The Great China Debate

Will Beijing Rule the World?

The Wobbly Dragon

DEREK SCISSORS

Arvind Subramanian claims that China will unquestionably replace the United States as the dominant global power in the next two decades ("The Inevitable Superpower," September/October 2011). He is right that if the U.S. economy continues on its current trajectory, the United States will not be able to maintain its position of global leadership. But he is far too bullish on China. Subramanian overlooks Chinese policies that will complicate the country's economic rise and ignores the possibility that Chinese growth will simply stop. And he uses a definition of "dominance" that bears little resemblance to the U.S.-style preeminence he sees China assuming.

Consider how Subramanian measures China's growing power. He cites the ability of Beijing to convince African countries to recognize it instead of Taipei, but outmuscling Taiwan diplomatically is hardly a sign of global leadership. He sees the ease with which China undervalues the yuan by pegging it to the dollar as proof of the country's strength, but hiding behind a foreign currency is not a sign of economic might. He forecasts that China in 2030 will have an economy that is one-third larger than the United States', yet he admits that it will remain only half as wealthy. These are notable trends, to be sure, but not ones that indicate China will attain anything close to the position the United States has held over the past 60 years.

The biggest flaw in Subramanian's index of dominance is the importance he assigns to China's status as a net creditor. Based on this alone, he is prepared to say that China's economic strength is already comparable to that of the United States. But China's creditor status does not make up for the fact that its economy is presently less than half the size of the United States' and its people are barely one-tenth as wealthy as Americans.

Creditor status is also a misleading metric by which to judge China because it is usually used to describe financially open economies, and China is largely closed. Countries with open economies can invest their money in many places. Beijing, because it cannot spend its foreign reserves at home, is forced to keep buying U.S. Treasury bonds.

China's creditor status arises largely from its weaknesses, not its strengths. The country's $3.2 trillion worth of foreign currency holdings represents an imbalance between investment and consumption. Instead of loaning money to rich countries, China should be importing capital in order to speed its domestic development and meet its sizable needs, starting with properly capitalized pension and financial systems.

China's financial books are strictly divided, with huge assets in foreign currency (primarily dollars) on one side and huge liabilities in local currency on the other. Local governments have incurred high debts by spending heavily on programs such as railroad expansion and by borrowing to fund the 2009 stimulus (which came mostly from local, not national, government coffers). Beijing should be paying down this debt and addressing other domestic shortfalls with its mountain of foreign currency, but it cannot do so under its present balance-of-payments rules, which are designed to keep foreign currency in the hands of the national monetary authorities. Due to a closed capital account, domestic holders cannot send money overseas, and foreign currency can be converted to yuan only through the state financial system.

The Chinese government has not let money flow freely because doing so would undermine its control of domestic interest rates, reducing its ability to influence economic cycles, and it would expose the domestic banking sector to devastating competition. If domestic entities were allowed to send money abroad, hundreds of billions of dollars would flee the country for financial institutions that operate commercially, unlike Chinese banks. Such a stark fear of competition does not suggest a country ready to exert dominance anytime soon.

Lastly, Subramanian inflates China's financial influence over the United States, forgetting that influence in a buyer-seller relationship is determined not by what-if scenarios but by who has better alternatives. The United States has already diversified away from Chinese debt by having the Federal Reserve flood the U.S. financial system with liquidity. This is hardly ideal, but it has driven down the Chinese share of U.S. debt while keeping interest rates historically low. In contrast, Beijing, despite its best efforts to diversify, still holds 70 percent of its foreign currency reserves in dollars. The reason is simple: those reserves are so large and growing so quickly that there is no alternative. The United States needs China to keep U.S. interest rates below historic norms; China needs the United States to maintain its entire balance-of-payments system.

Even if Subramanian acknowledges that China's lopsided financial system is holding the country back now, he assumes that Beijing will soon rewrite its balance-of-payments rules and become an open economy. This assumption underestimates the Communist Party's antipathy to change. In fact, the principal advocate for such reforms has been Washington, which hopes to encourage China's transformation from an investment-led to a consumption-led economy. Such a transition would undermine China's net creditor status—what Subramanian sees as its main claim to dominance. But implementing market reforms would also allow China to keep growing at its blistering pace and surpass the United States in GDP. If China insists on maintaining government control over development, on the other hand, its long-term growth prospects will be dim.

Salvatore Babones ("The Middling Kingdom," September/October 2011) warns against drawing conclusions about China's trajectory by simply projecting its growth rates forward. Indeed, it is entirely possible that Chinese GDP growth will simply stop. Growth depends on land, labor, capital, and innovation. China has depleted its ecology, its labor surplus will soon begin to erode, and vast overspending has driven down the return on capital—all discouraging trends from the standpoint of growth.

