Transparency, and the 'Santiago Principles,'" October 2008; Steffen Kern, "SWFs and Foreign Investment Policies—An Update," Deutsche Bank Research, October 22, 2008; Oxford Analytica, "Perceptions GAPP," World Next Week, October 17, 2008; and Edwin M. Truman, "Making the World Safe for Sovereign Wealth Funds" (Washington, D.C.: Peterson Institute for International Economics, October 14, 2008), http://www.iie.com/realtime/?p?105.

95. Sven Behrendt, "When Money Talks: Arab Sovereign Wealth Funds in the Global Public Policy Discourse," Carnegie Paper, No. 12 (Washington, D.C.: Carnegie Endowment for International Peace, October 2008).

96. David W. Drezner, *All Politics Is Global: Explaining International Regulatory Policies* (Princeton, N.J.: Princeton University Press, 2007), chap. 3.

one official involved in the IMF negotiations predicted the GAPP would be "toothless and devoid of anything other than motherhood and apple pie."[97] One financial publication characterized the IWG process as "pointless."[98] If this were the result, however, the next response by OECD economies would likely be to block SWF investments.[99] As previously noted, individual OECD governments were prepared to take such steps during early 2008.

Given the content of the Santiago Principles, it is likely that they will generate a high rate of compliance. The depth of the opposition from SWF officials during the negotiations, particularly those from China, suggests that they interpreted the GAPP as a significant shift from the status quo ante. This might be because the standards proposed by the OECD and IMF would be relatively easy to observe by private and public sector officials. As the GAPP's principal drafter David Murray pointed out, compliance with principles on transparency and governance is relatively easy to monitor.

What explains this outcome? Consistent with the statecraft literature, a concert of capital importers possessed greater power than the more heterogeneous group of capital exporters. The principal markets for inward investment were the OECD economies. When the United States and the European Union articulated similar preferences over SWF standards in early 2008, the two governments generated sufficient market power to deny capital exporters the ability to substitute toward other markets. This in turn triggered a cascade effect of cooperation by other market participants.[100]

The decision by GIC and ADIA to comply with U.S. requests for transparency is consistent with this argument. GIC and ADIA agreed to the voluntary principles as a way of preventing further strictures on cross-border investment. GIC's deputy chairman, Tony Tan Keng Yam, explained, "The greatest danger is if this is not addressed directly, then some form of financial protectionism will arise and barriers will be raised to hinder the flow of funds."[101] A few days before the policy principles were articulated, Abu Dhabi's director of

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97. Quoted in Weisman, "Sovereign Wealth Funds Resist IMF Attempts to Draft Code of Conduct."
98. Nicholas Pettifer, "IMF Persists with Pointless Sovereign Wealth 'Code,'" *International Financial Law Review,* September 4, 2008.
99. David M. Marchick and Matthew J. Slaughter, "Global FDI Policy: Correcting a Protectionist Drift," Council Special Report, No. 34 (New York: Council on Foreign Relations, June 2008).
100. Drezner, *All Politics Is Global,* chap. 5; and Beth A. Simmons, "The International Politics of Harmonization: The Case of Capital Market Integration," *International Organization,* Vol. 55, No. 3 (Summer 2001), pp. 589–620.
101. Quoted in Peter Thal Larsen and Martin Dickson, "Singapore Fund Pledges Greater Transparency," *Financial Times,* January 27, 2008.

international affairs, Yousef al Otaiba, wrote an open letter to the *Wall Street Journal* stressing the importance of an open investment climate.[102] In August an Arab League affiliate issued a report urging acceptance of a code of conduct, arguing that it would alleviate Western pressure to restrict SWF activity.[103] Survey evidence also indicates that sovereign wealth fund managers believed there was a linkage between agreeing to a code of conduct and warding off investment protectionism.[104] At the Santiago meeting, the more established SWFs, combined with recipient countries, were able to apply sufficient pressure on new capital exporters—China and Russia—to ensure agreement.[105]

Implicit and explicit threats of financial statecraft by SWFs proved to be hollow. It is true that the OECD economies—and prominent firms within these jurisdictions—needed SWF investment. Indeed, during the credit crunch in the fall of 2008, several OECD countries appealed directly to sovereign wealth funds for greater investments.[106] It is equally true, however, that capital exporters needed the United States and Europe to keep their jurisdictions open to capital inflows. The United Nations Conference on Trade and Development's 2008 World Investment Report concluded that, to date, three-quarters of SWF cross-border investments were concentrated in the developed world, particularly in Germany, the United Kingdom, and the United States.[107] Most other asset markets were neither big enough nor open enough to cater to large-scale sovereign wealth investments. Sovereign wealth funds could not invest sizable amounts of their portfolios in emerging markets without incurring excessive risk.[108] Furthermore, the very countries bulking up their sovereign wealth funds were the most protectionist when it came to inward foreign investment.[109]

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102. Yousef al Otaiba, "Our Sovereign Wealth Plans," *Wall Street Journal,* March 19, 2008.
103. Nadim Kawach, "SWFs Still Face Risk of Western Curbs," *Emirates Business 24/7,* August 1, 2008. The Inter-Arab Investment Guarantee Corporation issued the report.
104. Norton Rose LLP and Emerging Markets Private Equity Association, "Sovereign Wealth Funds and the Global Private Equity Landscape Survey" (London: Norton Rose, June 2008), http://www.nortonrose.com/knowledge/publications/2008/pub15287.aspx?page?all&lang?en-gb.
105. Krishna Guha, "Sovereign Funds Back Code," *Financial Times,* September 3, 2008.
106. "Spain Wants Sovereign Wealth Funds to Help Cover Its Debt," Reuters, October 20, 2008.
107. United Nations Conference on Trade and Development, *World Investment Report 2008: Transnational Corporations and the Infrastructure Challenge* (New York: United Nations, 2008), p. 21.
108. Simon Johnson, "The Rise of Sovereign Wealth Funds," *Finance and Development,* Vol. 44, No. 3 (September 2007), pp. 56–57.
109. Takeshi Koyama and Stephen Golub, "OECD's FDI Regulatory Restrictiveness Index: Revision and Extension to More Economies," Working Papers on International Investment, No. 2006/4 (Paris: OECD, December 2006); Rachel Ziemba, "Responses to Sovereign Wealth Funds: Are 'Draconian' Measures on the Way?" RGE Monitor, last updated November 1, 2007; and U.S. Government Accountability Office, "Foreign Investment: Laws and Policies Regulating Foreign

