CHAPTER

# 1

# The World has Changed



In the spring of 1999 I was teaching 54 Chinese graduate students at the Peking University business school in Beijing. Against the background of the NATO bombing of Serbia, on Friday May 7 a NATO aircraft bombed and destroyed the Chinese consulate in Belgrade, killing three Chinese nationals. The Chinese suspected the bombing was deliberate, and immediately complained strongly to the United States. My next class fell in the morning of the following day. Only a handful of students showed up. The rest were demonstrating outside the United States Embassy in Beijing. They stayed there for nearly a week, hurling stones through the Embassy windows, while the Ambassador James Sasser sat inside.

It now seems highly likely that the NATO bombing of the Chinese consulate was deliberate, and it appears that NATO felt itself not only justified but safe in taking a highly aggressive action against Chinese interests, extending even to loss of Chinese life. In October 1999 a report in a British newspaper[1] confirmed that NATO had deliberately bombed the Chinese consulate in Belgrade, after discovering that the building was being used to rebroadcast Serbian army communications. According to senior military and intelligence sources in Europe and the United States, the Chinese embassy was removed from a list of prohibited targets after NATO electronic intelligence detected the emanation from the embassy of military messages to Milosevic's forces. The story at the time, that NATO had confused the coordinates of the consulate's locations, appears to have been a fabrication.

At the end of May 1999, an article written by Stephen Yates, an analyst at the conservative US think-tank The Heritage Foundation, illustrated how conservative American sentiment stood towards China at the time. It commented:

> *Although the bombing [of the Chinese consulate] was a tragedy, the United States should not overreact to China's stage-managed protests. These protests call into question the overly optimistic objective of establishing a ''constructive strategic partnership'' with China. The US relationship with China needs to be placed on firmer ground with more realistic expectations and a greater appreciation of US long-range interests in Asia.*[2]

Two years later, in April 2001, a US surveillance plane monitoring China's coastline collided with one of two Chinese J-8 fighters that had been shadowing it, killing the Chinese pilot and forcing the US aircraft to make an emergency landing on Hainan Island, at the southernmost point of China's mainland.[3] Although the US aircraft was apparently operating just outside Chinese airspace, the incident was only resolved, and the aircraft's 24 crew released, after President George W Bush had written a letter to his opposite number, President Jiang Zemin, apologizing for the incident.

## A Permanent Shift of Power and Influence

China's position in the world has changed dramatically since 2001, and it will go on changing. This book is about a permanent shift of economic power and influence towards Asia, in particular towards China. Nearly eight years after the Hainan incident, in February 2009, Hillary Clinton, recently sworn in as the new US Secretary of State, made her first overseas visit. Not to Canada, or to Europe, but to Asia. This made her the first new Secretary of State since Dean Acheson, nearly 60 years before, to start an inaugural overseas trip in a westerly, rather than easterly or northerly, direction. With Tokyo, Seoul, and Beijing on her itinerary, she left China till last. In deference to the long-standing US alliances with Japan and South Korea, she could not have visited Beijing first.

But there was no doubt that the China leg of her visit was the most important. A contemporary editorial commenting on the trip, which appeared in *The Times* of London, stated:

> *On almost every global issue, China's policies are crucial. A Chinese veto on sanctions against Sudan or Zimbabwe sabotages hopes for tougher United Nations action on Darfur or Robert Mugabe. As the world's third largest economy and largest carbon emitter, China holds the key on climate change. On energy security, nuclear proliferation in Iran and North Korea or the junta in Burma, no co-ordinated action is possible without China.*[4]

Hillary Clinton's public address in Beijing reflected these realities. "The opportunities for us to work together are unmatched anywhere in the world," she said in her speech.[5] At their first meeting on the edge of the G20 London summit in April 2009, Presidents Hu Jintao and Barack Obama followed up Hillary Clinton's visit with an agreement for the US and China to hold a strategic and economic dialogue, to be led by the President's most senior lieutenants—Secretary of State Hillary Clinton and Treasury Secretary Tim Geithner. The dialogue would be based on the bilateral discussions covering economic and trade matters which had been set up by George W Bush in 2006. However, in President Obama's words, the US–China dialogue would be broadened out to "help set the stage for how the world deals with a whole host of challenges,"[6] signaling a significant upgrading and extending of the US relationship with China. President Hu's comment on the initiative was equally positive, but carried a subtly different message:

*Good relations with the United States are not only in the interest of the two peoples, but also beneficial to the peace, stability and prosperity of the Asia–Pacific region, and the world at large.*[7]

Even at this early stage in the new American President's term, Hu wanted to highlight China's relationship with the United States as a key link between the rich world and poorer, developing countries—a link which only China, itself a developing country, could make, and an important source of China's future global influence.

