Prospect

China vs. America: fight of the century

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Issue 169, March 22, 2010

The world's two great powers are growing dangerously hostile to one another. Could this be worse than the cold war?

At the World Economic Forum in Davos this January, Chinese vice premier, Li Keqiang, gave an entirely unremarkable speech. Steering clear of subjects that make headlines, he instead sung the praises of China's stability and technological progress. Yet the moment was made extraordinary by Li's entourage: a group of about 75 subordinates who laughed, cheered and applauded on cue—and all with apparently genuine gusto. This scene brought to my mind Deng Xiaoping's famous dictum that his country must "keep a low profile and never take the lead." There was plenty of Chinese exuberance in the room, and the rest of us were meant to notice. Has the need to lie low subsided, I wondered? Does China believe that its time has come?

That was the message many people took from the triumphalist pageantry of Beijing's 2008 Olympics. But the real game-changer was economic. The financial crisis, global recession, and China's remarkable recovery have produced a big shift in the world's most important state-to-state relationship. Chinese officials argue that their country's resilience in the face of America's meltdown has vindicated a Chinese model of development, one that rejects US-style free markets in favour of a "state capitalist" system. A relationship until recently shaped mainly by shared interests must now adapt to accommodate the two sides' increasingly divergent views of capitalism—and a large shift in the balance of confidence.

The list of irritants in US-Chinese relations is growing. Google threatens to quit China over censorship and cyber-attacks. Washington and Beijing are at cross purposes over Iran's nuclear programme. US lawmakers have again criticised China's unwillingness to allow the value of its currency to rise and its failure to protect the intellectual property of foreign companies. There are trade disputes over tyres and steel pipes. Yet these problems are merely symptoms of an illness that has progressed further than some observers realise.

Put bluntly, the Chinese leadership no longer believes that American power is as indispensable as it once was for either China's economic expansion or the Communist party's political survival. Nor does it accept that access to US capital or commercial know-how is quite so important for the next stage of China's development—or that its growth depends on the spending habits of American consumers.

China has embarked on a process of economic "decoupling." The western financial meltdown put millions of Chinese out of work in early 2009, as factories that produced goods for export closed their doors. Over the past 18 months, Beijing has seen how dependence on western markets can produce unacceptably high levels of risk at home. The solution is to shift its model to rely more on China's growing consumer base. This plan, however, must be undertaken with great care to ensure minimum industrial disruption.

Meanwhile, China's political decoupling from the west is also in full swing. We saw it at December's climate change summit in Copenhagen, as China spearheaded resistance from developing states to western-proposed targets on carbon emissions. We saw it in the strong reaction to an announcement in February of US arms sales to Taiwan and to Barack Obama's meeting with the Dalai Lama days later. We will see more public Chinese pushback against what Beijing considers "interference" from Washington in months to come.

There is still considerable mutual dependence between the US and China, grounded mainly in commercial ties. But the unfolding conflict is in many ways more dangerous than the cold war. Economic decision-making in Moscow had little impact on western power or standards of living. But globalisation means there is no equivalent to the Berlin wall, insulating China and America from turmoil inside the other.

The rivalry may take on a life of its own, growing beyond the governments' ability to contain it. American policymakers must ensure that US power remains indispensable to China's rise. This will not be a popular undertaking in Washington. Facing voters this November, US politicians will want to shift the blame for the country's woes onto someone else. Cultural conservatives of the right and labour champions of the left will tell voters that their problems are made in China. Even more sober figures are beginning to raise the alarm, as when economist Paul Krugman warned in March 2010 that China's economic policy "seriously damages the rest of the world."

Soon, more Americans will be asking why a country with 10 per cent unemployment can't persuade a country with 10 per cent growth to respect trade rules and play a responsible role on the global stage. And Beijing's new assertiveness is feeding a growing insecurity in the US. In a survey conducted by the Pew Research Centre in 2009, 44 per cent of Americans named China as "the world's leading economic power." Just 27 per cent chose the US. Reasonable or not, this is a sea change in attitudes—2008 was the last presidential election in which average voters didn't know or care where the candidates stood on China.

