

# The FORUM

Discussing International Affairs and Economics

# CHINA

Worldview and Ambitions  
Security Policy

The Exchange Rate Conundrum

Interviews, Essays, Editorials

David Axe	Anis H. Bajrektarevic	William A. Callahan	Jinzhao Chen	Jeffrey Frankel
Carla P. Freeman	Richard T. Froyen	Delio E. Gianturco	Yukon Huang	David Kerr
Haider Khan	Jens F. Laurson	Harsh Pant	David Phillips	George A. Pieler
Xingwang Qian	Anwar Shaikh	David H. Shinn	Ali Wyne	

*Student Award Winners*  
Roy Dale    Abhismita Sen



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## ABOUT THE FORUM

The Forum is a publication of the International Affairs Forum online journal. Inside each issue you'll find interviews, editorials, and short essays from academics and practitioners, presenting a wide spectrum of views and from around the globe. In this way, we wish to provide readers with an all-partisan, international look at today's major issues, and tap into the research and views of major thinkers and actors in the field within the 'space' between social science journalism and academic scholarship. That is, we look for carefully considered contributions that can nevertheless be published relatively quickly and which can therefore maintain the impetus of current thinking but which do not require detailed peer review. The extent of our review is therefore largely a matter of informed editorship. We think that this is a valuable approach to extending informed opinion on policy in the international sphere.

Another feature of each issue is recognizing winners of our Student Writing Competition Program by publishing their efforts. As part of our mission, we strive toward providing a platform for students to take next steps toward successful professional careers and as such, believe exceptional work should be recognized, regardless of experience level. The program is open to all college students around the world.

We hope you enjoy this issue on China and encourage feedback about it, as it relates to a specific piece or as a whole. Please send us your comments to [editor@ia-forum.org](mailto:editor@ia-forum.org).



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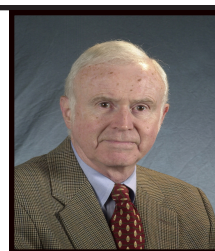
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## Contributors

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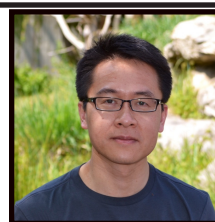
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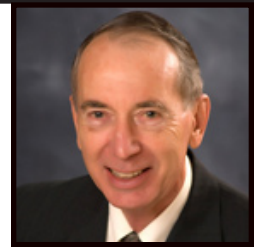




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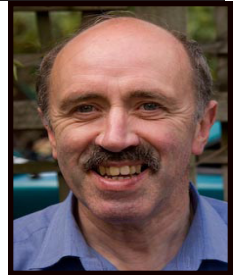
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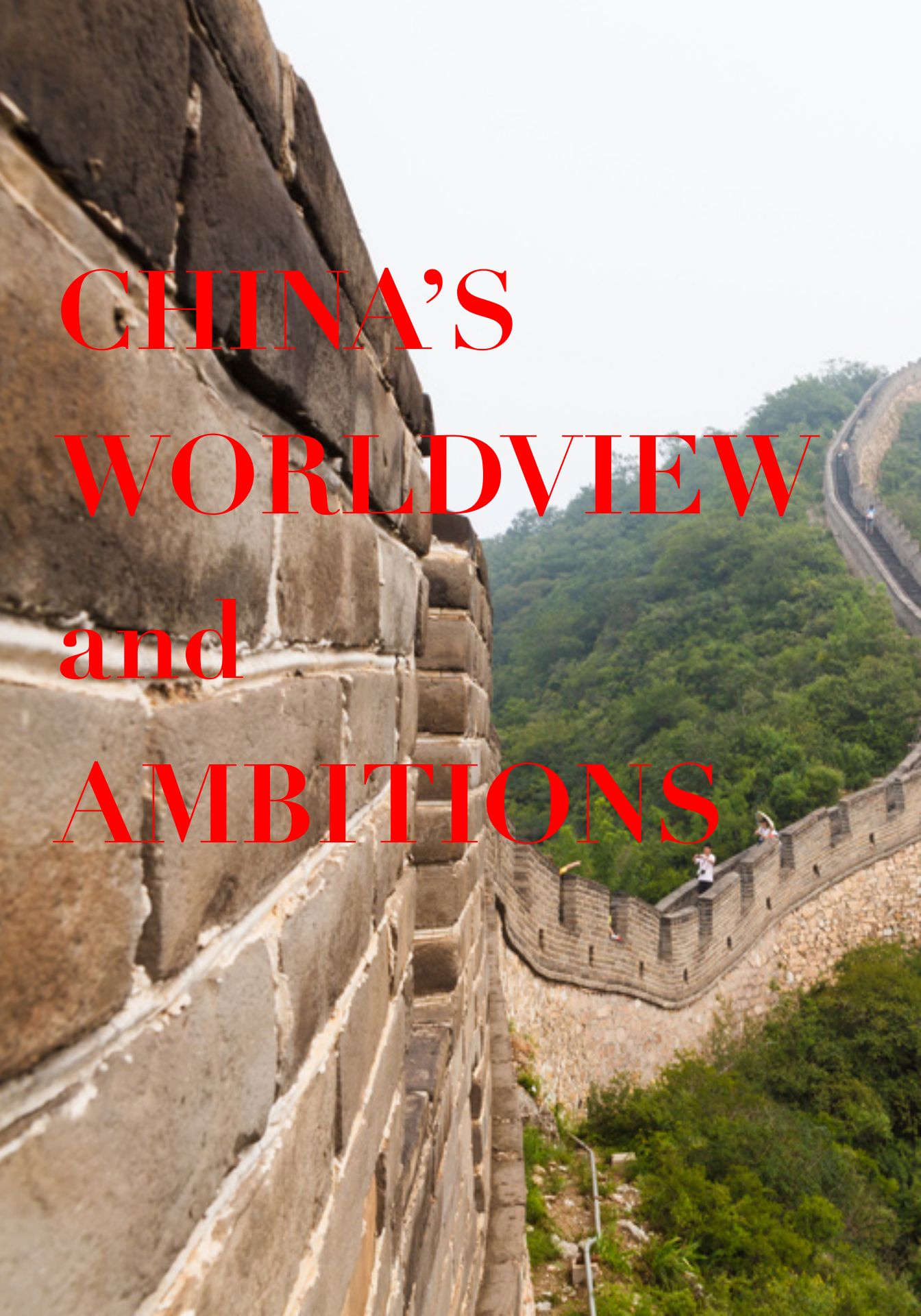
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**CHINA'S  
WORLDVIEW  
and  
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*(Student Award Winner)*  
**Abhismita Sen**

# Norms, Values and Exceptionalism in China's World View

**Prof. William A. Callahan**

Manchester University

UNITED KINGDOM

**T**here is a buzz in Beijing: Chinese people are very optimistic that the 21st century will be the “Chinese century.” Reflecting on their country’s recent economic success, China’s policy-makers and opinion-makers are now asking “what comes next?” How can the People’s Republic of China (PRC) leverage its growing economic power into enduring political and cultural influence in Asia and around the globe?

Here Chinese voices move from measuring the PRC’s material power to promote its soft power on the world stage: cultural power was the main topic at the most recent meeting of the Central Committee of the Chinese Communist Party in October 2011, and soft power is a huge topic among officials and scholars in China. The goal is to cultivate what Chinese call “comprehensive national power”: the combination of economic, military, political and cultural power.

As part of this general trend, China’s public intellectuals have been busy thinking about the contours of a post-American world order. In the early 2000s, arguments for a Chinese-style world order were largely aspirational: scholars and officials told us that the PRC “should” have its own global theory, or that Chinese-style models and norms were an “inevitable” part of China’s rise. Most of the arguments were negative, rather than positive: China’s world order will be better, they tell us, simply because it is different from “U.S. hegemony.” In highly moralized arguments, Chinese authors define the West in terms of “selfish individualism” as a way to promote China as “tolerant” due to its culture that is guided by “the principles of harmony, peace, and cooperation.” China thus will be a “mature, responsible, and attractive superpower,” China’s top political-economist Hu Angang explains in *China in 2020* (Brookings, 2011), because it is the opposite from the U.S. Hu here joins others who can only paint a rosy picture of China’s global power after they have “demonized” the West



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through negative stereotypes.

After declaring Western notions of international politics immoral, various Chinese ideas for a properly moral world order have been offered. In *The All-under-Heaven System* (Tianxia tixi, Renmin Univ. 2011), philosopher Zhao Tingyang revives the ancient Chinese idea of world unity (tianxia) as a truly global world utopia (as opposed to the present system that is selfish and violent due to its focus on the desires of individuals and nation-states). In his other works, Zhao looks to a romanticized version of hierarchical Chinese world order—the Tributary System, where countries like Korea recognized the superiority of Beijing—to argue that the world would benefit from China's magnanimous rule. He thus concludes that the All-under-Heaven system is the “acceptable empire” for the 21st century because its benevolent system of governance is “reasonable and commendable.”

In *Ancient Chinese Thought, Modern Chinese Power* strategist Yan Xuetong also argues that we need to understand global politics in moral terms (Princeton, 2011). He looks to the ancient distinction between the “Kingly Way” (wangdao) and the “Hegemonic Way” (badao). But rather than using these concepts for a sophisticated analysis of ethics and international affairs, Yan defines the Kingly Way as unquestionably good, and Hegemonic Way as thoroughly evil. Yan then follows the trend to code China and America: China is always the exemplary moral power, while the U.S. is always the hypocritically evil hegemon. Yan concludes that China's rise will benefit the world simply because it is not “American.” What is Yan's non-Western alternative? Yan argues that “the rejuvenation of China” in the 21st century will “restore China's power status to the prosperity enjoyed during the prime of the Han, Tang and early Qing dynasties” when it was at the center of a hierarchical world order.

Great Harmony (datong) is another ancient concept that is growing in popularity among China's futurologists. Great Harmony comes from a famous passage from the *Book of Rites* (Liji, 2nd century A.D.) that describes a perfect utopia, which is based on a unified world order. Like John Lennon's song “Imagine,” this utopian vision still informs plans to create a perfect world: the endgame for most of China's chief economic, social and political forecasters is the World of Great Harmony (shijie datong, tianxia datong). World Bank Chief Economist Justin Yifu Lin has a calligraphic scroll of the Great Harmony passage on his wall in Washington D.C.; he recently explained that its ideals guide his plans for the global economy. In *2030 China* Hu Angang concludes that China will create a Sinocentric world order to establish the World of Great Harmony, which is not only “China's dream,” but is also the “world's dream” (Renmin Univ., 2011).

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***China's economic success, however, does not benefit its citizens; the PRC is now the main engine of economic growth.***  
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What does Great Harmony mean? Descriptions are generally vague; but Pan Wei's detailed outline in *The China Model* can give us some clues (Zhongyang bianishi, 2009). The China Model is often summarized as a unique combination of “authoritarian state + free market,” that is also known as the “Beijing Consensus” (as opposed to the neoliberal Washington Consensus). Since 1978, Beijing's mix of authoritarian government and free markets has pulled over 300 million Chinese out of extreme poverty. China's economic success, however, does not just benefit its citizens; the PRC is now the main engine of global economic growth. Its economic ideas thus are gaining prominence in international institutions such as the World Bank and on the ground in

Africa. In 2009-10 the PRC actually lent more money to developing countries than the World Bank.

Pan Wei argues that the patriarchal values of village life, which is presented as a conflict-free organic society, are the source of the China's economic success. He sees the PRC as village society writ large, where the party loves the people like a caring father, and the masses are loyal, grateful and respectful, like good children. There is no room in this national village for open debate in “civil society;” Pan actually condemns civil society as a battleground of special interests that can only divide his organic whole. For Pan, diversity is “division,” and thus a problem that needs to be solved by the state. Unity here is the guiding value because Pan sees social order as a process of integrating divisions into the organic whole, and ultimately into the World of Great Harmony.

Pan's argument that the China Model is “uniquely superior” is part of a broader move towards Chinese exceptionalism. We are used to hearing about “American exceptionalism,” especially from Republican politicians in a presidential campaign year. Exceptionalism here means that your country and its values are not only unique, but uniquely unique—and uniquely superior. American exceptionalism grows out of the idea that the U.S. is the world's “first new nation.” It is “a city upon a hill,” according to John Winthrop's 1630 sermon “A Model of Christian Charity,” that would be judged not only by God, but by the world because “the eyes of all people are upon us.” America's democratic and capitalist values, according to

exceptionalists, are so uniquely superior that Americans have a moral duty to export them to other countries—whether those countries like it or not, and often through military force.

While America is the world's "first new nation," Chinese exceptionalism looks to the country's 5000 years of continuous history to see China as the world's "first ancient civilization." Like in the U.S., Chinese expressions of exceptionalism assume that their country is exceptionally good. Chinese philosopher Kang Xiaoguang explains this in his seminal essay "Chinese exceptionalism": "Chinese people themselves think that their race-nation is the most superior in the world. Even when they are in dire straits, they always feel that they should be the number one in the world" ([www.confucius2000.com](http://www.confucius2000.com), 2004). Chinese exceptionalism thus characteristically thinks of the future in terms of China's uniquely superior civilization uniting the globe in a World of Great Harmony that promises peace and prosperity.

Although his ultimate goal is the World of Great Harmony, Kang primarily sees Chinese exceptionalism as a negative factor—defining not what China is, but what it isn't. The short answer is now familiar: China is exceptional simply because it is not western or democratic. Many Chinese futurologists conclude that the world is in the midst a grand civilizational battle between the Chinese system and the western system. Pan Wei thus asks, "In next 30 years; what direction will the Chinese nation take? Will it preserve China's rejuvenation? Or will it have superstitious faith in the western 'liberal democracy' system, and go down the road of decline and enslavement?" While there is much discussion of Chinese culture's "inherent tolerance," Kang states that the "Chinese public's anti-American sentiment" is provoked by the "resentment of American values and norms."

Of course, there are many different views in China. In "Does China Need a Leviathan," Shanghai historian Xu Jilin provides a biting critique of current trends in Chinese thinking. He argues that the shift from nationalism to statism (in the sense of Thomas Hobbes's *Leviathan* that has complete control over people) is indicative of the "collective right turn" of many of China's intellectuals over the past decade. People who were liberals in the 1980s, and nationalists in the 1990s, are now statist who promote China's exceptional values, norms and model. He notes that Nazi Germany and Imperial Japan had similar statist/exceptionalist debates in the 1930s. Xu thus worries that the PRC's current ideological debate that feeds on China's exceptional values risks becoming the road to fascism, which he concludes would push China "off a cliff" (*Gongshiwang*, January 23, 2011).

Although there are liberal and cosmopolitan thinkers in China, we have to recognize the trend toward conservative and exceptionalist ideas in the PRC. Chinese

futurologists and world order theorists generally are looking to China's pre-modern imperial history for concepts. Most of the people mentioned here see "equality" as a problem, and promote various versions of elite governance: patriarchal society at home and the Chinese empire's hierarchical "Tributary System" abroad. Having more diversity in global debates is surely a good thing; including Chinese voices in such debates is a step in this direction. But as we see here, the main value promoted by China's public intellectuals is unity—ideological unity, national unity and global unity—which leaves little space for diversity. Indeed, the main goal of some of these theorists is geopolitical: conquering the global discussion of norms and values is seen as an important step in dominating the world.

Why should we care about ideological debates in China? The PRC is in the midst of a once-in-a-decade leadership transition. Xi Jinping and the rest of the 5th generation leaders are still formulating their major policy narratives. The public intellectuals mentioned here are consequential because they are debating the contours of the post-American world order in the mass media. They hope the new leadership will adopt their elaborate plans for China in the 21st century.

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# China and Inner Asia: New Frontiers and New Challenges

**Dr. David Kerr**  
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Inner Asia is an ambiguous region in the sense that sometimes it is there and sometimes it is not. 40 years ago Inner Asia had largely disappeared from view, obliterated not by one Cold War but three: the Cold War between the USSR and the West and the West's clients in Central Eurasia - Turkey and Iran; the Cold War between the USSR and the PRC that began in the 1960s but intensified with China's lean towards Washington after 1972; and the Cold War between China and India that began with the border war of 1962 but again intensified in the 1970s with Mrs Gandhi's lean towards Moscow and the dismemberment of Pakistan. At that time Inner Asia had nominally four states - the USSR, PRC, Mongolia and Afghanistan - but since the latter two had very significant Soviet military and intelligence presence in practice the region had two states and two proxies. At this time, therefore, Inner Asia was divided, isolated and militarized. This division, isolation and militarization was particularly notable for China. China's boundary in Inner Asia from the USSR, PRC, DPRK border in the Northeast round in an arc of some 16,800 kilometers to the India, Burma, PRC border in the Southwest was closed except for a single point of access to the interior of Asia over the Karakoram Range into Pakistan. So one principal effect of the multiple Cold Wars in Asia was to isolate China from interior Asia and to force its Inner Asian provinces into the role of Cold War frontiers. This Cold War Inner Asia has now been fully dismantled and the region has re-emerged in new configurations driven by internal, social changes and external, geopolitical changes.

In external geopolitical changes the most significant developments have been: the end of the USSR and the creation of sovereign Central Asia; the rise of China and India as modern Asian great powers; and the resurgence of Islam as a factor shaping the international relations of Central Eurasia and neighbouring regions. The primary internal and social changes have been: the emergence of some kind of civil society in post-socialist societies; the rise of new nationalisms in Inner Asia often drawing on

ethnic and religious solidarities, some of which are democratic and some of which are xenophobic and militant; and the development of new economic strategies for Inner Asia driven by activities like resource extraction, trade, investment and migrant labour. A further development that must also be noted is climate change, which will rise in diverse impacts in coming decades particularly through its effects in atmospheric warming, pressure on renewable water supply, and land degradation. These new forces - geopolitical, social, and environmental - will shape and define the region interacting with older issues in these societies to do with inter-ethnic identities and the relations between former empires and imperial subjects. The region now has eight states and within those eight states a number of significant regions of rising importance. The states are Turkmenistan, Uzbekistan, Kyrgyzstan, Kazakhstan, Tajikistan, Afghanistan, China and Mongolia. Regions of significance are particularly the Inner Asian provinces of China, which can be variously defined but typically Xinjiang, Tibet, Inner Mongolia, Ningxia, Gansu and Qinghai.