The tectonic plates which underlie the global architecture of power and influence started shifting some time ago. The premise of this book is that the global financial crisis was a major tremor which accelerated this global shift in power and influence, away from the developed world led by the US, towards Asia and the developing world. This book's purpose is to show how China's emergence contributed to the crisis, and as far as it is possible to tell at this early stage, what some of the major consequences of the shift could be for key aspects of international relations, and for the Chinese themselves. When we hear the President of Brazil, Luiz Inacio Lula da Silva, blaming the financial crisis on "white people with blue eyes," we know that already we are traveling through landscape that we in developed Western countries may not recognize.[8] The need to take stock of where we are going has become pressing. Soon the landscape passing outside our window will become strange and unfamiliar. This book is intended to help us give some thought to where we are headed.

## The China Effect

Part of the story of China and the credit crisis concerns China's involvement with the economic conditions underlying the crisis. The crisis occurred because of too much debt, which appeared cheap because of very low inflation and interest rates. China's emergence gave a strong supply shock to the world economy, which helped create the conditions for excessive debt. Securitization became a deadly weapon in assisting banks to leverage their balance sheets, but it did not cause the crisis. I argue that if the changes brought to the global economy by China's emergence had been better appreciated at the time they were happening, then, armed with this understanding, Western financial policymakers would probably have seen things differently. Better policy decisions might have been taken, with results that could have avoided the crisis altogether, or at least greatly modified its effects. In particular, if Western central banks and politicians had better appreciated the size and strength of the supply shock given by China to the global economic system, they would not have taken fright at the stable prices which occurred in the early part of the millennium. Instead of accommodating these stable prices by reducing interest rates and adding liquidity to an economic system already overloaded with it, they might have felt able to adopt a wiser policy of keeping savings rates at higher and more attractive levels, thereby encouraging investor prudence, reducing upward pressure on asset prices, and forestalling the "search for yield" which became such a strong feature of the run-up to the financial crash of 2008. The financial crisis was not inevitable. It was man-made. But people in high places allowed it to happen, because they were slow to appreciate the nature and extent of the fundamental changes brought by China to the way the world economy works.

Another part of the story of China and the credit crisis concerns the effect of the crisis on China's economy. The crisis brought a collapse in demand in the two principal markets for China's exports—the United States and Europe. In turn, this forced China's leaders to realize that the Chinese economy must be rebalanced, and China's potentially huge domestic demand must be released. The size, unsophistication, and immaturity of China's economy mean that a major change in the shape of the economy could take longer, perhaps much longer, than China's trade partners would like. Although the economic stimulus unleashed in China in November 2008 does assure the relatively rapid recovery of the Chinese economy from the global economic slowdown, the rebalancing of the global economy is not going to be easy to achieve and may produce unanticipated and dangerous side effects. How this economic rebalancing occurs, and how long it takes, is a key factor determining the success of China's continued growth and development after the credit crisis, and also has a vitally important bearing on the prospects for global growth in the next five to 10 years. As James Kynge comments in his Foreword, there are already encouraging signs of robust household and business demand within China which does not depend on exports. The strength and composition of Chinese import growth over the next year or two is one vital indicator of the emergence of strong, autonomous Chinese private demand.

As well as forcing key changes in China's economy, the crisis is affecting its regional profile in Asia and its world posture. China has suddenly appeared in the limelight, from behind the shadow of the United States, as a major force in world affairs. I turn from the impact of the crisis on China's economy to examining the changes brought by the crisis in some of the most important global institutions, in which a newly assertive China is becoming highly active. The Chinese are making their presence felt in the debate over important global institutions, the role of the dollar, and other central matters. Before the crisis, these were matters reserved for discussion and decision among the United States superpower and its G8 allies—chiefly Germany and Japan. The emergence of China as a global player will profoundly affect the configuration of power and influence in the world, and the role of developing countries. I analyze China's impact on the major multilateral institutions, discuss the much-debated role of the dollar as the world currency, and examine China's changing position with respect to three key geographical constituencies—the United States, Asia, and the emerging world.

## Chinese Leadership

Until the crisis, China tried to avoid suggestions that its size and fast growth were bringing the role and responsibilities of global leadership. But the crisis has forced China to recognize that it cannot avoid a leadership role any longer. Can China rise to the challenge of global leadership? Can a police state ruled by a communist dictatorship command the admiration of nations still under the influence of the American, French, and English Revolutions? China may be prepared to learn from its major global partners to improve mutual understanding and communication. But another critical success factor for China's continued development is the evolution of China's governing system towards generally accepted norms of justice, equity, and the rule of law, away from the arbitrary, unaccountable exercise of power. Yet, although multi-party democracy is one road to a modern civilized society, it may not be the only one. The West should not assume that China is doomed simply because its system is different.

