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Comment: Trading places? China, the United States and the evolution of the international political economy

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Comment: Trading places? China, the United States and the evolution of the international political economy

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ABSTRACT

The remarkable economic rise of China and the recent turmoil in US financial markets inevitably raises questions about the respective fortunes of both countries. This paper assesses the relative standing of the US and China by placing their relationship in historical context. It is suggested that China's accession to the WTO marked the highpoint of US influence and ascendancy. Since then, China's position has been steadily improving, something that the recent emergence of its first sovereign wealth fund and its subsequent role in bailing out distressed US financial institutions has dramatically highlighted. If China's form of 'state capitalism' continues to become more influential it will have major consequences for not only the US, but for the extant geopolitical order more generally.

KEYWORDS

China; United States; WTO; sovereign wealth funds; state capitalism.

How times change. During the 1990s it became almost obligatory to describe the US's position in the international system as unprecedented and 'unipolar'.¹ The power of the US, it seemed, was secure, American influence was pervasive, and other countries would have to bear the costs of adjustment to the new world order. One of the most telling expressions of the power of the US and the influence of the international order it had effectively created was China's accession to the World Trade Organization (WTO). So desperate was the Peoples' Republic of China (PRC) to join a capitalist world order dominated by the US generally and the Bretton Woods institutions in particular, that it was prepared to accept terms and obligations that far exceeded the obligations of previous new developing

nations' (Breslin, 2004: 665). Less than a decade later, however, the contours of a new international order are beginning to emerge as China's increasingly prominent 'sovereign wealth funds' (SWFs) play a key role in bailing out some of the US's largest financial institutions as they scramble to deal with massive losses accrued in various debt markets.

Ironically enough, China's accession to the WTO, which at the time seemed an unambiguous expression of American dominance, has played a significant part in the PRC's economic rise and at least some of the US's current problems. While there is a lively debate about the causes and significance of the US's trade deficit with China (Frankel, 2006; Hale and Hale, 2008), there is no doubt that China's concomitant accumulation of foreign currency reserves has given the PRC the wherewithal to play a prominent role as a source of investment, and as an increasingly important actor in the global economy. While this transformation in the relative standing of the US and China may not prove to be permanent, it does shed a revealing light on the forces that are shaping a rapidly evolving international political economy and the importance of historically contingent geopolitical forces. Although it is important not to overstate either China's capabilities or the extent of the US's decline, the latter's future policy options are likely to be more constrained by China's remarkable economic growth than we might have expected even a decade ago.

CHINA AND THE GLOBAL TRADE REGIME

The US is generally thought to enjoy a 'hegemonic' position in the international system (Agnew, 2005). While it is not possible to explore fully the complex nature of hegemony here (Beeson, 2006), a few simple points can be made. First, there is more to hegemony than simple military or material dominance: ideas matter, and the support or acquiescence of other states can significantly reduce the transaction costs associated with dominance and/or regime maintenance. For much of the post-war period, the international order the US effectively created and sustained appeared to reflect the values of American policymakers and further the interests of US-based economic actors (Ikenberry, 2001; Latham, 1997). In this regard, the influential organizations created at Bretton Woods seemed like the institutionalized expression of American primacy.

In some ways, China's accession to the WTO does mark a major 'victory' for the US. China's entry represented the symbolic and tangible end of any effective alternative to the almost universal adoption of some form of capitalism – even if there are important continuing differences about the way that capitalism is actually organized within national borders (Hall and Soskice, 2001). The record of Chinese participation in the WTO since it became a member in late 2001 also suggests that it has been

'socialised' into appropriate behavior in precisely the way that many either expected or hoped (Johnston 2008). As Margaret Pearson (2006: 256) points out, the evolving structure of the Chinese economy, and the importance of continuing access to markets in the US in particular have meant that, far from being a champion of 'developing country' interests, China 'does not seriously reject the status quo power structure of the WTO'.

