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After the GFC

Australia and the Chimerica challenge

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Cover image: The Chinese flag flies outside the New York Stock Exchange after a visit by a delegation from China, 8 September 2008. © CHIP EAST/epa/Corbis

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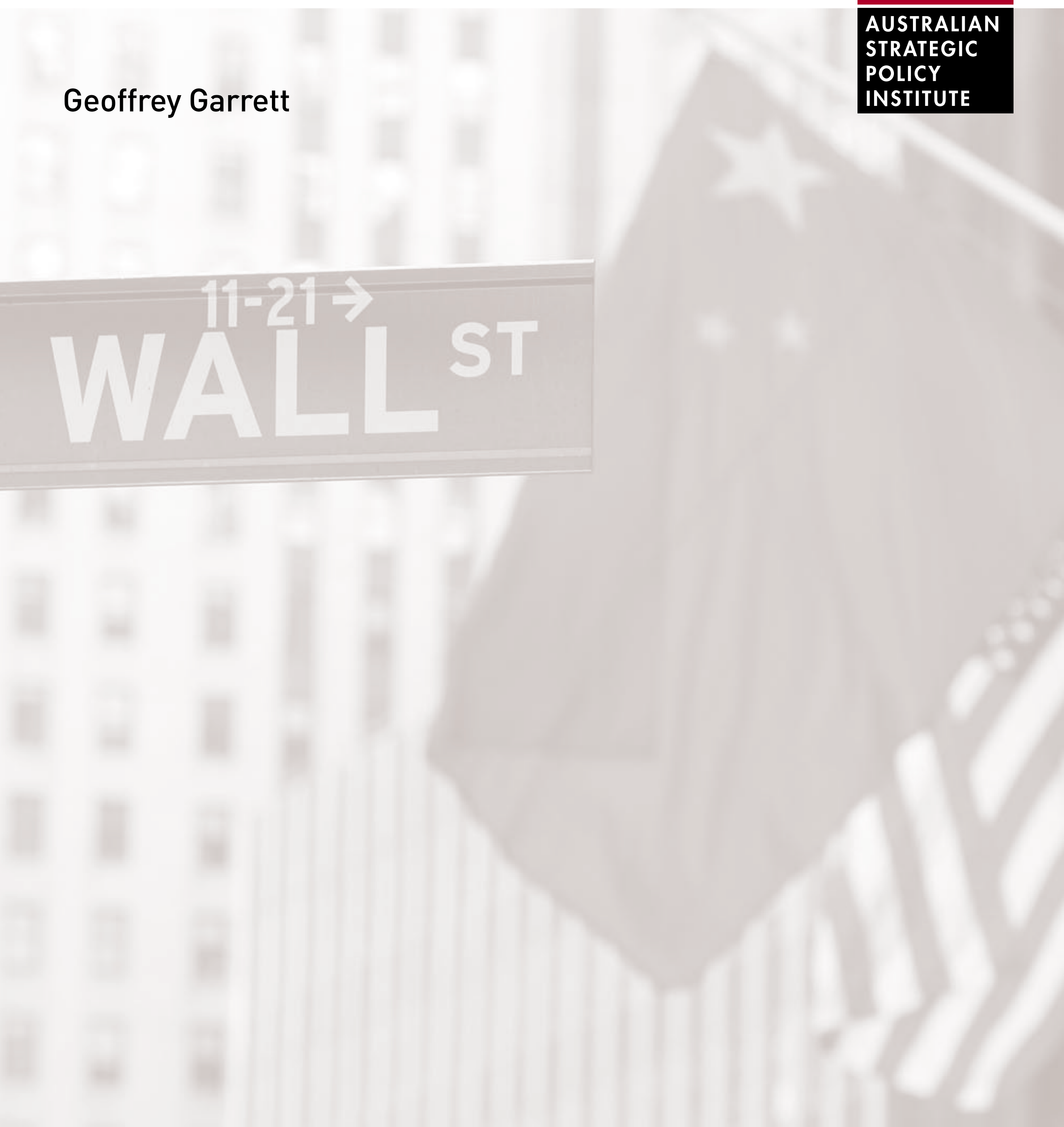

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Executive Director's introduction

The Global Financial Crisis has been a potent reminder for us all of the interconnectedness of the globalised world, and of the interlinkages between economic, political and strategic influence. Its effects have been felt more widely than the September 11 attacks. And its geopolitical consequences have been the subject of close study in many countries.

In this *Strategy* paper, Professor Geoffrey Garrett, the Chief Executive Officer of the US Studies Centre at the University of Sydney, provides an Australian perspective on the crisis and its consequences. His assessment turns upon the 'joined-at-the-hip' relationship between China and America—the key relationship in the emergence of the crisis, but also in managing the crisis and piloting the global order towards greater stability. He points to a world increasingly dominated by the G2 of China and the United States, but sounds a note of caution that the frictions within that relationship may become more abrasive, with effects across a wide range of political, economic and strategic issues.

Naturally, Australia's interests are closely tied to the continued good health of the 'Chimerica' relationship, our security and prosperity underpinned by our own ties to both countries. It will be important that we work where we can to nurture a more cooperative spirit between the two giants.

I am grateful for the work Professor Garrett has put into this paper, and pleased to publish it under the ASPI logo. ASPI, like all think tanks, is heavily dependent upon the efforts of busy experts to maintain its own illustrious publication schedule. And I am grateful too to those, both within ASPI and beyond, who have contributed to the publication of this *Strategy* paper in its final format. I know our readers will be the ultimate beneficiaries of the ideas and thoughts that the author explores here.

Peter Abigail
Executive Director

Photo opposite: US Secretary of State Hillary Clinton (R) and Chinese State Councillor Dai Bingguo, US–China Strategic and Economic Dialogue, Washington, DC, 27 July 2009.
© AFP/Nicholas KAMM via AAP

Executive summary

The global financial crisis (GFC) was born in the US—the product of too loose money and too lax regulation, aided and abetted by China's willingness to give the US endless credit so long as Chinese goods continued to fly off American shelves. The crisis has generated real challenges for both the US and China, but it won't change the broad geopolitical trajectory towards a world increasingly dominated by the US, still the world's most powerful country by a substantial margin, and China, its biggest and fastest growing emerging major power.

Welcome to a post-GFC 'Chimerica', the early 21st century's two most important countries joined at the economic hip but wary of each other's ambitions and with radically different world views. What China and the US do—alone, together, or in conflict—will increasingly define the global bounds of the possible for fixing finance, reviving trade, resisting protectionism and tackling climate change, and for geopolitical stability in the Asia–Pacific region and beyond.

For more than a decade, China and the US have successfully managed down their geopolitical frictions by focusing on win–win economic outcomes. What has been quite simply the most imbalanced economic relationship in recent human history has had the positive result of keeping a lid on Sino-American tensions.

Now the 'trade for Treasurys'-enabled bubble has burst, and Chinese and American leaders have joined the 'never again' global chorus. But undoing what everyone agrees has been unhealthy co-dependence between China and the US will be hard, demanding nothing less than recoding each country's economic DNA.

In the short term, the GFC-fighting measures enacted in both countries will exacerbate, not lessen, the imbalances of Chimerica. The Chinese Government is investing in and lending to Chinese industry on an unprecedented scale, driving production still higher. With little concomitant priming of the domestic consumer pump to absorb that production, China's dependence on exports won't diminish. The US is reviving domestic demand by replacing private debt with public debt, and increases in America's productive capacity are a long way off. As American demand recovers, so too will its appetite for imports.

In the longer term, there are substantial obstacles to encouraging Americans to consume less and Chinese to consume more. Politically popular enabling regulation and tax breaks fuel consumption in the US. The Chinese Government has favoured investment and production over building the social safety net and retail financial system in which Chinese consumerism could flourish.

Unless China and the US can quickly change the structure of their domestic economies, Chimerica will persist. But after the GFC, its persistence will heighten frustrations in both countries, and those frustrations could have deleterious economic and political effects. China and the US are already part of the rising protectionist tide around the world. With increasing concerns about foreign investment as well, the possibility of a damaging spiral of duelling US–China economic nationalism can't be ruled out. The more economic disputes get couched in nationalist terms, the higher the risk that they will spill over into the political and strategic realms.

Australia has a high stake in the future of Sino-American relations. The China–US balancing act on which our security and prosperity depend so heavily will probably be harder to maintain after the GFC. Australia will face challenges from China's desire to use foreign investment to help secure the raw materials it needs and from the US's desire to further its strategic objectives by asking more of its allies.

In addition to its dyadic relations with China and the US, Australia can foster better Sino-American interactions in ways that are consistent with its broader national interests. Prime Minister Kevin Rudd has articulated a vision for Australia to provide ideas and energy for an Asia–Pacific Community of which China and the US would be leading members.

However, the G-20 might offer more potential for Australia. It's the most important multilateral grouping in which China's major power status has been fully recognised, and that's been done without asking China to play an overt leadership role that it mightn't yet be ready to embrace. The G-20 allows the US to further its agenda of encouraging China to become a 'responsible stakeholder' on the global stage, while providing some ballast to leaven European influence on issues of difference with the US. Australia should work within the G-20 both to press its own agenda and to collaborate with China and the US in a forum that both want to succeed.

Chapter 1

CHINA AND THE US: JOINED AT THE HIP

The global financial crisis (GFC) was born in the US of too loose money and too lax regulation, aided and abetted by China's willingness to provide credit seemingly without limit to the US as long as Chinese goods continued to fly off American shelves. What began as a Wall Street meltdown metastasised into the world's worst economic slump in sixty years, spread around the globe with pandemic-like speed by the twin forces of globalisation: cross-border trade and the international integration of financial markets.

