

# China: An Unlikely Economic Hegemon

*Heather Fox, Major, USAF*

Before any nation can achieve hegemon status, it must have economic strength. Numerous authors note that a strong economic base is the seed from which all other sources of national power emerge and hence can be considered a type of national foundation. Martin Jaques, for example, states that “military and political power rest on economic strength.”<sup>1</sup> Economics forms the support base for national power, and major international power shifts typically emerge as a result of economic developments, not military power or political influence, as Paul Kennedy’s research into several centuries of global power politics highlights:

There is detectable a causal relationship between the shifts which have occurred over time in the general economic and productive balances and the position occupied by individual powers in the international system . . . economic shifts heralded the rise of new Great Powers which would one day have a decisive impact upon the military/territorial order. This is why the move in global productive balances toward the “Pacific rim” which has taken place over the past few decades cannot be of interest merely to economists alone.<sup>2</sup>

China continues to grow economically at what some consider an alarming rate.<sup>3</sup> Meanwhile, the United States, struggling with budget woes and sequestration, remains the world’s preeminent economic and military leader but in decline relative to China. The relationship between these two nations and the comparative power they possess may well lay the foundation for future global power shifts impacting not just China and the United States, but indeed the entire international community.<sup>4</sup> However, while China is still expected to become extremely powerful, it may not rise to the level many expect due to three limiting factors: currency, exports, and demographics. These factors, along with mutual dependency between the two nations, have implications for US policy

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Maj Heather Fox is a graduate of the US Air Force Academy and holds MA degrees in strategic intelligence and defense studies from the American Public University and King’s College London, respectively. She attended the UK’s Advanced Command and Staff Course and is currently serving with the RAF at Air Command. She has flown as an instructor and combat pilot in the United States, Europe, Southwest Asia, and the Republic of Korea.

toward China. Thus, it is in the best interest of the United States to form a coherent long-term plan to best engage China in a way that avoids friction and promotes prosperity for both states.

Certainly, other factors may significantly shape China's future, including domestic unrest, politics, resource consumption, and military capability. But it is the concept of economics as the base of power that makes China's rise significantly important to the United States. While the intent here is not to predict China's economic future—indeed doing so with any certainty would be difficult—formulating long-term US policies toward China would be better informed by considering the major factors which might impact its economy rather than simply extending current economic growth trends without considering dynamics that may change its trajectory.<sup>5</sup> This root of Chinese power must be understood for the United States to successfully relate to China, influence it when necessary, and, if extreme circumstances require, counter it.

## **China's Rising Economy**

*Experience: that most brutal of teachers. But you learn, my God do you learn.*

—Generally attributed to C. S. Lewis

China began economic reforms in 1978 allowing more private ownership, property rights, and international free trade while still imposing significant central government influence. Even with a recent slowdown, its economy has increased under these changes at a stunning annual rate of around 8–10 percent.<sup>6</sup> Since overtaking Japan in 2010, China now boasts the second largest gross domestic product (GDP) behind the United States and is expected to surpass the US economy in about a decade if it continues to grow at the present rate.<sup>7</sup> This rising economy, in conjunction with the world's largest foreign exchange reserve holdings of \$3 trillion, bestows significant financial power.<sup>8</sup> Arvin Subramanian notes that China is also emerging as a global creditor and is in fact the largest supplier of funds to the United States, creating the potential for escalating impact. He points out that “being a leading financier confers extraordinary influence over other countries that need funds, especially in times of crisis.”<sup>9</sup>

Many believe China's economic rise and gathering power will continue, hence the predictions of surpassing the United States in the coming decades. Institutions such as Goldman Sachs and the Carnegie Endowment predict China will surpass the US economy by 2027 or 2035, respectively.<sup>10</sup> Economist Robert Fogel expects that "by 2040 China not only will have long since surpassed the United States, but also its economy will be nearly three times as large and will account for fully 40 percent of total world output."<sup>11</sup> In a *Foreign Policy* article, Fogel contends, "According to my forecasts, China's share of global GDP—40 percent—will dwarf that of the United States (14 percent) and the European Union (5 percent) 30 years from now."<sup>12</sup>

Viewing Fogel's *Foreign Policy* article alongside his National Bureau of Economic Research working paper reveals his 2040 model is based on China maintaining an 8 percent GDP growth rate with essentially only positive influences on its economy, such as growth in education and rural production.<sup>13</sup> A 2010 *Economist* article predicts China overtaking the United States sometime in the 2019–22 range. Factors cited for this conclusion include GDP growth, inflation, and the increasing value of the yuan. Importantly, this article implies the increasing value of the yuan will *enable* China to fiscally overtake the United States, but it gives no mention to the dynamic of that increasing value having a detrimental impact on exports.<sup>14</sup> In fact, these predictions do not give much, if any, consideration to China's major economic limitations. Fogel's only nod to potential problems is his reference to skeptics pointing out issues such as "rising income inequality, potential social unrest, territorial disputes, fuel scarcity, water shortages, environmental pollution, and a still-rickety banking system," to which he replies, "Although the critics have a point, these concerns are no secret to China's leaders; in recent years, Beijing has proven quite adept in tackling problems it has set out to address."<sup>15</sup>

In the event these predictions are correct and China's GDP surpasses that of the United States between 2020 and 2040, having a larger GDP does not necessarily bestow the title "hegemon" to China. One can argue the legitimacy of referring to China as an economic hegemon if the US dollar and European Union euro are still the leading international currencies and China has only risen to this status by playing outside the rules by which other trading nations abide. China will certainly be powerful, but without control of the dominant international currency

and faced with potentially constant global pressure to change practices, its leadership and influence will be significantly limited. China's massive reserves and rising GDP may provide economic power, but the practices it will have to use to get to this predicted position certainly are not those of a leader.