And yet, while the ideational influence of 'Western' norms on Chinese elites is significant and potentially to the US's advantage, making an assessment about precisely which country has benefited most from China's participation in the WTO is surprisingly complex. Even though WTO membership has necessitated painful domestic adjustments like constitutional reform and increased pressure on China's uncompetitive state owned enterprises (Fewsmith, 2001), foreign direct investment (FDI) has grown rapidly, and has played a significant part in accelerating the rate of economic expansion and the growth of exports to the US in particular. At one level, this can be thought of as a positive sum game, in that both the US and China have arguably both benefited from this relationship: China gets the catalytic impact of greater investment from the US and assured access to American markets, while US-based companies can take advantage of China's massive pool of low-cost labor, and of the cheap consumer goods they produce for export. However, it is important to highlight three further aspects of this relationship which suggest that the long-term benefits are moving in China's direction. First, while FDI from the US and elsewhere has been an important stimulus to development in China, it has accounted for only 5% of capital formation (Bergsten *et al.*, 2006: 21). In other words, like Japan before it, China has relied on a remarkably high level of domestic savings to finance investment – a position that stands in marked contrast with the US's current situation.² Indeed, in Giovanni Arrighi's (2007: 353) view, China's cheap labor and potential markets meant that 'foreign (especially US) capital needed China far more than China needed foreign capital'.

The potential importance and implications of this claim can be seen in a second, related consideration: the trade and investment relationship between the US and China highlights the latter's importance to the profitability of American corporations like Wal-mart,³ and means that a powerful pro-China lobby has been created in the US, limiting the US policymakers' options as a consequence. Finally – and despite the concerns that are raised about the depth of the industrialization process in China and the amount of technological transfer that is actually occurring (Steinfeld, 2004) – some commentators are concerned that American companies are giving up their technological advantage as part of the investment process. David Lei (2007: 24), for example, argues that 'U.S. firms have essentially ceded their leadership positions across dozens of industries to eager suppliers that have

used the outsourcing arrangement as a vehicle for their own long-term learning and technology accumulation’.

Given the scale, complexity and rapid evolution of the Chinese economy, it is not surprising that the empirical record tends to be contradictory and unclear at times. What is more certain, however, and what has attracted increased political attention in the US and elsewhere as a consequence, is the scale of China’s expanding trade surplus with the US. The US runs an enormous overall trade deficit, but since China replaced Japan as the largest single contributor to this ‘problem’⁴ it has become the focus of growing protectionist pressures in the US. The fact that more than a quarter of ‘China’s exports to the US are actually generated by subsidiaries of American multinationals’ (Hale and Hale, 2008: 58) has done nothing to defuse political sensitivity in the US. But no matter how discomfiting the headlines may be for US political leaders, the reality may be that their ability to achieve a political resolution of this issue is increasingly circumscribed.

One of the most striking illustrations of both the rapid evolution of China’s place in the international economy and of the shifting balance of economic power between the US and China has been the latter’s rapidly expanding foreign currency reserves derived from its trade surplus with the US. This revealing development is given added significance by the fact that the vast majority of this money has been reinvested in the US, primarily in Treasury bonds.⁵ Without continuing inflows of capital from initially Japan and more recently China, the ability of the US government to fund its budget deficits so cheaply, and the ability of America’s consumers to continue propping up the American economy in quite the way they have, would be in even greater jeopardy (Murphy, 2006). In the long-term, the sustainability of this relationship is now in question. In the short-term, as successive Treasury Secretaries have discovered, there is little that the US can do to force the PRC government to revalue its currency or make other potentially painful adjustments to alleviate American problems (Presek, 2007).

The failure of American officials to secure the compliance of their Chinese counterparts in making such adjustments is a striking indication of the limits of US influence. But the more significant long-term story may be about the continuing, remarkably rapid, evolution of the international political economy and China’s place in it: China’s initial trade expansion and success is also transforming the basis of its overall integration into, and role in, the wider world economy. Crudely put, this marks a shift from a form of international integration primarily based in trade, to one that is increasingly centered in global finance. Equally significantly, in the same way that China’s leaders learned to adjust to, and take advantage of, the global trading system, they are also beginning to take a much more active role in the financial sector.

CHINA AND GLOBAL FINANCE

China now has the largest foreign exchange reserves in the world, totaling some \$1.5 trillion, up from \$1 trillion only a year before (*The Economist*, 2008a). But it is not simply the sheer scale of China's material assets that makes them significant: China is unencumbered by the sort of strategic and foreign policy constraints that generally made Japan – its regional rival and former developmental champion – unable to act decisively in pursuit of its own 'national interest', especially where this might be seen as conflicting with the preferences of the US (Samuels, 2007). China suffers from fewer inhibitions, and over the last decade or so has demonstrated a surprisingly effective capacity to develop a sophisticated foreign policy. Significantly, China's transformed economic position is facilitating the transformation of emerging material or structural power into political influence and agential capacity.