The collapse of venerable Lehman Brothers in New York on 15 September 2008 sent shockwaves around economic and political worlds. Credit markets froze and stock markets plummeted, triggering massive financial bailouts and fiscal stimulus packages. Welcome to the 'Great Recession'—IMF Managing Director Dominique Strauss-Kahn's term for a global downturn deeper and broader than the recessions of recent decades but not as cataclysmic as the Depression of the 1930s.[1]

The instant GFC conventional wisdom was that the US must reap what it had sown. British Prime Minister Gordon Brown declared in April 2009 that 'the old Washington consensus is over.'[2] Australia's Defence Minister at the time, Joel Fitzgibbon, said a month later that we were witnessing 'the beginning of the end of … the almost two-decade-long period in which the pre-eminence of … the United States was without question' (Defence Department 2009). Others have speculated about a new 'Beijing consensus' on state-managed capitalism (Holslag 2009). Yet others talk of a radically de-centred, chaotic and conflict-ridden global system along 19th century lines (Burrows and Harris 2009).

To paraphrase Mark Twain, all this talk of the demise of the US is likely to be greatly exaggerated. The world will certainly be a different place after the crisis. The American brand of laissez-faire capitalism will never be quite the same. No return to the go-go growth rates of the roaring noughties is in sight. Step function increases in western unemployment and poverty in developing countries will remain grim reminders of the carnage. The spectre of big government, debt mountains and protectionism will haunt western politics, while emerging market leaders will second-guess their western politicians' preoccupation with export-led growth. Economic volatility and western reticence about global engagement may heighten instability in developing countries.

But none of this will move geopolitics off the broad path it was already on, towards a world increasingly dominated by the US (still the world's most powerful country by a substantial margin) and China (the world's biggest and fastest growing emerging major power).

China and the US will face their own economic demons as they emerge from the crisis but, given the resources available to both countries, the challenges they face aren't insurmountable.

China and the US will face their own economic demons as they emerge from the crisis but, given the resources available to both countries, the challenges they face aren't insurmountable. It's hard to be as optimistic about the world's other major economies. Europe and Japan will be far from irrelevant, but profound internal problems will surely reduce their global clout. India, Brazil, Indonesia and others might be coming major powers, but their rise is fifteen years and more behind China's (Goldman Sachs 2007).

Welcome, then, not to a post-American world, but to a post-GFC 'Chimerica'—Niall Ferguson's term for the preponderant global impact of the US and China, joined at the economic hip but wary of each other's ambitions and with very different world views (Ferguson 2009). What the two countries do—alone, together, in multilateral forums, or in conflict with each other—will increasingly define the global bounds of the possible. US Secretary of State Hillary Clinton and Treasury Secretary Timothy Geithner said exactly that in late July 2009, on the eve of the first meeting of the new China–US Strategic and Economic Dialogue with their Chinese counterparts Vice Premier Wang Qishan and State Councillor Dai Bingguo:

> Few global problems can be solved by the US or China alone. And few can be solved without the US and China together. The strength of the global economy, the health of the global environment, the stability of fragile states and the solution to nonproliferation challenges turn in large measure on cooperation between the US and China. (Clinton and Geithner 2009)

What is in prospect is an expansion in the scale, scope and importance of US–China relations, the world's most important bilateral relationship according to Secretary Clinton. The problem for both countries, and for the world, is that after the GFC it will be harder, not easier, to achieve the cooperation sought by Clinton and Geithner and sought by both sides to soothe the inherent tensions in Sino-American relations.

For more than a decade, China and the US have focused squarely on securing win–win economic outcomes, successfully managing down their lurking geopolitical rivalry and keeping a lid on potentially incendiary political disagreements. The result was Chimerica's 'trade for Treasurys' imbalances, which both countries have now said they must dramatically reduce.

China was happy to buy up mountains of dollars and government bonds ('Treasurys') as long as Americans used the money to buy Chinese exports at levels unknown in the history of trade. The US was willing to live with ever-greater trade deficits with China as long as the low interest rates made possible by China's hunger for dollars kept the consumer-driven American economy humming.

Now that the bubble has spectacularly burst, Chinese and American leaders have joined the 'never again' global chorus. But undoing what everyone agrees has been unhealthy co-dependence between the world's top two economies will be painfully hard. It will demand nothing less than a recoding of each country's economic DNA, which will probably take decades rather than years.

In the short term, the GFC-fighting measures enacted in both countries will exacerbate, not lessen, the imbalances of Chimerica. The Chinese Government is driving production by state-controlled firms ever higher, crowding out private investment and with little priming of the domestic consumer pump. More exports seem the easiest way out. The Obama Administration is propping up demand through deficit spending, and increases in America's productive capacity are a long way off. As American demand recovers, its appetite for imports is also likely to.

In the longer term, the policy changes needed to get China to consume more and the US to consume less will run against the political grain in both countries. Politically popular regulation and tax breaks have long boosted consumption in the US. The Chinese Government has focused on steering the economy, and it has neglected the building of the social safety net and retail financial system needed to create a consumer society.

Despite all the protestations to the contrary, the economic imbalances of Chimerica will be very hard to reduce.

Despite all the protestations to the contrary, the economic imbalances of Chimerica will be very hard to reduce. The longer those imbalances persist, the greater their potential harm, not only economically but also politically. China and the US are already prominent parts of the rising protectionist tide around the world. The possibility of GFC-related protectionism growing into a bigger spiral of duelling US–China economic nationalism can't be ruled out, particularly given the suspicion with which each country views the foreign investment ambitions of the other. The more economic disputes are couched in nationalist terms, the higher the risk that they will spill over into potentially destabilising geopolitical tensions.

Nowhere are the stakes higher than in Australia, which in recent decades has successfully strengthened its political–military alliance with the US while increasingly staking its economic future on China. Australia will come out of the GFC in much better shape than most advanced economies, but the China–US balancing act on which Australia's security and prosperity depend will be both more important and harder to perform.

> Australia will come out of the GFC in much better shape than most advanced economies, but the China–US balancing act on which Australia's security and prosperity depend will be both more important and harder to perform.

Australia will have to come to grips with China's desire to use foreign direct investment to secure its minerals lifeblood and with the US's desire to achieve its global foreign and security policy goals at lower cost at home by asking more of its allies. In addition to its dyadic relations with China and the US, can Australia play a more active role between the two elephants? Prime Minister Kevin Rudd is well placed to act as a China–US go-between. He has also articulated a vision for Australia to become something akin to a Belgium of the Asia–Pacific region, providing the ideas and energy to help the region's major powers—China and the US above all—down the path towards community cum union.

Both strategies entail risk. China and the US probably don't need a third-party intermediary in their bilateral relations. Pushing for an Asia–Pacific Community before the big players are ready could backfire. The G-20 offers more potential for Australia to play a role in fostering better Sino-American relations while furthering our strategic relationships with both countries.

The G-20 is the first important multilateral grouping in which China's major power status has been recognised, and this has been done without asking China to play a leadership role it isn't yet ready to embrace. The G-20 allows the US to further its agenda for encouraging China to become a 'responsible stakeholder' on the global stage, as well as to gain some global ballast to leaven European recalcitrance about taking America's lead. And the G-20 is a global institution in which Australia is a well-respected member.

Australia can try to work within the G-20 on issues ranging from trade and finance to climate change, both to press its own agenda and to work with China and the US in a forum both sides want to support. Created on the fly in the eye of the global financial storm, the G-20 leaders meetings may ultimately prove the most important forum for executing what Prime Minister Rudd calls his government's 'creative middle power diplomacy'.

Chapter 2

A DE FACTO G-2, BY DEFAULT

At the April 2009 G-20 summit, the World Bank's American President, Robert Zoellick, and its Chinese Chief Economist, Justin Yifu Lin, spoiled the multilateralist celebrations surrounding the GFC-induced coming together of the 20th century western powers with the emerging powers of the 21st century. 'For the world's economy to recover', they said, 'the two economic powerhouses must cooperate and become the engine for the Group of 20 … Without a strong G-2, the G-20 will disappoint' (Zoellick and Lin 2009).

The two economic powerhouses, of course, were the US and China. Zbigniew Brzezinski told the Chinese that the G-2 was a good idea in January 2009, and Henry Kissinger backed him up the next month. In late April, British Foreign Secretary David Miliband warned his European colleagues that they would have to work hard to expand the G-2 into a G-3 including them. Others say the whole G-2 idea is fanciful, given the fundamental differences that divide China and the US (Economy and Segal 2009).

No American or Chinese official is ever likely to call the relationship between their countries 'G-2'. Both sides want to expand their successful high-level bilateral diplomacy, but they also want to couch it in terms of their commitment to multilateralism. Chinese Premier Wen Jiabao went out of his way to make this point at the May 2009 Sino-European Union summit in Prague, saying 'it is totally ungrounded and wrong to talk about the dominance of two countries in international affairs' (Jian Junbo 2009).