By June 2009 the SWF issue had largely receded into the background. The 2008 financial crisis devastated the balance sheets of many sovereign wealth funds. Morgan Stanley estimated paper losses of up to 25 percent during the 2008 calendar year, and lowered long-term growth estimates by 15 percent.[110] In 2008 Norway's fund reported a negative return of 23 percent; Singapore's Temasek lost more than 30 percent of its holdings.[111] The subsequent flight of private capital back to the OECD economies encouraged governments with sovereign wealth funds to redirect their investments inward to bolster sagging equity markets.[112] At present, these funds will likely function more like domestic development banks than aggressive cross-border investors. With reduced asset sizes and more conservative investment strategies, the potential creditor power of SWFs has been significantly reduced.

China's Direct Leverage over U.S. Financial Policies, 2008–09

As the acute phase of the credit crunch began in the summer of 2008, financial institutions found it increasingly difficult to borrow from each other. With cheap credit drying up, a growing number of U.S. financial institutions seemed poised on the edge of insolvency. U.S. dependence on continued Chinese capital inflows became abundantly clear. As the crisis deepened, China became increasingly outspoken about its desire to reform the international financial system and for the United States to accommodate Chinese preferences. Given the extent of the global credit crunch in the fall of 2008, and the size of China's dollar holdings, this represents an ideal case to test the power of financial leverage.

WHAT CHINA WANTED

Consistent with the traditional preferences of capital exporters,[113] Chinese officials wanted U.S. officials to protect the value of China's dollar-denominated assets. They also wanted guaranteed access to U.S. product mar-

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Investment in 10 Countries," GAO-08-320 (Washington, D.C.: U.S. Government Accountability Office, February 28, 2008).

110. Stephen Jen and Spyros Andreopoulos, "SWFs: Growth Tempered," Morgan Stanley, November 10, 2008, http://www.morganstanley.com/views/gef/archive/2008/20081110-Mon.html#anchor50bccf8d-419f-11de-a1b3-c771ef8db296.

111. "Singapore Wealth Fund Loses Steam," *BBC News*, February 10, 2009; and Robert Anderson, "Norway Reviews €75bn Loss in Wealth Fund," *Financial Times*, April 3, 2009.

112. William Miracky and Bernardo Bortolotti, eds., *Weathering the Storm: Sovereign Wealth Funds in the Global Economic Crisis of 2008* (Boston: Monitor Group, 2009), p. 17.

113. Setser, *Sovereign Wealth and Sovereign Power*, p. 18.

kets. As already observed, China had accumulated a massive portfolio of U.S. assets by the summer of 2008. The composition of this portfolio had shifted from safe assets, such as Treasury bills, to riskier assets, such as higher-yielding bonds and equities. Survey data from the U.S. Treasury show that, by the end of June 2008, more than half of China's portfolio of dollar holdings was outside of Treasury bills. China held $527 billion in long-term "agencies"—that is, bonds issued by government-sponsored enterprises (GSEs) such as Fannie Mae and Freddie Mac. Chinese financial institutions also held an additional $50 billion in corporate bonds and approximately $100 billion in equities. Between June 2007 and June 2008, the shift toward riskier assets accelerated. China tripled its holdings of equities and increased its holdings of agencies by at least 50 percent. In other words, China shifted into riskier investments in the United States just as the acute bubble phase of U.S. asset markets was about to end.[114]

Beyond the material risks for China, the acquisition of higher-risk investments carried significant political costs. As the size of China's external portfolio increased, so did the Chinese leadership's domestic headaches. They had to cope with bureaucratic rivalries between finance ministry, central bank, and development bank officials—all of whom wanted to control the accumulated foreign exchange.[115] Domestic discontent was also brewing about their foreign investment strategy.[116] Both officials and citizens debated whether holding so many dollars served Chinese national interests.[117] Debates over who should manage China's dollar portfolio broke out between finance ministry and central bank officials. The political leadership also had to cope with the political incongruity of investing trillions of government dollars in the developed world while tolerating significant pockets of domestic poverty. When these investments performed poorly, Chinese officials faced fierce internal criticism.

114. Data from U.S. Department of the Treasury, "Preliminary Report on Foreign Holdings of U.S. Securities at End—June 2007," February 29, 2008, http://www.ustreas.gov/press/releases/hp853.htm; and U.S. Department of the Treasury, "Preliminary Report on Foreign Holdings of U.S. Securities at End—June 2008," February 27, 2009, http://www.treas.gov/tic/shlprelim.html. See also Jamil Anderlini, "China Loses Billions on Equities Bets Ahead of Markets' Collapse," *Financial Times,* March 16, 2009.
115. Victor C. Shih, *Factions and Finance in China: Elite Conflict and Inflation* (Cambridge: Cambridge University Press, 2008); Michael H. Cognato, "China Investment Corporation: Threat or Opportunity?" *NBR Analysis,* Vol. 19, No. 1 (July 2008), pp. 9–36; and Cheng Li, "China's Team of Rivals," *Foreign Policy,* No. 171 (March/April 2009), pp. 88–93.
116. Geoff Dyer, "Beijing Pushed for Economic Disclosure," *Financial Times,* March 2, 2009; and Geoff Dyer, "China's Dollar Dilemma," *Financial Times,* February 22, 2009.
117. Xin Wang, "China as a Net Creditor: An Indication of Strength or Weaknesses?" *China and World Economy,* Vol. 15, No. 6 (December 2007), pp. 22–36; Keith Brasher, "Main Bank of China Is in Need of Capital," *New York Times,* September 4, 2008; and Dyer, "China's Dollar Dilemma."