Even if China's GDP does lead the world, so long as the yuan is not completely free nor the leading global reserve currency and China uses unfair practices to gain an advantage, it will not be the global economic hegemon. For these and other reasons, such as high raw material consumption and lack of soft power, David Shambaugh refers to China as a "partial power" having broad but not necessarily deep global power to influence. "China is a global actor without (yet) being a true global power—the distinction being that true global powers influence other nations and events. Merely having a global presence does not equal having global power unless a nation influences events in a particular region or realm."<sup>16</sup>

Despite this partial power concept, it is difficult for US leaders to ignore forecasts of China's economy expanding by 8 percent annually through 2040 as predicted by Fogel or 5.6 percent through 2050 per the Carnegie Endowment model.<sup>17</sup> No matter the actual growth rate, so long as it is greater than that of the United States, it is cause for concern within Washington given the power this cedes to China.<sup>18</sup> For example, some Western corporations are unwilling to criticize China over a range of issues due to the financial power China wields over them.<sup>19</sup> Asian nations may also be in the uncomfortable position of having to "choose between the two giants," based on China's growing strength.<sup>20</sup>

The paradoxical state of the Chinese economy, however, is such that some of the major driving forces fueling its financial boom cannot remain in place once a certain level of power is reached. Based on this conflict, Samuel Huntington's observation that "economic growth and other increases in a country's capabilities often proceed along an S curve: a slow start and then rapid acceleration followed by reduced rates of expansion and leveling off" seems far more realistic when explaining China's rise.<sup>21</sup>

All of these trends could make China's rise alarming to the United States, but it may not be as powerful as initially seem on the surface. Significant limitations could slow growth. Although there are a multitude of factors contributing to China's economic rise and resulting US trade deficit, those most likely to challenge China's long-term economic

growth include the value of its currency, an uneven economy based on exports and state investment, and changing demographics that will reduce its workforce.

### **China's Devalued Currency**

China has engaged in a deliberate policy of devaluing the yuan through currency pegging and currency restrictions to encourage significant foreign investment and manufacturing.<sup>22</sup> While such policies have created an economic boom for China in recent years, its growing economic power will make it increasingly difficult to keep its currency value so low, potentially driving out foreign investment and manufacturing to other developing nations able to offer cheaper services.

Although it is easy to say Beijing simply devalues its national currency, the complexities of this are far more intricate. The devaluation of the yuan has been largely facilitated through fixing its value to the US dollar and avoiding its internationalization. Economists estimate that the yuan is devalued by 15 to 40 percent.<sup>23</sup> China accomplishes this through significant purchases of US Treasury bonds to ensure the value of the dollar remains higher than the yuan.<sup>24</sup>

Salman Khan, a US economist and educator, uses a hypothetical example to clarify this interaction. He explains that if China exports \$50 million worth of goods to the United States, while it only imports \$20 million of US goods, a \$30 million trade deficit ensues. Chinese traders will exchange their 50 million US dollars for their own currency, while US traders will want \$20 million worth of that sum to convert the yuan to US currency. While the \$20 million worth is exchanged, there is a surplus of \$30 million flooding the market, and per supply and demand, the value of the dollar should fall accordingly. China, however, does not want the value of the US dollar to fall, as this would increase the relative value of the yuan and make Chinese manufacturing more expensive. Therefore, China uses its vast reserve holdings to buy the surplus US dollars, \$30 million in this example, to ensure the value of the dollar does not fall.<sup>25</sup> Unlike Khan's example, the actual 2012 US trade deficit with China was approximately \$315 billion.<sup>26</sup> While this illustration explains pegging and Chinese currency accumulation concepts, it is not the cause of the trade deficit itself. This involves multiple factors driving lower costs, thus higher consumer demand, for Chinese products. These are discussed in following sections.

This Chinese tactic of devaluing its currency by pegging it to the US dollar occurred from 1995 to 2005 and again from 2008 to essentially current times.<sup>27</sup> In 2005, the rate was approximately 8.1 yuan to the dollar and rose roughly 25 percent when it unpegged from the dollar in 2005.<sup>28</sup> When China reestablished the fixing policy in 2008, the rate was about 6.8 yuan to the dollar, but under global pressure, China announced in 2010 it would very gradually start to untie the yuan's fixed value from the dollar.<sup>29</sup> Some loosening has occurred, with the yuan currently valued at approximately 6.14 to the dollar; however, it still remains largely pegged to US currency.<sup>30</sup>