Nonetheless, it was hard to disagree with Timothy Geithner for putting the US and China at the epicentre of recovery from the GFC:

> A successful transition to a more balanced and stable global economy will require very substantial changes to economic policy and financial regulation around the world. But some of the most important of those changes will have to come in the United States

> and China. How successful we are in Washington and Beijing will be critically important to the economic fortunes of the rest of the world. (Geithner 2009)

There's no denying that both countries have been hard hit by the crisis and will never be quite the same again. The US will more closely resemble dirigiste France than the unbridled laissez-faire America of the Reagan revolution. American global engagement, which has been growing for decades, will be stretched to the limit and the US will want to ensure that its foreign policy, like its economy, becomes more solvent and sustainable. The crisis has shaken China's faith in its export-led growth strategy—the foundation of its uninterrupted thirty-year economic miracle. It also faces major structural challenges such as a rapidly ageing society, environmental degradation, mass urbanisation and rural poverty, and profound inequalities between coastal and interior regions—not to mention persistent questions about the stability of its political system.

… there can be little doubt that the US will continue to be the world's dominant geopolitical force well into the new century …

Despite all this post-GFC foment, there can be little doubt that the US will continue to be the world's dominant geopolitical force well into the new century, its economy still driven by its unparalleled verve for Schumpeterian 'creative destruction', its military hegemony enduring, and its cultural and political reach dwarfing that of other countries. The immense capacity of the Chinese state, coupled with its people's insatiable drive for a better life and their innate business acumen, makes it foolhardy to bet against China's continuing global ascent. Before the crisis, Goldman Sachs's BRICs team brought forward by almost two decades, to 2027, the date by which it predicted China would pass the US to become the world's largest economy. That still seems a reasonable projection today.

The bigger changes wrought by the current crisis are likely to take place below the US and China in the global pecking order. In 2007, the BRICs projections had China passing both Germany and Japan by 2011 to move into second place behind the US in total economic size, measured at market exchange rates (Goldman Sachs 2007). Using the purchasing power parity comparisons favoured by many development economists, China is already clearly the world's number 2 economy behind the US. This change in the global economic guard seems inevitable—if anything, made more certain by the damage wrought on Japan and Europe by the crisis.

The GFC has exposed Japan's economic recovery from the 'lost decade' of the 1990s as more apparent than real, built on booming exports to the US and China rather than the reforms so desperately needed at home. Leading Japanese global brands like Toyota and Sony might go from strength to strength, but they're the exception rather than the rule for the Japanese economy. The suffocating legacies of massive public debt, sclerotic regulation and an ageing and shrinking population are likely to make Japan's next decade a painful process of managing economic decline.

Plummeting exports, burst housing bubbles and toxic bank assets, coupled with piecemeal and often inadequate policy responses not well coordinated between the national and

European Union levels, have exposed the institutional weaknesses of the past two decades of rapid European economic integration. The countries of old Europe are also ageing quickly, weighing down the public sector with enormous retirement and health care liabilities. Though the full 27-member European Union will remain the world's largest economic bloc long after the crisis (far bigger than the US), size shouldn't be mistaken for strength. Europe's fundamental post-GFC tasks are likely to be shoring up foundering domestic economies and repairing its creaking union, rather than projecting its influence on the global stage.

The latest IMF global economic forecast predicts the drop in economic growth between 2007 and 2009 to be less in the US than in any other major G-20 economy.

The latest IMF global economic forecast predicts the drop in economic growth between 2007 and 2009 to be less in the US than in any other major G-20 economy (see Table 1). Europeans can't feel very good about their prospects when *The Economist* grudgingly anoints its long-time bête noir, France, as the continent's strongest economy, supported by the IMF's prediction about France's relatively limited vulnerability to the crisis.[3] Germany, because of its export dependence, and the UK, by virtue of its burst housing bubble and bank failures, are mired in downturns far deeper than the recession in the US. Things look even worse in Japan, where the crisis has halved exports with catastrophic effects for economic growth.

Among the BRICs, India has been relatively less affected by the crisis than China because, notwithstanding the global successes of India's software industry, much of its economy remains inward looking—and much less integrated into global trade and finance than China's. But China will still be the world's fastest growing major economy in 2009. In contrast, Brazil and Russia are mired in recession, with even steeper declines in growth than China's because of their vulnerability to sharp drops in commodity prices and trade volumes—most notably, of Russian oil and gas.

Table 1: IMF global economic forecast, selected G-20 countries, July 2009

Economic output (annual % change)	2007	2008	2009 forecast	2007–2009 forecast slowdown
US	2.0	1.1	–2.6	–4.6
India	9.3	7.3	5.4	–4.8
France	2.1	0.7	–3.0	–5.1
Australia[a]	4.0	2.1	–1.4	–5.4
China	13.0	9.0	7.5	–5.5
Italy	1.6	–1.0	–5.1	–6.7
Brazil	5.7	5.1	–1.3	–7.0
UK	3.0	0.7	–4.2	–7.2
Japan	2.4	–0.6	–6.0	–8.4
Germany	2.5	1.3	–6.2	–8.7
Russia	8.1	5.6	–6.5	–14.6

a April 2009 estimate.

Source: IMF (2009c)

Moreover, most forecasters believe the US and China will lead the path to global recovery, in no small measure because of the speed and scale of the GFC-fighting measures enacted by both countries. As Table 2 shows, the US and China have enacted the largest fiscal stimulus measures in the world, not only in total size but also when measured relative to the size of national economies.

Table 2: Fiscal stimulus and financial bailouts, selected G-20 countries, (% GDP)

	Discretionary fiscal stimulus 2008–2010	Financial assistance as of 18 February 2009[a]
China	6.3	0.5
US	4.9	73.7
Australia	4.5	0.7
Russia	3.9	7.1
Germany	3.5	21.7
Japan	2.2	12.9
UK	1.5	47.5
France	1.4	19
India	1.2	5.6
Brazil	0.6	1.5
Italy	0.3	3.8

a Includes all guarantees and purchases of financial assets by treasuries and central banks.

Source: IMF (2009a)

After less than a month in office, Barack Obama signed into law a nearly US$800 billion fiscal stimulus package. The Chinese Government announced its own massive fiscal stimulus in late 2008, almost as big as Obama's in terms of total dollars. Only the Rudd Government's efforts rival those of the US and China as a portion of national GDP. In contrast, critics continue to point to the relatively desultory efforts of the major European countries.

The scope of financial sector assistance has varied greatly across countries, in large measure because of the differences in the scale of their toxic financial assets. In a profound irony, given years of trenchant IMF and western criticism of their financial systems, banks in the major emerging markets have been sufficiently resilient during the GFC not to require big bailouts. Among developed countries, only Australia, with its strong regulatory regime and domestically focused major banks, has fared so well.

The alarm bells have rung much more loudly on the financial front in the US and western Europe, where major banks were very highly leveraged (asset to capital ratios before the crisis were often well over 30:1) and, once the crisis hit, were dangerously exposed to plummeting prices for mortgage-backed securities and other derivatives based on housing markets (Gros and Micossi 2008).

Again, the US has led the advanced economies with cash injections, asset purchases and guarantees by the Treasury and Federal Reserve that the IMF estimates total a staggering three-quarters of US GDP (and even bigger at well over US$10 trillion on some private estimates). Within two months of entering office, President Obama put more than a trillion dollars into shoring up American banks and insurance companies, on top of the US$700 billion the Bush Administration had already committed. In addition, guarantees yet to be cashed in are measured in the multiple trillions of dollars. Unprecedented activism by the Federal Reserve has added a trillion dollars to its balance sheet since the crisis began, with more likely to come (Bernanke 2009).

When it comes to financial institutions, however, the Chinese Government has been far from inactive in the crisis. Its state-controlled banks have gone on a lending spree to their big corporate customers: new loans in the first quarter of 2009 alone were more than the entire government fiscal stimulus plan for three years and greater than total bank loans for all of 2008, already the largest in Chinese history (Leow 2009). All told, China's fiscal–financial stimulus one–two punch is more aggressive than that of any country save the US.

Comparing all these government interventions, China and the US stand out because of the leading role they are playing in the long climb out of the GFC.

Comparing all these government interventions, China and the US stand out because of the leading role they are playing in the long climb out of the GFC. Activism does not guarantee success, but the long-run picture still looks brighter for the de facto G-2 than for Europe and Japan.

The financial crisis exposed a dark side to American risk-taking. In trying to make up for tight credit and limited demand, the US Government is running up enormous bills that will hamstring the American economy for many years. Nonetheless, there remains no better foundation for long-run economic growth than the entrepreneurship and innovation at which the US excels.

The trick for post-GFC America will be to ensure that its new public debt burden does not drive out private sector innovation in an environment in which gun-shy consumers and businesses will be less willing to borrow than in the past. The Obama Administration knows this, saying it doesn't want to get into the business of running the economy and is just nursing it back to health so that it can be back in private hands as soon as possible. Obama has also made 'fiscal sustainability' the centrepiece of his long-run domestic policy agenda, even as he has rolled out by far the biggest budget in US history, with a 2010 deficit projected to be well over 10% of GDP.

China will be the first country to grow old before it is rich. Its environmental problems are immense. Social instability is high and likely to increase—the result of inequality, mass internal migration and frustrations with the political system. But the capacity of the Chinese state is huge, and it's squarely focused on continuing to deliver China's economic growth miracle. The government knows that its legitimacy rests above all on its ability to keep providing better jobs and higher standards of living to its people. Add to the mix the entrepreneurial zeal of the Chinese people and it would be hard to bet against the country's continuing global ascent.

The post-GFC prospects of Europe and Japan are less rosy. For twenty years, Europe has successfully used expansion of the European Union to the south and east to compensate for the rigid and highly regulated labour and product markets, elaborate welfare states and rapidly ageing societies that have increasingly weighed down the big economies of old Europe. Now the GFC is shaking Europe to its foundations, raising real concerns about keeping the union together. Most attention is focused on the parlous state of Germany and the UK as Europe's growth engines. But insiders focus on the dire straits of the 'PIGS', an ugly acronym for the expanded European Union's first generation of star economic performers—Portugal, Ireland, Greece and Spain. Things are not much better in the former communist countries of eastern Europe, whose development has relied on trade with and investment from western Europe that has now slowed to a fraction of the levels of recent years.