As for innovation, Subramanian praises China's growing technology sector and its ability to absorb new advances. But a true economic leader must create, not absorb, and Beijing's favoritism toward large state firms will hinder innovation. Moreover, the quality of the Chinese higher-education system is poor and not necessarily improving. A no-growth scenario is a genuine danger—just ask the Japanese.

By underemphasizing or ignoring China's various weaknesses, Subramanian underestimates the United States' ability to influence the competition with China. That said, his criticisms of the United States are valid; indeed, his baseline prediction of U.S. growth at 2.5 percent annually may be too optimistic. Crippled by debt, the United States faces a period of stagnation. If the overall economy remains sluggish, a lack of import growth will cause trade to lag and further reduce the United States' global influence.

Still, the Chinese dragon will not fly forward indefinitely, as Subramanian suggests; it may even crash. For the foreseeable future, China will not attain the kind of dominance the United States has long held. The world should not expect to crown a new global leader but prepare for the absence of one.

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Subramanian Replies

Derek Scissors argues that my article prematurely heralds the rise of China and overstates the dominance that it will achieve. Above all, he takes issue with the importance I give to China's status as a net creditor and disputes my assessment of the country's prospects for growth and reform.

For starters, Scissors is simply wrong to claim that my characterization of China's economic might is driven by its status as a net creditor. In the index I designed to measure economic dominance, I give net creditor status a weight of just five percent; the size of a country's economy and the amount it trades account for the rest. I argue not that China's dominance in 2030 will depend on the country's remaining a creditor nation but rather that it will mostly stem from China's economy and trade outpacing those of the United States by nearly 50 percent.

That said, history is replete with examples of countries whose status as creditors has given them great power. After World War II, for example, the United States used its position as Europe's major creditor to design the rules of the International Monetary Fund, which, not coincidentally, favored the United States. Today, Europe is assiduously courting the world's new major creditor, China, in the hope that Beijing will put up the money for an EU bailout fund. If it does, it will surely use this leverage to shape the rules of international finance and trade.

Scissors also argues that China's creditor status reflects an underlying weakness because it is caused by "an imbalance between investment and consumption." But China's creditor status is the result of a strategy that has delivered humanity's most dramatic economic transformation in the shortest period of time, posting unprecedented rates of growth and consumption. That is hardly a sign of weakness.

Still, it is true that this strategy has distorted the economy, especially the prices of capital and foreign exchange. Keeping these prices artificially low will certainly entail future costs. Moreover, when China's exchange rate reverts to normal levels, its hoard of foreign reserves will lose value in terms of yuan. But whether these future costs will prove catastrophic for China, as Scissors contends, depends on the country's prospects for growth, since rapid growth makes all problems manageable.

On this issue, Scissors alleges that I am being too bullish; I would argue that he is being far too pessimistic. My central growth forecast assumes that China will grow at a rate of seven percent over the next two decades, about 40 percent slower than its current growth rate of 10.5 percent. This is a conservative estimate.

Plenty of countries at China's level of economic development have posted that kind of growth. And as long as China's standard of living remains lower than those of Western countries, its wages will stay low. This will continue to make China an attractive destination for investments and exports and will spur more growth. For this reason, Scissors' Japan analogy is misleading: at the time of its slowdown in the 1990s, Japan had already achieved Western standards of living and exhausted its catch-up possibilities. China, by contrast, has a GDP per capita that is only about 20–25 percent of the United States', which means China will remain internationally competitive for the foreseeable future.

Scissors nonetheless insists that China's growth could soon stop because the Communist Party will resist making necessary financial reforms. But China's policymakers know that delivering steady growth, which their legitimacy hinges on, will require reform. And although growth could always be derailed by developments overseas (such as a European crisis), China has shown that it can ably counteract such problems. In 2008, when the financial crisis caused Chinese exports to collapse, Beijing implemented a mammoth stimulus package to offset the shock in a way that few other countries could. As this suggests, China still has both the political will and the fiscal ability to grapple with problems as they arise.

Finally, Scissors argues that China will not be able to exercise economic dominance in the way that the United States has so long as it lacks the ability to create technology. True, innovation can give a country a unique kind of influence by inspiring others to want what it wants. As long as China remains politically closed, with a state-dominated economy and a lackluster technology sector, it cannot hope to attain this kind of dominance.

But my article focuses on a different kind of dominance: the ability to get others to do what you want or to prevent them from forcing you to do what you do not want. With its large and rapidly growing economy, China already wields such power. Consider, for example, how China's depressed exchange rate hurts economies from the United States to Bangladesh. Yet despite protests from across the world, Beijing continues to do what it wants. If that's not dominance, what is?