CIC officials, for example, received considerable domestic flak for their May 2007 investment in Blackstone, after that firm's stock value plummeted.[118]

Beijing also wanted guaranteed access to U.S. product markets. China was increasingly dependent on exports as a source of continued growth. From 2001 to 2007, the export share of China's economy had nearly doubled, reaching 36 percent of GDP.[119] The United States was the primary market for these exports. Indeed, Chinese officials expressed concern in early 2008 about their inability to diversify away from the U.S. market.[120] Although both China and the United States were World Trade Organization (WTO) members, the increasing bilateral trade deficit created significant domestic pressures in Washington to erect barriers against Chinese imports. These included antidumping measures, health and safety regulations, and the prospect of branding China a currency manipulator. The threat of protectionism was considerable: between 2005 and 2007, forty-five anti-China trade bills were introduced in Congress.[121]

Assessing China's Financial Statecraft on Asset Protection

How well did the Chinese use their financial leverage to pressure American policymakers into accepting their preferred set of policies? On asset protection, Chinese pressure yielded mixed results. The most significant accomplishment came in pushing the Treasury Department to place Fannie Mae and Freddie Mac into conservatorship. During the fall of 2008, however, persistent efforts to use financial statecraft failed to move U.S. policies on asset protection.

Senior Chinese officials became aware of their exposure to agencies only in the summer of 2008.[122] By July the plummeting stock prices of the two institutions worried sovereign creditors, who held well more than $1 trillion of agency debt.[123] Their decline in value forced China's central bank to look to the finance ministry for additional injections of capital.[124]

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118. One tangible result of this was that Lou Jiwei, head of the CIC, did worse than expected in subsequent Central Committee elections. See Heidi Crebo-Rediker and Douglas Rediker, "Watching Sovereign Wealth," *Wall Street Journal*, February 28, 2008; and Cognato, "China Investment Corporation."
119. Roach, "A Wake-Up Call for the U.S. and China," p. 2.
120. Bruce Jones, Carlos Pascual, and Stephen J. Stedman, *Power and Responsibility: Building International Order in an Era of Transnational Threats* (Washington, D.C.: Brookings Institution Press, 2009), p. 237.
121. Roach, "A Wake-Up Call for the U.S. and China," p. 6.
122. Jason Dean, James T. Areddy, and Serena Ng, "Chinese Premier Blames Recession on U.S. Actions," *Wall Street Journal*, January 29, 2009; and Jamil Anderlini, "China Forex Fund Finds Safety in Secrecy," *Financial Times*, March 15, 2009.
123. Heather Timmons, "Trouble at Fannie Mae and Freddie Mac Stirs Concern Abroad," *New York Times*, July 21, 2008.
124. Bradsher, "Main Bank of China Is in Need of Capital."

As their balance sheets worsened, sovereign creditors began to make public and private calls for more concerted U.S. government action. Russian state investors expressed their displeasure and began to sell off their agencies in June. China reacted on a number of fronts. Publicly, individuals linked closely to China's central bank signaled their preferences for explicit U.S. government guarantees of agency debt. One former central bank adviser, Yu Yongding, told Bloomberg News, "If the U.S. government allows Fannie and Freddie to fail and international investors are not compensated adequately, the consequences will be catastrophic." Privately, China demanded and received regular briefings on possible government action from high-ranking Treasury officials.[125] Despite these consultations, during the month of August Chinese financial institutions stopped buying new agencies and started selling off some of their existing holdings.[126]

On September 5 the Treasury Department decided to put Fannie Mae and Freddie Mac into a government conservatorship. Foreign pressure for intervention clearly played a role in the decision. Senator Charles Schumer told the press that government officials informed him that "there was a real fear that foreign governments would start dumping Fannie and Freddie." Mark Zandi wrote immediately afterward that "it was the mounting evidence that central banks, sovereign wealth funds, and other global investors were growing reluctant to invest in the debt that was the catalyst for the Treasury Department's actions." Treasury Secretary Paulson maintained that foreign pressure was not the "major driver" of the move. He acknowledged, however, that "these companies are so big, and they are owned by investors all around the world. You are obviously going to get concerns. It was definitely concerning overseas, but there was [also] concern in this country."[127] As in the sovereign wealth fund case, a key factor behind the policy concession was that the creditors—intentionally or not—acted in concert. They all displayed similar preferences on this issue, and they all put pressure on Treasury officials.

The takeover of Fannie Mae and Freddie Mac went some way toward meet-

125. Dean, Areddy, and Ng, "Chinese Premier Blames Recession on U.S. Actions." Yu quoted in Kevin Hamlin, "Freddie, Fannie Failure Could Be World 'Catastrophe,'" Bloomberg, August 22, 2008.
126. Saskia Scholtes and James Politi, "Bank of China Flees Fannie-Freddie," *Financial Times,* August 28, 2008.
127. Charles Schumer, quoted in Deborah Solomon, Sudeep Reddy, and Susanne Craig, "Mounting Woes Left Officials with Little Room to Maneuver," *Wall Street Journal,* September 8, 2008; Mark Zandi, "The Fannie-Freddie Takeover: A Latter-Day RTC," *Moody's Economy.com,* September 7, 2008, http://www.economy.com/dismal/article_free.asp?cid?108515&src?hp_economy; and David M. Dickson and David R. Sands, "Overseas Debt Drives Bailout of Fannie, Freddie," *Washington Times,* September 9, 2008.

ing the demands of sovereign creditors. The bailout decision was also met with positive feedback from Asian markets and Chinese officials. A spokesman for the People's Bank of China stated, "These measures were positive and would stabilize the market and boost confidence."[128] China's role should not be overstated, however. Throughout 2008, as housing prices in the United States fell and mortgage default rates rose, the balance sheets of Fannie Mae and Freddie Mac looked increasingly perilous. In the spring, the two firms reported \$81 billion in capital against \$5.2 trillion in mortgages that they owned or guaranteed. Throughout the summer of 2008, Treasury officials had been mulling the possibility of a takeover.[129] Although foreign pressure contributed to the timing of U.S. government action, any plausible counterfactual suggests it would have happened at some point in 2008. In other words, the cause for the conservatorship decision is overdetermined.