The historical powers of continental Europe won't let their long-cherished integration project fail, but they haven't built a fiscal machine capable of directing money where it's needed. The European Central Bank is myopically focused on price stability. Cash-strapped governments in old Europe, facing outsized health and retirement commitments, are in no position to step into the breach with renewed largesse for their less developed neighbours.

Europe is likely to come out of the GFC considerably weaker and more inward looking than when it went into the crisis, but things seem even more dire in Japan.

Europe is likely to come out of the GFC considerably weaker and more inward looking than when it went into the crisis, but things seem even more dire in Japan. It's now clear that Japan has recovered from its lost decade of the 1990s not by fixing its mix of domestic structural problems but by exporting its way out of recession to booming markets in China and the US. The GFC has dramatically cut into trade all around the world, but it has decimated Japan's.

Japan will exit the crisis with the fastest ageing population in the world, a social consensus that renders large-scale immigration implausible, and a public debt burden that will be by far the biggest among the major advanced countries—more than twice the size of the entire Japanese economy. Servicing that debt will eat up big chunks of Japanese GDP year after year, crowding out desperately needed private investment. Paralysed first by an inert Liberal Democratic Party (LDP) government and then by its apparently rudderless left-leaning replacement, history will probably view Japan's shallow economic recovery earlier this decade as a pyrrhic victory for a country that seems unlikely ever to return to the affluence and influence of the 1980s.

Projections for public debt are a useful indicator of the long-run impact of the GFC. The IMF's forecast figures from early 2009 reflect both how active governments have been in fighting the crisis and the fiscal overhang they will have to deal with when it ends (see Table 3).

Apart from Japan's looming fiscal insolvency, two features stand out in the IMF's public debt projections. First, despite its massive stimulus package, China will exit the crisis with very little debt, certainly by western standards. Among other things, this demonstrates the size of the fiscal war chest China can deploy in its ceaseless striving for more growth, more jobs and more prosperity.

Table 3: IMF public debt forecasts, selected G-20 countries (% GDP)

	2014	Increase from 2006
Japan	222.3	27.0
Italy	118.0	11.1
US	99.5	37.6
France	79.4	15.8
Germany	77.2	11.2
UK	76.2	32.9
India	71.6	–10.4
Brazil	54.1	–9.6
China	18.6	2.1
Russia	6.4	–2.7
Australia	4.2	–5.4*

* estimates before 2009 Australian budget released

Source: IMF (2009b)

Second, the US is soon going to look decidedly European when it comes to public debt (in marked contrast to Australia's relatively strong fiscal position). Now is possibly the worst time for the US and Europe to be running up public debt, because the health and retirement costs of ageing baby boomers will begin to escalate in the coming years. Dealing with large public debt burdens is inevitably going to be a drag on most western economies coming out of the crisis, and higher interest rates and higher taxes are seemingly inevitable.

However, the US is in a better position to manage its public debt than Europe. The reserve currency status of the US dollar reduces the interest rate premium attached to American public debt, and gradual inflation in the US will likely have less downward pressure on the exchange rate than would be the case for other countries. This has been exemplified during the crisis when unprecedented government spending and increases in the Federal Reserve balance sheet, coupled with near-zero interest rates, have been associated with a strengthening dollar as Americans have repatriated capital into the country and global investors have looked for a safe haven in the storm.

Putting together all that we know about the economics of the GFC, the world appears to be moving towards a de facto G-2, almost by default, because the crisis has hit other major economies harder than the US and China, and the effect on those economies will be longer lasting. The problem is that China–US relations will probably be more difficult to manage than they were before the crisis.

Chapter 3

STUBBORN CHIMERICA

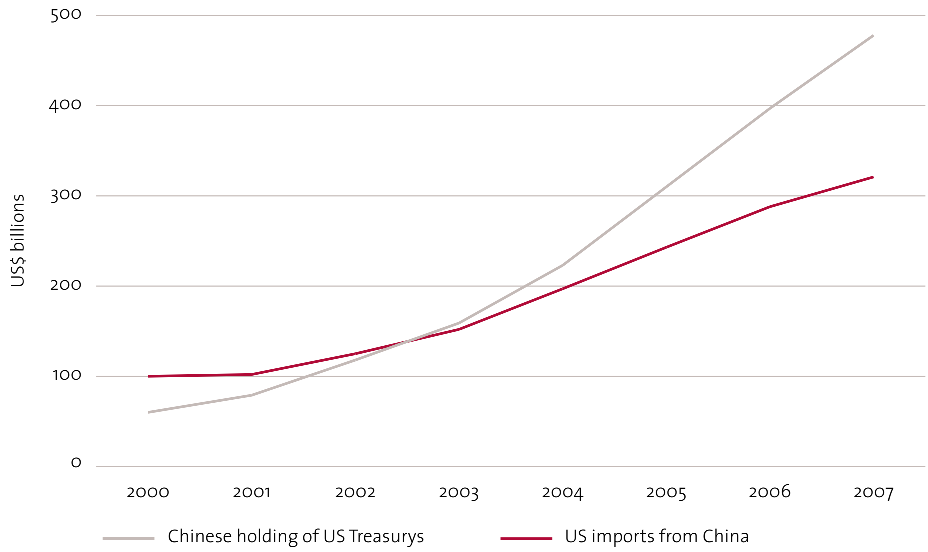
The first US–China Strategic and Economic Dialogue, in July 2009, showed that the focus of Sino-American relations will continue to be economic, and Chimerica's pre-crisis 'trade for Treasurys' co-dependence looms largest of all. The headline statistics for mushrooming Chinese Government purchases of American Treasury bonds and American consumption of Chinese goods before the GFC are by now well known (see Figure 1).

China increased its holdings of US Treasury bills more than fivefold to US$500 billion from 2000 to 2007. Over the same period, American imports of Chinese goods more than trebled to over US$300 billion. When the US housing and financial assets bubbles burst, the US–China economic relationship was quite simply both the largest and least balanced bilateral relationship in history.

In response to the GFC, the governments of China and the US have both decried their economic imbalances, making lofty declarations about redressing them by dramatically reforming their domestic economies. Secretaries Clinton and Geithner were very clear about this on the eve of the first Strategic and Economic Dialogue meetings with their Chinese counterparts:

> As we move toward recovery, we must take additional steps to lay the foundation for balanced and sustainable growth in the years to come. That will involve Americans rebuilding our savings, strengthening our financial system and investing in energy, education and health care to make our nation more productive and prosperous. For China it involves continuing financial sector reform and development. It also involves spurring domestic demand growth and making the Chinese economy less reliant on exports. Raising personal incomes and strengthening the social safety net to address the reasons why Chinese feel compelled to save so much would provide a powerful boost to Chinese domestic demand and global growth. (Clinton and Geithner 2009)

Figure 1: Trade and US Treasurys co-dependence, 2000 to 2007



The pre-crisis reality is clear. China kept its currency from appreciating quickly against the dollar by buying dollars and dollar-denominated paper, which kept US interest rates low and American debt-financed consumption booming. US red ink kept Chinese exports flying off American shelves and made possible year after year of extraordinary and even accelerating growth in China.

Economists constantly decried these imbalances as 'unsustainable', but neither China nor the US wanted to stop the party while the music was still playing. Then the music stopped and both sides made solemn declarations about how they will change. China has said it wants to increase domestic consumption and domestic demand and to reduce its reliance on exports. The US wants to save more and spend less, be less dependent on foreign borrowing, and import less and export more.

A balancing of the China–US economic relationship could be the GFC's economic silver lining, but translating the two countries' lofty aspirations into action is a herculean task. It's much easier for China and the US to blame each other for their woes than to take responsibility for their own damaging actions. Unfortunately, that's what the world witnessed in the first half of 2009.

Global trade took a pummelling from early 2008 as American-led demand dried up and large exporters, led by China, Germany and Japan, suffered the consequences. Many analysts have pointed to the fact that one salutary consequence of the crisis was a dramatic reduction in the overall US trade deficit. In the first half of 2008, the US trade deficit with the rest of the world (excluding China) was US$287 billion. In the first half of 2009, this figure shrank by 60% to US$114 billion—testimony to the magnitude of the GFC.

But over the same period, the US trade deficit with China declined by only 13%, to US$103 billion, close to the size of the US deficit with the rest of the world. At the same time, China's Treasurys holdings increased faster than those by other countries. From June 2008 to June 2009, China's Treasury holdings increased by almost US$250 billion, or 45%, whereas the holdings by the rest of the world only increased by a little over a quarter (see Table 4).

Table 4: Trade and US Treasurys holdings during the GFC (US$ billion)			
US trade deficit	**January 2008 – June 2008**	**January 2009 – June 2009**	**Change**
with China	118.6	103	–13%
with rest of world	287.6	113.9	–60%
US Treasury holdings	**June 2008**	**June 2009**	**Change**
by China	535.1	776.4	+45%
by rest of world	2052.1	2606.0	+27%

Sources: Trade deficit—http://www.census.gov/foreign-trade/balance/; Treasury holdings— http://www.treas.gov/tic/mfh.txt

These statistics belie the often mooted notion that the GFC is going to go a long way towards the reduced China–US imbalances both countries say they want. Instead, they are graphic testimony to the stubborn persistence of Chimerica. As a result, it's not surprising that the first half of 2009 witnessed high-level public mudslinging between the two sides that was very different from the 'softly, softly in public, keep disagreements behind closed doors' diplomacy of much of the previous decade.