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How did we get here? For the past 30 years, China's rise and America's power have been complementary. In the late 1970s, the Chinese leadership began to tinker with capitalism and to cautiously open the country to foreign trade and investment. Less hawkish officials in Washington and Beijing hoped that a relationship could be built, but fallout from the Tiananmen Square massacre in 1989 put their plans on hold. As the Warsaw pact governments fell later that year and the Soviet empire followed in 1991, China's hardliners applied the brakes on capitalist experimentation. But in 1992, 88-year-old Deng Xiaoping breathed new life into market reform. Deng's successor, Jiang Zemin, beat back old guard resistance to liberalisation, and stepped up the pace of reform in the early 1990s.

The collapse of European communism taught China's leadership that to hold onto power, it must succeed where other socialist states had failed by offering people a rising standard of living. Building China's economy meant establishing the country as an export powerhouse, a plan that required access to consumers in the US, EU and Japan—still China's three largest trading partners. That meant opening the economy to ever-higher levels of foreign trade and investment—effectively"coupling" China's growth to the west's.

US companies were happy to oblige. Wal-Mart became the world's largest retailer because its founder, Sam Walton, recognised the possibilities of low-cost Chinese labour. In the years since, a growing number of American companies have begun banking on huge profits based on sales to China's potentially enormous middle class. In turn, Chinese companies looking to move up the value chain have benefited from exposure to the management, advanced technologies and marketing techniques of US, European and Japanese companies.

Beijing's relationship with the US reached a crucial moment in January 1993, when Bill Clinton entered the White House. As a candidate Clinton had denounced China's leaders as "butchers," and promised to end the "most favoured nation" trade status that China had enjoyed since 1980. As president, Clinton proved more circumspect, pursuing a policy of "constructive engagement." US consumers benefited as cheap Chinese products helped to keep inflation in check during the 1990s. Before leaving office, Clinton signed into law "permanent normal trade relations" between the two countries. The relationship had become too big to fail.

At the time, Beijing had good reason to value American power and Washington's willingness to use it. Developing trade and investment relationships with potentially volatile emerging states in Africa, the middle east, southeast Asia and Latin America exposed China to risks it had little experience in managing. America's willingness to play the global policeman helped open and maintain trade routes and sea lanes for Chinese companies. Expanded access to US consumers helped China's economy create millions of jobs. Washington proved willing (for the most part) to respect Chinese sensitivities on Taiwan, Tibet and Tiananmen Square.

In 2001, China joined the World Trade Organisation: a landmark moment in its embrace of the global status quo. In the years since, the creative destruction that comes with decades of double-digit growth has created big problems inside China: the disparities of wealth between coastal cities and the rest of the country, serious environmental damage and social unrest. To ensure a more "harmonious" rise, a new generation of leaders led by President Hu Jintao and Premier Wen Jiabao has taken a direct hand in managing expansion. The government already relied heavily on state-owned companies to secure access to resources. It now began to use privately owned companies to dominate certain sectors: Yingli and Suntech have taken over the solar-power industry; BYD dominates batteries and cars. Beijing relies on both public and private sectors to manage the pace of growth and the distribution of its benefits. And sovereign wealth funds, created from the country's enormous reserves of foreign currency—the People's Bank of China valued the country's holdings at $2.399 trillion (£1.580 trillion) in December 2009—are used to direct huge flows of investment.

In sum, the Communist party is using markets to create wealth that can be directed as officials see fit. The ultimate motive is not economic but political: to maximise the state's control of development and the leadership's chance of survival. It is a model that has so far been strikingly successful—to the extent that China no longer needs to keep a low profile and let the US take the lead. But it is not a system that offers a level-playing field to foreign companies and investors.

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The signs of decoupling are all around us. In January, Google claimed that its proprietary source code and the Gmail accounts of human rights activists had been targeted in a sophisticated cyber-attack from inside China. In response, the company threatened to quit the Chinese market. It remains unclear whether the Chinese government played a direct role in the attacks, condones them, or is simply unable to stop them. The government promotes "indigenous innovation," a vaguely articulated plan to encourage homegrown intellectual property and the companies that develop it. Some of that innovation has been stolen. Google's charges placed the issue of Chinese cyber-espionage in the headlines, but the problem has been building for years. Following the Gulf war in 1991, the Chinese government saw the need to invest in the information warfare capabilities of the People's Liberation Army. At first, cyber-espionage was mainly confined to the military realm, but in the past three years it seems to have expanded into the corporate world.