In a similar vein, China has managed to keep the value of the yuan artificially low by currency restrictions and, until very recently, essentially avoided trading it in international markets. China's motivation for this policy has been the same as pegging the yuan to the dollar. Because of expanding Chinese industry and economics, the demand for a freely traded yuan would be high, driving up its value. The rise would subsequently mean more expensive Chinese goods and assembly, potentially pushing significant business to lower-cost nations. Banking executive Ken Miller states, "Beijing does not dare make its capital account convertible;" its export industry simply would not be the competitive giant it is now if the yuan were freely traded.<sup>31</sup>

Recent developments, however, indicate China may be taking Miller's dare. In 2009 China started to allow some nations to import and export using the yuan,<sup>32</sup> and it has slowly allowed that list to increase to 19 countries and regions as of March 2013. Brazil and Australia are some of the most notable new additions to the list, and France, Great Britain, and Switzerland are also vying for similar arrangements. New and potential currency deals certainly indicate a significant appetite for internationalization of the yuan, and a recent report from international bank HSBC predicts further loosening of the yuan will make it one of the major globally traded currencies by 2015.<sup>33</sup> Despite these developments, the yuan still has substantial government controls and is not a free-market commodity allowed to reach its equilibrium value,<sup>34</sup> leading China to a substantial crossroads regarding its desire to become a global reserve currency versus the need to keep the value of the yuan low.

The global financial crisis created anxiety over US dollar holdings and with increasing fiscal confidence, China is starting to push for use of the yuan rather than the dollar or euro as a major international reserve

currency.<sup>35</sup> The dollar and euro made up about 90 percent of all foreign exchange reserves in early 2012 and account for approximately 74 percent of current international payments as the only currencies large and powerful enough to sustain the volume of international trading.<sup>36</sup> But confidence in these two currencies is waning, and some are looking to diversify with alternatives. Specifically, China no longer trusts the dollar, and many leaders in Beijing are making moves to promote replacing the dollar and euro with the yuan as a global reserve currency. To do this, though, China must unpeg the yuan and allow full international access for it to become a trusted international form of currency and reserves.<sup>37</sup> This means the value of the yuan is very likely to rise and the massive exports China relies on to fuel its economy will no longer be as attractive to foreign investors.

China cannot attain the economic influence needed to be considered a fiscal hegemon unless its currency is at least one of the major internationally traded and saved currencies. Thus, it cannot become the next global economic hegemon without the value of the yuan increasing, creating a major incongruity: can it become the leading global economic power without the artificial measures Beijing has put in place to fuel the economy? While China's economy can continue to grow, it will have difficulty becoming a global financial authority unless the yuan is freely traded, but China's economy is very likely to suffer if the yuan's value significantly increases. This dynamic will serve as a major growth restraint. While China is undoubtedly becoming a financial power, straight-line economic predictions on its imminent dominance must be adjusted.

### **Exports and the State-Fueled Economy**

The International Monetary Fund (IMF) reported that “by 2003, China's export growth rate was seven times higher than the export growth rate recorded by the world as a whole,”<sup>38</sup> and exports only continue to thrive.<sup>39</sup> While this strategy has certainly succeeded in propelling China's international economy, that growth has come at significant expense to its domestic economy—that is, consumption within China and the average individual's buying power—creating what some have referred to as, “a lopsided giant.”<sup>40</sup> Beijing's financial policies require strict government control to manipulate the value of the yuan, influence internal economics through interest rates and state investment, and protect Chinese banks from open competition which could have a significantly

upsetting effect on the Chinese economy.<sup>41</sup> To achieve these three effects, China's government must possess considerable reserve holdings to buy US bonds, influence and invest domestically, and have enough assets to keep its domestic banking system isolated. Not only are reserves needed for these functions, but that need continues to grow as China's buying off currency surpluses to keep the yuan devalued forces it to continue reserve accumulation.<sup>42</sup>

In 2010, Chen Zhiwu of MIT assessed that the Chinese government controlled approximately 70 percent of domestic assets,<sup>43</sup> and in February 2012 economist Adam Hersh testified before the US-China Economic and Security Review Commission that "government control over China's economy remains pervasive, including through direct ownership of virtually all of the formal financial system and much of the economy's productive assets."<sup>44</sup> The tactic of government control through reserve holdings may work for China in the short term, but without domestic stimulation, this unbalanced financial system will become a significant liability if foreign investments and exports continue to decline.

China's domestic consumption is the lowest among major global economies, at about 50 percent of US rates.<sup>45</sup> Claude Meyer describes this state versus household spending discrepancy by noting, "China's financial might demonstrates the power of the State, financial institutions and businesses, but does not in any way reflect the situation of its households, whose income lies between that of El Salvador and Egypt."<sup>46</sup> In addition to insufficient cash flow failing to stimulate domestic spending, government interest rate controls are leading to minimal investment, saving, and wealth accumulation.