On the US side, Treasury Secretary Geithner let slip in the heat of his confirmation hearing that China 'manipulates' its currency to benefit its exporters at the expense of would-be American exports to China. Understanding that this could trigger a legislative process requiring US retaliation against China, President Obama quickly sought to recover the situation by saying his Treasury Secretary had misspoken.

But the Obama Administration is well aware of the pent-up demand in America, particularly in the Democrat-dominated Congress, to get tough with China. The reason was amply clear in the job statistics even before the GFC hit, when American unemployment was less than 5%, when no-one expected month after month of American job losses measured in the many hundreds of thousands, and before the spectre of double-digit unemployment for a couple of years became the focus of every elected official's attention.

The simple inference to be drawn from the statistics is clear: cheap Chinese imports have cost American jobs. Figure 2 shows that as Chinese imports into the US grew rapidly this decade, more than four million manufacturing jobs were lost in the US. China excels at producing and assembling goods that need a relatively low-skilled workforce. The top five categories of Chinese imports into the US (according to the sometimes anachronistic Harmonised Tariff Schedule) are clocks, watches and portable typewriters; computers; computer accessories; textiles and apparel; and toys, sporting goods and bicycles. Those are the areas in which manufacturing job losses in the US have been concentrated.

Of course, manufacturing supplies only a small portion of total American employment these days. But manufacturing remains central to the US political debate for at least two reasons. First, Americans still look back fondly on the 20th century model of stable, high-paying manufacturing jobs with generous health care and retirement benefits that spread prosperity to the middle class. Second, manufacturing is concentrated in the swing states of the Midwest that invariably tip presidential elections one way or the other.

It's also much easier politically to blame foreign competition for job losses than to look harder into domestic dynamics. Most studies show that manufacturing job losses have more to do with technological change than with trade. But congressional representatives from the rustbelt nonetheless often draw a straight line between lost jobs at home and unfair

Chinese competition, and demand that Obama do something about it. Here's how Ohio senator Sherrod Brown painted the picture in March 2009:

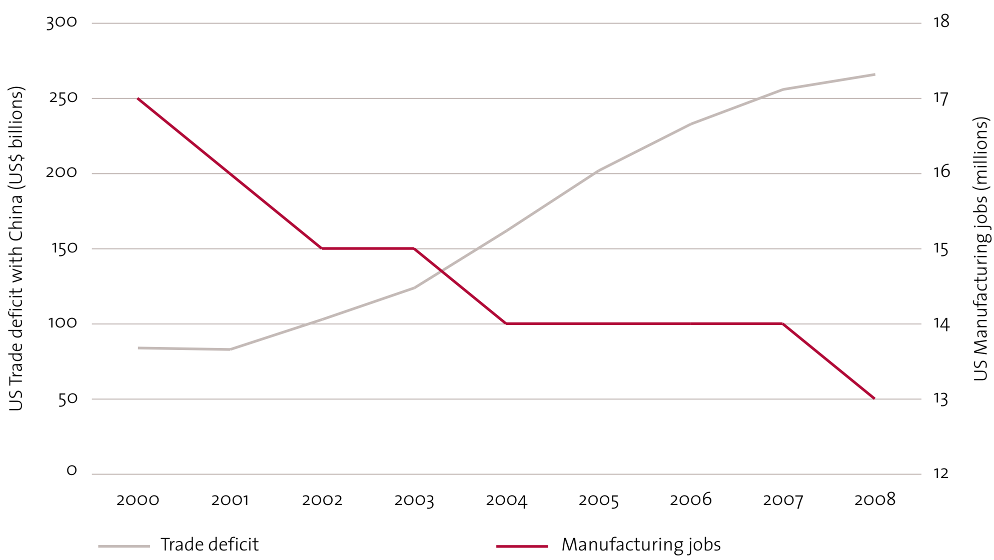
> The Ohio manufacturer has a minimum wage to pay his workers. He has clean air and workplace and product safety standards by which to abide, helping to keep his workers healthy and productive and his customers safe. The Chinese manufacturer has no minimum wage to maintain and is allowed to pollute the local water sources and let workers use dangerous and faulty machinery. The Ohio manufacturer pays taxes, health benefits, and social security. He typically allows family leave and gives WARN notices when there is a plant closing. The Chinese manufacturer often allows child labor. The Ohio manufacturer receives no government subsidies, and the Chinese manufacturer often receives subsidies for the development of new technologies, or for export assistance. The Chinese manufacturer benefits from China's manipulation of its currency, which gives up to a 40% cost advantage.[4]

There were thus clear political reasons for Secretary Geithner to let slip the word 'manipulation' during his confirmation hearings. But what played well in middle America had a very different effect on Sino-American relations. High-level Chinese reactions to this significant diplomatic faux pas were swift and pointed.

Premier Wen Jiabao worried aloud to the world's press about the safety of China's dollar-based holdings. He said that, in the light of the US Government deficits and public debt, 'of course we are concerned about the safety of our assets'. This caused President Obama to take the extraordinary step of publicly stating that 'not just the Chinese government, but every investor can have absolute confidence in the soundness of investments in the US.'[5]

But the Chinese were not finished. Just one week later, the Governor of the Bank of China, Zhou Xiaochuan, proposed the replacement of the dollar with a new global reserve currency 'that is disconnected from individual nations and is able to remain stable in the long run, thus removing the inherent deficiencies caused by using credit-based national currencies'

Figure 2: Chinese imports and American job losses, 2000 to 2008



(Anderlini 2009a). The US wasn't mentioned by name, but no-one had any doubts about the 'individual nations' with 'inherent deficiencies' he was talking about.

American profligacy and Chinese dollar asset purchases have long been at the heart of Chimerican imbalances.

American profligacy and Chinese dollar asset purchases have long been at the heart of Chimerican imbalances. What stands out about the recent spats between leaders from the two countries is just how public they have been. Both sides are deeply concerned about the economic imbalances at the core of their bilateral relationship. Both countries know what each would have to do domestically to reduce them. The problem is that there are short-term and long-term impediments in both countries to transforming Chimerica into more balanced interdependence.

In the short term, the policies the US and China are using to fight the GFC are reinforcing the domestic dynamics underpinning the imbalances of Chimerica. The Obama Administration is compensating for large-scale deleveraging by consumers and firms with unprecedented government spending. The strategy is to revive American demand first. Even though Obama has couched his stimulus plan in terms of long-term investments in productivity through reforms in education, energy and health care, significant increases in America's productive capacity remain uncertain and a long way off. In the short term, there will be more American demand and more imports from China.

The Chinese Government is trying to compensate for the slump in global demand with large-scale investments and bank lending for public infrastructure projects and to large companies that are mostly state owned or state controlled. The rate of investment in China is slated to rise this year from an already very high 40% of GDP to an even higher 45% (Anderlini 2009b). But unless and until Chinese consumers start buying more of what Chinese firms produce, exports, above all to the US, will be the principal way to translate investment into economic growth.

When it comes to the longer term, reducing the imbalances of Chimerica will entail changing the economic DNA of both countries: Americans will need to become more Chinese in their behaviour by saving much more, and the Chinese will need to become more American by consuming much more.

The US is replacing private debt with public debt as citizens and businesses rein in their borrowing and the government steps in to take up the slack. The Administration claims its spending will increase the productivity of the American economy through investments in infrastructure, alternative energy and the like, but the productivity benefits are a long way off.

For the foreseeable future, the biggest domestic challenge for the US will be what Obama is calling 'fiscal sustainability'. However, just stabilising US public debt after the full effects of Obama's spending are felt would require tax increases or spending cuts of nearly one-third of central government spending, or 7%–9% of GDP (Auerbach and Gale 2009).

Americans have repeatedly shown that they will punish politicians for smaller increases in taxes or cuts to spending than the US's crisis-generated debts demand—just remember George HW Bush's betrayal of his 'Read my lips: no new taxes' pledge. Beyond identifying inefficiencies in current spending (and hence potential savings), it's hard to see how the US could cut expenditures by this much. Retirement and health care liabilities are the two biggest ticket items. Social security has long been the third rail of American politics. The previous Democrat in the White House, Bill Clinton, was transformed from bold progressive to triangulating centrist by a painful defeat on health care reform.

When it comes to the longer term, reducing the imbalances of Chimerica will entail changing the economic DNA of both countries…

What about tax increases, focusing on measures that would also reduce incentives for Americans to borrow money? The volume of home mortgages in the US is about as big as the entire economy, but every dollar spent on servicing mortgage debt on residential real estate (including second homes) is fully tax deductible. As housing prices ran up in the 2000s, Americans added another 10% of GDP to housing debt, this time in the form of credit card–equivalent home equity lines of credit secured against homes, with much lower interest rates than regular credit cards—and with all debt interest fully tax deductible. It's doubtful Obama has the will or ability to wean Americans off government-subsidised borrowing to realise the American motherhood-and-apple-pie dream of home ownership.

Americans' inveterate optimism has no doubt been shaken by the GFC, as personal and corporate savings rates have risen for the first time in years. However, rather than forcing consumers and firms to live within their means, the Obama Administration has put off the day of reckoning by pump-priming demand. As the American economy improves, calls for spending cuts and tax increases are unlikely to be heeded—particularly if unemployment remains high for an extended period.