The dynamics across Inner Asia between these states and regions are now interwoven with influences from external states, drawn towards the region by a number of interests in security and economics, and of course their need to manage their relations with each other. Of these external powers the most important are the US, Russia, India, Turkey, Iran and the European Union. China is in a unique position since it is the only state that is both internal and external to Inner Asia: it is internal on account of its Inner Asian provinces, but it has been historically and culturally external since the vast proportion of its population, economy, government and security focus has traditionally been in East Asia not Inner Asia. Therefore China's role in Inner Asia deserves special attention. The status of being both inside and outside of Inner Asia presents the rising power of East Asia with unusual opportunities and

risks. As part of the Inner Asian region it must have concern for the transnational politics of the region; as an international actor it must concern itself in the dynamic between internal and external powers, and in particular the ambitions of the US, Russia and India.

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China's diplomacy towards Inner Asia is a complex mix of the new and old. In terms of tradition China's diplomacy is as old as the frontier itself, and has taken typically three forms. From time to time it was necessary to conduct campaigns of punishment or extermination to pacify the

frontier. More often China sought to organize and enrich the frontier societies since this was a far more economic means of securing the frontier than continuous warfare. Lattimore as ever states this most elegantly in his study of the Qing government's frontier diplomacy towards the Mongols which favoured subsidy and sedentarisation:

*The system was one of the standard expedients in Chinese history, whatever the ruling dynasty, and by no means a Manchu invention. It kept the peace at an expense that was very small compared with the cost of frontier wars, and it stabilized the nominally nomadic society of the Mongols, because the regular payment of subsidy according to a classification of greater and lesser chiefs demanded a fixed habitat for each chief and his tribe. This promoted the demarcation of tribal boundaries, converting what had once been tribal followings into territorial principalities, in which the chiefs were no longer leaders of war-bands, but hereditary wardens of the "peace and order" which is always the frontier fetish of the central governments of great empires.<sup>1</sup>*

This system of managing peace and order on the frontier by enrichment and social organization had important normative aspects; by which I mean that Chinese diplomacy was strongly focused on forms of social and ethical propriety and ritual, including through the naming of things and people. This ordering by norms, naming and enrichment was always considered more desirable and economic than full-scale eradication which was only reserved for the most intransigent of cases.<sup>2</sup> In this way the creation of the frontier was quite a different thing from the creation of a boundary. The Empires, Russian and Chinese, Ottoman, Persian and Mughal, did want to demarcate their territories - the Empire's property rights - but these boundaries were laid upon an Inner Asian frontier that was more mobile and governed in China's case by subsidy, by social organization, and by acculturation to Chinese norms. The reason why some parts of Inner Asia came inside the Chinese Empire and some parts were allocated to other Empires was a result of both kinds of politics. As this suggests China's diplomacy has conventionally mixed organizational power of economy and security with forms of normative power that sought to repress unwanted ideologies and political movements and promote instead a narrative of China as a benevolent and civilising leader for the region and its diverse peoples.<sup>3</sup> Following the none too successful attempt to create organizational and normative power for China under socialism, China has returned to this conventional mode of promoting 'peace and order' at the frontier and seeking expansion of China's influence beyond the frontier. This engagement of the frontier allows China to expand its influence outwards, even as it agrees to demarcation of territorial rights with the former Soviet states and attempts to do this with India.

China's ambition to create new organizational and normative frontiers for itself in the

West is an important test case of China's new great power status, therefore. This is particularly the case because if China can expand to the West then it can claim to be a Eurasian great power for the first time, and not just an East Asian power. Two points need to be emphasized, however. First, we are still in the era of China's emergent power: the organizational mode of expansion - by trade, aid, investment, resource extraction, logistical corridors, civilian and military infrastructures, and bureaucracies of an economic or security nature - are in the first stages of development. This even more true of China's normative power. Those who say that China is already a superpower need to accept that not only would China need to have more organizational power than it presently does, but we would have to have a much more clearly defined idea of China's normative purposes. These are arguably more important than the organizational structures of China's power since it will be China's normative character that will shape what the organizational power is used for.<sup>4</sup> It is best to say that at present the normative shape of China's power is opaque, which is precisely why this space is open to such vastly different interpretations from peace and order to threat and instability. The second critical point to note is that the new Inner Asia is quite different from the old. Empire has been the conventional form of government for Inner Asia but this cannot now come back. The interaction between the new geopolitical character of Inner Asia and the social changes within Inner Asian societies will shape the context of China's power; and of course it will bring it into contact and competition with the organizational and normative resources of the other ambitious powers - Russia, America, India, and others - none of whom can afford to leave the new open frontier to be dominated by China. Therefore, China's power in Inner Asia is undetermined within an undetermined region. China has new frontiers, new ambitions but also new challenges to meet. The rest of this paper will set aside the organizational prospects of China, which are being debated at length in other publications, to consider China's role in the new normative politics of Inner Asia.

### The New Politics of Inner Asia

As noted China traditionally has governed the Inner Asian frontier by a mix of norms, subsidy, assimilation by culture, and repression of hostile forces; and it continues to employ these mechanisms in the new era of Inner Asia. The Beijing government defines those hostile to its rule in the Western regions of China as 'three evil forces'; these evils being terrorism, religious extremism, and splittism.<sup>5</sup> The claim of terrorism is directed against armed militants said to be attacking government agencies and civilians. The claim of religious extremism is directed against groups rejecting the Chinese government's right to define, monitor and control religious activities, particularly of Muslims and Buddhists. The claim of splittism is directed against those who promote self-government, typically Tibetans, Uyghurs, and Mongols who say



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that they are not ethnic minorities of a Chinese nation (*Zhonghua minzu*) but proto-nations entitled to self-determination. These forces are not unique to Chinese Inner Asia and are typical of political conditions in other parts of the region. Many political elites say they are battling against militants, against religious extremism, and against ethno-national separation, though the extent of these movements varies considerably and in a number of cases is being exaggerated by elites to justify authoritarian government and the use of repression and violence to maintain themselves in power, the Karimov regime in Uzbekistan being the obvious case.<sup>6</sup> The extent to which the new politics of Inner Asia is generating militancy, radicalism and independence pressures and the extent to which these are responses to authoritarian and arbitrary government is hard to determine. In Tibet and Xinjiang as in other Inner Asian societies what the government defines as the cure for political radicalization can often seem to be its cause. Nevertheless, China can use the common problems that elites face from anti-regime radicalism to create a channel for its diplomacy. This is, for example, one defined function for its multilateral forum for Inner Asia, the Shanghai Cooperation Organization, founded in 2001 with Russia, China, Turkmenistan, Uzbekistan, Kazakhstan, and Kyrgyzstan as members; and India, Pakistan, Iran and Mongolia as observers.

The point that is rarely mentioned by China and its partners is that a lot of the new politics of Inner Asia is democratic, in the sense that it emerges from a new civil society that is seeking autonomy and self-organisation following the long period of hibernation in socialist society. Broadly speaking three types of consciousness are rising in Inner Asia - national, religious and democratic - and these combine in different ways. Sometimes the national and democratic combine giving rise to what are known as the 'colour revolutions'; sometimes the religious and democratic combine as groups in society push for freedom of religious expression; and sometimes the national and the religious combine as Muslims and Buddhists use religious solidarity as a driver for national solidarity. Of course, not all of this consciousness can be classed as civil and democratic; some of it is xenophobic, and even violent.<sup>7</sup> It is important to remember that xenophobia means fear of the strangers we know - or at least think we know - and not fear of the unknown. In Inner Asia different ethnic and religious groups have histories of mistrust as well as histories of coexistence. Nearly all Inner Asian societies are multi-ethnic (Mongolia is an exception) so rising ethnonational consciousness can exacerbate traditional ethnic phobias within and across societies. This problem then mixes with another stemming from the imperial past. Since Inner Asia was governed in history largely by Empires the horizontal xenophobias between ethnic groups can be cross-cut by vertical xenophobias between former imperial subjects and imperial rulers. In this sense imperial rule casts a long shadow over regional identities. The political

contentiousness of Inner Asia is multi-faceted, therefore. It exhibits rising religious, national, and democratic consciousness within societies and the challenge this poses to ruling elites. It also embraces problems of xenophobia on lines of either horizontal ethno-national cleavage or vertical post-imperial cleavage. Managing this complex contentiousness has become an issue in international, as much as, national politics.

China has its own version of normative ordering and aspires to provide solutions for the contentious diversity of Inner Asia. Beijing seeks to promote ethnic harmony (minzu hexie) and talks about harmony within diversity (he er butong) enshrining this as one of the normative structures for the SCO process. But China also encounters resistance to its ordering along both the ethnic and post-imperial divides. One way to consider this is by contrast to the other great normative orderer on the Inner Asian frontier, Russia. Russian and Soviet rule over Inner Asia was authoritarian and brought many hardships, especially in the Stalin era; but it also brought economic development and aspects of European culture that were welcomed. Russia's normative legacy in Inner Asia is bound up with the idea of a transcultural Eurasian identity - a multi-ethnic and multi-confessional identity that blurred distinctions between Europeans, Turks, Mongols and Siberians. Russia is able to use this cultural legacy to maintain a form of normative power in Inner Asia, and compensate for the fact that its organizational capacity is at a low historical ebb. If we ask what is the Chinese equivalent of Eurasianism, it is clear that there isn't one. In Chinese Inner Asia Han Chinese and the other nationalities lead separate cultural, economic, religious and often linguistic lives.<sup>8</sup> The same is true of Chinese living beyond the border, where being Chinese is viewed as being largely monocultural in contrast to the transcultural Eurasianism that aspires to transcend and mix different cultural and ethnic heritages. As far as Chinese are present across Inner Asia, especially taking up new economic roles, this can give rise to forms of post-imperial anxiety. Part of the anxiety is no more than demographic pressure. The total population of the region is above 180 million (assuming the definition of Inner Asia given above) of whom Han Chinese are the largest ethnic group at perhaps 60 million, with other groups in excess of 5 million being: Uzbeks at 28 million, Tajiks 15 million, Pashtuns 13 million, Kazakhs 13 million, Uyghurs 10 million, Mongols 8 million, Russians 6 million, and Hui 6 million. But the frontier is now much more open than in the preceding 50 years and societies feel demographically exposed to Chinese migration. To this perception of Chinese demographic pressure must be added memories of the Chinese hierarchical system of the past. The Chinese dynastic system placed China at the centre of its known order and in a position of superiority over frontier societies. The Chinese methods of subsidy, assimilation by culture, and, where necessary, punitive campaigns can still shape public perception of China's contemporary power. None of this suggests movement towards anti-Chinese xenophobia on any scale; it does suggest that China faces resistance to its new movement into the frontier, a

movement all the more problematic because it encounters other major states moving into the same space.<sup>9</sup>

As this suggests China's normative ordering for Inner Asia is unlikely to be a matter of smooth progression. In distinction to those who see China expanding by means of normative or soft power the view from Inner Asia is either indifference to this project or actual resistance. Often Chinese normative power is seen as a potential mechanism for Chinese penetration of new nation-states that are in difficult processes of establishing autonomous political identities and have long memories of imperial subordination. The fact that key parts of West China - Inner Mongolia, Xinjiang, and Tibet most obviously - appear to be participating in the new Inner Asian politics of rising national, democratic, and religious consciousness suggests that the Chinese government will be more concerned with managing the internal part of the frontier than it will be engaged in expanding into the external frontier. As with past Chinese states achieving 'peace and order' on the frontier will remain a fetish for the central government; and many obstacles, internal and international, will have to be overcome before China can become a great power in the West.

#### Notes

1 Owen Lattimore, "The Historical Setting of Inner Mongolian Nationalism", *Pacific Affairs*, Vol. 9, No. 3, 1936, p. 391.

2 See Perdue's account of the Qing campaign to pacify the frontier in the 18th century: Peter C. Perdue, *China Marches West: the Qing conquest of Central Eurasia*, Harvard: Belknap Press, 2005.

3 I discuss the on-going attempt to create a stable frontier between China and Islamic societies in David Kerr, "Paradoxes of Tradition and Modernity at the New Frontier: China, Islam, and the problem of 'different heavens'", in *China Orders the World: Normative Soft Power and Foreign Policy*, William A. Callahan and Elena Barabantseva (eds.) The Johns Hopkins University Press, Baltimore for the Woodrow Wilson Center Press Washington, D.C. 2012, pp. 143-179.

4 See the essays in Callahan and Barabantseva, 2012, *op. cit.* for various outlines of the origins and purposes of China's normative power.

5 See the government White Paper produced in the wake of inter-communal violence in Xinjiang in July 2009: *Xinjiang's Development and Progress*, State Council of the People's Republic of China, September 21 2009, Beijing.

6 See, for example, the discussion in "No One Left to Witness": Torture, the Failure of Habeas Corpus, and the Silencing of Lawyers in Uzbekistan," New York: Human Rights Watch, December 2011.

7 Violence can be directed towards the self as well as outwards to others. In China's Tibetan areas, which include not only the Tibet Autonomous Region but four adjacent provinces with Tibetan populations and monasteries, monks and nuns have since March 2011 been adopting the practice of self-immolation to protest at government policies, interacting with

heavy saturation of Tibetan areas by security forces. This protest strategy spread outside of China with an exiled Tibetan self-immolating in Delhi in advance of President Hu Jintao's participation in the BRICs summit in March 2012. The issue of self-immolation is addressed by Amnesty International and Human Rights Watch in their open letter to President Hu Jintao of November 3 2011, available at: <http://www.hrw.org/news/2011/11/03/open-letter-president-people-s-republic-china-self-immolations-tibetan-populated-are>. An academic evaluation by Dibyesh Anand is available at: [http://zeenews.india.com/news/exclusive/tibet-self-immolation-won-t-trigger-china-spring\\_742597.html](http://zeenews.india.com/news/exclusive/tibet-self-immolation-won-t-trigger-china-spring_742597.html)

8 For a recent study of ethnic segregation in Xinjiang based on field interviews see, David Tobin, "Competing Communities: Ethnic Unity and Ethnic Boundaries on China's North-West Frontier," *Inner Asia*, 13, 2011, pp. 7–25.

9 I discuss the Central Asian dimensions of these problems more fully in, David Kerr, "Central Asian and Russian perspectives on China's strategic emergence," *International Affairs* 86: 1, 2010, pp. 127-152.

# What China Wants in Asia: 1975 or 1908?

(Gunboat diplomacy in the South China Sea  
– Chinese strategic mistake)

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**O**n the eastern, ascendant flank of the Eurasian continent, the Chinese vertigo economy is overheated and too-well integrated in the petrodollar system. Beijing, presently, cannot contemplate or afford to allocate any resources in a search for an alternative. (The Sino economy is low-wage- and labor intensive- centered. Chinese revenues are heavily dependent on exports and Chinese reserves are predominantly a mix of the USD and US Treasury bonds.) To sustain itself as a single socio-political and formidably performing economic entity, the People's Republic requires more energy and less external dependency. Domestically, the demographic-migratory pressures are huge, regional demands are high, and expectations are brewing. Considering its best external energy dependency equalizer (and inner cohesion solidifier), China seems to be turning to its military upgrade rather than towards the resolute alternative energy/Green Tech investments – as it has no time, plan or resources to do both at once. Inattentive of a broader picture, Beijing (probably falsely) believes that lasting containment, especially in the South China Sea, is unbearable, and that – at the same time – fossil-fuels are available (e.g., in Africa and the Gulf), and even cheaper with the help of warships.<sup>1</sup>

In effect, the forthcoming Chinese military buildup will only strengthen the existing and open up new bilateral security deals of neighboring countries, primarily with the US – as nowadays in Asia, none wants to be a passive downloader. Ultimately, it may create a politico-military isolation (and financial burden) for China that would consequently justify and (politically and financially) cheapen the bolder reinforced American military presence in the Asia-Pacific, especially in the South China Sea. It perfectly adds up to the intensified demonization of China in parts of influential Western media.

Hence, the Chinese grab for fossil fuels or its military competition for naval control

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*...the Chinese grab for fossil fuels or its military competition for naval control is not a challenge but rather a boost for the US Asia Pacific*  
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is not a challenge but rather a boost for the US Asia-Pacific – even an overall – posture. (Calibrating the contraction of its overseas projection and commitments – some would call it managing the decline of an empire – the US does not fail to note that nowadays half of the world’s merchant tonnage passes through the South China Sea. Therefore, the US will exploit any regional territorial dispute and other frictions to its own security benefit, including the costs sharing of its military presence by the local partners, as to maintain pivotal on the maritime edge of Asia that arches from the Persian Gulf to the Indian Ocean, Malacca and South China Sea up to the northwest–central Pacific.)

A real challenge is always to optimize the (moral political and financial) costs in meeting the national strategic objectives. In this case, it would be a resolute turn of China towards green technology, coupled with the firm buildup of the Asian multilateralism. Without a grand rapprochement to the champions of multilateralism in Asia, which are Indonesia, India and Japan, there is no environment for China to seriously evolve and emerge as a formidable, lasting and trusted global leader.<sup>2</sup> Consequently, what China needs in Asia is not a naval race of 1908, but the Helsinki process of 1975.