I argue that the crisis has changed China's view of the West, undermining the perception of Western superiority which had gained ground in China since the 1990s, and replacing it with China's own history and philosophy as an inspiration for China's search for meaning and identity. Moreover, the lessons and ideas of China's past as an influence for the future will be shared more widely. China's size, the significance of Chinese civilization, and the competence of its people have always seemed to indicate that the increase of Chinese influence on the West would be not a question of if, but of when and how. The effect of the crisis and China's much-increased global influence will be to turn the recent one-way traffic of Western ideas to China into a two-way exchange and sharing of economic and philosophical approaches.

## China Goes Global

A few months after the Belgrade consulate bombing, in November 1999, China announced it had reached agreement with the United States over the terms of China's accession to the World Trade Organization (WTO). Although it took a couple more years to dot all the i's and cross all the t's, that moment, in November 1999, was when China crossed the Rubicon to join the rest of the world. Suddenly China promised to become an easier, less risky place for foreign companies to do business in.

Through the 1990s, many large multinationals—such as Kingfisher, Metro, Rewe, Tesco, and Carrefour from Europe, and Walmart from America—had opened offices in Hong Kong to buy from Chinese factories. From late 1999, China inside the WTO looked set to become the West's Aladdin's cave, providing first a stream, then a torrent of everyday products to Western consumers at prices which fattened multinational margins and drove down shop-floor prices. The story of Aladdin and his magic lamp was borrowed in mid-1999 by Jack Ma for his China export company Alibaba based in Hangzhou, near Shanghai. Alibaba started using the Internet to facilitate the sourcing by Western importers of Chinese factory products, aiming its services at Western importers who were too small to establish their own buying operations in China, and at Chinese factories based all over China who lacked direct access to Western buyers. Jack Ma caught the start of a huge wave of Chinese products that hit Western markets in the early years of the millennium. In 2007 Alibaba listed on the Hong Kong stock market; in 2008 it reported net profits of RMB 1.2 billion (US$177 million), and in April 2009 it was valued at nearly US$5 billion.[9] Alibaba's startling success mirrors China's own meteoric trade growth from the late 1990s, when it agreed to terms with American negotiators for joining the WTO. That moment shifted China's impact on the rest of the world into high gear, and that was when the world economic system started to change.

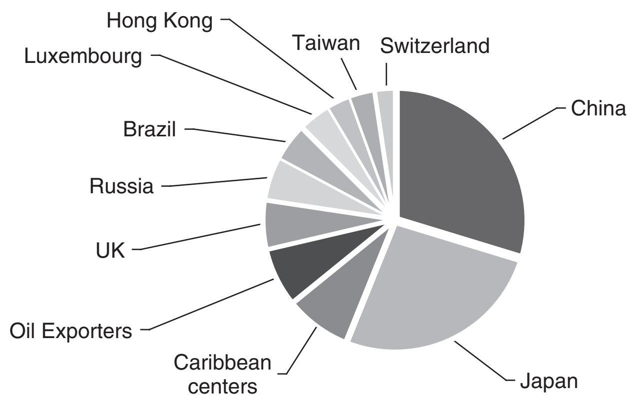
Jack Ma and Alibaba anticipated what would happen, but people in the West, who lacked a knowledge of China's size and dynamism, did not foresee the size of the shock given to the Western economic system by China. For most, the consciousness of China's economic significance has only grown gradually over the last 10 years. It is the credit crisis that has made most of us realize that the balance of global economic power really has started to shift from the developed, Western world, led by the US, towards the newly industrializing countries, led by China. But our memories are short. We forget how very different the world was only a decade ago, and we may overlook the extent to which rapid changes in world economic power can also quickly change who influences world affairs.