The government in Beijing, through a closed banking system with no competition, has kept interest rates it pays savers low, while the interest rates it charges borrowers are significantly higher than normal market forces would dictate. According to the Wharton School of Business, in 2010 China's tightly governed interest rate spread between what borrowers are charged and savers are paid was 1.5 to 2.5 percentage points larger than other banks around the world which allow free-market forces to determine rates.<sup>47</sup> This controlling practice leads to wealth accumulation for Chinese banks, and hence the Chinese government,<sup>48</sup> which is needed to buy off foreign surpluses to devalue the yuan. It also creates yet another dynamic where the Chinese population has little ability to generate wealth. Artificially low interest rates may not keep up with

inflation, creating an actual *negative* net return for savers.<sup>49</sup> Chinese investors have few options for better returns due to significant restrictions on domestic savers investing anywhere except Chinese banks.<sup>50</sup> Additionally, these abysmal saving options force many domestic consumers to put aside additional income to cover necessities such as health care or education, further stagnating the domestic consumption engine.<sup>51</sup>

Vice Premier Li Keqiang's 2010 comments on an "irrational economic structure . . . [and] uncoordinated and unsustainable development" indicate China's awareness of the problem.<sup>52</sup> Yet in June 2012, both lending and deposit interest rates were cut equally by 25 percent,<sup>53</sup> and in July 2012, rates were lowered again but this time slightly unequally, narrowing the rate spread by 0.06 percent.<sup>54</sup> While a slightly smaller rate spread is a step in the right direction, it is questionable how much lowering rates in a way that benefits borrowers, but not individual savers, might stimulate Chinese domestic growth.

The summer of 2012 also witnessed slightly relaxed rate restrictions, with Chinese banks allowed to set rates as low as 70 percent of the benchmark for loans and up to 110 percent of par for deposits.<sup>55</sup> While these changes lend hope for further loosening of restrictions, Chinese banks are still highly controlled by a government which needs profits to fuel its export-driven yuan pegging. The lower lending rate may stimulate some domestic improvements, but China's overall interest rate picture can be viewed as supporting its export rather than domestic economy. Unfortunately for those who would initiate reform, a devalued yuan and low interest rates fuelling exports at the expense of domestic spending are profitable for the most powerful. Sebastian Mallaby and Olin Wethington explain in their 2012 article:

State-owned banks do not want to pay depositors market interest rates. Politically connected borrowers, such as state-owned construction companies that build China's impressive infrastructure, do not want to give up access to cheap capital. Politically connected exporters, on whom provincial governors count to create jobs in their regions, do not want to give up the advantage created by the favorable exchange rate. Groups that have an interest in reform—savers who receive artificially low returns and consumers who pay a high price for imports—are no match for powerful producers.<sup>56</sup>

A final aspect to this lopsided picture, but perhaps one of the most important dynamics to the current economic boom, is massive state investment in Chinese industry.<sup>57</sup> According to Asian economic theorists Michael Pettis and Claude Meyer, China is following a model that others,

including Japan, have used to jumpstart a national economy. In very basic terms, the model prescribes that nations with little industry or infrastructure inject significant government investment to establish a subsidized and, therefore, very competitive industrial and production base. This, in turn, starts measurable foreign trade and the accumulation of reserves, which a nation can further inject into its industrial capacity and enter the global financial stage.<sup>58</sup> In China's case this model has thus far been highly successful, with its "abundant savings deposits and vast resources of labour" proving a powerful engine to support its industrial might.<sup>59</sup> As Pettis and Meyer point out, however, the model is not sustainable. At a certain point every new industrial enterprise is no longer necessary, some of the significant government investments fund unprofitable enterprises, and debt begins to accumulate. Pettis describes more specifically China's use of this model:

China has the highest investment rate ever recorded, and the highest growth rate of investment probably ever recorded, [such] that we start to run out of economically viable projects. But because the system was so geared toward continuous increases in investments, we keep on investing, and when that happens, investments become allocated into projects that do not generate sufficient real returns.<sup>60</sup>

Similar to the devaluation of the yuan, this tactic of government-supported industry may have sparked a near-term boom but set the stage for longer-term fiscal problems. The global economic crisis of 2008 succinctly demonstrates China's long-term problem with its state investment strategy. When the global crisis impacted exports and its domestic economy was not able to absorb the downturn, the Chinese government introduced a two-year stimulus plan in 2008 worth \$600 billion. While this indeed sparked some short-term growth, it has created the potential for even more debt while doing nothing toward fixing a more fundamental problem of a poor domestic economy and low household incomes.<sup>61</sup> Meyer explains the recent stimulus, though the issue he raises also illustrates the larger problem with the industrial investment model China started decades ago:

The surge in [2008] bank lending has exacerbated industrial overcapacity and may fuel a property and stock market bubble, the bursting of which would leave a massive overhang of bad debt. Even more worrying, the stimulus plan has worsened rather than improved the quality of growth. Investment has taken over from faltering external demand and was responsible for over 90 percent of growth in 2009. Continuing in 2010, the stimulus plan did little to redirect the Chinese economy toward stronger domestic demand.<sup>62</sup>

While reserve holdings, artificial interest rates, and government investment in industry have helped fuel the Chinese economic boom, it could be at the expense of long-term financial health. For China to remain on a relatively stable economic growth trajectory, its domestic consumption must be able to absorb downturns in exports which could result from factors such as the global financial crisis and the yuan's increasing value. Despite China's apparent awareness, as evidenced in Vice Premier Li's comments, its ability to grow a domestic spending engine simply may not compensate quickly enough for the downturn in exports caused by an increasingly powerful yuan.<sup>63</sup>

Therefore, experts contend the tools China will need to effect actual domestic financial reform will be at the expense of those it uses to artificially stimulate its economy. Higher interest rates and actual returns on savings will give the average Chinese consumer more confidence to spend rather than set aside earnings. Similarly, a looser market and rising yuan will also increase Chinese spending by giving consumers more international purchasing power and increasing imports. Yet, exports and state profits gained through exports and low deposit rates will suffer, as well as the degree of Chinese government control over the economy. Hence, whether due to exports lagging and domestic consumption unable to fill the gap or balancing the export giant by generating a sound domestic market at the expense of "comparative advantages" such as substantial government investment or a devalued yuan,<sup>64</sup> there may be a significant slowing effect on Chinese economic growth.