Opting for either strategic choice will reverberate in the dynamic Asia–Pacific theatre. However, the messages are diametrical: An assertive military – alienates, new technology – attracts neighbors. Finally, armies conquer (and spend) while technology builds (and accumulates)! At this point, any eventual accelerated armament in the Asia-Pacific theatre would only strengthen the hydrocarbon status quo. With its present configuration, it is hard to imagine that anybody can outplay the US in the petro-security, petro-financial and petro-military global playground in the following few decades. Given the planetary petro-financial-tech-military causal constellations, this type of confrontation is so well mastered by and would further only benefit the US and the closest of its allies.

Within the OECD/IEA grouping, or closely; the G-8 (the states with resources, infrastructure, tradition of and know-how to advance the fundamental technological breakthroughs), it is only Japan that may seriously consider a Green/Renewable-

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tech U-turn. Tokyo's external energy dependencies are stark and long-lasting. After the recent nuclear trauma, Japan will need a few years to (psychologically and economically) absorb the shock – but it will learn a lesson. For such an impressive economy and considerable demography, situated on a small land-mass which is repeatedly brutalized by devastating natural catastrophes (and dependent on yet another disruptive external influence – Arab oil), it might be that a decisive shift towards green energy is the only way to survive, revive, and eventually to emancipate.

An important part of the US–Japan security treaty is the US energy supply lines security guaranty given to (the post-WWII demilitarized) Tokyo. After the recent earthquake-tsunami-radiation armageddon, as well as witnessing the current Chinese military/naval noise, Japan will inevitably rethink and revisit its energy policy, as well as the composition of its primary energy mix.

Tokyo is well aware that the Asian geostrategic myopias are strong and lasting, as many Asian states are either locked up in their narrow regionalisms or/and entrenched in their economic egoisms. Finally, Japan is the only Asian country that has clearly learned from its own modern history, all about the limits of hard power projection and the strong repulsive forces that come in aftermath from the neighbors. Their own pre-modern and modern history does not offer a similar experience to other two Asian heavyweights, China and India. That indicates the Far East as a probable zone of the Green-tech excellence and a place of attraction for many Asians in the decade to come.

1 Since the glorious Treasure Fleets of Admiral Zhèng Hé have been dismantled by the order of the Mandarin bureaucracy in 1433, China has never recovered its pivotal naval status in the Asia-Pacific.

2 More on the pan-Asian architectures in my 2011 work: “Preventive diplomacy: No Asian century...”

*Student Writing Competition Winner*

# China-Getting Ahead or Losing Ground?

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INDIA

China and the United States, both littoral states on the opposite sides of the Northern Pacific Ocean seem destined to a clash of competing ambitions sometimes in the 21st Century. While China has not tried to colonize or “absorb” other countries, their military aspirations cannot be denied. With 2.3 million active troops, the People’s Liberation Army (PLA) is the largest standing military force in the world, commanded by the Central Military Commission (People’s Republic of China)“Central Military Commission (CMC).<sup>1</sup> According to SIPRI, China’s military expenditure in 2010 totaled US\$114.3 billion (808 billion yuan), constituting the world’s second-largest military budget, after the United States.<sup>2</sup> In 2011, the Pentagon reported that China was believed to be testing the JL-2 missile, a new submarine-launched nuclear ICBM with MIRV”multiple-warhead delivery capabilities.<sup>3</sup> On 13 March 2011, the PLAN missile frigate Xuzhou was spotted off the coast of Libya, the journalist and author Fareed Zakaria viewed the mission as also being an attempt to increase China’s global military presence.<sup>4</sup>

China is obviously an important economic player. According to the IMF, China’s Annual average GDP growth”annual average GDP growth between 2001 and 2010 was 10.5%, and the Chinese economy is predicted to grow at an average annual rate of 9.5% between 2011 and 2015.<sup>5</sup> As of 2012, China has the world’s second-largest nominal GDP, totaling approximately 47.2 trillion yuan (US\$7.47 trillion) according to the country’s National Bureau of Statistics of China”National Bureau of Statistics.<sup>6</sup> China’s market-oriented economic reforms sparked exponential increases in energy demand, fueling an expanding industrial base, burgeoning commercial enterprises, and rising living standards. Like the United States, China also struggles with the issue of energy. China is a consumer, not a producer of energy. It is estimated that China’s proven oil reserves will be depleted by 2018.<sup>7</sup> Hence, China looks to the Middle East as a growing source of hydrocarbon imports to meet its escalating energy needs.



According to the IEA, by 2010 as much as 80 percent of China's oil imports came from the Middle East.<sup>8</sup> The Chinese drive for energy is already a source of tension in bilateral relations. China's efforts to establish influence with Middle Eastern energy producers have thwarted U.S. efforts to impose sanctions on Sudan over the Darfur genocide and are currently complicating Washington's attempts to persuade the IAEA to refer Iran to the Security Council for violating its nonproliferation obligations

China not only has a huge pool of labor, but also its laborers are moving from sectors with low labor productivity to sectors with higher labor productivity, that is from agricultural activities to nonagricultural activities. According to Angang Hu of 'The China Policy Institute' China's total employed population would be about 820 million in 2020, with 65% of them in nonagricultural employment, i.e. 533 million.<sup>9</sup> China's success has been primarily due to manufacturing as a low-cost producer. This is attributed to a combination of cheap labor, good infrastructure, relatively high productivity, favorable government policy, and a possibly undervalued exchange rate.

As China emerges as a global power it is important to understand what role it will play and the security perceptions it has of both Asia and the world. One theme that has emerged from China's military modernization has been the closer ties it has established with Russia. China has made tremendous strides in gaining market share in India's import market in commoditized -mass produced products. China is likely to overtake the United States in terms of economic aggregate (GDP) and India would overtake Japan by 2020.<sup>10</sup> The first thing to note is that the data do not support the idea that China is a massive net exporter of manufactures to countries in Asia that are potential competitors as producers of manufactures. Exports of primary products to China have provided enormous opportunities for supplying countries, but most of these primary products come from Latin America and Africa.

Given the tremendous complexity of China's reality, it is quite difficult to draw any definite conclusions. As a member of the United Nations (UN) Security Council, the People's Republic of China (PRC) belongs to the elite club of recognized great powers. It is involved in more than 1000 international governmental

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China has made  
tremendous strides  
in gaining market  
share in India's  
import market  
in commoditized  
- mass produced  
products  
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organizations that deal with issues ranging from drug trafficking to the environment. While China's performance has been impressive, it also has the potential to maintain this growth. At the global level, China, so far has been unsuccessful to make any headway in terms of limiting United States unipolar pre-dominance except for some minimal nuclear deterrence. America enjoys much better relations with the rest of the world than China in terms of both quantity and quality. America has more than 50 formal military allies, while China has none. North Korea and Pakistan are only quasi-allies of China. China also is unfortunate that it has no "natural allies" in East Asia, (other than the dubious North Korea) with whom it could forge alliances. The Chinese Navy is yet to emerge as a 'blue water' navy and China lacks significant 'force projection' capability. While economic and social controls have been greatly relaxed in China since the 1970s, political freedom is still tightly restricted. In 2010, Premier Wen Jiabao stated that China needs "to gradually improve the democratic election system so that state power will truly belong to the people and state power will be used to serve the people." Despite his status, Wen's comments were later censored by the government.<sup>11</sup> Double-digit growth can't hide the fact that China's state-controlled economy is leaving the vast majority of citizens behind.

China has had a head start. In terms of world powers, one cannot forget that an innovative America, an integrating Europe, and possibly a revitalising Russia, are also contenders. Viewed from a 'society of states' perspective, that is, a system intent on preserving itself, contention is matched with concerting behaviour. Great powers - indeed global powers with unprecedented economic and security interdependence - must concert together as much as compete. Unfortunately, the world no longer operates, if ever it did, as a zero-sum game.

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3 Bill Gertz, n.2

4 CNN news, March 13, 2011) , accessed on 21st april 2012

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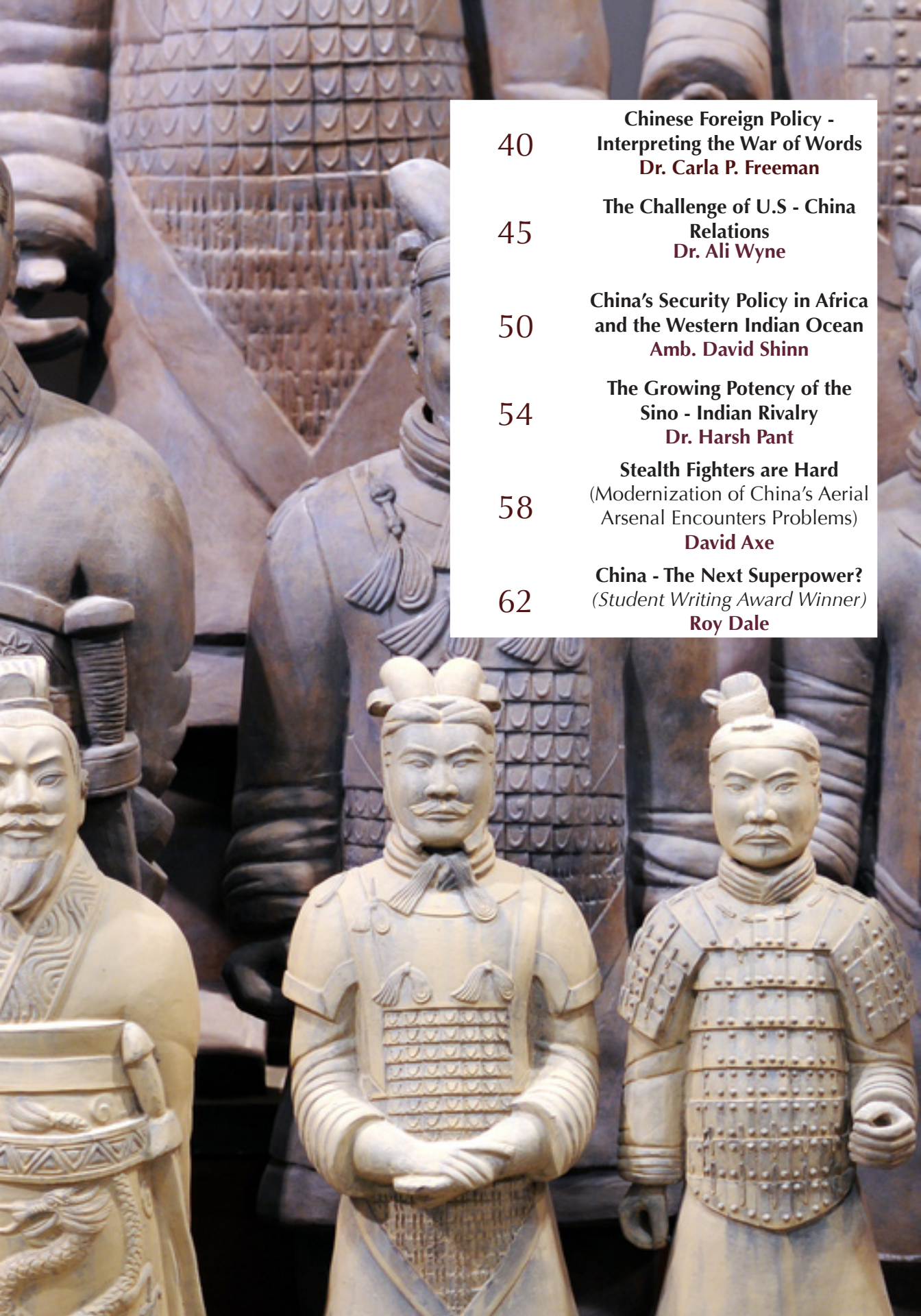
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# SECURITY POLICY



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# Chinese Foreign Policy-Interpreting the Recent War of Words

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UNITED STATES

In the past few years, China has seemed more willing to engage in wars of words with the United States and American allies over areas of disagreement in the international arena than at any time since it introduced its reform and opening policies more than three decades ago. China's harsh rhetoric on challenges to its interests in the South China Sea has drawn particular attention of late, but commentators have also taken note of Beijing's hard-line position at the UN Climate Change Conference in Copenhagen, its confrontational reaction to the Obama Administration's decision to have the president meet with the Dalai Lama and proceed with Taiwan arms sales in late 2009, and its recalcitrance on Iran sanctions, among other examples.

How should we interpret Beijing's greater rhetorical assertiveness in the international arena and what are its implications? There is no shortage of opinion on these questions; but three views seem to get the most play. The first of these assesses the tough language emanating from Beijing as evidence of a significant shift in China's international policy. According to this perspective, China, emboldened by its relative resilience through the global financial crisis, has abandoned its *taoguang yanghui* "low profile" approach to international affairs introduced by Deng Xiaoping in the early 1990s that focused national energies on economic development. Beijing's rhetorical push in pursuit of its interests today is seen as a harbinger of a China that is willing to more actively use its economic and military power to assert its interests, can be expected in the near future.

An alternative explanation characterizes the phenomenon as the natural outcome of China's increasingly far-reaching international ties. As China's international reach and influence have become global, the chance that its international actions are closely scrutinized and even challenged by other countries has also grown. A result



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has been that China finds itself in the position of defending its international policies more than in the past-- and also sees greater significance for its national interests in doing so. Many western analysts who share this view contend that harsh rhetoric from Beijing is a symptom of Beijing's inexperience and limited capacity to manage its rapidly expanding influence, a capacity they see few signs of Beijing acquiring anytime soon.

A third view sees Chinese rhetorical assertiveness in the context of Chinese domestic politics. The country's current leadership transition is a key factor, in this assessment, which sees it contributing to an atmosphere of insecurity and driving Chinese leaders to ratchet up nationalist rhetoric. This includes propagation of the idea that the West is engaged in a conspiracy to thwart China's rise through a policy of containment. The West's talk of international responsibility and partnership is a sop aimed at bogging China down in commitments it is unprepared for. Western analysts have argued that such domestic and social insecurity in China could constrain China's freedom of action in the foreign policy arena at best or at worst lead it to develop and act on policies that satisfy nationalist sentiment but may not be the most prudent choices in support of China's international interests and international stability.

These assessments of Chinese foreign policy behavior all argue for different approaches by the US toward China --and all have their merits. But none of them is much of a guide, if cooperation between China and the US in the international arena is a goal. If policy makers adopt the first view, they are likely informed by a model of the US-China relationship that sees it as an inherently competitive and confrontational dynamic, with power relations between the two countries a zero-sum calculus. This perspective sees very limited potential for cooperation between China and the US in any dimension of international policy. The second perspective is skeptical of China's ability to assume the responsibilities that accompany its growing influence. China prefers to free-ride and is not a team player and therefore makes an unlikely and unreliable prospective international partner. Finally, the third view does suggest that US policy makers have the potential to enhance US-China relations by recognizing that the Chinese public's interpretation of US policy may affect China's response to it; however, this view also implies a high degree of fragility and unpredictability in the bilateral dynamic with a lots of opportunity for miscalculation, boding ill for a stable relationship based on mutual trust.

As China's power grows, if current powers, most importantly the US, wish to enable the international system to adjust to incorporate its rise in the absence of conflict, improved mutual understanding is critical. If a foreign policy goal of US policymakers is to promote cooperation, not confrontation, toward this end,

the assessments of Chinese foreign policy behavior noted above have significant limitations. Of these, there are two in particular that do not get adequate attention.

One limitation of the views summarized above is that to varying degrees they all treat China as a unitary actor. For example, although the third view gives weight to the role of public opinion as a Chinese foreign policy driver, generally, little is said about the source of that public opinion, enabling the argument that it is the Chinese Party-State that takes the lead in shaping opinion-making in China about international events.

In reality, it has been a long time since the Chinese media spoke with one voice. Chinese media remains heavily censored and regulated, but today there are dozens of formal media outlets, hundreds of radio and television stations and thousands of cable channels, all heavily dependent on commercial revenue. The audience for media in China is enormous, with more than 1.2 billion television viewers and 500 million internet users. Any international issue affecting China WILL [may now] trigger a flood of many different streams of public opinion. These include the viewpoints of a new class of celebrity pundits and hyper-nationalistic netizens, as well as around 7 million Chinese citizens overseas. Beijing may not always respond to these voices, but they may be a factor in its policies. The decision to refrain from vetoing a Security Council resolution to approve the use of force in Libya last year may have been shaped in part by the widespread expression of concern through the internet by Chinese nationals about the protection of the tens of thousands of their fellow citizens in that country.

In addition, a myriad of governmental actors have joined the Ministry of Foreign Affairs as actors in China's foreign affairs. The Ministry of Commerce, National Development and Reform Commission, People's Bank of China, and Ministry of Finance, as well as the People's Liberation Army and local governments, among other parts of the Chinese government, all seek to advance their own policy agendas, including weighing in in public forums on international issues. The fragmentation of influence in the foreign policy arena makes interpreting and responding to China in the international arena extremely challenging, particularly because China's policy making process if pluralized remains opaque. What is clear is that while this may make assessing the direction of Chinese policy more complex, it is important to distinguish between opinions of scholars and other pundits, even those with close ties to branches of the Chinese government. For example, the flames of speculation in US policy circles over whether the South China Sea had been redefined as a "core interest," thus joining a set of issues on which China has asserted a nonnegotiable position-- namely territorial integrity and sovereignty, were briefly fanned by a misinterpretation that a PLA major general who frequently airs his hawkish views in

the Chinese media was speaking in an official capacity for the Chinese government.

Second, none of the three views gives attention to what is conveyed by the Chinese government in criticizing the actions of a foreign country as having “hurt the feelings of the Chinese people.” This is also a challenge for westerners who may not grasp the nuance of this meme, frequently connected to other harsh language by Beijing in response to the actions of other countries it opposes. It is a phrase that speaks to Chinese history and its use of history in contemporary policy, as well as to the very construction of China’s identity as an international actor. This identity rests heavily on an understanding of China’s past that casts the Chinese people as having suffered at the hands of foreign powers.