China's challenge is the mirror image of America's. Whereas Americans borrow because they're confident about the future, Chinese citizens save for a rainy day. Members of close-knit extended families save because the family, rather than the state, will look after them when they get sick, grow old or lose their jobs. Even if Chinese citizens wanted to spend and borrow more, the retail financial sector needed to service a consumer society is at best rudimentary in China.

The Chinese Government has the capacity to build an effective social safety net and to change the regulatory environment to favour the growth of retail banks, credit cards and insurance targeted at consumers. But instead it has invested in infrastructure and state-owned enterprises and state-controlled companies, using state-owned banks as a preferred intermediary.

That strategy makes political as well as economic sense for the Chinese Government. By focusing on driving productive capacity higher, it can deliver on its implicit guarantees of full employment and higher living standards for all its citizens. The government also knows that the development of a large consumerist middle class is the lynchpin in the development of democracy.

As a result, Beijing remains cautious about the kinds of reforms that would make Chinese citizens more American in their economic behaviour. Such reforms would entail giving up cherished control over the economy at a time when the government is worried that its political control is being increasingly questioned. Chinese leaders learned the lessons of Gorbachev's *glasnost* and *perestroika* well, and they won't lightly walk down what they might consider the former Soviet Union's naive path to openness.

China and the US both say they want to reduce their glaring economic imbalances and to have balanced national economic models with more comparable mixes of savings and borrowing, production and consumption, and exports and imports.

China and the US both say they want to reduce their glaring economic imbalances and to have balanced national economic models with more comparable mixes of savings and borrowing, production and consumption, and exports and imports. The changes that are needed are within the control of governments in both countries. But the political will and capacity required to make these changes is immense. Hu Jintao and Barack Obama are gifted and ambitious leaders. They are also pragmatists, however, who are acutely aware of the political constraints they face. The imbalances of Chimerica are likely to remain an important consequence of that political pragmatism.

Chapter 4

THE THREAT OF ECONOMIC NATIONALISM

For all its intrinsic economic problems, Chimerica has for a decade been the glue holding together stable US–China relations, keeping a lid on potential geopolitical frictions. But now both sides want to undo their economic imbalances in a process that's likely to be long and frustrating. Temptations to engage in a two-way blame game are likely to increase. With the stubborn persistence of Chimerica, the risks for both countries are clear.

All the debt the US is racking up to fight the GFC creates incentives for the Obama Administration to let inflation creep back into daily life—allowing the government to reduce the real value of what it owes China and its other creditors. The bond markets are already pricing inflation into the US's long-term borrowing. As the Federal Reserve has kept its key short-term interest rate near zero, the yield on ten-year Treasury bonds almost doubled in the first half of 2009.

The spectre of the US inflating away its public debt provoked Premier Wen Jiabao to express China's concern about the security of its American assets and China's central bank governor to suggest that the world needs a new reserve currency. What they did not say, but what is surely on their minds, is that American inflation will only add to upward pressure on the renminbi against the dollar in nominal terms, decreasing (at least in the short term) the competitiveness of Chinese exports to the US.

For its part, the Chinese Government knows that there are diminishing returns on its ever higher rates of investment—the highest in the world today, and probably the highest outside traditional state socialist economies in the past half century. Continually pushing up production that isn't matched by domestic consumer demand is a risky business. Although in recent years China has been able to fight off the classic communist foes of overcapacity and inefficiency through booming exports, that will be harder to do in the future.

The last time there was anything approaching such a volatile combination of economic asymmetries was in the 1980s—the last time US unemployment was over 10%. Back then, Americans worried that they might be replaced by Japan as the world's top economic dog. They complained that this was the result of unfair Japanese trade practices that were destroying American jobs.

Ronald Reagan did something big about Japanese competition, engineering via the then G-6 Louvre and Plaza accords a doubling of the value of the yen against the dollar in a few short years. American exports to Japan grew appreciably, and Japanese imports into the US declined. America's economy recovered; Japan's subsequently went into freefall. Japan used the stronger yen to buy iconic American assets, such as Rockefeller Center in New York, and to turn what had been the most visible Japanese imports into the US, Toyotas and Hondas, into products made in America.

It took years for Americans to become comfortable that Japan wasn't a threat to their way of life and that Japanese investment in the US was good for America. The appreciation of the yen and the decline in Japanese exports laid the foundation for Japan's disastrous lost decade of the 1990s.

The challenges facing post-GFC China–US relations are even more formidable. Japan was a staunch ally of the US, stably democratic and solidly capitalist. China is none of those things, raising American suspicions on each count. Japan was a partner, acquiescent if not willing, in the US plan to drive up the value of the yen. China continues to assert its sovereign autonomy where the exchange rate is concerned.

On the campaign trail, Barack Obama insisted that fair trade was more important than free trade. That was before the full effects of the crisis, particularly on unemployment, were clear.

The international face of the Chinese economy is sovereign wealth funds led by the China Investment Corporation and parastatal industrial firms with apparently close but frustratingly opaque connections to the central government, such as CNOOC (the China National Offshore Oil Corporation) and Chinalco. The already significant barriers to American firms investing in China can be expected to intensify, given China's commitment to creating a large number of global champion companies in markets that US multinationals currently dominate.

On top of this, the US is a much more unequal society today than it was in the early 1980s. The political incentive to 'feel the pain' of ordinary people is high, and getting tough on globalisation is an effective way to do it. On the campaign trail, Barack Obama insisted that fair trade was more important than free trade. That was before the full effects of the crisis, particularly on unemployment, were clear.

If much of the rest of the world considers globalisation to be a process of Americanisation, things are very different in the US. For most Americans, China represents the leading edge of globalisation's dark side.

Even before the GFC, Americans were growing tired of globalisation. Gallup has been asking Americans for a decade: 'Do you see foreign trade more as an opportunity for economic growth through increased U.S. exports or a threat to the economy from foreign imports?'[6] In 2000, 56% of respondents thought trade was an 'opportunity', whereas 36% viewed it as a 'threat' (a +20% opportunity–threat balance in favour of globalisation). In 2008, only 41% thought of trade as an opportunity for America, while 52% considered it a threat (–11% for opportunity–threat)—a swing of thirty one percentage points against globalisation in eight years.

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The US has joined the other G-20 countries in proclaiming that it will resist the protectionist temptation because succumbing to it would only make the GFC worse—the memory of America's Smoot–Hawley tariffs deepening the Great Depression is indelibly etched in the minds of the leaders of the world's major economies. However, as the World Bank has reported, new barriers to trade were introduced by seventeen members of the G-20, including China and the US, between the November 2008 G-20 summit when the abstinence vow was first made and the next meeting of the group in April 2009.[7]

Buy American, hire American and lend American provisions crept into the US's GFC-fighting fiscal stimulus and bank bailout packages. Government bailouts cum de facto nationalisation of the General Motors and Chrysler auto companies—now running to well over US$50 billion—have the explicit goal of propping up ailing domestic companies to keep their workforces in jobs. The bailouts also hurt international competitors and violate the 'level playing field' norms underpinning the global trading regime.

The US's GFC-fighting one–two punch of fiscal stimulus and financial bailouts will inevitably privilege American firms over foreign ones, but these forms of subsidies are not the kinds of tariff and non-tariff barriers to trade that the World Trade Organization was designed to counteract. American financial bailouts have focused on domestically owned institutions like Bank of America, Citigroup and AIG, and the heat is on those institutions to privilege domestic clients, now with sizable government ownership stakes, over foreign ones. The large-scale infrastructure projects at the core of the Obama stimulus package initially contained explicit provisions mandating that work be done using American iron, steel and manufactures—all core parts of the Chinese export machine.

The climate change bill passed by the House of Representatives in June 2009 adds a new protectionist barrier to the mix, imposing heavy tariffs on countries with less stringent regulation of carbon emissions than the bill would mandate for the US. China, the world's largest emitter and without anything akin to the Obama Administration's bill, looms as the largest target for climate change tariffs.

In addition to these new forms of American trade protection, there's likely to be rising nationalism surrounding foreign investment.

In addition to these new forms of American trade protection, there's likely to be rising nationalism surrounding foreign investment. China's sovereign wealth funds and its large parastatal companies wanted to buy American firms before the crisis, but the backlash in America was intense—most vividly in the congressional firestorm in the summer of 2005 that led CNOOC to withdraw its bid for Unocal, a small American oil and gas company. Since then, China has kept a low profile in the market for corporate control in the US, opting for minority stakes in shadow banks like the private equity firm Blackstone over more visible acquisitions of manufacturing firms and their quintessentially American middle-class jobs.

With American asset prices battered by the GFC, China worried about the security of its T-bill holdings, and the Chinese currency likely to continue its slow appreciation against the dollar, the economic incentives are high for China to go on a foreign direct investment buying spree in the US. In the wake of the Chapter 11 bankruptcy of General Motors, the US Government was willing to allow a Chinese firm to acquire the iconic Hummer brand. But that was a special case, both because the buyer was an unknown Chinese firm from the private sector and because the gas-guzzling Hummer is seen as a relic of the age of excess that many Americans would like to forget.

For its part, China was one of the countries named by the World Bank for erecting new protectionist barriers after the November 2008 G-20 meeting—in the form of bans on some imports and, more importantly, new tax breaks for exporters. On top of that, the Chinese Government apparently chose to slow the appreciation of the renminbi against the dollar as the full effects of the GFC began to be felt in the last quarter of 2008. The *Wall Street Journal* has reported that the Chinese Government has included its own 'buy Chinese' mandate in the regulations governing the use of its GFC-fighting fiscal stimulus measures: 'Apart from engineering goods or services that cannot be obtained under reasonable business conditions inside China, domestic products should be purchased for the government investment program' (Johnson 2009).