### **Chinese Demographics**

The Chinese workforce is approximately 900 million to 1.34 billion strong,<sup>65</sup> fueling a significant production base for China's export boom with its cheap labor the "driving force behind their industrial competitiveness."<sup>66</sup> Two critical factors, China's one-child policy and its lack of health care, however, may cut away at these numbers and greatly reduce the masses available to work in assembly lines, factories, and production facilities. It is this future impact to the available workforce that will serve as the final influence to plateau Chinese economic expansion.

Different sources cite slightly different fertility rates in China today, but the child-to-mother ratio ranges from 1.1 to 1.56 thanks to the one-child policy.<sup>67</sup> At the same time, a dynamic called replacement rate, which is the fertility rate a population requires to remain at relatively

constant numbers, is currently 2.1 children per mother for China.<sup>68</sup> This discrepancy indicates a population decline at some future point. The UN estimates China's population will peak in 2015, followed by a rapid drop-off as a direct result of the one-child policy.<sup>69</sup> A ripple effect of the one-child policy will lead to further decreases in coming generations due to significantly more boys than girls being born, as Chinese culture favors male offspring, leading to some female infanticide, or more commonly, sex-selective abortions. Therefore, "In about 20 or 25 years' time, there will not be enough brides for almost a fifth of today's [Chinese] baby boys—with the potentially vast destabilizing consequences that could have."<sup>70</sup>

A final effect of the policy is an aging population. Because Chinese children are not replacing their elders in equivalent numbers, the percentage of the population over the age of 60 is expanding, while the percentage of those below 14 is falling.<sup>71</sup> An older population will significantly reduce the work force, with China's 2010 ratio of nine laborers per retiree falling to just four per retiree by 2030.<sup>72</sup> The aging population also means an increased health care burden. A World Health Organization study predicts China's "burden of diseased population" as a percentage of overall population will rise dramatically from 44 percent in 2004 to 65 percent in 2030 due to its elderly increase.<sup>73</sup> Thus, the coming decades will see the one-child policy significantly eat away at China's overall population and masses of cheap labor, and the increasing portion of elderly Chinese will add an additional burden to that decreasing workforce.

While demographic impacts of the one-child policy will impact China's approximately billion-strong workforce as early as 2015, the growing health crisis will also factor into its economic future. Yanzhong Huang, a senior fellow for global health at Seton Hall University, has termed China, "the sick man of Asia," based on the alarming rates of disease and sickness there today. China leads the world in diabetes and noncommunicable diseases such as cancer; has a significant and increasing HIV/AIDS threat; accounts for one-third of worldwide hepatitis B virus carriers; and faces a burgeoning mental health crisis with data suggesting an approximate 50 percent rate of mental illness.<sup>74</sup> Many of these problems stem from an aging population but also from China focusing on manufacturing and GDP growth rather than any type of

effective health care system. While officials are starting to reform health care, it still has a long way to go.<sup>75</sup>

Government investment in health spending has increased since 2002, and the Chinese government now reports 94 percent of its population has some sort of health care coverage. Despite this seemingly positive trend, the system is government-run with an inefficient structure, suffers from rampant corruption, and emphasizes care in urban areas at the expense of rural ones. Therefore, the reality is closer to the coverage provided by a 2010 rural cooperative program that technically covers individuals, but only at the rate of “8.6 percent of total health-care expenditures per capita.”<sup>76</sup> This means many average citizens have to set aside savings to cover potentially significant out-of-pocket expenses for health care at the cost of domestic spending. As Huang explains, “When people have to worry about expensive medical bills, they are less likely to spend money on other things. Between the mid-1990s and 2006, more than 50 percent of total health care spending was out-of-pocket payments.”<sup>77</sup> Unfortunately, the situation may be difficult to resolve. The Yale-China association highlights that China may struggle to find an easy solution with significant obstacles to providing quality care, including “a hybrid market-socialist society,” no established health insurance industry, and low per-capita income.<sup>78</sup>

While this is a dismal state of affairs in human terms, it will also hit China on an economic level. Widespread health issues mean a loss of productivity; a 2011 report by economists and health care experts concluded that in 2005 China lost a sum equivalent to 13 percent of its GDP due to disease and lost labor.<sup>79</sup> An aging population with little health care will also push workers to spend less time on the production line and more time taking care of elderly parents and grandparents.<sup>80</sup> And finally, as with low interest rates, significant out-of-pocket health expenses for not only an individual worker, but an aging family as well, means less money going into the domestic Chinese economy.<sup>81</sup>