That the phrase offers a vehicle for the Chinese government to reinforce Chinese national unity against the outside world is certainly one of its purposes. But it also conveys the view that the perpetrator has deliberately humiliated China and caused it to lose face, an injury that requires both punishment and an effort by the victimizer at redemption. Humiliation and the loss of face requires an audience, and the phrase most often is applied to acts that China sees as deliberate efforts to diminish its national standing. The phrase was recently invoked by the Chinese foreign ministry in response to American involvement in the case of blind Chinese activist Chen Guangcheng. International policy clearly cannot be hostage to this formulation by China; however, its real meaning should not be dismissed and understanding this may offer opportunities to manage certain bilateral issues with greater discretion for a better outcome to the extent that that is possible by more open societies.

“*this is a critical time in relations between China and the US and its allies*”

This is a critical time in relations between China and the US and its allies when the stakes for getting relations right are high. Putting China’s war of words in informed perspective is important to doing this.

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# The Challenge of U.S.-China Relations

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Last October, while discussing the intractability of certain foreign-policy challenges, Council on Foreign Relations President Richard Haass told an audience at the Harvard Kennedy School that he “see[s] some things not as problems, but as conditions, and conditions are not to be fixed, but...to be lived with and managed as best as you can.” Although he was discussing the relationship between the United States and Pakistan when he rendered this judgment, he could easily have been discussing that between the U.S. and China. For the better part of the past decade, policymakers and commentators in both countries have been struggling to articulate an overarching framework to define their interactions.

In September 2005, then-U.S. Deputy Secretary of State Robert Zoellick famously advised China to be a “responsible stakeholder”: “All nations conduct diplomacy to promote their national interests. Responsible stakeholders go further: They recognize that the international system sustains their peaceful prosperity, so they work to sustain that system.” This March, Secretary of State Hillary Clinton concluded that China has been a “selective stakeholder,” capitalizing on its dual status as a great power and a developing one. She urged it to become a “full stakeholder” that, “for the long run, play[s] a positive role that will enhance security, stability, and prosperity.”

Interestingly, the same month that Zoellick delivered his address, influential Chinese strategist Zheng Bijian took to the pages of Foreign Affairs to introduce the term “peaceful rise,” which would become China’s official doctrine for the first decade of this century: it would lift “its people out of poverty by embracing economic globalization and improving relations with the rest of the world.” Last spring, however, arguing that that doctrine needed to be “concretized,” Zheng proposed a new one for China to adopt for this decade, “global convergence of interests,” whereby China would “expand and deepen the convergence of interests of all

parties' and foster 'communities of interests' with other countries and regions in different areas and at various levels."

While the U.S. and China will doubtless continue to refine these conceptions as their relationship evolves, their relationship is sufficiently complex that a guiding concept is likely to prove elusive. Never before have a superpower and its chief competitor exhibited a comparable degree of economic interdependence or played as central a joint role in sustaining international order.

### The Challenge

Secretary Clinton captured the enormity of the challenge at the fourth round of the U.S.-China Strategic and Economic Dialogue: "The United States and China are trying to do something that is historically unprecedented, to write a new answer to the age-old question of what happens when an established power and a rising power meet." Writing such an answer would be challenging even if they had anticipated the question decades in advance. In reality, it emerged with rapidity that no one—certainly not China—could have expected. Indeed, while arguments about the singular importance of U.S.-China relations have now assumed axiomatic status, it would be difficult to find such a consensus a decade earlier—when America's strategic outlook was rooted in considerable part in the strength of the trilateral framework: North America, Europe, and Japan—or even five years earlier. Most mainstream judgments at that time held China to be an emerging power of rapidly growing importance, not an ascendant superpower. Take the 2006 National Security Strategy:

*As China becomes a global player, it must act as a responsible stakeholder that fulfills its obligations and works with the United States and others to advance the international system that has enabled its success...China shares our exposure to the challenges of globalization and other transnational concerns. Mutual interests can guide our cooperation on issues such as terrorism, proliferation, and energy security.*

Or consider then-Senator Barack Obama's essay in the July/August 2007 issue of *Foreign Affairs*: he pledged to "encourage China to play a responsible role as a growing power—to help lead in addressing the common problems of the twenty-first century. We [the U.S.] will compete with China in some areas and cooperate in others. Our essential challenge is to build a relationship that broadens cooperation while strengthening our ability to compete."

While the geopolitical challenges that China's rise poses to the U.S. are widely discussed, it is the psychological challenges that may prove more vexing. Only two

decades after the Soviet Union's implosion seemed to usher in uncontested U.S. preeminence, it must concede an uncomfortable likelihood: that it will, before the middle of this century, cede to its putative replacement the titles of largest economy and largest defense spender—the titles that arguably define “number 1” more than any others. Ceding them to any country would be difficult to accept; ceding them to one whose ideology, governance, and worldview are as different as China's— and which, in the aftermath of Cold War, were widely believed to be obsolete—is likely to prove doubly difficult.

As this calibration between the two countries continues, the U.S. must ensure that the various measures it is taking to hedge against China's rise do not add up to a de facto strategy of containment. China, for its part, must not proceed from an exaggerated assessment of American decline: the past decade of U.S. foreign policy demonstrates the peril of overreaching when strategic trends appear to be in one's favor.

#### Unanswered Questions

It is not only America's future China policy and China's future U.S. policy that are uncertain. Notwithstanding a prodigious volume of analysis on Sino-U.S. relations, some of the most basic questions that will shape their evolution remain unanswered:

- What is China's long-term geopolitical objective, if indeed it has one?

- What long-term geopolitical objective does China believe that it can achieve, and how will that assessment change over time?

- What does the U.S. believe China's long-term geopolitical objective to be, if indeed it believes China to have one?

- What long-term geopolitical objective does the U.S. believe that China can achieve, and how will that assessment change over time?

At one end of the spectrum is Chinese Vice Foreign Minister Cui Tiankai's answer: “China's developmental goal is just one thing: to allow ordinary Chinese people to have better lives. It is not about vying with any other country for the no. 1 spot in the world.” At the other end is the

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...it is the  
psychological  
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judgment that China seeks to displace the U.S. as the preeminent power in the Asia-Pacific and ultimately in the world.

If both countries' objectives and decision-making processes were completely transparent, their relationship would principally evolve in accordance with objective realities: for example, the balance in their power-projection capabilities. The greater the gap in mutual understanding, the more likely it is that they will formulate policy toward each other on the basis of unfounded interpretations. Conjecture, then, rather than insight, becomes the basis of policy. Henry Kissinger explains that "[b]oth sides should be open to conceiving of each other's activities as a normal part of international life and not in themselves as a cause for alarm. The inevitable tendency to impinge on each other should not be equated with a conscious drive to contain or dominate." That such common sense has to be explicated evinces the depth of strategic mistrust between them.

#### The Next 40 Years

Given that mistrust, there is considerable concern about the potential for Sino-U.S. war:

- Although China's gradual economic integration of Taiwan reduces the likelihood that the latter will push for independence, one cannot rule out that move, and the attendant possibility of a military response by China that would, in turn, pressure the U.S. to intervene.

- Tensions in the South China Sea continue to escalate, with some suggesting that it is the site of an emerging great game." If China were to attempt to establish its sovereignty over the Scarborough Shoal through force, it is unclear how the U.S. would respond. On the one hand, its mutual defense treaty with the Philippines obliges it to respond to an attack on "island territories under [Filipino] jurisdiction in the Pacific." On the other hand, the U.S. insists that it takes no position on the territorial dispute between China and the Philippines.

- The Department of Defense's latest appraisal of Chinese military power asserts that "Chinese actors are the world's most active and persistent perpetrators of economic espionage. Chinese attempts to collect U.S. technological and economic information will continue at a high level and will represent a growing and persistent threat to U.S. economic security." Absent clear, enforceable cyber rules of the road, there is a concern that a damaging cyberattack that is believed to have occurred with the Chinese government's permission or support could trigger a U.S. military response.



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And yet, it is not the prospect of a military conflict between the two that is most concerning. It is, instead, the reality that the basis for cooperation between them is not developing nearly as quickly as the global challenges that it must address. If the signature achievement of Sino-U.S. diplomacy in the past 40 years was to integrate China into the international system, the central challenge of the next 40 will be to close that gap.

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# China's Security Policy in Africa and the Western Indian Ocean

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Africa and the western Indian Ocean have security implications for China only to the extent that Chinese nationals and investments in the region are threatened or there are interruptions in the flow from Africa of critical raw materials that support China's economy. As a result, China puts a premium on strengthening the stability of African countries, irrespective of their political ideology, especially those that are major exporters of raw materials or have a significant Chinese presence.

China's security-related interests in Africa began in the late 1950s with military assistance and training for a variety of African liberation groups fighting for independence from colonial rule. During the 1960s, China even supported a small number of African rebel groups that opposed independent African governments. This early policy was part of China's doctrine of revolutionary warfare and support globally for wars of national liberation.

As African countries under colonial rule obtained independence and China ended in the 1970s its support for rebel groups opposing independent African governments, it refocused Chinese security strategy in Africa. China became an early although modest supplier of military equipment, especially small arms and light weapons, to African governments. From the 1960s to the 1990s, China's share of conventional arms deliveries to Africa by dollar value varied between 3 and 5 percent of the global total. Since the late 1990s, as China produced higher quality and a wider selection of conventional military equipment, it increased its transfers to Sub-Saharan Africa to about 15 percent. These percentages exclude small arms and light weapons, which are difficult to track but for which China is a major supplier.

Small arms and light weapons do not contribute significantly to the dollar value of

Chinese arms transfers, but those that have made their way into African conflicts such as Darfur, Somalia, Liberia, Chad and the eastern Congo have, together with weapons from other countries, contributed to the loss of life. It is China's policy to transfer weapons only to governments and there is no evidence in recent years that China has provided them directly to rebel groups. In some cases, African governments have transferred them to rebel organizations or they are purchased on the international arms market. A UN Panel of Experts concluded, for example, that Sudan supplied the allied Janjaweed rebel organization with Chinese arms for use in Darfur even after a United Nations' embargo had taken effect.

From the beginning, China's military strategy has relied on a steady stream of exchange visits with African military counterparts. Members of the People's Liberation Army (PLA) and Navy (PLAN) are constantly visiting African countries and African military leaders are frequent guests of the PLA and PLAN. This is a relatively low cost policy with a potentially high return. Some twenty-eight African countries have defense attachés assigned to their embassies in Beijing. China has some sixteen defense attaché offices in Africa accredited to about thirty countries, a surprisingly low number in view of China's growing security interests.

UN peacekeeping operations in Africa have increasingly become a significant component of China's policy. It deployed twenty military observers in 1989 to a UN election monitoring operation in Namibia, its first military deployment with the UN. This was followed by a steady increase of support for UN peacekeeping operations. China now has about 1,500 non-combatant troops and police assigned to six of the seven UN missions in Africa, more than any other permanent member of the Security Council. China sends primarily engineers, transport specialists and medical units. China sees this contribution

as a way to increase its standing in the world, test its military ability, learn more about African security, and put it in a position to help protect Chinese interests in Africa. Support for UN peacekeeping is now central to China's military strategy in Africa. By all accounts, including those from American military personnel, China's

“China and Western countries have...a different understanding of the ultimate goal of UN peacekeeping operations.”

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peacekeepers have performed well. China has also increased its financial support for UN peacekeeping operations and made modest contributions to operations such as Somalia undertaken by the African Union and sub-regional African organizations.

China and Western countries have, however, a different understanding of the ultimate goal of UN peacekeeping operations. While both camps seek a return to political stability in conflict countries, Western governments emphasize an outcome that results in a liberal democratic government while China's primary goal is economic development that includes poverty reduction, increased employment and infrastructure creation. The establishment of a liberal democratic regime is low on its priority list.

As China increased its engagement with and its physical presence in Africa, it has become subject to more security challenges. The Nigerian Movement for the Emancipation of the Niger Delta (MEND) warned China to stay out of the region. MEND or similar organizations kidnapped more than twenty Chinese working in the area. Chinese personnel have been kidnapped and killed in Sudan's Southern Kordofan region by forces that oppose Sudan's government. Nine Chinese oil workers died in an attack on their base in the Ogaden region of Ethiopia by the Ogaden National Liberation Front. China's 2009 crackdown on the Muslim Uighurs in Xinjiang Uygur Autonomous Region of western China resulted in threats against Chinese workers, who number as many as 50,000, in Algeria by al-Qaeda in the Islamic Maghreb. The collapse of the regime in Libya required the evacuation of 35,000 Chinese workers from that country in 2011. These and other incidents have caused China to reassess the level of risk it is willing to take and its ability to protect its nationals in Africa.

The outbreak of Somali piracy in the Gulf of Aden and subsequently throughout the western Indian Ocean has impacted Chinese-owned vessels and crews. In its first ever out of region tactical deployment, the PLAN sent at the end of 2008 two frigates and a supply ship to the Gulf of Aden to help the international anti-piracy effort. China continues to maintain this naval presence in the region. In addition to protecting Chinese shipping interests, the naval force is intended to help ensure the safe transit of oil and minerals on other nations' flagged vessels from Africa and the Middle East to Chinese ports. This naval presence has resulted in more frequent PLAN visits to African and Indian Ocean ports and raised the question whether China may seek more permanent naval supply arrangements in the region.

There is significant evidence that China is working to develop a carrier force. Its first carrier began sea trials in 2011 but will not be operational until 2013. In 2008, fifty

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students began training as naval pilots capable of operating fixed-wing aircraft from an aircraft carrier. The U.S. Department of Defense believes the PLAN is considering building multiple carriers by 2020. While the western Indian Ocean will not be the highest operational priority for a Chinese carrier task force, it will certainly be a strong candidate. Both the U.S. and Indian navies are following this issue closely. A captain in the Indian Navy wrote in 2010 that deployment of PLAN ships in the Gulf of Aden is a manifestation of the Chinese desire to shed its image as a “brown water” navy and signal to the world its aspiration to become a blue water navy. Some Indian analysts worry that China’s goal is the “strategic encirclement” of India.

China’s 2010 white paper on national defense states that it “will never seek hegemony, nor will it adopt the approach of military expansion now or in the future, no matter how its economy develops.” China has no bases in Africa and insists that it has no intention to establish any, and it has not entered into any formal military alliance with an African or western Indian Ocean country. On the other hand, it is in discussion with Kenya on building a major port facility north of Mombasa, has interests in two container facilities in Port Said, Egypt, and is considering the Seychelles as a resupply port for PLAN vessels taking part in the anti-piracy operation. Several senior retired PLAN officers have recently commented publicly on the need to obtain a permanent resupply base in the region to support Chinese ships.

China has been careful so far to limit its military presence in Africa and the western Indian Ocean, but the fact that it is today the world’s second largest economy and will soon take over first place changes the equation. China certainly does not want to rely on the U.S. Navy to protect the sea lanes that transport so much of its imported oil and minerals from Africa and the Middle East. These concerns have already changed China’s security strategy and, moving forward, will almost certainly increase its interest in expanding its military reach and ties with countries in Africa and the western Indian Ocean.

# The Growing Potency of the Sino-Indian Rivalry

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India grabbed global headlines last month when it successfully test-fired the nuclear capable, 5000 kilometer-range Agni-V ballistic missile and gained entry into an elite club of nations. Only five other states – the US, Russia, China, France and Israel – have this capability. Predictably, Pakistan responded a few days later by test-firing an “improved version” of its nuclear capable Hatf-4 intermediate range ballistic missile, almost demanding the world to pay attention to its own travails. No one actually did because the world is now more interested in a bigger story shaping up in Asia – a Sino-Indian rivalry that is becoming more potent with every passing day.

The success of Agni-V is a significant achievement for India's Defense Research and Development Organization (DRDO) and a culmination, in many ways, of efforts that started in 1983 as part of the Integrated Guided Missile Development Program (IGMDP). As the DRDO chief underlined, “the launch has given a message to the entire world that India has the capability to design, develop, build and manufacture missiles of this class.” The DRDO has to work on its missile program in face of international technology sanctions and the latest achievement is a testament to the dedication of the Indian scientific community.

The reaction of the US, underlining India's “solid non-proliferation record” is also very instructive of the changing geopolitical realities shaping the Asian strategic landscape and the distance US-India ties have travelled in the last few years. India is widely considered a responsible nuclear power and the logic of India's tests is well understood. The US today welcomes its rise as a balancer in the Asia-Pacific and as a powerful democratic partner at a time when America's traditional allies in the West no longer have the will and the ability to carry the burdens of a global power.

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India's no-first use nuclear doctrine relies fundamentally on a credible second strike nuclear capability. The Agni-V, by bringing Chinese heartland into India's missile orbit, makes the Sino-Indian nuclear dynamic more stable than before. India's Agni-III had been deployed very close to the Chinese border to give India a credible second strike capability. Now for the first time India has demonstrated missile capability that is able to cover China. This will give Indian military planners greater flexibility in the deployment of their missile arsenal. This test is also psychologically important for India, boosting its confidence to deal with China as an equal.

China is already at a much advanced stage in its missile capability. China's nuclear arsenal is more than double India's estimated 100 warheads and it continues to deploy both land and submarine launched ballistic missiles. China's reaction has been predictable, underscoring once again the disdain sections of the Chinese elite feel for India. Though officially China just emphasised that India and China are not rivals, the state-run *Global Times* was openly dismissive of Indian claims arguing that India "should be clear that China's nuclear power is stronger and more reliable," and that "for the foreseeable future, India would stand no chance in an overall arms race with China." But a credible second strike capability vis-à-vis China is just one part of the larger Indian strategy towards China.