Beyond the espionage problem, China's ambitions have provoked a sharp response from high-tech companies in the US and Europe. They charge that China's policy of favouring products made with domestically created intellectual property proves that Beijing is no longer even pretending to observe international intellectual property rules. That's why the Google story is not really about censorship or state persecution of dissidents. It is mainly about Baidu, Google's main Chinese rival. Baidu already holds the dominant market share within China, and if Google leaves or is forced out, Baidu will benefit the most. Companies such as Baidu have growing influence within China's state bureaucracy and have also become symbols of pride for the government and public.

In January, the US government announced a plan to sell $6.4bn in weaponry to Taiwan. This kind of deal was sure to provoke an angry response from the mainland, and it did. But this time Beijing added an extraordinary threat: the imposition of sanctions on US aircraft manufacturer Boeing, which dominates China's airline market, worth $400bn over the next 20 years. Were Boeing to lose this business, some of it would surely fall to European aircraft-maker Airbus. But over time, more of it would move to emerging Chinese companies.

The predicaments of Boeing and Google illustrate how the US and Chinese brands of capitalism are pushing Washington and Beijing towards conflict. For the moment, the governments' incentives for co-operation outweigh any advantage that either can find in direct confrontation. But the forces that divide them are too large for either side to fully control.

There is also trouble looming over the dollar. As China moves to shift from exports to greater domestic consumption, the need to purchase dollars will lessen and much of the extra cash will flow into the purchase of commodities. America will then have to look elsewhere to make up the difference in financing its debt. This larger shift in the balance of power in the relationship will also empower Chinese hawks to call for greater resistance to US pressure on places like Iran, Burma and Sudan. Chinese state-owned companies have established lucrative commercial relationships with these governments—ties that serve China's interests. In exchange, China provides these governments with the resources and political cover they need to reject US and European demands for policy change.

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Back at Davos, tensions were evident during an exchange between Zhu Min, the deputy governor of the People's Bank of China, and the Democratic congressman Barney Frank of Massachusetts. Zhu was questioned on China's currency. "It is very important to have a stable yuan… It is good for China and good for the world," Zhu said. "Could it be stable but a little higher?" Frank asked. The audience laughed. Zhu smiled, unperturbed. No need to explain your strategy when you're holding a winning hand. Nonetheless, the same dispute broke into the open again in March 2010, when Premier Wen Jiabao slapped down calls by another group of American lawmakers for China to allow its currency to appreciate.

Last autumn, Washington moved against Chinese exports of tyres and steel pipes to protect American companies and jobs in these industries. But the next conflict will extend well beyond trade. In December, Senate Majority Leader Harry Reid sent an open letter to President Hu Jintao in which he accused China of, among other things, pursuing "a policy to undermine American competitiveness… while simultaneously benefiting from open access to the US market" and "rampant intellectual property theft." There is an abundance of bootleg Windows software in China, for example, something Microsoft has been unable to control; it's estimated that up to 80 per cent of all software sold in the country is pirated. When congress debates energy policy later this year, Republicans will demand to know why the US should accept binding commitments on carbon emissions that undermine its competitiveness while China refuses to follow suit. In turn, China's fast-growing blogosphere will ask why free market champions in the US are threatening them with protectionism.

China will not mount a military challenge to the US any time soon. Its economy and living standards have grown so quickly over the past two decades that it's hard to imagine the kind of catastrophic event that could push its leadership to risk it all. Beijing knows that no US government will support Taiwanese independence, and China need not invade an island that it has largely co-opted already by offering Taiwan's business elite privileged investment opportunities.

That said, China's determination to defend its territorial integrity, its ambitions to extend its influence in Asia, and its plan to form new commercial partnerships in far-flung places have given momentum to military plans. With 2.3m soldiers under arms, the People's Liberation Army is already the world's largest. Its investments in cyberwarfare technology continue to cause anxiety in Washington. Its military budget is thought to have tripled between 2003 and 2009 to about $70bn. This is only 13 per cent of what the US spends each year, but significant enough to pose future challenges.