China is beginning to add more health reforms, and prudent measures to improve the quality of health care and insurance coverage may solve some of these issues. Although true, it will be at the expense of production, as expressed by Salvatore Babones: “Today’s little emperors will spend their most productive years taking care of their parents. And as they do, China’s economic activity will have to move away from high-productivity manufacturing and toward low-productivity health

services.”<sup>82</sup> Jack Chow of Carnegie Mellon University paints a slightly more promising picture with Beijing further increasing health reforms in 2009 and government programs leading to a 3 percent drop in child mortality and incidents of tuberculosis decreasing 45 percent from 2000 to 2010.<sup>83</sup> While these trends are good news for Chinese citizens and one hopes they persist, continued health care improvements will divert funds from practices allowing continued GDP expansion. According to Meyer, “The financial cost of such a [health] system is likely to become increasingly onerous, and perhaps even crushing, as the population ages and the labour force shrinks as it will from 2015–20.”<sup>84</sup> Whether lost workdays and household health care costs limit domestic spending or Beijing decides to spend resources to overhaul its health system, either path will cost China and impact its economy.

Thus, the combined effect of the one-child policy and an impending health-care-related slowdown is likely to influence China’s ability to produce at current rates. Its leaders clearly understand this exports-based, state-capital-infused, and cheap-labor-driven economy is not sustainable, and the Chinese government has emphasized increasing productivity to fill the gap. A 2011–15 “Five Year Plan” has been put in place which will, among other things, put a premium on productivity, with rewards/repercussion for companies based on efficiency performance.<sup>85</sup> Since China is currently in the lower ranks on the global productivity-per-worker scale, there is room for substantial improvement.<sup>86</sup> It is possible then, that it may offset the decline in workforce with increased productivity. Despite the potential for increased production technology reducing the number of workers needed,<sup>87</sup> it is still conceivable a significant reduction in the workforce will hamper China’s cheap exports machine. Whether this is through less capacity to produce or higher wages to a smaller but more skilled workforce, it will be further impacted by the possible effects of a “crushing” health care crisis. Although challenging to accurately predict, it is quite feasible all these factors will have an overall negative influence on China’s capacity to produce through 2015–30 as both population decline and the health crisis begin to fully bear their weight.

## Implications for US Policy

*The preservation of commercial and financial interests constitutes now a political consideration of the first importance, making for peace and deterring from war.*

—Alfred Thayer Mahan, July 1902

Forecasting China's economic and, therefore, military and political power in the coming decades with any precision is difficult due to a vast range of changing dynamics. These include some important issues not discussed here, such as its vast consumption of raw materials, the global oil market, and ecological factors. What does seem clear, however, is that an undervalued yuan, large state investment, and masses of cheap labor are not sustainable, leading to an eventual economic slowdown. Given this likelihood of China *not* surpassing the United States economically in the coming decades and settling into a position of "partial power," as David Shambaugh suggests, what are the implications for US policy toward China?

### **Economics as a Policy Tool**

Foremost, one must understand the potential for misunderstandings is high. Headlines proclaiming China's economy will overtake that of the United States in 20–30 years or that China holds 22 percent of US foreign debt may strike fear in the hearts of US officials and the American public, leading to shortsighted policies and unhelpful rhetoric. A Pew Research Center poll found that at the end of 2009, 53 percent of Americans viewed China as a major threat, while 44 percent thought China was the world's leading economic power compared to the 37 percent who thought the United States had the foremost financial strength.<sup>88</sup> Such factors may be easy targets for political candidates to exploit, which only strengthens the escalation potential of such rhetoric.

US leaders need to understand that China's economy is not as threatening as a cursory analysis might indicate. This does not mean China's monetary rise should not demand significant attention. On the contrary, US policymakers must dig deeper to see China is an emerging power with significant growing pains yet to overcome and with considerable dependence upon the United States. Rather than viewing China's growing economy as a threat, it must be continually analyzed and understood

to find ways to work toward mutual benefit rather than allowing misunderstanding and fear to drive inappropriate headlines or policies.

Claude Meyer asserts, “The United States is a key [Chinese] economic partner at the moment, but it is American hegemony that will ultimately be challenged. The quest for supremacy in Asia is just a step on the way. . . . There can be no doubt that considerable tension will remain.”<sup>89</sup> This tension, along with press reports and slightly frenetic attitudes of China overtaking US hegemony, has potential to lead to US missteps which must be avoided. Shambaugh supports this concept in his comments on overestimating China’s dominance:

China is certainly not about to “rule the world,” [as] in the estimate of Martin Jaques’s recent popular book. To the contrary, as Joseph Nye has observed: “The greatest danger we have is overestimating China and China overestimating itself. China is nowhere near close to the United States. So this magnification of China, which creates fear in the U.S. and hubris in China, is the biggest danger we face.”<sup>90</sup>

Understanding not only China’s long-term economic sustainability challenges, but also the interrelationship between the economies of China and the United States is important for developing policy and successfully navigating these tensions. One of the more significant concerns is China’s massing of US securities, which could confer substantial power over the US economy. Due to China’s need to buy US trade-deficit funds, primarily US Treasury bonds, its holdings of US assets was an impressive \$1.16 trillion in September 2012—approximately 22 percent of US foreign debt.<sup>91</sup> While this has been a source of anxiety in terms of China’s potential impact and power over the US economy, it also leverages significant US influence over the Chinese economy. Estimates put China’s foreign exchange reserve, arguably the bedrock of its economy, at approximately 70 percent in US dollars.<sup>92</sup> China has just as much cause to feel uncomfortable about the economic relationship as the United States.