Despite all the rhetoric, the Sino-Indian relations have been unstable for some time now amidst a growing consensus in New Delhi that not only does China remain insensitive to core Indian security concerns, but that, among major powers, China remains the only one that does not accept India as a rising global player that should be accommodated into the global political order. This has led New Delhi to adopt a more assertive posture vis-à-vis Beijing in recent times. The most significant has been India's move into the South China Sea waters. The Indian External Affairs Minister last year snubbed China and made it clear that India's ONGC Videsh Ltd (OVL) would continue to pursue oil and natural gas exploration in two Vietnamese blocks in the South China Sea despite Chinese criticism. Asking countries "outside the region" to stay away from the South China Sea, China had issued a demarche to India underlining that Beijing's permission should be sought for exploration in Blocks 127 and 128 and that without it, OVL's activities would be considered illegal. Vietnam, meanwhile had underlined the 1982 United Nations Convention on the Law of the Sea to claim its sovereign rights over the two blocks being explored. India decided to go by Vietnam's claims and ignore China's objections.

India's bold move is aimed at asserting India's legal claims in the international waters of the South China Sea as well as strengthening its relationship with Vietnam. Both moves unsettle China which views India's growing engagement in East Asia with suspicion. In late July, an unidentified Chinese warship had demanded that the INS

Airavat, an amphibious assault vessel, identify itself and explain its presence in the South China Sea after the vessel left Vietnamese waters. The Indian warship was completing a scheduled port call in Vietnam and was in international waters. Though the Indian Navy promptly denied that a Chinese warship had confronted its assault vessel as reported by London's Financial Times, it did not completely deny the factual basis of the report.

With China expanding its presence in South Asia and the Indian Ocean region, India is staking its own claims in East Asia. Most significant in this regard is India's growing engagement with Vietnam. India has decided to work with Vietnam to establish a regular Indian presence in the region as part of a larger Delhi-Hanoi security partnership with Vietnam giving India the right to use its port of Nha Trang. Delhi and Hanoi have significant stakes in ensuring sea lanes security and preventing sea piracy while they also share concerns about Chinese access to the Indian Ocean and South China Sea. Indian strategic interests demand that Vietnam emerge as a major regional player and India is well placed to help Hanoi achieve that objective. Just as China has used states in India's periphery to contain India, many in India would like Delhi to build states like Vietnam as strategic pressure points against China. They argue

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## With China expanding its presence in South Asia and the Indian Ocean region, India is staking its own claims in East Asia.

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that if the South China Sea is a disputed area for China and India should refrain from entering the fray so as to respect Chinese sensitivities, then India can rightfully ask China to do the same in Pakistan Occupied Kashmir, an area recognized by all major powers as a disputed territory. With this in mind, India has been providing Vietnam with help in beefing up its naval and air capabilities.

China is too big and too powerful to be ignored by the regional states. But it is clear that regional states are now seeking to expand their strategic space by reaching out to other regional and global powers. Smaller states in the region are now looking to India to act as a balancer in view of China's growing influence and America's anticipated retrenchment from the region in the near future, while larger states see it as an attractive engine for regional growth. It remains to be seen if India can indeed live up to its full potential, as well as to the region's expectations. Neither India nor the regional states in East Asia have any incentive to define their relationship in opposition to China. But what they are certainly interested in is leveraging their ties



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with other states to gain benefits from China and to bring a semblance of equality in their relationships.

The rise of China poses one of the most significant challenges for Indian policy makers, and how they manage this very complicated bilateral relationship would shape not only India's future but also the larger Asian strategic landscape.

# Stealth Fighters Are Hard

## Modernization of China's Aerial Arsenal Encounters Obstacles

**David Axe**

Wired

UNITED STATES

**C**hina has a brand new jet fighter. Only it's not really brand new at all. The emergence of the much-touted Shenyang J-16, following years of speculation, represents a surprising twist in China's more than decade-long effort to build a world-class air force – and a reminder to outsiders that even Beijing with its tight central control, extensive manufacturing base and apparent deep pockets cannot perform aerospace miracles.

In December 2010, the Chinese People's Liberation Army Air Force shocked observers when it allowed civilian photographers to snap and publish photos of China's very first, and previously unseen, stealth fighter prototype undergoing ground testing in Chengdu in central China.

The J-20 "Mighty Dragon" took off for its apparent first test flight on January 11, inaugurating what some have described as a new era of aerial warfare, in which advanced Chinese aircraft might challenge the decades-long dominance of the U.S. military with its stealth fighters and bombers. "China's new Chengdu J-20 stealth fighter was an important milestone in China's Long March toward parity in military technology with Russia and the West," wrote Carlo Kopp, an analyst with Air Power Australia, an independent think tank.

Not only did China possess the J-20, its aviation companies were also said to be hard at work on several other radar-evading fighters similar in philosophy to the American F-117, F-22 and F-35 fighters and B-2 bomber. Among these rumored warplanes was the J-16, reportedly in development in Shenyang in northeastern China. The J-16 was, if anything, scarier to the American defense establishment than the J-20, for it was more practical.

The Mighty Dragon was clearly an experimental aircraft incorporating design elements typically not seen on Chinese warplanes, including internal weapons bays. Moreover, the twin-engine J-20 apparently lacked purpose-built engines and could be seen flying with Russian-made AL-31F engines likely poorly-suited for the airframe.

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*The Mighty Dragon  
is likely a decade  
away from frontline  
service*  
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A year after its debut the first J-20 had completed only 60 confirmed testing flights of the thousands required by a new warplane design. A second copy of the Mighty Dragon appeared in the spring of 2012 but by summer still hadn't flown.

The J-16, by contrast, was rumored to be a heavily upgraded version of China's existing J-11 and J-15 fighters, themselves both reverse-engineered models of Russia's twin-engine T-10 "Flanker," which has its roots in the late 1970s but has since evolved into a highly-effective heavyweight interceptor and ground-attack plane. The AL-31 engine was designed specifically for the Flanker. Russian T-10 derivatives still use the AL-31, as do most J-11s and J-15s.

In essence, the J-16 was thought to be equivalent to the Russian T-50, an adaptation of the T-10 with the same basic engines but a new airframe optimized for its low radar signature – though not as low a signature as the U.S. F-22. "It's not an F-22 in many important ways," Bill Sweetman, a highly regarded aviation journalist, wrote about the T-50. The new Russian fighter first flew in January 2010. Today there are three T-50s undergoing testing towards a possible full production version of the jet sometime in the 2020s.

Inasmuch as the Chinese J-16 represented a parallel development to the Russian T-50, it promised to provide Beijing a more harmonious new fighter – and much sooner – than would be possible with the J-20. The Mighty Dragon is likely a decade away from frontline service, if it's even meant to serve in that capacity. The evolutionary (as opposed to revolutionary) J-16 could be ready for combat in just a few years – and still offer big improvements over older jets and better prospects against American-made warplanes. "It's the race of the stealth fighters," commented Larkins Dsouza, an analyst with Defence Aviation.

The J-16's first public appearance occurred in Shenyang in April, when the PLA AF flew at least one of the new fighters before a press audience. Hong Kong's Kanwa magazine described the J-16 as a direct copy of the Su-30, a version of the T-10

dating from the late 1990s. The J-16 in fact doesn't feature any of the rumored stealth enhancements, such as can be found on the T-50. Apparently, the only difference between the Chinese J-16 and the Russian Su-30 it's copied from is that the J-16 can carry Chinese-made weapons. Both the J-16 and the Su-30 use the standard, Russian-made AL-31 engine.

In that sense, the "new" Chinese fighter isn't new at all. Instead of representing an immediate step towards a stealthy fighter force rivaling America's, Beijing's new warplane holds the line at late '90s-early 2000s technology. Unless China is developing any other new warplanes – and that's certainly possible – a true generational leap in front-line fighter technology will have to wait for the J-20 to achieve operational readiness. That could take a decade, by which time the U.S. military will likely have brought potentially hundreds of new F-35 stealth fighters into service.

As the J-16 was making its first public appearance, Beijing was also negotiating with Russia to purchase copies of the Su-35, the newest T-10 model. The proposed purchase only underscores China's apparent inability to produce its own combat-capable versions of even moderately stealthy warplanes anytime soon. Perhaps Beijing is learning the lesson that the U.S. government learned during the 15-year, \$70-billion development of the F-22: that inventing stealth fighters is hard.

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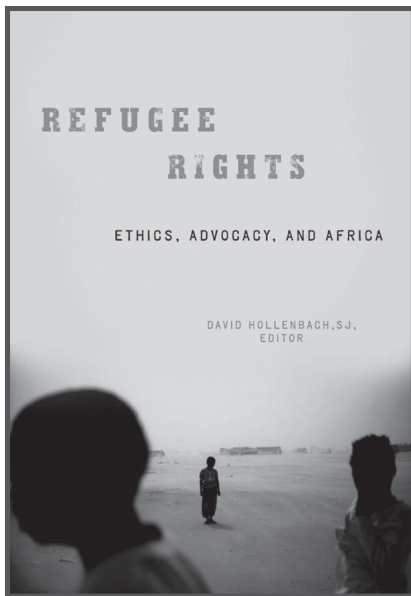
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# China—the Next Superpower?

**Roy Dale**

Victoria University of Wellington

NEW ZEALAND

China, since the end of the Cultural Revolution in 1968, has embarked on a number of actions which have led to a stage where it can now be regarded as a very powerful nation with a large global footprint. It maintains a high profile in the UN Security Council where it has recently allied itself to its one-time rival, Russia, in vetoing UN action in Syria. China has dispensed disproportionately large amounts of development aid to Africa, in particular, in the same period, giving it ideological leverage in significant areas of the continent. More recently it has been engaged in the process of modernising its domestic economy and armed forces. As a consequence, the world should keep a watch on the current military build-up by both America and China in the Asia-Pacific region.

China's investment in Africa dates back at least four decades. In 1973, when most of southern Africa was white-ruled, China had reached the midway point in building a railway from the copper belt of Zambia to the Tanzanian port of Dar es Salaam. Described by Rettman<sup>1</sup> as a means of bypassing the stranglehold imposed on Zambia's mainly copper exports, the Tanzam railway project was, at the time, the third largest foreign aid project ever undertaken and the largest aid project ever financed by a single nation. The hoped-for return on this investment, Rettman argues, was to establish China as a Third World leader and increase its influence throughout Black Africa.<sup>2</sup> Rettman contends that China's drive to build the railway at an estimated cost of \$400 million<sup>3</sup>, at a time when it had a pressing need for domestic investment and technically skilled manpower, could only be justified on political and ideological factors. In addition to building the railway, China provided two major locomotive repair workshops, all rolling stock and locomotives, as well as staff training. The total cost of the railway was to be financed by an interest-free loan, repayable in thirty years commencing in 1983.<sup>4</sup> All considered, it was an offer that the governments of Zambia and Tanzania could ill afford to refuse.

Forty years later, attitudes to China in Africa have changed. *The Economist* reported, in 2011, that China is no longer regarded as a saviour in much of Africa.<sup>5</sup> Chinese goods are held up as examples of shoddy manufacture; business practices are described as poor. Corruption, endemic in mainland China, is being imported into Africa. Chinese construction standards are slipping: the 130km road from Lusaka, Zambia's capital, to Chirundu was quickly swept away by rains. A Chinese-built hospital in Luanda, capital of Angola, was forced to close when cracks appeared in its walls. Matching standards in mainland China, scant attention is paid to rules and regulations, and local sensitivities. Oil exploration has taken place in a Gabonese national park and a Chinese oil company has created lakes of crude oil in Southern Sudan. Miners in Chinese-run copper belt mines have to work for two years before they are issued with a safety helmet. Protesting miners have been fired by managers. However, African consumers have benefitted from cheaper Chinese imports.

China intends to ring Africa with free-trade ports. *The Economist* considers that China views Africa as a stepping stone to a greater global commercial presence. Beijing, it holds, is encouraging yet more activity in Africa, notwithstanding the antithesis of an increasing number of Africans. Construction accounts for three-quarters of recent private Chinese investment in Africa. Infrastructure deals alone are worth more than \$50 billion a year. For investment in African farming, China has earmarked

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## China is no longer regarded as a saviour in much of Africa

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\$5 billion. The two main lenders (China Exim Bank and China Development Bank) publish no information about their vast loans to poor countries, some of which are likely to default on their repayments. Harding argues that the emergence of serious and widespread economic problems (especially inflation and unemployment) or an environmental catastrophe for which the government was blamed could lead to protests in major cities.<sup>6</sup>

If aid projects illustrate China's soft-power drive, then the world's biggest military expansion forcefully demonstrates the build-up of China's hard-power in the Asia-Pacific region. China is rapidly modernising its armed forces. China's defence budget has almost certainly experienced double digit growth for two decades.<sup>7</sup> SIPRI<sup>8</sup>, estimates that China's defence expenditure in 2012 will amount to \$160 billion. On present trends, SIPRI forecasts that China's defence spending will overtake that of the USA after 2035. Until recently, the main strategy of the 2.3 million-strong People's

Liberation Army (PLA) has been to fight an enemy face-to-face, crushing them by sheer force of numbers. US military planners now see China's military strength lies in destroying targets, such as aircraft-carrier groups, from afar using a variety of methods including anti-ship missiles, cyber, and anti-satellite weapons. The American government, recognising this threat, has committed itself to a build-up of its forces in the Asia-Pacific region at a time of cutbacks and withdrawals in other areas of the world.<sup>9</sup>

There are many locations in the Asia-Pacific region which could serve as flashpoints in any future conflict involving China. One example is the Scarborough Shoal in the South China Sea, currently disputed by the Philippines and China; both nations are maintaining a naval presence. Unstable governments can turn a stand-off into regional warfare very quickly. A determined but unstable China, with a modernised PLA, could yet be the twenty-first century version of 1941 Japan.

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# The Chinese Yuan-U.S. Dollar Exchange Rate: What Are the Issues?

**Prof. Richard T. Froyen**

University of North Carolina, Chapel Hill

UNITED STATES

**T**he mood in the United States is one of disquietude. Two complex wars, a financial crisis and deep recession have unsettled confidence. Where has the “great moderation” gone, not to mention the three trillion dollar budget surplus that was projected at the start of this century? Such a mood creates a climate for books with ridiculous titles such as: *After America: Get Ready for Armageddon and Becoming China’s Bitch*, the latter by a former senior partner at Goldman Sachs. Even a sensible commentator, a former Washington bureau chief of the Financial Times, Edward Luce, judges it *Time to Start Thinking: America and the Spectre of Decline*.

This colors the current view of U.S.-China economic relations, including the question of the yuan/dollar exchange rate. Reasonable projections indicate that China’s GDP will surpass that of the United States sometime prior to 2030. At that point, per capita Chinese GDP will reach one-fourth of that in the United States. If that sounds to you like Armageddon see the above cited book, otherwise read on.

## The Broad Context

The Chinese economy has grown by 9.6 percent per year since 2008, while in the United States, growth has averaged less than 1 percent. The Chinese growth model is investment- and export-led. Investment in China is twice the fraction of GDP relative to that in the United States; consumption about one half. The recent disparate growth rates heighten U.S. anxiety about being overtaken by China. An undervalued Chinese yuan is seen as an element, perhaps an unfair one, in the Chinese growth strategy. This broad context raises two questions: Should the growth of the Chinese economy be a concern to the United States, and what role does the exchange rate play in Chinese economic growth or other areas of concern to the United States.

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By the middle of the 21st century, the population of India and China will account for somewhere near one third of the world's population, Africa for something over 20 percent, the United States for perhaps 4 percent. In this context, should it be a concern that the U.S. share of world GDP will likely fall substantially from the recent range of 20 percent to 22 percent? How should one think about a "spectre of decline?" A metric of absolute share of world output seems both wrong and designed to promote disquietude.

The United States seems worried about a coming age of austerity. But surely the metric for evaluating these concerns is our own GDP. Real GDP in the United States doubled between 1984 and 2008, and before that between 1963 and 1984. Even allowing for a "bad patch" between 2008 and 2012, this would lead us to expect that GDP will be twice the current level well before mid-century, which would scarcely be austere. There are reasons for concern about the uneven distribution of the recent gains from growth and about future U.S. growth. Chinese growth or more specifically the yuan/dollar exchange rate doesn't seem highly relevant to these concerns. More generally, stable prosperous economies in Asia and Africa are likely to be beneficial to U.S. growth prospects. A "hard landing" or worse for the Chinese economy would delay the date when it became the world's largest but would also hurt the U.S. economy.

The role of China in U.S. large current account deficits and accumulating foreign debts is another area of concern. Large global current account imbalances may have played a role in the world financial crisis of 2007-09 and may cause future instability in the world financial system. The bilateral U.S.-China current account imbalance is certainly a part of the problem. A possible direct channel is that large purchases of U.S. treasuries by China and other Asian countries bid down yields and increased the appetite for other more complex predominately housing backed securities. The link to U.S. accumulating debt is less clear. The overall U.S. overseas investment position has in fact changed very little since 2007 in spite of large cumulated current account deficits. Chinese holdings of U.S. treasury securities have grown rapidly. But as long as the United States runs large deficits, the debt must end up somewhere.

### The Narrow Context

The question of the U.S. current account deficit brings us to the real issue concerning the yuan/ dollar exchange rate. The U.S. current account deficit has fallen in recent years from 6.1 percent of GDP in 2006 to 3.1 percent in 2011. China's current account surplus has also fallen substantially. The bilateral trade deficit between the two countries has fallen only slightly. A misaligned exchange rate is a plausible cause. Our current account deficit with China is now approximately two thirds of

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a “currency  
manipulator” and  
respond with a  
tariff on Chinese  
products isn’t a  
good idea*  
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the value of our overall current account deficit. It has been known since the time of Malynes, Misselden and Mun in the 17th century that the focus should be on the overall balance of trade but with one bilateral balance so large it rightly attracts attention.