Beyond trade protection, tight Chinese Government control of its domestic market has always created high hurdles for American firms wanting to establish footholds in China. Beijing can void potential foreign investments if they threaten what it calls 'national economic security'.[8] China now wants to build dozens of home-grown global champion companies capable of taking on the world in sectors where American firms have long been leaders, such as aerospace and information and communications technology. In this environment, Chinese authorities are unlikely to look more favourably on American multinationals wanting greater presence in their market.

American firms salivate at the prospect of satisfying the needs of China's growing middle class, and they have been willing to go to great lengths to get inside the Chinese market. Wal-Mart is now China's biggest retailer, but the infamously anti-organised labour firm was willing not only to let its Chinese workers unionise but also to let them hold meetings of the Chinese Communist Party on Wal-Mart premises.[9] General Motors is China's biggest car maker, but its joint venture is still controlled by its Chinese partner. American banks continue to expend immense effort trying to open branches in China, but getting anything more than a small minority stake has proved impossible.

> The spectre of post-GFC economic nationalism around the world, and in China and the US above all, is real.

The spectre of post-GFC economic nationalism around the world, and in China and the US above all, is real. The more frustrations grow about the stubborn persistence of Chimerica, the greater the temptation for the two countries to point the finger at each other.

Trade disputes are already on the rise. China is poised to ban chicken imports from the US, in retaliation for an American ban on Chinese chicken. The US International Trade Commission has recommended that America impose tariffs of up to 55% on tyre imports from China, arguing that Chinese tyres are being unfairly dumped on the American market, hurting US producers (Etta and Power 2009). In late June 2009, the US joined the European Union in initiating proceedings against Chinese restrictions on raw material exports, which they claim unfairly hurt countries and companies wanting to export to China. US Trade Representative Ron Kirk said that the Obama Administration would insist 'on the rights of American businesses and workers to a level playing field'.[10]

Things threaten to get more heated as China and the US stare each other down over climate change. President Obama has taken important domestic initiatives to turn his country from a climate change sceptic into a climate change leader, but he has also said that a major US commitment can only take place in the context of a binding global agreement that brings China to the table. For its part, China says it is also taking climate change very seriously and is in the midst of its own major domestic reforms. But China's position remains that, in the very early stages of its industrial evolution, it shouldn't have to pay via deep emissions reductions for problems caused by almost 200 years of western industrial production. China, like India, also insists that emissions should be measured per capita, not per country.

These tensions in the China–US economic relationship will play out against the backdrop of enduring national security anxieties between the two countries. Those concerns are likely to grow as the US reassesses the limits of its global engagement after the war on terrorism and China continues to expand its external reach and military capacity.

China insists that its security objectives are wholly defensive, and principally focused on securing its land borders with its nearly twenty neighbours. But security hawks in the Pentagon continue to pore over China's defence budget, which they believe is rising too rapidly and is too focused on bluewater naval power to be only about securing the mainland.

US military expenditures, roughly half the global total, grew by two-thirds over the decade ending in 2008 as a result of America's war on terrorism. But as Table 5 shows, China's military spending almost trebled over the same period from albeit a much lower base—not only because the Chinese economy grew more quickly over the decade but also because the Chinese Government chose to devote increasing portions of GDP to defence.

Table 5: Military expenditures, 1999–2008 (billions of constant 2005 US$)

	1999	2008	Dollar increase	Percentage increase
United States	329	549	220	67%
China	22	64	42	194%

Source: Stålenheim, P. et al. 'Military expenditure data, 1999–2008', Stockholm International Peace Research Institute, SIPRI Yearbook 2009: Armaments, Disarmament and International Security

The pace of China's 'catch up' to American military spending will increase if the Obama Administration sticks to the defence spending plans it has already laid out for the next decade. After a dramatic increase in spending to support the troop surge in Afghanistan and Pakistan in 2009–2010, the Obama Administration projects a reduction in the Defense Department budget of more than US$60 billion by 2012, with the total defence budget not returning to its 2010 level until 2018. In real terms, this would mean a substantial reduction in defence spending over the next decade, given the likelihood of significant post-GFC inflation in the US.[11] Obama's plan is for the US to devote one-third less of its budget to national defence in a decade's time than it does today. This is on the same scale as Bill Clinton's 'peace dividend' in the 1990s, in global conditions that seem far less benign than those in the period immediately following the end of the Cold War.

Fortunately, potential flashpoints that could trigger military confrontation between the US and China are few and apparently becoming fewer. Taiwan's economic integration with China continues to build stronger linkages between the island and the mainland, and Taiwan's new president has taken a decidedly less vocal stance on independence than his recent predecessors. The US and China have cooperated more closely over curtailing North Korea's nuclear ambitions in recent years than many predicted.

Nonetheless, mutual suspicions about each other's world views and long-run ambitions will remain in China and the US. On top of the persistence of Chimerica and the temptations to economic nationalism generated by the GFC, there are clearly big challenges facing Sino-American relations.

Chapter 5

AUSTRALIA'S BALANCING ACT

How China and the US behave as they come out of the financial crisis will have global ramifications, but in few places are the stakes higher than in Australia. Australia will exit the GFC in better economic shape than most countries. Even if our public finances are worrying to many Australians, they will be the envy of the western world. Our system of prudential regulation has been shown to be among the world's best, and our financial institutions will come through the crisis relatively unscathed. The downturn in Australia may well end up being shallower than that in any other OECD country.

However Australia's economic resilience should not conceal the very real challenges we will face in the post-GFC world, first and foremost concerning China and the US. For close to three decades, Australia has successfully twinned objectives at the very top of its strategic agenda—building powerful economic linkages with China focused on the exploitation of Australia's raw material bounty, while simultaneously strengthening Australia's security alliance with the US based on the long history of shared values and interests between the two countries.

Like both his Liberal and Labor predecessors, Prime Minister Kevin Rudd has already shown his commitment to continuing this US–China balancing act. The challenge for Australia is that Sino-American relations are likely to be more difficult after the GFC than before it. How should Australia act in this environment?

The 2009 Defence White Paper makes the case for an upgraded, modernised and expanded Australian defence capability to insure against the fallout of military conflict among the major powers of the Asia–Pacific region—an unlikely outcome, but one defence planners must consider with seriousness. Although the White Paper talks also of India, Japan and Russia, the authors' primary concern is widely viewed to be the potential for conflict generated by China's rise, coupled with a lessening of US primacy (Defence Department 2009).

The White Paper gives projections to 2030, as acquiring new weapons systems and the personnel to use them takes decades rather than years. But even if Australia invests in the recommended military insurance policy, Australian leaders will want to supplement it with a diplomatic strategy designed not only to strengthen relations with both China and the US but also to help smooth tensions between them.

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Australia will have to come to grips with the prospect of substantial Chinese foreign investment—the almost inevitable consequence of China's insatiable appetite for raw materials and its desire to secure stable supply. Australians are understandably concerned about large-scale Chinese acquisitions of national 'crown jewels' in the minerals sector. The potential use of iron, steel and other minerals in military production, strong but often opaque links between Chinese firms and the Chinese Government, and doubts about Beijing's ultimate objectives as a great power all give Australians pause when it comes to Chinese investment.

Over time, Australia may well have to accept that large-scale trade with China will also mean large-scale Chinese investment. Around the world, trade and foreign direct investment have long proved complements, rather than substitutes. This was of course true for Japan's trade and investment in Australia in previous decades. China is following this logic in Latin America and Africa today, and it will surely expect Australia to take the same line.

It would be unwise to view the fallout from Chinalco's bid for a greater stake in Rio Tinto as anything but a harbinger of things to come. Australia may wish to consider a more proactive strategy of welcoming Chinese investment whilst ensuring that it's of maximum benefit to the country.

There's no indication that President Obama will scale back the far-reaching global ambitions of his post–Cold War predecessors. Nonetheless, the long years of protracted wars in Iraq and Afghanistan have taken their toll. The Obama Administration's mantra of 'smart power' has many elements, but one of its underlying messages is the US's desire to pursue its foreign policy goals at somewhat lower cost. This certainly entails more use of diplomacy and less military force, but it also means asking more of American allies.

The US under Obama may no longer be fighting a 'war on terrorism', but the struggle against violent Islamic extremism remains central to American foreign policy. So, too, does Washington's desire to protect its strategic interests in stability in the western Pacific from Korea to Southeast Asia.

At the same time, President Obama is giving US allies what they said they wanted—more involvement in setting shared strategic objectives. In return, Obama will want American allies to take on more responsibility in furthering those objectives. Australian strategists often talk about policy towards the US in terms of 'alliance management'—doing what it takes to stay among the US's most trusted allies. If so, the costs of staying on Washington's A-team are likely to grow over the next decade, and Australia might well be better placed and more willing to pay them than some of the US's other traditional alliance partners—most notably in continental Europe.

However, in addition to developing its bilateral relations with China and the US, Australia will want to do what it can to smooth the frictions between the two great powers.

Some suggest that Australia should try to play a direct intermediation role, particularly as we have a Prime Minister who speaks fluent Mandarin and who shares many political and policy views with President Obama. There's no doubt something to that notion, but the less attention is drawn to it the more effective it will be.

Working with China and the US on the multilateral stage in areas of shared interest seems a better strategy for Australia than seeking to intercede directly in Sino-American relations.