Some contend that China selling off US securities or significantly lowering its US investment rate represent their two largest economic concerns.<sup>93</sup> Both would flood the market with US assets and lower the value of the dollar, not to mention introducing significant flux into the US economy. The potential for these actions also calls into question the extent of influence such involvement in the US dollar confers to China.

Although these three concerns are legitimate, China's economic threat may not be as one-sided and powerful as it initially seems.

While any large-scale selloff of US Treasury bonds would lead to the US dollar falling, this would also diminish the value of China's sizable savings in US dollars. Further, the United States constitutes China's largest export market.<sup>94</sup> If the value of the US dollar falls and the US economy declines, Chinese export profits will suffer. China could deliver an economic blow to the United States by rapidly selling US Treasuries; however, any lessening of the dollar's value or the purchasing power of the US consumer will subsequently impact China by reducing the value of its vast savings in US dollars and its ability to export to US consumers.

There is also concern that China will stop investing so heavily in US Treasuries for any number of reasons, including diversifying its financial holdings or investing in domestic Chinese programs instead. While a slow and deliberate reduction of Chinese investment could even be positive for the United States if it means unpegging the yuan, an abrupt and significant decrease from current levels could be considerably detrimental to the US economy if it does not allow for other markets to fill the void. As noted in a recent report to Congress, "Given [a] relatively low savings rate, the US economy depends heavily on foreign capital inflows from countries with a high savings rate (such as China) to meet its domestic investment needs and to fund the federal budget deficit."<sup>95</sup> A rapid reduction of Chinese purchases will have a similar effect on large-scale sales of US Treasuries, in that a surplus of assets will inundate markets, and the value of the US dollar will fall. While the US economy will no doubt suffer in the event of a rapid reduction of Chinese investment, so will China's. Once again, the Chinese action impacting the dollar will produce a counteraction to lessen the value of China's vast US holdings and reduce its exports to the United States so long as the current state of dependency exists. China cannot fiscally wound the United States without also hurting itself.

As long as US leaders understand these interactions, China has little influence to bend US markets and policies to its will through economic intimidation or otherwise, as it has much to lose if US markets fail. As viewed from the Chinese perspective, the United States has significant influence over China's economic future as the controller of that asset. Further, and in the most extreme and abysmal of circumstances, should the two nations come to outright hostilities, those US Treasury bonds

representing most of China's national wealth are unlikely to be honored and may well turn the vast Chinese savings into a worthless pile of IOU notes. US economic reliance on China is unquestionable and understandably uncomfortable; nevertheless, China is just as much a hostage of US economic policies. This marriage somewhat negates the question of untoward Chinese influence over US policy, and the threat of hostile Chinese economic actions wanes with an understanding of the second-order effects US finances have on China. The US economy's reliance on China may not be comfortable, but China is also dependent, with that dependency conferring still significant US leverage over China if required.

In determining US policy toward China then, the bottom line is the use of economics as a policy tool can and should be employed if necessary to forestall physical conflict. There are global precedents for the use of economics as a weapon in warfare. Nicholas Lambert's *Planning Armageddon* outlines Great Britain's plan to destroy Germany fiscally at the outset of World War One as an alternative to continental warfare. The economic plan was executed in August 1914 to such effect that after just three weeks, neutral nations and powerful bankers successfully pressured the British government to stop, based on fears of the impact on global markets. Assuming the war would be quickly won anyway, Britain succumbed to pressure and quickly ended the economic warfare plan and, in its place, carried out a drastically reduced fiscal attack in the form of a naval blockade on Germany.<sup>96</sup> One must wonder how much might have been saved had Britain carried through on its economic plan instead?

Another example is that of the United States pressuring the United Kingdom to withdraw from Egypt in the Suez Crisis of 1956. The pound sterling's stability and value was key to British economics, and the UK's outflow of financial reserves at the time was seriously threatening the pound in comparison to the dollar. To save the pound sterling, the UK needed a massive inflow of currency through, at the time, the essentially US-controlled IMF. The United States successfully used this leverage to force Britain out of Egypt with the incentive of an IMF bailout; "The United Kingdom's need for financial assistance gave the Americans the perfect lever to force an immediate withdrawal."<sup>97</sup>

Aside from historic examples, economist Robert Ross cites more recent instances of this working for the United States with respect to China: "In bilateral economic relations, the United States has negotiated

with China to resolve conflicts arising from Chinese protectionism and from Beijing's inadequate protection of intellectual property rights. In each case, Washington has used coercive tactics to elicit near one-sided Chinese compliance."<sup>98</sup>

More specifically, in 1992 the United States threatened significant economic sanctions if China did not make considerable trade reforms allowing increased external access to Chinese markets, and by 1995 most requested reforms were in place. Perhaps most important was China's 2001 accession into the World Trade Organization (WTO), which occurred only after it completed a number of trade reforms requiring years of negotiation and coming primarily at the behest of the United States and the European Union.<sup>99</sup>