What should be done? To brand China a “currency manipulator” and respond with a tariff on Chinese products isn’t a good idea. The definition of manipulate is “to influence of manage shrewdly or deviously.” This is different from the meaning of “fix.” Germany and the Netherlands have fixed their exchange rates at a level where they run persistent trade surpluses and accumulate financial claims on chronic deficit countries within

the euro area. They are hardly currency manipulators. Retaliatory tariffs such as those proposed by prominent U.S. senators would set off a trade conflict that would hurt both economies and cause difficulties in broader aspects of U.S.-China relations.

To an extent, the problem of an undervalued yuan is receding. The yuan has risen from 8.1 yuan to the dollar in 2005 to 6.3 in May 2012. Chinese inflation has been running at 1 percent to 1.5 percent above that of the United States increasing the real appreciation of the yuan since 2007. In April 2012, the band within which the yuan is allowed to fluctuate on a daily basis was widened. As the Chinese economy does move toward being the world’s largest, Chinese policymakers will want their currency to assume more international importance. That will require more freedom of capital flows and most likely more flexibility in the yuan’s value. U.S. policy is correct in pushing these processes along to the degree possible.

An important caveat here is that progress in this area must continue. The bilateral trade deficit with China is an issue for the United States. If the dollar strengthens as a currency, against the euro, for example, China mustn’t let the yuan fall relative the dollar to promote its exports. Perhaps the rise in the value of the yuan will pause but a Chinese policy to depreciate the yuan relative to the dollar in the near term future would constitute currency manipulation and should be resisted.

Shortly after his election. U.S. President John F. Kennedy told one of his economic

advisors that the two problems which worried him the most were the hydrogen bomb and U.S. balance of payments. Rather than 1 and 2, the ranking should have been closer to 1 and 10. Prioritizing concerns is important. The yuan/ dollar exchange rate should be on, but not near the top, of the list of U.S. economic concerns.

# Internationalization of the Renminbi: What Does History Tell Us About the Precedents?

**Dr. Jeffrey Frankel**

Harvard University

UNITED STATES

All of a sudden, the renminbi (RMB) is being touted as the next big international currency.

Just in the last year or two, the Chinese currency has begun to internationalize along a number of dimensions. A RMB bond market has grown rapidly in Hong Kong, and one in RMB bank deposits. The currency is starting to be used to invoice some of China's international trade. Foreign central banks have been able to hold RMB since August 2010, with Malaysia going first.

Some are now claiming that the renminbi could overtake the dollar for the number one slot in the international currency rankings within a decade<sup>1</sup>. The basis of this prediction is, first, the likelihood that the Chinese economy will surpass the US economy in size and, second, the historical precedent when the dollar overtook the pound sterling as the number one international currency during the period after World War I.

It used to be said that international currency status was subject to much inertia (e.g., Krugman, 1984). There was said to have been a long lag between the date when the US economy had passed the UK economy with respect to size (1872, by the criterion of GNP) and the time when the dollar had passed the pound (1946, by the criterion of shares in central banks' holdings of reserves). The "new view," represented in particular by Eichengreen, is that the lag was in fact rather short. It took until World War I for the dollar to fulfill the criterion of an international currency. And the date when the dollar is said to have come to rival the pound as an international currency has now been moved up to the mid-1920s. The first point is right. If trade is the measure of size, the US first caught up with the UK during World War I. The other important criteria came soon thereafter: creditor status for



the country; the perceived prospects for the currency to remain strong in value; and deep, liquid, open financial markets<sup>2</sup>. The second point seems a matter of whether or not one wants to distinguish between the concept of “coming to rival” / “catching up with” the pound (1920s) versus the phenomenon of definitively “pulling ahead” / “displacing” the pound (1945). Under either interpretation, the dollar’s initial rise as an international currency was indeed rapid, once the conditions were in place. The US did not even have a permanent central bank until 1913.

The dollar is one of three national currencies to have attained international status during the 20th century. The other two were the yen and the mark, which became major international currencies after the breakup of the Bretton Woods system in 1971-73. (The euro, of course, did so after 1999.) In the early 1990s, both were spoken of as potential rivals of the dollar for the number one slot. It is easy to forget that now, because Japan’s relative role has diminished since then and the mark has been superseded. In retrospect, the two currencies’ shares in central bank reserves were peaking as the 1990s began.

The current RMB phenomenon differs in an interesting way from the historical circumstances of the rise of the three earlier currencies. The Chinese government is actively promoting the international use of its currency. Neither Germany nor Japan, nor even the US, did that, at least not at first. In all three cases, export interests, who stood to lose competitiveness if international demand for the currency were to rise, were much stronger than the financial sector, which might have supported internationalization. (The financial sector carried much more weight in the UK and Switzerland.) One would expect the same fears of a stronger currency and its effects on manufacturing exports to dominate the calculations in China.

In the case of the mark and yen after 1973, internationalization came despite the reluctance of the German and Japanese governments. In the case of the United States after 1914, a tiny elite promoted internationalization of the dollar despite the indifference or hostility to such a project in the nation at large. These individuals, led by Benjamin Strong, the first president of the New York Fed, were the same ones who

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had conspired in 1910 to establish the Federal Reserve in the first place. It is not yet clear that China's new enthusiasm for internationalizing its currency includes a willingness to end financial repression in the domestic financial system, remove cross-border capital controls, and allow the RMB to appreciate. Perhaps a small elite will be able to accomplish these things, in the way that Strong did a century earlier. But so far the government is only promoting international use of the RMB offshore, walled off from the domestic financial system. That will not be enough to do it.

#### Notes:

1 Subramanian (2011a, p.19 l; 2011b): "Applying the historical experience of broader economic dominance to today's situation, it appears that the renminbi could actually surpass the dollar towards the middle or early part of the next decade." Eichengreen (2011) is a bit more circumspect. Both recognize that China's financial markets will have to develop much further if the RMB is indeed to take on this role.

2 The criteria are discussed and econometrically evaluated in Chinn and Frankel (2007), which also gives further references.

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# The New Trading Band and Its Repercussions

Interview with **Hon. Delio E. Gianturco**  
George Mason University

UNITED STATES

**International Affairs Forum:** Recently, the Chinese increased their trading band from .5 to 1 percent. What factors triggered this action?

**Professor Delio Gianturco:** There appears to be a growing sense on the part of the Chinese of the importance of international economic cooperation, and a greater feeling of confidence that their exchange rates are in line with supply and demand considerations. Growing liberalization of exchange rate trading bands is part of this belief. Another indicator of this is China's action to raise the value of the yuan vs. the U.S. dollar, and since 2010 the yuan has been increased by eight percent in this regard.

Also, we should remember that the U.S. dollar, to which the official exchange rate and thus the trading band are tied, has strengthened considerably during the same period vs. most other

currencies. This has the effect of further strengthening the yuan against a majority of non-U.S. markets. Adding to Chinese confidence, and a rising sense of control in the field of international exchange rates, is the fact that they own over one trillion dollars in foreign exchange reserves, much of which is in U.S. cash and government instruments. Chinese ability to purchase and sell parts of this immense portfolio has contributed to the strengthening of the dollar, and thus also of the yuan.

**What do you think Chinese leaders believe the impact of these exchange rate developments will be on their country?**

**Professor Gianturco:** I think they believe a wider trading band, coupled with a gradually rising yuan, will have a positive impact on internationalizing use

of the yuan, making it more attractive as an international currency and opening the way to have new financial services headquartered in China. They see such broadening and deepening of the capital markets as serving their best interests in the international balance of payments and the pace of domestic economic development.

**U.S. manufacturers and many economists have been critical of China's exchange rate policy; principally that**

**There's also the ongoing issue of China's balance of payments surplus...**

**Professor Gianturco:** Actually, China had a current balance of payments deficit earlier this year, but it looks as if that was a very temporary situation unlikely to be repeated in the near future. So I think that shouldn't prevent the Chinese from continuing to liberalize exchange rate policy. Again, the long term goal is to make the yuan a fully acceptable international currency, which brings with it expanded access to international

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...we should press [China] to expand the acceptable band of rates in ways that will accommodate normal supply and demand pressures

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**it's had a negative impact on U.S. jobs. Do you think this new rate will have a positive impact?**

**Professor Gianturco:** I think that remains to be seen. If recent actions are followed up with continuing measures to strengthen the yuan, it should definitely encourage growing U.S. exports to China with associated employment benefits to our country. It should also make our goods more competitive with Chinese products and thus increase our share of our own market and of third country markets. Recent Chinese exchange rate policy is certainly a movement in line with free market ideology and this is something we should welcome.

capital, a more developed internal banking system, and other private market improvements. It should change the nature of the Chinese economy to an increasingly significant exporter of capital and a greater recipient of earnings on foreign direct investments, loans, and portfolio investments.

**Do you envision a free floating Chinese currency in the future?**

**Professor Gianturco:** Yes, I do. I think they will get there in stages. Rather than continuing to encourage the Chinese to revalue their official currency rate, we should press for them to expand the acceptable band of rates in ways that will accommodate normal supply

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and demand pressures. Moving in this way, the Chinese could build upon their recent trend, in which the band has grown from .3 percent to .5 percent to 1 percent at present. As the monetary authorities grow comfortable with this system, there's no reason that the band couldn't be gradually expanded to 3 percent, 5 percent, 10 percent or even higher, and then removed entirely if things go well. Such a system would be more compatible with basic principles of free markets and assure that temporary dislocations in daily activity do not produce catastrophic short-term movements in exchange rate, thereby promoting smooth system performance and greater assurance of currency liquidity and rates of return from foreign activity.

to a wide range of developing nations, the latter have welcomed the results of Chinese exchange rate policy in recent years.

### **What impact has the Chinese exchange rate policy had on developing countries?**

**Professor Gianturco:** Because the yuan is tied to the strengthening U.S. dollar and because the yuan has been revalued upward with regard to the dollar, China's foreign exchange policy has had a major favorable impact on developing countries' exports. This is both for goods that compete with China, but much more so for those developing country exports that are incorporated in Chinese export products. This has been welcomed by many in the World Bank and the IMF. Also, because the Chinese system has produced huge foreign exchange reserves, a portion of which are used to lend money on very favorable terms

# America's Hammering China's Rmb Makes Little Sense

**Dr. Yukon Huang**  
Carnegie Institute of Peace

UNITED STATES

In a close election year, the easy option for politicians is to blame America's economic woes on China. America's bilateral deficit with China hit a record \$295 billion for last year. Protectionist sentiments are running high with recent complaints filed with the WTO that China does not follow the rules. Passage of a countervailing tariff bill exemplifies the skirmishes that are coming. These efforts are bolstered by repeated calls for the renminbi to be revalued upwards to offset China's alleged currency manipulation.

The problem is that this isn't the real story.

From China's perspective, admonitions that the renminbi is significantly undervalued seem devoid of logic. China's current account surplus has declined from 10 percent of GDP five years ago to less than 3 percent last year and many project even further declines. Moreover, Beijing finds it perplexing that after steadily appreciating the renminbi by nearly 40 percent in real terms since 2005, critics say that the renminbi is still undervalued by the same 20 percent or more as if nothing has happened over the past five years.

Much of the confusion comes from focusing on the still huge US-China bilateral trade imbalances rather than looking at it from a global perspective.

Chinese policy-makers are reminded that the US took a similar approach in complaining decades ago that an undervalued yen was the major reason for Japan's sustained trade surpluses. That the Japanese yen appreciated from 240 to 80 to a dollar in response to the 1985 Plaza Accord and yet continued to run a surplus until its recent nuclear disaster reminds the Chinese leadership that factors other than the exchange rate are far more important in shaping trade balances.

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The truth is that China's surpluses are not driving America's deficits. This is illustrated by the differences in timing for when changes to both countries' trade balances occurred. The US trade deficit began increasing rapidly around 1998 and peaked around 2005. China's trade surpluses began increasing around 2005 and peaked in 2008. This pattern suggests that US deficits and China's surpluses are not directly related but reflect global shifts and country specific circumstances.

Clearly "manipulating" the value of the renminbi had little to do with the emergence of China's trade surplus since its value was pegged to the dollar until 2005. And only as the renminbi began to appreciate, did China's surplus increase.

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## The driving force behind the US deficits and China's surpluses lies not in exchange rates but in structural factors that built up over time.

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One could argue that China's reluctance to allow the renminbi to appreciate even more rapidly after 2005 allowed surpluses to grow larger. However more rapid appreciation would likely not have reduced US trade deficits but only transferred some of the China specific surpluses to other Asian countries as long as the US continued to run major fiscal deficits.

The driving force behind the US deficits and China's surpluses lies not in exchange rates but in structural factors that built up over time. Three factors largely explain the emergence of China's trade surpluses: surging US consumption that fueled import demand, maturation of the East Asian production sharing network centered on China, and ratcheting up of China's savings rates.

The story of the origins of the decline in US household savings rates which was then exacerbated by growing fiscal deficits and together led to the excessive demand for imports is well known and still unresolved. This part of the story has little to do with China but reflects the political gridlock in Washington.

The role of the Asian production sharing network did not just surface in the mid-2000s. It began much earlier as Japan moved portions of its production base to Southeast Asia decades ago. China's central role took off only with its accession to WTO in 2001, giving it easier access to Western markets. This was supported

by a massive infrastructure construction program that strengthened its competitive position.

Thus despite substantial real wage increases of around 12 percent annually, labor productivity increased even more rapidly at an estimated 15-20 percent, making it profitable for multinational firms to use China as the assembly plant for the world. Thus the US trade balance with China is really a regional rather than a bilateral issue and one which has been substantially shaped by the interests of firms like Wal-Mart in driving costs down.

Processing exports account for about half of China's trade volumes but generate the entirety of its surplus. This trade – often exemplified by China's exports of Apple's I-Pads to the US – typically depends on the import of high technology components made elsewhere and then brought into China for assembly and export to the West. Eighty percent of the value added for these components is generated elsewhere with China's contribution concentrated in the lower technology components and labor assembly.

The particular country mix in processing trade is shown by the jump in the trade surpluses of South Korea, Japan and Taiwan with China which went from \$30 billion to over \$200 billion in the decade up to 2010. Thus China's trade surplus with the US originates largely from this North Asian trio. And rather than complain about China's exports of low tech – labor intensive products, the real question is why America is not able to produce the high tech- capital intensive components coming to the US via China from the North Asian trio. These activities command the skills and salaries that would be more appropriate for American workers.

When President Obama welcomed his counterpart from South Korea to Washington last year, he commented approvingly that South Korea's trade with the US was in balance – “as it should be”. What Obama should've done was congratulate Lee by noting that South Korea along with several others has been able to avoid US criticism by hiding its trade surpluses behind the Great Wall of China.

Studies such as one done recently by a Federal Reserve Bank have shown that appreciation of the renminbi by itself would do very little to curb China's trades surplus with the West, since much of the impact is negated by the lower cost of imports into China. Since exchange rates for the major East Asian countries are now closely aligned in their movements, it would take a more coordinated approach of the major East Asian countries to make a difference. Only the domestic labor content is affected and this is typically only a few percentage points of the cost.



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More significant in its impact on trade balances has been the rise in household savings rates. Accounting identities tell us that the trade balance is the difference between what an economy saves and what it invests. The surge in China's savings rates in excess of the rapid growth in investment explains the emergence of the huge trade surplus during 2005-08.

While many studies have suggested that Chinese household savings rates rose because of welfare concerns and demographics, the major factor has gone unrecognized. Rapid urbanization and the movement of some 250 million migrant workers into the major coastal cities have changed the savings dynamics in China. Restrictive policies have prevented these migrants from being given formal residency rights and thus repressed their consumption instincts. Consequently, migrant workers savings rates are as much as twice that of established residents in some cities, and as their incomes have soared, this has led to a sharp increase in household savings and in turn amplified China's large trade surpluses.

These trade surpluses began to decline when China's stimulus program drove up investment rates after 2008. But such high investment rates are not sustainable, thus consumption needs to increase as a share of GDP. For this to happen, the key is more rapid urbanization and lower household savings rates.

This has already begun. In the last two years there has been a modest increase in the share of consumption to GDP (which has not yet shown up in the official accounts). This has occurred because recently rural incomes have been increasing faster than urban. Since savings rates are lower for rural relative to urban households this is reversing the historic decline in consumption as a share of GDP. In addition, as migrant workers move inland because of lower living costs and better job opportunities, this is also boosting consumption.

This process of rebalancing in favor of more consumption would be given a big boost if migrants were given formal residency rights. Since their abnormally high savings amount to 2-3 percent of GDP, this would lead to a surge in consumption that would eliminate China's trade surpluses even as investment rates decline in the coming years.

Financial markets typically focus on exchange rates in analyzing China growth and trade prospects. But in doing so they miss the power of these kinds of structural shifts which would moderate global trade imbalances in ways that are far more beneficial to both China and the US than the politically charged focus on appreciating the renminbi and actions that push both sides toward more protectionism.

# Competition Matters: China's Exchange Rate and Balance of Trade

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**T**he US has run a massive trade deficit for over 30 years. In recent times there has been a growing chorus of commentators who seek to place the blame on our trading partners, most notably China, just as in an earlier time others had targeted Japan and Germany. It is said that the problem stems not from our reduced international competitiveness, but rather from the manipulation of exchange rates by our more successful trading partners.

This claim is not based on any direct evidence, but rather on an inference derived from standard international trade theory which predicts that free trade will automatically lead to balanced trade. From this particular theoretical perspective, our large and persistent large trade deficit must be rooted in some obstacles to free trade. The large surpluses of our trading partners such as China then make them natural candidates for our opprobrium. Of course, if the standard theory is incorrect, this line of inference collapses. I wish to argue that the standard theory is wrong, on both theoretical and empirical grounds, and that free trade does not automatically eliminate trade imbalances. On the contrary, free trade *reflects* international competitiveness, and persistent trade deficits are symptoms of persistent competitive weakness.