The Treasury's conservatorship decision was the acme of China's leverage, and it should be coded as only a partial concession. In seizing Fannie Mae and Freddie Mac, the Treasury Department did not provide explicit guarantees for agency debts. Guaranteeing the \$5.2 trillion in agencies would have increased outstanding U.S. debt by more than 50 percent. This step would have inevitably lowered the sovereign bond rating of the United States, increasing the borrowing cost of capital just as plans for additional financial bailouts and fiscal boosts were being formulated. Federal Housing Finance Agency officials instead characterized the U.S. government's backing of the GSEs as "effective" but not "explicit." Without the full faith and credit guarantee, foreign investors remained wary of agency debt.[130]

Throughout the fall of 2008, high-ranking U.S. officials pleaded with Chinese officials for continued purchases of dollars.[131] Chinese officials repeat-

128. Vikas Bajaj and Keith Bradsher, "Treasury's Move Relieves Worries of Overseas Investors," *International Herald Tribune,* September 7, 2008; and People's Bank of China, "PBC Spokesman Interviewed for the Takeover of the Fannie Mae and Freddie Mac by the U.S. Government," September 8, 2008, http://www.pbc.gov.cn/english//detail.asp?col?6400&ID?1147.
129. See Bethany McLean, "Fannie Mae's Last Stand," *Vanity Fair,* February 2009, pp. 118–147; James R. Hagerty, Deborah Solomon, and Damian Paletta, "U.S. Mulls Future of Fannie, Freddie," *Wall Street Journal,* July 10, 2008; and Solomon, Reddy, and Craig, "Mounting Woes Left Officials with Little Room to Maneuver."
130. McLean, "Fannie Mae's Last Stand"; Hagerty, Solomon, and Paletta, "U.S. Mulls Future of Fannie, Freddie"; Solomon, Reddy, and Craig, "Mounting Woes Left Officials with Little Room to Maneuver"; and Wes Goodman and Jody Shenn, "Fannie Mae Rescue Hindered as Asians Seek Guarantee," Bloomberg, February 20, 2009.
131. This includes conversations between President George W. Bush and Chinese President Hu Jintao. See Wayne M. Morrison, "China and the Global Financial Crisis: Implications for the United States," CRS Report for Congress (Washington, D.C.: Congressional Research Service, Library of Congress, November 2008), Order Code No. RS22984.

edly demanded explicit U.S. government guarantees of the agency debt, warning of financial consequences otherwise. An overseas *People's Daily* commentary urged the creation of a "fair and just financial order that is not dependent on the United States." A *China Daily* editorial warned, "[The United States] should not expect continuous inflows of more cheap foreign capital to fund its one-after-another massive bailouts." At the meeting of the U.S.-China Strategic Economic Dialogue in December 2008, Vice Premier Wang Qishan called on the United States "to ensure the security of China's assets and investments in the U.S."[132]

U.S. officials nevertheless refused to provide an explicit guarantee of the GSE debt. In response, China switched the composition of its holdings during the fall of 2008, diversifying away from agencies in favor of U.S. Treasury bonds. Overall, foreign investors sold $170 billion in agencies in the last six months of 2008. The Federal Reserve intervened, pledging to purchase $500 billion in agencies. By November 2008, however, the spread between Fannie Mae's ten-year debt and Treasury bonds of similar length was at a record 1.75 .[133] Beyond acting on its holdings of agencies, China took other steps to show its displeasure. Chinese officials began to allow the dollar to appreciate against the renminbi. In November 2008 China was a net seller of U.S. debt—Treasury bonds and agencies—for the first time in more than two years. Chinese officials also suggested to their EU counterparts that trade between the two regions be denominated in euros rather than dollars.[134]

Setser characterizes these steps as "the first concrete demonstration of China's financial leverage."[135] By the standards developed in the economic statecraft literature, it is certainly true that China's actions intentionally imposed costs on the United States.[136] The question is: Did Chinese leverage affect U.S. policy? The answer here appears to be no. Despite the sell-off, neither the George W. Bush administration nor the Obama administration provided an explicit guarantee for the agencies. Furthermore, the effects of Chinese pressure had receded by early 2009. By February 2009, Fannie Mae notes were within fifteen basis points of government-guaranteed corporate debt. The

132. *People's Daily* quoted in Chris Buckley, "China Paper Urges New Currency Order after 'Tsunami,'" Reuters, September 17, 2008. Wang and *China Daily* quoted in Dean, Areddy, and Ng, "Chinese Premier Blames Recession on U.S. Actions."
133. Goodman and Shenn, "Fannie Mae Rescue Hindered as Asians Seek Guarantee."
134. Elizabeth C. Economy and Adam Segal, "In China, Stimulus and Questions about Global Financial Governance," Expert Brief (New York: Council on Foreign Relations, November 13, 2008), http://www.cfr.org/publication/17742/.
135. Brad Setser, "China: Creditor to the Rich," *China Security,* Vol. 4, No. 4 (Autumn 2008), p. 21.
136. David A. Baldwin, *Economic Statecraft* (Princeton, N.J.: Princeton University Press, 1985); and Kirshner, *Currency and Coercion,* pp. 214–215.

spread between Fannie Mae's ten-year debt and Treasury bonds fell to 0.64 percent.[137] The Obama administration indicated its comfort with the status quo, deferring final negotiations on the status of the GSEs until the fall of 2009.[138] China achieved a partial success in accelerating the timetable of the Treasury's decision to place the GSEs into conservatorship; its efforts to pressure a more explicit guarantee proved unsuccessful.