Despite an apparent working relationship on the economic front, the same cannot be said for US military and diplomatic relations with China. Chinese aggression in the South China Sea, its military buildup with opaque strategic intent, and cyber intrusions are just some concerns where the United States has recently tried to exert diplomatic and military power to clarify or change Chinese actions. Despite considerable effort and increased US military presence in Southeast Asia, the United States has had little to no success in altering these Chinese activities.<sup>100</sup> On the other hand, the instances of fiscal pressure account for just a few examples of US economic power, and many more fiscal issues have been resolved through US pressure and threats of economic sanctions.<sup>101</sup> Although these illustrations have far deeper complexities than presented here, they demonstrate the general trend of China bending to US pressure when that pressure is in the form of an economic rebuke rather than political or military threats.

## Conclusion: US Foreign Policy and China

*"Treat China as an enemy," goes one piece of well-worn conventional wisdom, "and it will become one."*

—Aaron Friedberg, *A Contest for Supremacy*

China is unlikely to sustain its current economic growth rates and surpass the United States, thus leaving US hegemony probable for at least the near future. China and the United States work best on the economic level, with the United States being somewhat successful in

pressuring China into reforms through the weight of economic sanctions. The United States also has significant leverage over China because its wealth is dependent, at least for now, on the health of the US dollar. Historical precedence also demonstrates fiscal power can be a potent tool when applied to other nations.

When considering these aspects of US foreign policy toward China, one must also consider Paul Kennedy's point that economics is the support base of all other forms of national power, and ensuring that defense spending and economic growth remain in healthy equilibrium is essential for long-term national success. The United States may be in danger of overstretch and tipping the balance too far toward military spending at the expense of the US economic engine.<sup>102</sup> Binding together all these concepts could lead to the belief that US foreign policy toward China should allow significantly more flexibility than directed by the 2012 *Sustaining US Global Leadership* strategic guidance emphasis on the "re-balance toward the Asia-Pacific region."<sup>103</sup> This would possibly ease tensions while also allowing the United States more resources to spend on strengthening its economy. Yet, what about China's continued lack of recognition of international norms?

Chinese economic practices are at times outside of international trading norms as they give China a significant advantage over other trading bodies, but there are also issues such as China increasingly ignoring international and UN convention by claiming much of the South China Sea for its abundant resources.<sup>104</sup> How should the United States react if China's aggressive actions in the South China Sea continue and freedom of navigation in international waters is restricted, or Chinese actions infringe upon the claims of US allies? While these examples are by no means exhaustive and omit important issues such as human rights concerns, cyber intrusions, and Chinese resource consumption, they highlight the US problem. The ultimate challenge then is creating US policy that avoids conflict and promotes a prosperous relationship with a rising China while also ensuring China does not unfairly violate international norms nor threaten US interests or those of US allies.

For Washington to hold the line on its interests, while engaging China in a productive way, US leaders must find a way to maintain their position without becoming so threatening that China feels pushed toward war. On the positive side, the United States has many nonphysical tools at its disposal to achieve this balancing act. With the United States likely

to remain more powerful despite current economic faltering, these tools could include fiscal pressure and sanctions, including limiting China's access to US markets. At the extreme end of the spectrum, should US-China relations turn considerably negative, are measures which take advantage of the US-controlled currency that dominates China's reserve base. The most drastic of these could include defaulting on the vast US Treasuries China maintains to dilute its economic power, accepting that the follow-on effects to the US economy and credit rating are preferable to all-out war.

Taking advantage of a future Chinese economic slowdown or fiscal levers, however, requires Washington to adopt a long-term approach. Unfortunately, this is something US leaders are often not well placed to do within election-cycle politics and the resulting need for immediacy. Notwithstanding, US policymakers must consider digging in and waiting out China's economic boom. Although this may often be difficult politically, the importance of maintaining a working US-Chinese relationship cannot be overlooked, with significant implications or even physical conflict if it is pressed too hard or mishandled. Consequently, US policymakers must factor the potential for China to have less relative power in the coming years than it currently enjoys and make appropriate long-term choices on how hard to press for resolutions as a result.

Along with long-term fortitude, fiscal pressure may be useful to safeguard US interests. This concept should not just apply in the economic arena, but—similar to the British economic attack on Germany in World War One and US economic pressure on the UK through the IMF over the Suez crisis—fiscal action should be the first response to most Chinese actions requiring a US response. The use of economics to push Chinese compliance should apply to a host of issues, both inside and outside of the fiscal arena, such as WTO violations, cyber intrusions, or territorial violations in the South China Sea.

US-Chinese policy will require constant analysis and tending. A fundamental understanding of China's fiscal future with consideration of a long-term approach and economic pressure, or even attack, as the first response will be paramount to success. The United States will always require a strong military to back fiscal pressure. Indeed the diplomatic and military tools of US national power in addition to fiscal pressure will add depth and credibility to any economic policy meant to protect US interests. The balance required to steer the two nations away from

conflict and toward a productive relationship while protecting US interests, however, may be far more achievable if first viewed and conducted from an economic perspective. ■■■

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