The theory of international trade is actually a subset of the general theory of competition. In a business driven world, international trade is largely conducted by *businesses*. Domestic exporters sell to foreign importers who in turn sell to their residents, while domestic importers buy from foreign exporters and sell to us. At each step in the chain, it is profit that motivates the business decision. Standard (comparative cost) theory rests on the proposition that a trade deficit in a country will drive down the real price of its currency, which in turn will reduce the deficit, until at some point both the balance of trade and the balance of payments are automatically

reduced to zero. A trade surplus would have the opposite initial effect, bringing once again back to this double balance. When the nominal exchange rate is fixed, as it was during the Bretton Woods era, a trade deficit generates a money outflow, and this is assumed to lower the national price level, thereby making the country's goods more competitive on a world scale. When the exchange rate is flexible, as it has been since the collapse of the Bretton Woods agreement in the early 1970s, a trade deficit is assumed to depreciate the currency, once again making the country more competitive on the world market. In either case, the process is supposed to operate until the trade deficit has been eliminated.

In his book *International Economics* (1957), the eminent Oxford economist Roy Harrod came to a rather different conclusion: in a trade deficit country, the resulting money outflows decrease liquidity and increase interest rates, while in the trade surplus country the opposite effect obtains and interest rates rise – all through the normal reactions of financial markets. Neither of these substantially alters the trade balance. Instead, they induce short term capital flows, which are highly sensitive to interest rate differentials, into the high interest rate (trade deficit) country from the low interest (trade surplus) country. Such a process will continue until the overall balance of payments in each country is in equilibrium. In other words, the normal operations of free markets tend to cover trade deficits with international debt, and offset trade surpluses through international lending<sup>1</sup>. As long as neither side does anything to intervene, the differences in trade balances arising from differences in international competitiveness are maintained. This is why successful countries have always known that one must first build up a country's competitiveness. In earlier times this was the policy of the UK, Germany, France and the US. In more recent times, it has been that of Japan, South Korea, and China.

In a recent article on China, David Leonhardt says that “there is ... no question that China's currency remains undervalued”<sup>2</sup> because “the huge demand for Chinese goods should be driving up the price of its currency”. Since China's large trade surplus has not driven up its exchange rate, he concludes that “Beijing has been intervening to prevent that”. Note that this explicitly relies on the standard theory. Leonhardt also cites estimates of the extent to which China's exchange rate is supposedly undervalued. Yet all such estimates are also derived from models that assume that balanced trade is the normal outcome of free trade. The renowned trade theorist and Nobel Laureate Paul Krugman takes the same stance, accusing China of obstructing the “automatic mechanisms” of international trade which would otherwise bring about automatic balance.<sup>3</sup> He too explicitly links his inference to the underlying expectation that free trade will automatically lead to balanced trade – a proposition which he has elsewhere called a ‘sacred tenet’ of standard theory.

It is precisely this tenet that Harrod disputed. He was well aware that the absolute

level of a country's trade balance is also affected by (domestic and foreign) output levels, and vice versa. But this feedback does not imply that trade will be automatically balanced through output effects alone. Indeed, in the real world, persistent trade balances are perfectly normal even in the post Bretton Woods era of flexible exchange rates. A central implication of this argument is that competitiveness matters. A country's terms of trade is a relative price, the price of its exports relative to the price of its imports expressed in common currency. On the argument of standard trade theory this will adjust automatically to ensure trade. But within the alternate framework I propose, a country's terms of trade is regulated by relative real costs – in much the same manner a relative price within a country. This can be demonstrated at an empirical level, and it explains several patterns which appear puzzling to standard theory. Most importantly, it provides an empirical benchmark for the real exchange rate which could be highly relevant for policy purposes.<sup>4</sup>

The foregoing argument does not exclude the possibility that China pegs its exchange rate below the free market level. What it does tell us is that we cannot simply make any such inference from the mere existence of China's trade surplus and our trade deficit. And then, having consulted different stars, we may find that some part of the fault lies in ourselves.

1 Roy Harrod, *International Economics*, pp. 90-96, 112-116, 130-138

2 David Leonhardt, "The Long View of China's Currency", *New York Times*, September 21, 2010)

3 Paul Krugman, various articles in the *New York Times*, 2007, 2009, 2010. See for instance "China, Japan, America" in 2010.

4 Shaikh, Anwar and Rania Antonopoulos. 2012. "Explaining Long-Term Exchange Rate Behavior in the United States and Japan " In *Alternative Theories of Competition: Challenges to the Orthodoxy*, ed. J. Moudud, C. Bina and P. L. Mason. Abingdon: Routledge.

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# Slow Float to China

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Is the yuan (renminbi to the cognoscenti) artificially undervalued to boost Chinese exports? Is the dollar? Does China measure up to modern standards of openness to trade and investment? Does the US? The tentative consensus is “yes”, “somewhat”, “no”, and “yes, but.” When it comes to US-China relations on currency, capital flows, and trade, China is pulling up the rear, but neither country comes to this debate with clean hands.

Still, there is reason for US concern. China does not let market forces value its currency. Instead it dictates a narrow trading band for buying and selling renminbi. Although China has been very slow in opening its own, huge market to imports, US exports to China “have almost doubled in the past five years” (Bloomberg). That doesn’t prove the bilateral trade imbalance is caused by controlling its currency, but it’s consistent with that narrative.

The yuan has been overvalued by as much as 40% relative to the idealized (but calculable) value based on its economic fundamentals. It remains overvalued by some 12% according to the US Congressional Research Service. Although the Chinese currency has declined relative to the dollar as of late (helped by a flight-to-safety as the Euro threatens to implode), since 2007 it has risen by over 20 percent. During the same period the dollar has fluctuated too: a significant decline during the 2007-2008 recession; strengthening more recently.

Fluctuated relative to what, you ask: Relative to gold, the euro, and (until recently) the yuan. With so many geopolitical factors in the US, Europe and Asia playing into this, it becomes hard to isolate the artificial-currency-management. That’s why it seems overkill for Presidential aspirant Mitt Romney and other politicians and commentators to keep putting so much emphasis on formally labeling China

a currency-manipulator and using that to impose compensatory tariffs on Chinese exports to the US. The Romney gambit echoes legislation passed by the Senate last October which directs the Treasury to make that currency-manipulator determination and impose countervailing tariffs.

The Obama administration meanwhile has been carefully triangulating on the issue of economic relations with China. The official US position is that China manipulates its currency (which should be allowed to float freely on global markets), but that the problem is under control right now and that China's moves towards letting the yuan decline in value are most welcome.

Yet the Obama administration is hitting China in a more sensitive area: threatening it with penalties for selling solar panels and wind turbines below-cost on the US market. These moves play into the administration's narrative that failing clean-energy subsidies are the result of forces beyond its control—Chinese dumping, not the consequence of its ideologically, rather than economically founded alternative energy schemes. Unsurprisingly China hit right back with a WTO complaint arguing the US is illegally subsidizing its clean-energy industries across-the-board. (Incidentally, they have a point.)

When economic times are tough, China-bashing becomes an inevitable election year activity. That isn't surprising, but it begs the question whether it will be tempered by the US' economic self-interest, and whether the Chinese response will be constrained by prudence.

In that regard, at least the new Chinese WTO complaint brings in an independent arbiter that can help avert all-out trade war. The US anti-dumping complaints—outgrowth of that election year dynamic—are different, and may be cause for concern. Not the least because so many US companies save money using Chinese imports as industrial inputs (including those cheap solar panels), meaning there is a serious blowback risk in going after China-trade for domestic political gain. Higher-cost industrial inputs from China may produce worse economic results for the US than any actual or real gains from restraints on Chinese dumping might offset.

Overlaying all these disputes is a larger issue: will the dollar survive as the world's reserve currency and will the yuan supplant it (or supplement it) in that function? That is not a predictable event, and China has only begun to open up its capital markets and let the yuan trade more freely. As Gordon Chang points out, "as long as Beijing depends on investment fueled by cheap money to create growth, it must maintain its controls [on yuan convertibility]". Since China's financial markets are considerably

less open than its goods and services markets. China's yuan remains some distance from being a viable reserve currency with a stable and predictable store of value. The recent launch of direct yen-yuan trading in Tokyo and Shanghai however, demonstrates China's increasingly global aspirations for its currency.

The dollar's future status is also unclear, as US domestic priorities trump reserve-currency concerns for the foreseeable future. The US Federal Reserve is determined to keep interest rates low, regardless of the global economic consequences. The turmoil in Europe has conveniently made this goal relatively easy to achieve without the dollar losing preferred status. No crisis lasts forever though, and no one disputes

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## ...will the dollar survive as the world's reserve currency and the the yuan supplant it (or supplement it)?

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the global economy is rebalancing itself in a more Asia-centric direction.<sup>1</sup> This is one reason Nobel Prize-winning Canadian economist Robert Mundell predicts a future reserve currency basket embracing the dollar, the yuan, the yen, and others.

Two lessons can be taken away from this. First: Governments do not make economic decisions—they make political decisions with economic consequences. Second: No government, however aggressive in managing its economic relations with other nations and private investors, is immune from the magic of the marketplace. China may limit the trading range of the yuan, but it can't achieve the global status it wants without relaxing those limits or without offering greater certainty to foreign investors that the state will not clamp down on trade and finance.

Nor can the US forever maintain a zero-interest rate policy without suffering consequences: either inflation, flight from the dollar, or massive misallocation of resources. Much is made of US dependence on China to buy up its debt so that it can keep running trillion-dollar annual deficits in a desperate pursuit of fiscal stimulus. Yes, China holds a big chunk of that debt, around 11 percent. It is not clear, though, why China would suddenly dump US debt to make a grand gesture of defiance. As much as the US wants China to buy its debt, China wants to buy that debt for its own investment-diversification purposes and it depends on the US as its primary export market. It is a situation of mutual benefit. It's also something of a constraint on US efforts to pressure China on human rights, strategic relations (e.g. North Korea), and

economic openness, which may seem a nifty bonus for the Chinese government. But mostly it helps keep US-China disputes from getting wholly out of hand.

Until and unless global finance finds itself a new anchoring device (that currency basket, or gold, or some other agreed-on secure measure of value to govern currency and monetary relations), currency manipulation in a myriad of forms will be an unavoidable part of the political economy. In the meantime, the safety-valves provided by the WTO, the G20, and other forums for airing transnational disputes ought to keep the US-China friction at manageable levels where mutual dependence doesn't. But really, given that close interdependence of the two nations it's hard to avoid the slogan: US and China—perfect together.



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# Chinese Exchange Rate, the US Current Account Deficit, and the Global Imbalance

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**T**he growth pace of Chinese current account surplus in the past few decades has been remarkable. It jumped from about 2.5% of Chinese GDP in 2002 to the peak in 2007 when the current account surplus accounted for more than 10% of GDP (Figure 1). The 2008 - 2009 global financial crises hammered down the current account surplus dramatically, but it still hangs at about 4% in 2011.

In contrast, the United States ran in the opposite direction – consistent and rapidly increasing current account deficits up until 2006 when the deficit reached about 6% of the total GDP of the US. The 2008 – 2009 financial crises wrecked the US economy and shocked the US consumers, resulting in a sharp contraction in the current account deficit. The US current account deficit subsequently bottomed at 2.7% of GDP in 2009. But such a deficit contraction was short-lived. It started to expand again in 2010 and 2011. One can expect that, with the gradual recovery of the US economy from “the great recession”, the rising pace of current account deficit would be likely to pick up again.

These concurrently opposite runs on current account balance in China and the United States and the flash reversal of current account balance in both countries, albeit quick and incomplete, naturally lead people to question whether these two events have a causal relation. In other words, are large deficits in the US caused by the large surplus in China?

This is certainly not the first time that people have raised similar questions. Since the early 2000's, there has been vigorous debate on the association of the large and rapidly growing Chinese current account surplus, the global payment imbalance, and the US swelling current account deficit. One of the drivers of the US current account

deficit is the persistently large trade deficit against China. Many observers argue that, in addition to the rapid improvement of productivity in China, China arbitrarily undervalued its currency, RMB, to gain an unfair comparative advantage for its exports. This argument has been quite popular among the policy circle. Enormous political pressures have been sent from the U.S. lawmakers and government to push the Chinese government to reevaluate the RMB. During the current time period when policymakers seek to establish the foundation for a sustained recovery from the world's most serious financial crisis since "the great depression" in 1930, the pressure over the Chinese currency issue is mounting. The most recent one is a bill passed in the U.S. Senate in Oct. 2011. The lawmakers argue that China's policy of holding down the value of the RMB benefits China's exporters by acting as a trade subsidy. The U.S. therefore will impose extra tariff on Chinese exports to the US. Although it has been relatively quiet in the first quarter of 2012, one believes that, when the election of Nov. 2012 is approaching and the political debates are intensified, the Chinese currency manipulation issue will be emerging again.

Before one can validate the merit of the aforementioned argument that China uses its undervalued currency to subsidize its exports, causing the US trade deficit, it is useful to obtain a clear answer to the following questions: 1) Is RMB really undervalued? If it is, by how much it is undervalued? 2) Can the revaluated RMB exchange rate reduce the US current account deficit and rebalance the global economy?

There is a plethora of economic studies examining whether the RMB is undervalued. However, the findings are far from conclusive, particularly regarding to the extent to which the RMB value has been undervalued. Various studies yield a wide range of estimation for the RMB undervaluation from almost 0% to as far as 50%. Some find that the RMB is undervalued by from 20% to 50% (e.g. Coudert and Couharde, 2007; Goldstein, 2004; Frankel, 2004); others find that that the undervaluation of RMB is small, say, less than 5% (e.g. Lee et al. 2005; Wang, 2004). Cheung, Chinn, and Fujii (2007) find little statistical evidence that the RMB is undervalued. Professors Cheung, Chinn, and Fujii produced a series of studies to track down the critical reasons why there is such a wide range of estimation for the RMB undervaluation. They revealed three main sources - the choice of modeling approaches, the impact of data uncertainty, and the selection of econometric methods. Any modification in one of the above three could yield strikingly different results. For instance, many studies use the national price level data from International Comparison Program (ICP). A data revision in ICP would induce a wild change to the results of many studies on RMB undervaluation. As Cheung and Fujii (2011) point out that the new undervaluation estimate for 2004 using the revised ICP data turns out to be around 18%, which is

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only about one-third of the “old” estimate of 53%.

It seems to be challenging to precisely estimate the degree of RMB undervaluation. Now let us turn to the second question – even if we assume the RMB is undervalued, can a revaluated RMB alter the U.S. deficit and rebalance the global economy? There are again vigorous debates in both the academic and policy circle. One of the main schools of thought argues that the RMB revaluation will have a limited effect on the U.S. deficit. Since China’s weight in the Federal Reserve’s trade weighted index for the dollar is only about 15 percent, a 20 percent appreciation of RMB against the U.S. dollar would only translate into 3 percent depreciation in the trade weighted U.S. dollar. This hardly contributes to the overall current account deficit. Indeed, the RMB has been appreciated more than 20% since July 2005. The U.S. imports from China, however, have been growing at a pace even faster than it was before 2005. Moreover, even the prices of Chinese exports are more expensive after the revaluation of RMB and subsequently the U.S. reduce their demands for imports from China, the U.S. consumers will probably turn to the imports from other countries, e.g. other East-Asian countries, for substitution, making the U.S. deficit remain at the same level as it used to be. Thus, some suggest that the U.S. should constrain the spending spree, and raise its own national saving rate, if it wants to significantly improve future U.S. current account deficits (Roach, 2007).

The United States and China are the two biggest economies in the world. The large and persistent current account imbalances in these two countries reflect, to some extent, the imbalances of global payment, which were blamed for playing a predominant role in causing the current financial crisis. To correct the global imbalances, it is not merely a matter of the U.S. and China (Chinn, Eichengreen and Ito, 2010). In fact, besides China, Germany, oil-exporting countries, and other emerging Asian countries account for a significant share of global current account surplus as well. On the deficit side, even though the U.S. current account deficits are still dominant, the southern Europe peripheries are also in the trouble of deep deficits. Apparently, the RMB revaluation is not the only solution to the rebalancing of the world economies, let alone that it may only have limited effect on the U.S. current account deficit.

Although a revaluated RMB may not resolve America’s deficit issues, a more flexible, even free floating, RMB exchange system and a fully convertible RMB capital account serve for China’s own interests and, in some sense, may help correct the global payment imbalances. China abandoned its fixed exchange rate in July 2005 and currently has adopted a “managed floating system”, where the exchange rate is determined more flexibly “with reference to a basket of currencies”. But the daily fluctuation of exchange rate is limited in a narrow band of 0.5% in either direction

and the component currencies and their weights are still kept as a secret. According to a number of authors (e.g. Ogawa and Sakane, 2006; Frankel and Wei, 2007), China has a de facto peg to the U.S. dollar since July 2005.

Given the size of the Chinese economy and the growth perspective, it is widely seen that the RMB will eventually free float and be fully convertible, allowing China to operate a more independent monetary policy. The key is the timing of letting RMB freely float. Many think that it is for China's good to do it now when both the economy and the RMB are strong, rather than waiting until the economy is cooling and the currency is under attack (the devastating experience of many East-Asian countries in 1997 financial crisis).

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floating the RMB  
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However, floating the RMB is much more complicated than a simple timing issue. The RMB exchange rate system intertwines with all aspects of Chinese economy. A rush to liberalize the RMB exchange system could cause ill effects on the Chinese economy, particularly for the weak domestic financial system which may find itself hard to survive under the fierce competition from the incoming

foreign capitals. Thus, in the process of liberalizing the RMB exchange system, China should put each step in a proper order – they are not necessary to be implemented simultaneously, but the cart should not be in front of the horse. As Prasad et al. (2005) point out that “a flexible RMB exchange rate system may go first, but a more stable and robust financial system should be regarded as a prerequisite for undertaking a substantial liberalization of the capital account”.