The idea that China might possess 'soft power' still seems outlandish to many given the PRC's association with authoritarianism and its still modest levels of overall development. And yet China has not only established itself as an effective actor in, and supporter of, multilateral institutions in a way that stands in conspicuous contrast with the Bush administration, it is also becoming associated with an alternative model of development that resonates powerfully with some states in Asia, Africa and Latin America (Kurlantzick, 2007; Ramo, 2004). However, China's growing influence also highlights the tensions and uncertainties in the bilateral relationship as it is currently configured.

In what was described by former US Treasury secretary Larry Summers as the 'balance of financial terror', China and Japan in particular have been willing to invest huge sums – an estimated trillion dollars in China's case – in US securities to underwrite the US budget and support overall consumption patterns (Ellis, 2007). For some observers, US indebtedness is, paradoxically enough, actually a manifestation of strength and structural leverage in the global economy. According to Panitch and Gindin (2004: 63), for example, the:

... increase in international holdings of highly liquid US Treasury bills not only had a major impact on furthering the development of massive secondary markets in bonds, but lay at the core of the re-constituted form of American imperial rule. It allowed the American state to consistently rely on global financial reserves to expand its – and capitalism's – global reach.

This argument had much to recommend it while Japan and China were passive investors and too intimidated by the possible consequences of their own actions to undermine the status quo; any suggestion that they might be seriously re-thinking their commitment to the US economy and

currency might trigger a disastrous collapse in the value of the American dollar and the ability of the US market to continue absorbing Asian exports (Beeson, 2007). However, the recent rapid decline in the value of the dollar has focused the attention of Chinese (and other) policymakers on the risks involved in holding dollar-denominated assets. As Chinese Premier Wen Jiabao recently observed: 'We are worried about how to preserve the value of our reserves'. Well they might be. Although the precise scale and composition of China's foreign exchange reserves is unclear, given that it is generally thought to be above \$1400 billion, of which two-thirds is US dollars, this is plainly a significant problem and level of exposure for China's government (Dickie, 2007).

The risk of triggering a currency crisis involving an even more rapid depreciation of the dollar has meant that the PRC government has, understandably enough, been keen to offer rhetorical support for the dollar's status as a global reserve currency (McGregor, 2007). Significantly, however, the actions of China's policymakers tell a different story and reflect a decline in confidence about the US economy, a sophisticated appreciation of the need to diversify risk, and a recognition that they can combine capitalist dynamics with *realpolitik*. At one level this is manifest in China's participation in the growing move out of the dollar and into other currencies, especially the euro (Peters, 2007). This is significant enough in itself, because such a move, should it persist, will undermine the US's 'seigniorage' privileges,⁶ increase the associated cost of borrowing, and generally undermine the centrality of the US economy in the international system. Of potentially equal long-term significance, however, is the fact that Chinese policymakers have shifted from being passive to active investors and are rapidly expanding their activities – and the impact of their form of capitalism – on global markets.

'STATE CAPITALISM' AND THE RISE OF SOVEREIGN WEALTH FUNDS

The rise of China and the growing economic power of resource-based economies like Russia, Venezuela and the oil-rich states of the Middle East, highlight the growth or persistence of illiberal forms of economic and political development (Gat, 2007; Zakaria, 2003). It is no longer eccentric to argue that neoliberal forms of capitalism may continue to be rejected in east Asia and elsewhere (Beeson and Islam, 2005), or that countries like China may successfully 'marry capitalism with a large state role in the economy' (Rachman, 2008). In short, the increasing prominence of 'state capitalism', fuelled by a powerful combination of economic nationalism and the proceeds of trade and resource revenues, is overturning assumptions about the direction of economic development and the best methods

of achieving it (Bremmer, 2008). The growth of sovereign wealth funds is emblematic of this new reality.

Although SWFs have been around for decades,⁷ the recent emergence of the China Investment Corp. (CIC) has provoked particular attention because of its potential 'strategic' role on behalf of the state. Such fears have been reinforced because of the sheer scale of extant SWFs. The recent growth in the size and number of SWFs is in large part a consequence of the overall growth of global foreign exchange reserves, which now total some \$5.75 trillion, with Asia alone accounting for \$3.66 trillion (Lyons, 2007: 4). What made the establishment of the PRC's first SWF especially significant was not simply its potential scale given China's rapidly expanding foreign reserves, but recent conflict with the US over other potentially 'strategic' investments. When the China National Offshore Oil Corporation (CNOOC) announced an unsolicited bid for the US-based Unocal Corporation, for example, it sparked a major debate about the national security implications of such a move in the US, and an unabashedly protectionist policy response.