Beyond the inability to receive explicit guarantees of GSE debt, China's financial muscle failed to yield other concrete policy actions. Despite repeated Chinese entreaties, the U.S. government did not afford special protection for China's other dollar investments.[139] CIC had $5.4 billion in the Reserve Primary Fund, but found its assets frozen after that money market fund "broke the buck." CIC's investments in Blackstone and Morgan Stanley plummeted in value as the stock market crashed. China's State Administration of Foreign Exchange lost hundreds of millions of dollars when its investment into Washington Mutual failed to prevent a U.S. government takeover.[140] Because of these outcomes, Chinese officials stated repeatedly that they would abstain from further investments into high-risk bonds, commercial paper, or equities. These statements have not altered U.S. policies, however.

The Chinese also failed to receive any enhanced guarantee of access to U.S. markets. In 2008 the United States imposed six times the number of antidumping measures against China that it did in 2007.[141] In the fall of 2008, Treasury Undersecretary David McCormick told the *New York Times,* "[The Chinese] can't count on exports being such a driver of their economy going forward."[142] In January 2009 Treasury Secretary Timothy Geithner stated explicitly in written testimony that China was "manipulating" its currency. This was a loaded term, because any official designation of China as a currency manipulator would lead to a request for IMF intervention. Geithner's language reversed the George W. Bush administration's silence on this issue, sent bond markets into a frenzy, and prompted a vigorous pushback from Chinese officials.[143] U.S. Trade Representative Ron Kirk reaffirmed this sentiment in March, telling

137. Goodman and Shenn, "Fannie Mae Rescue Hindered as Asians Seek Guarantee."
138. Charles Duhigg, "U.S. Likely to Keep the Reins on Fannie and Freddie," *New York Times,* March 3, 2009.
139. Geoff Dyer, "China Lectures U.S. on Economy," *Financial Times,* December 4, 2008.
140. George Dean, "China Forex Watchdog Burnt by WaMu Collapse," Reuters, December 30, 2008; and Dean, Areddy, and Ng, "Chinese Premier Blames Recession on U.S. Actions."
141. Data from Chad P. Bown, "Global Antidumping Database," March 2009 update, http://people.brandeis.edu/?cbown/global_ad/.
142. Quoted in Jim Yardley and Keith Bradsher, "China, an Engine of Growth, Faces a Global Slump," *New York Times,* October 23, 2008.
143. Quoted in Krishna Guha and Alan Beattie, "Remarks by Geithner 'Will Anger China,'" *Financial Times,* January 22, 2009.

Congress that the executive branch would review China's currency actions "for consistency with its WTO obligations."[144] Secretary of Energy Steven Chu floated the idea of additional tariffs on carbon-intensive imports as a "weapon" in case China fails to act on greenhouse gas emissions.[145]

In February 2009 Congress passed a $700 billion emergency stimulus package that contained "Buy American" provisions requiring government procurement contracts to go to either U.S. firms or firms from countries that signed the WTO's Government Procurement Agreement (which prohibited signatories from discriminating against firms located in participating countries on procurement issues).[146] That excluded China, which is not a party to the agreement. In response, China's official Xinhua news agency labeled the provision "poison." The central government included a "Buy China" provision in its economic stimulus program.[147]

THE SECOND WAVE OF FINANCIAL STATECRAFT

Six months into the financial crisis, Chinese analysts grew frustrated with their government's inability to convert its financial leverage into shifts in U.S. policy. Nongovernment observers reiterated that China should demand the United States pursue stringent fiscal policies to prevent the erosion of Chinese holdings. With the prospect of more than $2 trillion in new U.S. debt to be issued in 2009, Chinese officials expected the value of their existing holdings to decline.[148] Think tank analysts in China articulated policy "wish lists" to ensure continued investment in U.S. debt. Chinese officials signaled the prospect of redirecting China's foreign exchange to inward investment.[149] The Boao Forum was replete with Chinese analysts and officials calling for changes in U.S. fiscal and monetary policies.[150]

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144. U.S. Senate Committee on Finance, Banking, hearing on confirmation of Mr. Ronald Kirk to be U.S. Trade Representative, 111th Cong., 1st sess., March 9, 2009, p. 98, http://finance.senate.gov/hearings/testimony/2009test/031109QFRs percent20for percent20SubmissionRK.pdf.
145. Ian Talley and Tom Barkley, "Energy Chief Says U.S. Is Open to Carbon Tariff," *Wall Street Journal*, March 18, 2009.
146. Louis Uchitelle, "'Buy America' in Stimulus (but Good Luck with That)," *New York Times*, February 20, 2009.
147. Jason Subler, "China Commentary Blasts 'Buy American' Plan," Reuters, February 14, 2009; and Jamil Anderlini, "'Buy China' Policy Set to Raise Tensions," *Financial Times*, June 16, 2009.
148. Lori Montgomery, "U.S. Debt Expected to Soar This Year," *Washington Post*, January 3, 2009.
149. Dyer, "China's Dollar Dilemma"; and Belinda Cao and Judy Chen, "China Needs U.S. Guarantees for Treasuries, Yu Says," Bloomberg, February 11, 2009.
150. See, for example, Zheng Xinli, "Expanding Economic Cooperation in China, Helping the Globe Get Rid of Crises," April 18, 2009, http://www.boaoforum.org/CPF/News _ShowContent-en.asp?Seq?2005000982.