In addition to freeing the RMB exchange rate and liberalizing the capital account convertibility, it is necessary for China to adjust its economic structure and rebalance its economy first. For instance, China may shift away from an investment-intensive and export-led growth model to a more domestically demand-driven economic structure, reinforce social safety network to reduce household precautionary savings, deregulate the service sector to encourage more private investments in non-tradable sectors, and promote a balanced and sustainable economic growth across regions and industrial sectors.

To sum up, the emergence of China in the 21st century as the second biggest

economic power in the world and its great integration into the global economy make China increasingly influence the global markets. The large current account surplus that China built up in the last few decades is not necessarily the only reason that caused the persistent current account deficit in the United States and the global imbalance. However, a more aligned and flexible RMB exchange rate may not only benefit the Chinese economy itself, but also to some extent may help the U.S. alleviate its huge current account deficit and alter the trend of global imbalance. In view of the complication, the rebalancing process in China, in the United State, and of the global imbalance is likely to be an extended one. It needs multilateral efforts and coordination of major industrial and emerging countries and other international organizations.

#### Footnotes:

1 As an effort to enhance the flexibility of RMB exchange rate, China expanded the RMB daily trading band against US dollar to 1.0% in either direction in April 16, 2012.

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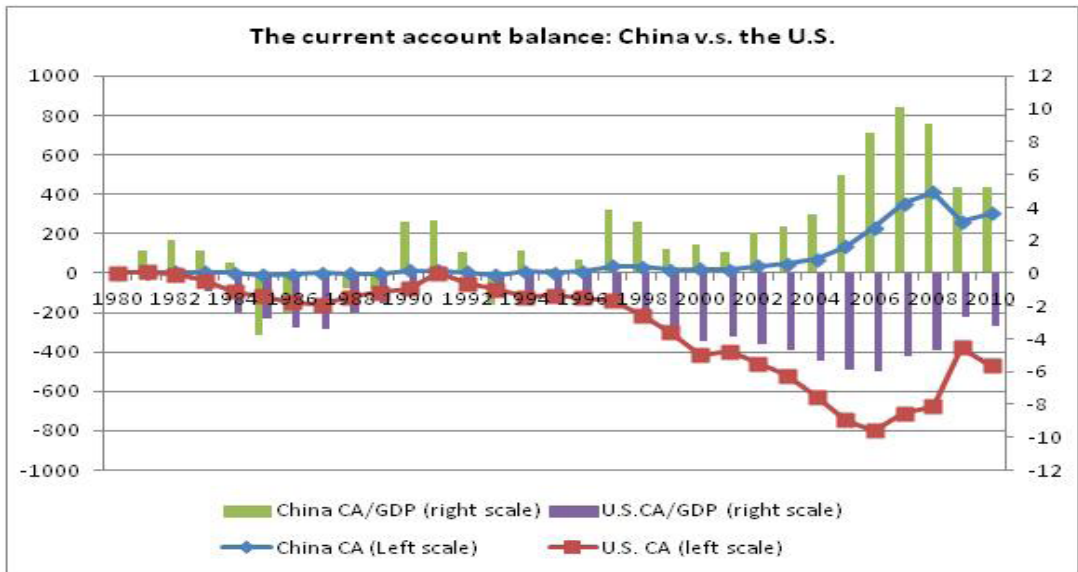


Figure 1: The current account balance of China and the United States, in Billions US dollar (left scale) and in percent (right scale). Data source: CEIC.

As an effort to enhance the flexibility of RMB exchange rate, China expanded the RMB daily trading band against US dollar to 1.0% in either direction in April 16, 2012.

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# US-China Problems: Is Revaluation of Yuan the Solution?

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*\*I would like to thank Ilene Grabel for helpful suggestions. All remaining errors are mine.*

**T**he debate on US-China exchange rate has been an almost constant feature during the 21st century. The New York Times reported in late 2010 that the critics of Chinese policy

“...[s]ay there was a way to create a half-million American jobs over the next two years without adding a dime to the debt or deficit. And say it would also revive moribund Rust Belt factories, reduce the country’s gaping trade deficit and help stabilize the international economic system. (NYT Sep.18, 2010)

If only fixing the problems of the largest economy in our world were that simple! As experts have long recognized, debates about exchange rates are largely political. Even existing exchange rates are results of both market forces and manipulations by the big players including the central banks. The slogan of central bank independence is largely a smokescreen to hide the roles of specific factions of big capital in each nation state. Does this mean that there is no fundamental equilibrium exchange rate(FEER)?

According to economic theory, the exchange rates are indeed a general equilibrium solution under stringent assumptions of a model economy without frictions. Therefore, there should be an FEER for any pair of currencies. In the real world, the frictions matter. Most importantly, these include but are not limited to political interventions. This is quite clear on the Chinese side and one might say that there is a certain charm in the non-hypocritical manner in which the Chinese acknowledge the primacy of their internal--far from transparent--politics in setting their policy targets. On the American side, however, there is a camouflage of technocratic, supposedly politics-free jargon-ridden economic rhetoric. Even progressive critics in the US such

as Robert Scott of the Economic Policy Institute seem to be seduced by the rhetoric and accept uncritically the results from models uncritically when they confirm the conventional wisdom regarding U.S.-China problems.

Economic modeling is worthwhile and much can be learned from both sectoral econometric models and economy wide models. Notwithstanding such attempts to model our complex economy for which I, too, plead guilty, the recognition of the imperfections of global markets and global politics will be vital for solving the problems of exchange rate issues between China and the US. More broadly, the issue of global exchange rate mechanism must be seen as part of building a new global financial architecture of which exchange rate mechanisms are a transparent part. But first let us take a close look at the actual situation of the yuan (more generally, renminbi or RMB)-dollar exchange rates.

Reading the popular press and accounts of Congressional debates, one could be forgiven for thinking that the evil character called China has forever fixed its exchange rate at a rate which is unfavorable to the US and favorable only to China.

The reality is more complex. Just to mention one set of contradictory forces, a revaluation of RMB upwards will ease inflationary pressures on China but will not be welcome to the powerful exporting interests particularly in Southeast China. The practical political question from the Chinese side is how far to revalue and how fast. The American jawboning as well as the frictions of the complex economies of the world have led to considerable fluctuations in the RMB-dollar rate. The overall tendency is towards revaluation of RMB. Recently, a report from the reputable Peterson Institute pointed out:

The latest semiannual estimates of fundamental equilibrium exchange rates (FEERs) by Peterson Institute researchers William R. Cline and John Williamson find that modest appreciation of the renminbi against the dollar, combined with higher inflation in China than in the United States, has narrowed the undervaluation of the Chinese currency from 16 percent in April to 11 percent in late October [2011]. However, the bilateral undervaluation of the renminbi against the dollar still amounts to 24 percent; this is the rise in the renminbi that would be required to achieve multilateral equilibrium if all currencies were to move to their FEERs.

Although my own estimates show an FEER that indicates a larger adjustment of RMB than does the Peterson Institute estimates, still the direction of the movement is the same in both exercises. The technical article by Cline and Williamson also reports



real effective exchange rates where a further adjustment of only about 10.6 percent is needed(column 5 of their table 1).Furthermore, Cline and Williamson also observe correctly that US has bilateral exchange rate issues with other countries as well. Thus:

The Mexican peso has become more undervalued than the renminbi. The safe-haven effect boosted the Japanese yen and the Swiss franc, and both countries intervened to resist appreciation. Because the yen had become overvalued but the franc remains undervalued, Japanese intervention was justifiable but Swiss intervention was not.

Underlying all these imbalances are both political factors, global financial instability and the economic weakness of the US . The long- term growth rate will not and perhaps can not equal that of the golden age of capitalism during the 1950s and 60s. The policy- induced weaknesses from the Bush-Greenspan era are still with us and will not disappear soon.The problems of heavy financialization and indebtedness including the lack of fundamental institutional reform in the US will not go away any time soon. Thus the medium term outlook for the US and the World Economy is crisis- ridden and uncertain. This will most likely result in more political frictions internationally. China will loom large in this conflictual scenario but so will many others including the EU.

It is also proper to note here that the Chinese development strategy is flawed in its own terms. I have pointed out in an earlier essay written for the World Institute for Development Economics -United Nations University(WIDER-UNU) in Helsinki and in a chapter on China's Energy Security and Development Strategy(2010) that the current strategy is creating an unequal society within China and a serious ecological crisis. Internationally it will pit China against other powerful industrialized countries in a race for resources that will exacerbate global tensions and may even lead to war. This can be avoided by following a new egalitarian and eco-friendly development strategy on China's part.

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Turning again to the exchange rate issues, let me conclude this short essay by observing that the global imbalances are largely a result of the demise of the Bretton Woods financial architecture and lack of a new Global financial architecture(GFA)

to take its place. There have been many discussions since the Asian financial crisis in the late 1990s and-- needless to say-- since the great global recession more recently. As Barry Eichengreen correctly pointed out earlier, most proposals for ideal GFAs don't have "a snowball's chance in hell" to get implemented. Yet the discussions have been informative. The key asymmetries and imbalances have come to the fore. The neoliberal turn in general and of the IMF during late 1970s and 80s continuing almost upto now has been criticized to various degrees. Many alternatives have been suggested including some by the present author. Unfortunately, it must be admitted that until now not much has been done in terms of changing fundamental policy orientation of the international organizations and key national governments. But there is some possibility that as the debate opens up and dogmatism takes a backseat the chances of better policies and global and regional institution building will improve. My colleague Prof. Ilene Grabel has also recognized such possibilities in her recent work. Jose Antonio Ocampo and other progressive Latin American economists in particular, are also keen on exploring the possibilities for regional cooperation in financial matters.

In my working papers around 2001-2002 and my subsequent book, *Global Markets and Financial Crises*(Palgrave,2004), I proposed a Hybrid GFA(HGFA) which would crucially make room for effective regional financial architecture. A reformed IMF and the RFAs together, liberated from the straitjackets of monetarism and a simplistic long run equilibrium view where money is neutral can form an HGFA that can work--- not without inevitable frictions--- reasonably well. More recently, I have elaborated on these ideas in a report to the UNDP. The main point is to take seriously the unevenness of the global economy and address the emerging problems strategically through an enhanced, more democratic global economic governance system. From this perspective, making G-20 an effective economic forum is a step in the right direction. But more needs to happen. In particular, the voices of the poorer nations need to be heard. The US-China economic issues, including the exchange rate issues, need to be viewed within this broader perspective. The policy makers of the powerful economies in the world then would be able to perform globally the kind of necessary public service that the New Deal was intended to perform domestically in the US during the 1930s.

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# How to Deal with the Chinese Exchange Rate

**Dr. David Phillips**

GBRW

UNITED STATES

I address here a few important aspects of the long term problem of economic relations between the United States and China, something that deserves, and has been the subject of, extensive study and commentary.

The 2010 IMF Article IV Report based on its annual consultations with Country Governments concluded that the Chinese currency was substantially below the level that was consistent with ‘medium-term economic fundamentals’. This meant that it underpriced Chinese exports and overpriced Chinese imports, assisting in a large and rapidly increasing Chinese trade surplus, to the detriment of competing economies. The Chinese authorities disagreed on the interpretation of the evidence and some members of the IMF Executive Board (IMF, 2010) concurred with China. But at the extreme some US observers thought that the global financial crisis itself could be blamed on the imbalances caused by Chinese monetary and exchange rate policies.

The debate on Chinese exchange rate misalignment has continued since the 1990s. While the US is concerned about its debt obligations to the Chinese Government and its growing competitive disadvantage, at the receiving end of low priced Chinese imported products, with even more consequences than those facing the US, are also the many poor, developing countries that face Chinese competition. In the incipient manufacturing industries of Africa, such as textiles and garment production, many suppliers have been unable to survive the relentless competition from Chinese imports. There has been a process of de-industrialization in Africa for the past twenty years partly resulting from this. While in the short term poorer economies might be able to defend themselves from import pressure through a depreciation or competitive devaluation of their currencies against the dollar, this process exacerbates the US current account deficit and the longer term pressure on the dollar.

In the US the debate about the Chinese Yuan gathered steam as a result of, for example, comments by Paul Krugman in 2009<sup>1</sup> in which he argued that exchange rate misalignment in China was damaging the US economy and that a proactive face-off with the Chinese Government was a low risk and justified strategy. He wrote that the pegging of the Yuan to the dollar gave Chinese manufacturing a large cost advantage over its competitors while the undervalued rate was supported by the Government's controls on capital imports and at the same time the Government's action in buying up dollars and investing them outside the country, in for example US Treasuries. This in turn had kept down US interest rates and supported the explosion of risky bank lending. (At the end of 2009, China was the top foreign investor U.S. government debt, with holdings of \$900 billion in Treasury securities, which have now exceeded \$ 1 trillion). Following the crisis, with interest close to zero as a result of the worldwide recession, the Chinese capital exports simply led to a buildup in liquidity, draining demand from a depressed world economy. Krugman suggested that the Chinese 'mercantilism' could reduce U.S. employment by around 1.4 million jobs by 2012. Later he repeated his argument, stating that China's currency policy was depressing economic growth in the U.S., Europe and Japan. "If we could get some change in China's currency policy, it would help the world." <sup>2</sup>

Despite the certainties expressed by some US and other commentators, and even the unusually single minded statement of the IMF, there does however remain much disagreement about what determines the correct equilibrium exchange rate on which to base a measure of exchange rate misalignment, if any.<sup>3</sup> The estimate of misalignment is very sensitive to small changes in calculation assumptions such as time periods for estimation.<sup>4</sup> Using various different approaches the estimates of currency misalignment have in fact ranged from significant undervaluation (33% or 49%)<sup>5</sup> to significant overvaluation (33% to as much as 100%)<sup>6</sup> and many points in between these extremes. When the World Bank revised downward the estimate of Chinese GDP to take into account Purchasing Power Parity the estimated undervaluation disappeared.

Even if it was possible to establish clearly whether and to what extent there is a misalignment, this is also not the end of the story for several reasons. First, the 'appropriate' exchange rate for targeting would need to be identified and it is not necessarily clear how to do this. Secondly, the international community would have to judge what should be done about it and which countries, if any, should be compensated.<sup>7</sup> To complicate matters, over the past few years the Chinese have allowed their currency to appreciate slowly against the dollar in both nominal and real terms even as China's current account surplus has still continued to widen. There is a chicken and egg question. Were Chinese capital exports the inevitable

result of export surpluses arising from Chinese productive efficiency or did the Chinese Government use capital exports as an economic device to maintain a high level of competitiveness and ensure an export surplus? The answer is probably a bit of both, and both have become inextricably linked.

While some economic observers rail against Chinese mercantilism and apparent short-sightedness in an interdependent world, it seems highly probable, given the number of Chinese macro-economists trained in the US, that the entire problem and its complex resolution is perfectly well understood within the Chinese Government; it is also aware that the fate of the US and Chinese economies are intertwined in trade and monetary co-dependence, and that it is searching for ways to remedy it. At the same time it has to be remembered that the Chinese Government is responsible for the fate of a nation that comprises about one sixth of humanity, of which a substantial part (approximately 200 million) still live in severe poverty despite the economic progress achieved in the past 20 years. A serious macroeconomic policy mistake by the Chinese authorities could potentially have a far more damaging effect (say in terms of increased unemployment) on the Chinese people than a similar mistake in the US whose population consists of about one twentieth of humanity, of whom about 90% live at a far more comfortable level than the vast majority of Chinese. Just on this basis it appears to be a very good idea to continue to resolve the global imbalance problem facing China, the US, and other countries by working together to adopt comprehensive reforms of the exchange rate regime and also domestic structural reforms in their respective countries. The structural reforms in China have to involve the rebalancing of domestic demand toward private consumption through boosting household incomes, and in the US they have to involve the shift of consumption to savings involving some lowering of relative real wages. Chinese real wages are already rising and the result will be a reduction on their export surplus.

Given the confusion about what constitutes an appropriate exchange rate parity, and the need to combine reforms on a systemic basis, exclusive and aggressive focus on the exchange rate issue is likely to be both ineffective and counter-productive, and especially if aggressive tactics are deployed to this single problem. There is little alternative for the US to diplomacy and persuasion possibly backed up only as a last resort by piecemeal measures, such as selective import tariffs in clear cases of unfair trade, just to ensure that focus is sustained, but remembering that some kind of

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retaliation is likely.

## Notes

1 Krugman, P. Chinese New Year New York Times, December 31, 2009

2 At a meeting of the Economic Policy Institute, Washington March 11, 2011

3 One of the many analyses is Yin-Wong Cheung Exchange rate misalignment –the case of the Chinese Renminbi CESIFO working paper no. 3797, April 2012

4 Steven Dunaway, Lamin Leigh, and Xiangming Li How Robust are Estimates of Equilibrium Real Exchange Rates: The Case of China IMF Working Paper 06/220

5 Plus 49% against the free trade equilibrium exchange rate according to the Economist Big Mac Index, July 2011 and plus 33% according to the economists Cline and Williamson. Lardy and Goldstein of the Peterson Institute of International Economics estimated an undervaluation of 12 to 16% at the end of 2008.

6 Negative 36% (CCF(2010)); negative 100%; Schnatz, Bernd, 2011, Global Imbalances and the Pretence of Knowing FEERs, Pacific Economic Review 16 (5), 604–615.

7 Maya Eden Ha Nguyen Correcting Real Exchange Rate Misalignment Conceptual and Practical Issues World Bank Policy Research Working Paper 6045, May 2012

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