As the phalanx of cabinet level officials from both sides at the first meeting of the new Strategic and Economic Dialogue in Washington in July 2009 amply showed, China and the US will devote considerable resources to their bilateral relationship. But both countries have gone out of their way to signal that the relationship should be embedded in broader global dialogues. Working with China and the US on the multilateral stage in areas of shared interest seems a better strategy for Australia than seeking to intercede directly in Sino-American relations.

Prime Minister Rudd has proposed the creation of an Asia–Pacific Community (APC) that would include most countries on both sides of the Pacific, and the simultaneous revival and upgrading of what in recent years has been a decreasingly active Asia–Pacific Economic Cooperation process. However, there's a clear and cautionary lesson from the long and successful history of European integration. Unless and until both China and the US actively support the APC idea, and Australia's playing Belgium to their France and Germany, Australia's quiet diplomacy is unlikely to generate much traction.

A more assertive Australian stance could ruffle feathers rather than build bridges. In his June 2009 confirmation hearings for US Assistant Secretary of State for East Asia and the Pacific, Kurt Campbell said with characteristic forthrightness that 'Asians hate to be compared with Europe' and that if the APC idea is to succeed 'it has to have deeper roots' (Norington 2009). In a Singapore speech to a large group of Asian leaders in late May 2009, Prime Minister Rudd acknowledged the slow progress his APC initiative has made, the mixed reactions it has received, and the importance of not overplaying Australia's hand. He concluded that 'an Asia–Pacific community isn't a short-term project; it would take a very long time to achieve' (Rudd 2009).

In the meantime, another possible option for Australia would be to work to include the US more formally in an expanded East Asia Summit comprising the members of the Association of Southeast Asian Nations, the northeast Asian powers, and Australia, India and

New Zealand. However, that gambit would also be fraught with difficulties. China has already expressed its reservations about extending the grouping beyond its natural geographic meaning—and implicitly about including more democratic allies of Japan in an East Asian context where Beijing's model of managed capitalism and benign authoritarianism remains the regional norm.

Moreover, the whole 'ASEAN plus' process of regional institution building was born of Asian disappointment with, if not anger at, what was considered America's malign neglect during the Asian financial crisis a decade ago. On top of that, the US showed little interest in more direct involvement in Asian forums during the Bush years. This seems unlikely to change dramatically under President Obama, given his focus on the Muslim world and his implicit outsourcing of Asian responsibilities to his Secretary of State, Hillary Clinton.

The best diplomatic track for Australia to work collectively with the US and China seems to be in supporting the meteoric ascent of the G-20 from an obscure meeting of finance ministers into what might well become the most important institution of global governance in the coming decade. Indeed, Kevin Rudd lauded the new leadership grouping in the same speech that he used to acknowledge the uphill battle facing his APC ambitions, saying that 'the G20 bridges ... the strategic and economic weight of the present and of the future. It is small enough to have efficiency but large enough to have legitimacy' (Rudd 2009).

Presidents Hu and Obama have both committed to furthering their national interests through active participation in multilateral forums. While their two countries might increasingly look like a de facto G-2, they will embed their bilateral relations in multilateral interactions. And here the G-20 looms largest.

China and the US have both embraced the G-20, albeit for quite different reasons. For China, the G-20 represents the leading edge of worldwide recognition of its status as a global power, draped in the less threatening cloth of a broader balancing between the old powers of the 20th century and the rising powers of the 21st century. The G-20 is also big enough for the spotlight not to shine too brightly on China, allowing it to grow slowly into a global leadership role it remains uncomfortable with. For the US, the G-20 represents a tangible reaching out to the new powers and a central plank in its policy of encouraging China to be a responsible global stakeholder, while also serving to lessen the influence of the big countries of old Europe, which seem increasingly not to see eye to eye with the US on a range of global issues. Both China and the US will have de facto vetoes in the G-20 without ever having to appear heavy-handed.

The short-term agenda for the G-20 is also very consistent with American and Chinese goals. Reforming the international financial institutions to give China and other emerging economies a bigger role might also increase China's confidence that it doesn't need to accumulate such a large reserve of dollars to insure against the prospect of something like a second Asian financial crisis. Greater Chinese involvement in the IMF and the other major global financial institutions may increase Beijing's willingness to allow its currency to float more freely in global markets. Both China and the US are looking to the G-20 as an appropriate forum for reaching an in principle agreement on climate change before any formalisation under the UN banner.

The G-20 is also an opportunity for Australia to play on the biggest global stage. It's only a few short years since some influential pundits pushed a global architecture based on fourteen members and radiating out from the current G-8.[12] Australia wasn't in the fourteen, but it's very much part of the G-20, and it played to very good reviews at the first two G-20 summits.

The G-20 agenda will focus on issues of vital importance to Australia—financial regulation, resisting protectionism, furthering free trade, and reconciling the climate change agenda with global economic integration. Australia's positions on these issues will probably also sit well with both the US and China—advocating a sensible global architecture for financial integration that's not as 'anti-American' as some might prefer and that accords China its rightful status as a major economic force; pushing for a completion of the Doha Round in ways that require concessions from both China and the US as well as Europe, India and Japan; arguing as a relatively small economy that's both a major exporter and an international price taker that the domestic temptations of protectionism must be resisted; and using its position as a big carbon exporter to confront climate change in ways that are consistent with the evolution of carbon-based industries towards cleaner and more sustainable futures.

China and the US mightn't always agree with Australia's position on these issues, and Australia will not stand squarely on one side or the other when it comes to their biggest challenges, but Australia's position will be respected. As the challenges facing Sino-American relations grow more complex and potentially more charged after the GFC, Australia is well positioned to help the two global giants work through their differences. The future of China–US relations is critical to Australia's future, and the G-20 might offer the best chance for us to help shape that future.

Before the GFC, the US National Intelligence Council expressed the consensus view about global transformation, the forging of a new international system that 'will be almost unrecognizable by 2025 owing to the rise of emerging powers, a globalizing economy, an historic transfer of relative wealth and economic power from West to East' (NIC 2008).

That transformation will continue after all the GFC dust settles, but it will increasingly focus on China and the US as Europe and Japan struggle with enduring internal problems that the crisis has only made worse. China and the US have their own major challenges as well, but the US isn't going away as the world's dominant power anytime soon, and it seems most unlikely that China's three-decade economic miracle is about to come to a halt.

As a result, the interrelationships between China and the US will probably be the dominant feature of the post-GFC world. The problem is that those interrelations are likely to become increasingly difficult. The good news is that Sino-American tensions will be about economic issues in the first instance, rather than political and military ones. The bad news is that the gaping economic imbalances between the two countries will no longer be the glue holding their relationship together, but rather an increasing source of friction.

Ensuring that the two elephants dance rather than fight is of vital importance to Australia, and the Australian Government is well positioned to play a constructive role in helping to keep them on the dance floor. The challenge for Australia will be to further its interests without overplaying its hand. The G-20 seems to offer Australia its best chance for creative middle power diplomacy where it matters most, in relation to China and the US.

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Acronyms and abbreviations

APC	Asia–Pacific Community
ASEAN	Association of Southeast Asian Nations
BRIC	Brazil, Russia, India and China
CNOOC	China National Offshore Oil Corporation
GFC	global financial crisis
GDP	gross domestic product
IMF	International Monetary Fund
LDP	Liberal Democratic Party
OECD	Organisation for Economic Co-operation and Development
UN	United Nations

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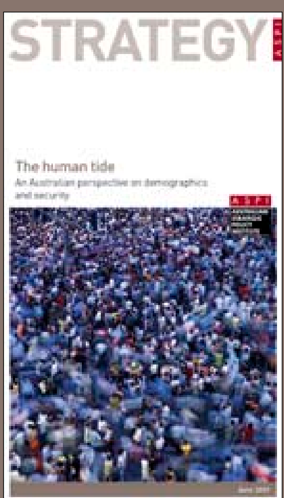

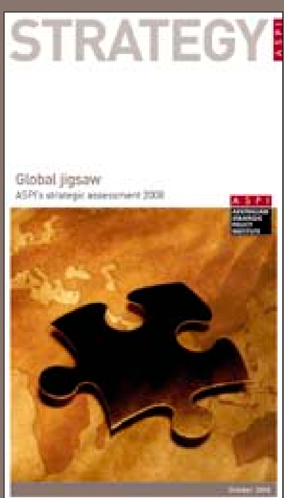

After the GFC
Australia and the Chimerica challenge

The economic imbalances of 'Chimerica'—US trade deficits with China coupled with Chinese purchases of US Treasury securities, both on unprecedented scales—paradoxically have stabilised Sino-American relations over the past decade. After the global financial crisis, the imbalances of Chimerica will persist. But they will turn from a source of stability into a source of friction between the two countries, affecting the global bounds of the possible for fixing finance, reviving trade, resisting protectionism and tackling climate change, and for geopolitical stability in the Asia–Pacific region and beyond.

To fight the GFC, Beijing has increased investment and lending in industrial production while paying less attention to domestic consumer demand, maintaining China's export dependence. Washington is replacing private debt with public debt. As American demand recovers, so will imports. In the longer term, there are obstacles to encouraging Americans to consume less and Chinese to consume more. Politically popular enabling regulation and tax breaks fuel consumption in the US. The Chinese Government favours industrial production over building the social safety net and retail financial system that its consumers need. As a result, heightened frustrations in both countries mean that the possibility of a damaging spiral of duelling US–China economic nationalism can't be ruled out.

The stakes are high for Australia's China–US balancing act, on which Australia's security and prosperity depend. Australia will be challenged by China's need for foreign raw materials and by the US's rising expectations of its allies, but can also foster better Sino-American interactions in international forums, particularly the G-20 group.

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