In March 2009, Chinese officials ramped up their rhetoric. As noted in the introduction to this article, Prime Minister Wen explicitly voiced his concerns about the direction of U.S. fiscal policy at his annual press conference. Later in the month, China's central bank governor, Zhao Xiaochuan, argued that the costs of relying on the dollar as the world's reserve currency now exceeded its benefits. He proposed the creation of "a super-sovereign reserve currency" patterned after the IMF's Special Drawing Rights as a way to diversify away from the dollar.[151]

China's threats and rhetoric failed to yield significant policy concessions, however. On the trade front, the Treasury Department refrained from labeling China as a currency manipulator in its April 2009 report. This was not a shift in policy, however, so much as a reaffirmation of the status quo; as previously noted, the Bush administration had also refrained from using such a label. At the same time, the United States joined the European Union in filing a World Trade Organization complaint over China's hoarding of primary commodities to lower producer prices. Chinese trade officials repeatedly complained that U.S. protectionism was on the rise.[152]

On the monetary front, Chinese pressure led U.S. officials to issue public reassurances about the safety of U.S. Treasury bonds. At the same time, however, these officials were undeterred in pursuing more fiscal and monetary expansion. Less than a week after Wen's statement of concern, the Federal Reserve announced that it would issue currency to buy $300 billion of long-term Treasury bonds and $500 billion in agencies to lower interest rates even more.[153] The minutes of the Federal Open Market Committee (FOMC) meeting that made that decision show no discussion whatsoever of Chinese pressure or concerns.[154] Chinese officials were irate at the Fed's action, however, and voiced their displeasure directly to Federal Reserve officials visiting China in April.[155] This concern did not affect FOMC's decisionmaking at its next meetings in June and August 2009, however.[156]

Zhou's proposal to reform the reserve currency was received posi-

151. Zhou, "Reform the International Monetary System."
152. Alan Rappeport, "Chinese Official Warns U.S. on Protectionism," *Financial Times*, April 21, 2009; and Chen Deming, "Strengthen U.S.-China Trade Ties," *Wall Street Journal*, April 27, 2009.
153. Federal Reserve, press release, March 18, 2009, http://www.federalreserve.gov/newsevents/press/monetary/20090318a.htm.
154. Minutes of the Federal Open Market Committee, March 17–18, 2009, http://federalreserve.gov/monetarypolicy/fomcminutes20090318.htm.
155. Mary Anastasia O'Grady, "Don't Monetize the Debt," *Wall Street Journal*, May 23, 2009.
156. Federal Reserve, press release, June 24, 2009, http://federalreserve.gov/newsevents/press/monetary/20090624a.htm.

tively in Russia, the developing world, and the United Nations, and even by some IMF officials. Nevertheless, senior U.S. officials—including President Obama, Treasury Secretary Geithner, and Federal Reserve Chairman Benjamin Bernanke—categorically rejected calls to replace the dollar as the world's reserve currency. Chinese officials did not raise the issue in their private contacts with U.S. Treasury officials, and President Hu Jintao did not raise the issue in his April 2009 meeting with President Obama.[157] The dollar's status was not even mentioned in the April G-20 communiqué.

Beyond the inability to convince U.S. officials to budge, China's rhetoric failed to create any market pressure on the United States. Wen's statements did not affect either foreign exchange markets or bond markets. Zhou's white paper also left both markets largely unaffected.[158] In June 2009 Pierre Cailleteau, the managing director of Moody's Sovereign Risk Group, said it was a "pretty remote risk" that the dollar would cease to be the global reserve currency in the medium term.[159] In contrast, U.S. officials did move markets through their words and deeds. Both bond and foreign exchange markets moved significantly after the Federal Reserve's announcement of quantitative easing. The dollar also fell temporarily after a report erroneously claimed that Secretary Geithner was open to a transition away from the dollar as the world's reserve currency.[160] The only Chinese statement that created pressure on the dollar came in June, when BRIC leaders called for a "more diversified currency system" in their communiqué.[161] Again, the effectiveness of financial statecraft improved when a concert of creditors sounded out a common position.

China's failure to move markets or policymakers was largely the result of its interdependent economic relationship with the United States. The threat to diversify was not viewed as a feasible option by most analysts.[162] A JPMorgan Chase report concluded that continued Chinese purchases of U.S. debt were

157. Andrew Batson, Andrew Browne, and Michael M. Phillips, "U.S. Insists China Fears over Debt Unfounded," *Wall Street Journal,* March 14, 2009; and Geoff Dyer, "China Agrees on Need for Cooperation," *Financial Times,* April 1, 2009.
158. David J. Lynch, "Chinese Leader Wen's Remarks Put Focus on U.S. Treasuries," *USA Today,* March 15, 2009; and Andrew Batson, "China Takes Aim at Dollar," *Wall Street Journal,* March 24, 2009.
159. Quoted in "Moody's Says U.S. Credit Rating Is 'Safe,'" Reuters, June 23, 2009.
160. Krishna Guha and Tom Braithwaite, "Dollar Dips on Geithner's 'Loose Talk,'" *Financial Times,* March 25, 2009.
161. "Dollar Declines; BRICs Want Diversity," Dow Jones, June 16, 2009.
162. John M. Berry, "China Toys with Biting Hand Feeding Its Surplus," Bloomberg, March 18, 2009; Gady Epstein, "China's U.S. Debt Quandary," *Forbes.com,* March 19, 2009; Joanna Slater, "Beijing Faces Big Barriers in Effort to Supplant Dollar," *Wall Street Journal,* March 24, 2009; and David Pilling, "China Is Just Sabre-Rattling over the Dollar," *Financial Times,* April 1, 2009.

inevitable, because "there is no viable and liquid alternative market in which to invest China's massive and still growing reserves."[163] Throughout the spring of 2009, high-ranking Chinese officials repeatedly stressed their intent to purchase Treasury notes.[164] These statements were backed by data showing that China was continuing to purchase U.S. Treasury notes, though in shorter denominations than in the past.[165] In public comments, Chinese officials began stressing the advantage of liquidity in their portfolio of dollar holdings.[166] Although China took modest steps to expand the global use of the renminbi, it did not take the serious measures on capital account liberalization that would have signaled an aggressive promotion of its currency.