The US found itself in the ideologically awkward position of having to oppose an ostensibly commercial investment on national interest grounds – precisely the sort of argument it had spent years discouraging developing countries from adopting in response to the investment strategies of US-based multinational corporations (Schortegen, 2006). The priority attached to energy security by the Bush administration and the dependence of the US economy on oil (Klare, 2004), especially when combined with a perception that China was increasing its geopolitical influence at US expense (Sutter, 2005), meant that a clash with China of some sort was almost inevitable. What is surprising, perhaps, is the muted nature of the US response thus far – especially as far as China's non-resource-based investments are concerned.

The CIC was established with an initial capital base of \$200 billion, and its first major investment – a \$3 billion, 9.9% stake in Blackstone, a US buy-out firm – gave an indication of the breadth and ambition of China's evolving strategy. In a significant attempt to defuse a Unocal-style protectionist backlash, the Chinese government took the 'unusual step' of giving up its voting rights (Guerrera, 2007). However, two developments have changed the underlying dynamic and balance of influence between US and Chinese interests since the Blackstone deal was struck. On the one hand, the Chinese have seen the value of their investment drop by 25% as a consequence of a general decline in equity values brought on by the sub-prime crisis in the US. On the other, this experience has led the CIC to take a much more assertive line in subsequent negotiations with distressed American financial institutions (Barker, 2007).

Although it is not possible at the time of writing to know quite how deep, prolonged or painful the impact of the US's debt crisis will prove

to be,⁸ some things seem clear already. First, the status of some of the most prominent financial institutions in the heartlands of Western capitalism have been profoundly altered: Morgan Stanley, Merrill Lynch, Bear Sterns,⁹ Barclays, Standard Chartered and HSBC all found themselves having to accept capital injections from SWFs in Asia and the Middle East. Most spectacularly, perhaps, Citigroup, the largest financial institution in the world, posted losses of nearly \$10 billion in a single quarter, forcing it to go cap-in-hand to SWFs in China and elsewhere for urgent assistance (Thomas, 2008). The most acute problem for the distressed Western financial institutions, however, was not that their new dependence on, and loss of control to, SWFs and other overseas financial institutions would continue, but that it wouldn't. It is becoming clear that many foreign investors are concerned about the possibility of throwing good money after bad in American markets.¹⁰

Such concerns have seen a noteworthy new development in China's rapidly evolving foreign investment strategies which, while they may not have as immediate an impact on the US in the short-term, are illustrative of an international order that is shifting against the US and shoring up China's relative position. The Chinese government-backed company Chinalco provoked surprise and consternation when – in a noteworthy collaboration with the US company Alcoa – it spent \$14 billion to acquire a 12% share in Rio Tinto, making BHP Billiton's proposed takeover (and potential dominance of a resource sector upon which the PRC is highly dependent), that much more difficult (Trounson, 2008). Not only was this the largest ever cross border investment by a Chinese company, but it signaled both a growing capacity to take part in such corporate power plays, and a lively appreciation of the need to secure long-term resource supplies. Indeed, so savvy have Chinese officials become as a consequence of their integration into the conduits of Western capitalism that there was a real possibility that they would attempt to take legal action against BHP on the grounds of anti-competitive behavior (Webb and Schneyer, 2008).

Some might see such behavior as an indicator of the US's continuing hegemonic power and the pervasive influence of American legal norms and practices (Kelemen and Sibbitt, 2004). While there is something in this argument, the ability of Chinese public officials to turn such mechanisms to their advantage should not be underestimated. There is, however, a more traditional and unambiguous expression of the US's declining influence which China's recent investment in Rio Tinto highlights: not only are such strategic investments designed to ensure long-term resource security, but they are also presenting acute foreign policy challenges for countries like Australia, where such investments are taking place (Uren, 2008).

When formerly stalwart allies like Australia begin to recalibrate their foreign policy to reflect new economic and strategic realities, clearly

something important is changing in the region. China has become a vital, if not the single most important, economic partner for much of east Asia, and this helps to explain its growing influence and acceptance as a major diplomatic force in the region (Lampton, 2007). The PRC's highly effective diplomatic offensive in the region stands in marked contrast to that of the US, and has further consolidated China's influence and importance as a consequence (Bergsten *et al.*, 2006: 133–34). If China's remarkable growth trajectory can be sustained in the face of profound environmental constraints – a very big 'if', and one that is still not given the attention it deserves (but see, Economy, 2007) – then we might expect the long-run transformation in its influence to continue.