Any cold war-type conflict is much more likely to develop over issues of economic security than military confrontation. Charges of Chinese corporate espionage will complicate the efforts of Chinese companies to invest in the US. China will respond with investment restrictions of its own. And western companies will find themselves competing for natural resources across the developing world with Chinese state-owned companies, armed with subsidies and political backing. This is already happening openly in places like Nigeria and Ghana, and there is more subtle competition taking place from Angola to Venezuela to Iraq. China and other authoritarian governments that embrace state capitalism will increasingly direct trade flows toward one another, lowering the trajectory of economic growth in the west. Finally, though China's military will not offer the US a global challenge, it can certainly take on American forces in Asia.

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So how should America respond? The country's cold war experience offers a useful strategy. The stalemate imposed by "mutually assured destruction" that prevented the US-Soviet conflict from igniting created a sense of stability. Today, the US and China are locked in a new form of "mutually assured economic destruction," a dependence that can force some degree of co-operation even as political, economic and security disputes simmer. America still needs China to help finance its debt. For the moment, China needs access to US consumers to keep unemployment in check and for continuing foreign investment. Even if the Chinese economy becomes more driven by domestic demand, consumers will still want access to foreign-made products. The two sides will be doing business for decades to come.

US officials should do their best to ensure that this "mutually assured economic destruction" continues. But in Washington's poisonous political climate, populist opportunists will cast engagement as appeasement. With criticism of China from both left and right, those who see the wisdom of deepening mutual dependence will need courage—particularly when China's leaders criticise US policy to appease hardliners within the leadership, and a restive population.

American (and other foreign) companies doing business in China can take lessons from how multinational oil companies have adapted to a world in which state-owned energy companies control at least 80 per cent of the global oil reserves—by shifting their business models to exploit their remaining comparative advantages. To compete with state-owned energy operations, multinationals now invest in the project management and advanced technology that their rivals can't yet match. Foreign companies in China should similarly invest more heavily in products with a blazing-fast product cycle, like advanced electronics and videogaming. By the time their Chinese rivals have broken the code on this intellectual property, they will already have a newer model. And given the greying of China's population, foreign investment will remain welcome in healthcare innovations. There are many such examples.

It is also important for the US government and American companies to invest in those areas where their comparative advantage is most likely to endure. For Washington, that means maintaining US “hard power” advantages. Soft power helped America survive the cold war, and continues to play a crucial role in extending US influence. But over the next several years, hard power will ensure that the US remains indispensable for global political and economic stability. The US now spends more on its military capacity than all potential competitors combined. It outspends China by about eight to one. Even if defence spending were significantly reduced, the US will hold a dominant military position for the foreseeable future, because it will be decades before any rival will prove both willing and able to accept the burdens that come with global leadership. China will continue to expand its influence, particularly within Asia. But it makes little sense for a still developing nation to challenge US hard power outside its immediate neighbourhood—particularly when China’s state-owned oil companies will rely for several decades on oil and gas supplies from unstable parts of the world such as the middle east, the Caspian sea basin and west Africa. In addition, the presence of US troops in Japan and South Korea limits the risk of an Asian arms race. That saves China, Japan, South Korea and India a great deal of money.

Finally, America will have to get by with a little help from its friends. US relations with Japan have been tested over the past year as the Obama administration and the new Democratic party of Japan-led government re-establish the common interests that bind the two countries. The Clinton and George W Bush administrations built closer ties with India; that work should be broadened and deepened. The US should co-ordinate more closely with the EU—and its most influential member states—on ways to create a unified front in trade disputes with Beijing.

Post-cold war US hegemony didn’t last long. But there is no coherent alliance of rising powers to contain the American colossus. Instead, the speed with which ideas, information, people, money, goods and services now cross borders has enabled a host of nations to make a mark on the international stage—just at a moment when the US is overstretched militarily, and its responses to international terrorism have exacerbated global anti-Americanism. And no single relationship will play a larger role in shaping Washington’s response to the messy new order that is now emerging than its increasingly troubled relations with Beijing.