Luo Ping, a director-general at China's Banking Regulatory Commission, bluntly explained China's predicament in a speech in New York:

> Except for U.S. Treasuries, what can you hold? Gold? You don't hold Japanese government bonds or UK bonds. U.S. Treasuries are the safe haven. For everyone, including China, it is the only option.
>
> We hate you guys. Once you start issuing $1 trillion–$2 trillion . . . we know the dollar is going to depreciate, so we hate you guys but there is nothing much we can do.[167]

China's efforts at financial statecraft have not appreciably affected U.S. foreign and economic policies.[168] Indeed, Zhang Ming, an economist at the Chinese Academy of Social Sciences, told Reuters, "The United States is making policy decisions purely according to domestic considerations and is giving little thought to the outside world."[169] Beijing succeeded in accelerating the

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163. Quoted in Lakshmanan, "Clinton Urges China to Keep Buying U.S. Treasury Securities."
164. Zhou Xin and Jason Subler, "China Still Prefers Treasuries—Gov't Advisor," Reuters, March 4, 2009; Zhou Xin, "China Keeps Faith with U.S. Treasuries," Reuters, March 23, 2009; and Lionel Barber, Martin Wolf, Jamil Anderlini, and Kathrin Hale, "U.S. Dollar Backed as Reserve Currency," *Financial Times,* June 1, 2009.
165. Vincent Del Giudice, "China Bought More U.S. Securities Even Amid Concerns," Bloomberg, April 15, 2009; John Murphy, Peter Stein, and Neil Shah, "Dollar Vexes Asian Central Banks," *Wall Street Journal,* May 26, 2009; and Andrew Batson, "China—Watch the Body Language," *Wall Street Journal,* June 5, 2009;
166. See, for example, Chinese Foreign Minister Yang Jiechi's comments in his February press conference with U.S. Secretary of State Hillary Clinton. Hillary Rodham Clinton, "Toward a Deeper and Broader Relationship with China," Beijing, China, February 21, 2009, http://www.state.gov/secretary/rm/2009a/02/119432.htm.
167. Quoted in Henny Sender, "China to Stick with U.S. Bonds," *Financial Times,* February 11, 2009.
168. This includes the reaction to the naval skirmishes in March 2009. The United States sent a destroyer to guard the ship and stated that surveillance missions in the South China Sea would continue. See Demetri Sevastopulo and Kathrin Hille, "Beijing's Naval Harassment Rouses U.S.," *Financial Times,* March 25, 2009.
169. Quoted in Simon Rabinovitch, "Wary of U.S. Debt, China Shifts Gears on Investment," Reuters, May 19, 2009.

partial nationalization of Fannie Mae and Freddie Mac, but only by acting as part of a concert of foreign creditors. It failed at every other influence attempt. The U.S. government refrained from explicitly guaranteeing GSE debt, despite China's decision to diversify away from its holding of agencies to Treasuries. No special protections were offered for the rest of China's holdings in U.S. assets. No guarantees were offered for greater access to U.S. product markets. No accommodation was made on ending the dollar as the world's reserve currency.

CHINA'S FINANCIAL DETERRENCE

While China's compellence measures against the United States fell short, Beijing used its capital surplus to deter pressure from others. Financial statecraft allowed Beijing to reduce its risk and increase its flexibility in its foreign exchange portfolio. As the financial crisis deepened, China allowed the renminbi to depreciate, ignoring U.S. pressure to alter course. Prime Minister Wen asserted, "No country can pressure us to appreciate or depreciate" the renminbi.[170] Continuing its quasi-mercantilist policies, the government offered tax rebates for exporters as a way to boost economic growth and rebuffed efforts by Coca-Cola to acquire a Chinese juice maker.[171]

China's financial muscle also tempered U.S. foreign policy. Secretary of State Hillary Clinton acknowledged in her February 2009 trip to Beijing that pressuring China on human rights would take a backseat to economic issues for the foreseeable future.[172] In his June 2009 trip to China, Treasury Secretary Geithner backed away from earlier U.S. calls for China to allow the renminbi to appreciate.[173] Geithner explained this shift in policy by noting the absence of U.S. leverage given China's financial leverage.[174] Although China could not compel the United States, it could deter Washington from trying to apply its own foreign policy pressure.

China also used creditor power to get its way within international institutions. Beijing effectively vetoed any discussion within the IMF to investigate whether China's currency was fundamentally misaligned.[175] China vetoed

170. Quoted in Batson, Browne, and Phillips, "U.S. Insists China Fears over Debt Unfounded."
171. Mure Dickie, "Tax Rebates Raised for Chinese Exporters," *Financial Times,* November 12, 2008.
172. Glenn Kessler, "Clinton's Candor Draws Mixed Reviews," *Washington Post,* February 23, 2009.
173. "Statement by Treasury Secretary Timothy Geithner on Release of Semi-Annual Report to U.S. Congress on International Economic and Exchange Rate Policies," April 15, 2009, http://www.treas.gov/press/releases/tg90.htm.
174. Leonhardt, "The China Puzzle."
175. Alan Beattie, "IMF in Discord over Renminbi," *Financial Times,* January 26, 2009.

Asian Development Bank loans to India because of a territorial dispute with New Delhi.[176] In concert with the other BRIC economies, China agreed to contribute to IMF reserves. It did so, however, through the purchase of IMF bonds denominated in Special Drawing Rights, a weighted basket of major currencies. In doing so, Beijing modestly advanced its goal of generating alternatives to the dollar as a reserve currency.[177]

China's capital surplus also increased its ability to offer inducements to countries beyond the United States. In February 2009, Chinese banks signed more than $40 billion worth of deals with state oil firms in Brazil, Iran, Russia, and Venezuela, guaranteeing China a steady flow of oil for decades at reasonable rates. China was able to obtain good terms on these deals because these countries—unlike the United States—had greater difficulties obtaining foreign capital.[178] Beijing pledged to double its planned investments in Africa and offered $10 billion in credit to central Asian economies.[179] In an effort to promote greater global use of the yuan, the People's Bank of China initiated $95 billion of bilateral currency swaps prior to the April G-20 summit with countries as diverse as Argentina, Belarus, and Malaysia.[180] Even if China's financial power is limited in its effect on U.S. foreign policy, it has yielded gains in other capital-starved countries.