CONCLUDING REMARKS

A belief that some sort of tectonic shift in the structure of the international system is underway and gathering pace has now become an increasingly uncontroversial view. Some of the most influential champions of Western free market capitalism are beginning to acknowledge the damage that has been done to the US's material and ideational standing as a consequence of the Bush administration's foreign policies in general and the recent crisis of American capitalism in particular. As Martin Wolf (2007) of the *Financial Times* observed:

what is happening in credit markets today is a huge blow to the credibility of the Anglo-Saxon model of transactions-orientated financial capitalism. A mixture of crony capitalism and gross incompetence has been on display in the core financial markets of New York and London.

This matters for two reasons. First, the problems in the US economy and the increased reliance on China to underwrite its overall economic position and bail-out distressed financial institutions is a dramatic and unambiguous illustration of how much has changed in only the last decade or so. This material transformation in the relative position of the two economies is important enough in itself, but it is arguably the longer-term ideational shift that underpins a second, even more significant consequence of recent developments. Not so long ago, the US was able to encourage or impose the array of policy prescriptions subsumed under the rubric of the 'Washington consensus' because its economy was dominant, its concomitant political leverage was immense, and its capacity to institutionalize and operationalize its policy preferences was unrivalled. In such circumstances, it was difficult for critics of the neoliberal orthodoxy to get much of a hearing, much less carve out the policy space in which alternative paradigms might be adopted (Wade, 2003). Now, however, things look rather different. Not only is there an alternative 'Beijing

consensus' emerging around China's pragmatic, state-centric approach to development, but the unparalleled development of the Chinese economy is dramatically reinforcing its material influence and even its ideational appeal.

Given that China has only been integrated into the global economy and an active participant in its international institutions for a few decades, its achievements and pace of growth are remarkable and unprecedented. If it can be sustained, then its rise and the US's relative decline are likely to be the key dynamics that will reshape the international system. If it can't, China's problems rather than its strengths may well be what will preoccupy its – and everyone else's – policymakers. For better or worse, coming to terms with China is likely to be the defining issue of the twenty-first century.

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NOTES

- 1 There is a substantial literature on this issue. Representative samples include Wohlforth (2002) and Kagan (1998).
- 2 Increased levels of foreign ownership in the US are leading some prominent figures to fret about long-term security and autonomy. Larry Summers (2004: 48) argues that 'in a real sense, the countries that hold US currency and securities in their banks also hold US prosperity in their hands'.
- 3 Wal-mart alone is China's eighth largest trading partner and its low-cost business strategy would not be as feasible without the China connection. See Hughes (2005: 94).
- 4 There are some widely recognized problems in measuring and/or making sense of trade flows in an environment where trade is often replaced by FDI. See Quinlan and Chandler (2001).
- 5 The details of China's investments are unclear, but it is estimated that in addition to \$600 billion of US Treasury bonds, it may have another \$100 billion exposure to the US's troubled mortgage-backed securities. See Bradsher (2007).
- 6 Seigniorage refers to the difference between the face value of money and the cost of actually producing it. The US's international seigniorage refers to benefits that accrue from the dollar's cross-border circulation and the fact that such activity effectively generates a subsidized or interest-free loan from abroad. An international shift away from the dollar will erode both this benefit and an important source of US hegemony. See Cohen (1998: 123–25).
- 7 Lyons (2007) suggests that began in the early 1950s in the Middle East. The combined assets of the top 20 SWFs are already estimated to be over \$2 trillion, and this figure is expected to rise rapidly.
- 8 Some seasoned observers considered it 'the worst crisis in 30 years'. See Hutton (2007).
- 9 Only fortunate timing allowed China's Citic Securities to avoid losing money when Bear Stearns collapsed. Attitudes in Asia have subsequently become

far more critical as a consequence of Wall Street's problems and the apparent fragility of Western finance, however. See *The Economist* (2008b).

- 10 As Gillian Tett (2008) observed, 'having stepped into the breach so visibly late last year, some funds are now getting jitters. In China, there are rising complaints that funds are foolish to shovel cash directly into risk-laden US banks when they could be using it in better ways, such as purchasing western commodity or manufacturing groups'.

NOTES ON CONTRIBUTOR

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