Conclusion

The financial indebtedness of the United States has fueled fears that the country will be beholden to the policy whims of authoritarian capitalist creditors. This article concludes that the power of credit has been inflated beyond its true worth. The utility of financial statecraft is more circumscribed than current fears suggest. To be sure, China's reserves endow it with greater policy autonomy. Capital exporters can use their financial leverage against dependent allies and when acting in concert. Against great powers, however, financial statecraft is of limited use. For great powers to become truly dependent, the

176. Raphael Minder, Jamil Anderlini, and James Lamont, "China Blocks ADB Loan Plan," *Financial Times,* April 10, 2009.
177. Bob Davis, "Developing Nations Try to Build Long-term Leverage at the IMF," *Wall Street Journal,* April 27, 2009.
178. David Barboza, "China Starts Investing Globally," *New York Times,* February 20, 2009; and Ariana Eunjung Cha, "China Gains Key Assets in Spate of Purchases," *Washington Post,* March 17, 2009.
179. Tom Burgis, "Beijing to Boost Spending in Africa Fund," *Financial Times,* March 16, 2009; and "China Offers Central Asia $10bn Credit Boost," Reuters, June 16, 2009.
180. See People's Bank of China, "Strengthen Regional Financial Cooperation and Actively Conduct Currency Swap," press release, March 31, 2009, http://www.pbc.gov.cn/english//detail.asp?col?6400&ID?1299.

size of the flows must be so big that the creditor becomes enmeshed in the fortunes of the debtor. The limits of financial power can be seen in the negotiations surrounding sovereign wealth funds and the Chinese efforts to influence U.S. economic policy from June 2008 to June 2009. Both case studies reveal that multilateral coordination is needed for financial statecraft to affect great power policies. They also reveal the constraints on China's ability to convert its financial holdings into policy leverage. As Paul Krugman recently concluded, "[China's rhetoric] amounts to a plea that someone rescue China from its own investment mistakes. That's not going to happen."[181] Other commentators have begun to echo this view.[182]

The results presented in this article are preliminary, and further study is clearly needed. Going forward, there will be medium-term and long-term tests of this thesis. For the medium term, a Chinese threat of decoupling from the United States is not economically viable, as China's economy remains heavily reliant on OECD markets.[183] The tight coupling and complex interdependence between the United States and China will cause the incentive structures in global finance to more closely resemble the logic of nuclear deterrence. A "balance of financial terror" implies a more peaceful coexistence, but at the same time it is a relatively nervous coexistence.[184] Trembling hands, in the form of rising nationalism or bureaucratic rivalries, could trigger a cascade of inadvertent actions that ends with a trade war between the United States and China. This does not mean that the financial equivalent of World War III will take place. It does mean that policymakers must be increasingly cognizant of that contingency.

For the long term, escalating U.S. budget deficits might shift the Sino-American financial relationship from mutual dependence to asymmetric dependence. According to 2009 Congressional Budget Office projections, the ratio of U.S. debt as a percentage of GDP will approach record levels by the year 2020.[185] Although the increase in domestic savings can absorb current

181. Paul Krugman, "China's Dollar Trap," *New York Times*, April 3, 2009.
182. Jamil Anderlini, "China Stuck in 'Dollar Trap,'" *Financial Times*, May, 24, 2009; Sebastian Mallaby, "Beijing's Would-Be Houdinis," *Washington Post*, May 26, 2009; Zachary Karabell, "Why Beijing Wants a Strong Dollar," *Wall Street Journal*, May 28, 2009; and Stephen S. Roach, "Manchurian Paradox," *National Interest*, No. 101 (May/June 2009), pp. 59–65.
183. On this point, see Asian Development Bank, "The Uncoupling Myth: The G3 Slowdown and Developing Asia," in *Asian Development Outlook 2008* (Manila: Asian Development Bank, 2008), http://www.adb.org/Documents/Books/ADO/2008/prelims.asp.
184. Lawrence H. Summers coined this term. Summers, "The United States and the Global Adjustment Process," speech given at the Institute for International Economics, Washington, D.C., March 23, 2004.
185. Congressional Budget Office, "The Long-Term Budget Outlook" (Washington, D.C.: Congressional Budget Office, June 2009).

increases in deficit spending, it is unlikely that domestic absorption can match the projected increase in deficit spending. If the United States is forced to offer its debt at higher interest rates to ensure the requisite capital inflows, it will exact a long-term drag on the U.S. economy. It is possible that, rather than pay that price, the U.S. government could choose to enact policies more consistent with the foreign policy preferences of sovereign creditors.

Finally, Beijing will be eager to engage in the kind of economic decoupling that was believed to exist in 2008. One aftermath of the Asian financial crisis was that the affected regimes were determined never to have to go back to the International Monetary Fund hat in hand. A significant reason for the amassing of hard currency reserves during the Bretton Woods II era was to avoid this contingency.[186] The tight coupling of the global economy caused export-dependent economies to face significant downturns because of the collapse in demand from the OECD economies. These governments will likely respond to the current crisis by creating the trade equivalent of currency reserves—a protected space of demand for national champions. The most direct way to do this will be to boost domestic consumption while restricting competition from foreign producers. This kind of decoupling would contribute to the unwinding of the macroeconomic imbalances caused by the Bretton Woods II arrangements. It would also reduce whatever constraints economic interdependence has placed on aggressive financial statecraft in world politics.

186. Aizenman and Lee, "Financial versus Monetary Mercantilism."