## Economic Upheaval

China's accession to the WTO started a huge upheaval in the world economy. We will see how this economic upheaval occurred, and why it played an important role in the self-administered financial collapse of the United States. It took a series of policy mistakes, mainly in the United States, to unleash the greed and irresponsibility which precipitated the financial disaster. These policy mistakes were based on a misinterpretation of economic and market signals by key decision-makers, of which the errors of judgment made by the Federal Reserve Bank in Washington, the most powerful decision-maker of all, were the most destructive. But if the changes wrought in Western economies by globalization, in particular by China's supply shock, had been understood at the time, then it would have been possible to set policies in place which averted disaster and preserved the large gains of globalization without having to suffer the huge downside. The financial crash, and the pain and suffering it has caused, could probably have been avoided. The post-crash writings of former Federal Reserve Chairman Alan Greenspan, aimed at finding reasons for the financial crash (reasons preferably unconnected to his own 18-year tenure as head of the US central bank), indicate the low level of significance he continues to attach to these international developments, which actually provided the economic foundation for the crisis. Like a huge dinosaur at the top of the food chain, the years of US global dominance and economic success had dulled its sensitivity to being ambushed by events. Its capacity for sensing hostile developments larger than itself, over which it had no control, atrophied for want of use, so that when a monster threat came along, it grossly underestimated its size and miscalculated its own ability to avert or manage it.

The speed of the financial and economic collapse of the advanced Western nations created an economic and political power vacuum affecting all of the world's key institutions and mechanisms, into which new power from emerging countries, led by China, has begun to flow. For years, countries such as China, India, and Brazil, rich in history and culture, with huge resources and populations, argued for a bigger say in how the world is run. But they lacked the financial clout to persuade the developed countries, led by the United States, to listen to their requests for a fairer representation in global decision-making institutions, such as the International Monetary Fund (IMF) and the G8. Now, thanks to the credit crisis, China's sudden emergence as a great

**Figure 1.1** Major Foreign Holders of US Dollar Debt (April 2009)




Source: US Treasury

financial power has changed that. Within a few short years, China has become easily the largest external creditor of a United States with huge future financing requirements (see Figure 1.1). Anyone who has been a middle-class teenager knows that if you want money and you don't have any, then you have to do a deal with your parents. If your parents are sensible and far-sighted, they won't make you, the child, feel resentful for taking their money. If they're not so smart, the relationship between parent and child can sour rapidly and permanently. China has to be careful how it treats the United States which needs lots of cash. But the United States, previously in denial about overspending and real estate prices, is now in denial about the extent of its reliance on the foreign funding that must inevitably follow from its overspending, a large part of which must come from outsiders—Russia, Brazil, the Gulf states, Japan, and in particular China, who since 2006 has been the largest buyer of US debt apart from the US Government itself. A US Treasury spokesman recently estimated that the United States Government was looking for China to buy 30 percent of America's multitrillion-dollar debt issues over the next few years. In 2008, one of America's most perceptive and experienced journalists, James Fallows, interviewed the US-educated chief executive of China's sovereign wealth fund China Investment Corporation, Gao Xiqing. ''Be nice to the countries that lend you money,'' was what Mr. Gao said during the interview, and this became the title of the interview that was published in December 2008 in the American current affairs journal *Atlantic Monthly*.[10]

Some Americans have responded to Mr. Gao's request, that they be nice to him and his Chinese banker colleagues, by arguing that China has nowhere to invest with its dollars except in the United States, and the United States is doing China a favor by absorbing China's huge investing needs. This argument misses an important point. Beyond the immediate short term, China can find sensible alternatives to investing new money in the United States. One such alternative is for China to stop generating such large foreign exchange surpluses, as its currency and its imports gradually rise, thereby reducing the quantity of freely investable reserves. Another alternative is to start allocating more of its reserves to domestic projects, as many of the Chinese Government's domestic critics have urged it to do. One such project, which requires very large financial commitments, but would have a very high rate of return to the Chinese economy and Chinese society, would be the funding of a comprehensive Chinese social security system. This large-scale project requires an upfront Chinese currency investment in domestic Chinese securities of several hundred billion in US dollar equivalent terms—enough to put a big dent in China's ability to buy American debt. In fact, a Chinese think-tank closely associated with the government published in January 2009 its estimate of the scope and funding of projects aimed at providing China with a modern system of social security benefits. Their estimate of the budget at the time of writing was 5.74 trillion yuan, or US$840 billion at current exchange rates by 2020.[11] Other large projects relate to China's defense spending, including the recently announced decision to build a blue-water navy which includes aircraft carriers.

The realistic future is that China might not stop investing in the United States altogether, but Chinese funds available for US dollar investment will likely diminish, as China, feeling it is already over-invested in American assets, reweights its geographical investment allocations and finds many productive uses at home and elsewhere for its wealth. The following report, which appeared on Bloomberg Television on June 13, 2009, may be a sign of things to come:

*Russia has full confidence in the dollar and there are no immediate plans to switch to a new reserve currency, Finance Minister Alexei Kudrin said. ''It's too early to speak of an alternative'' to the dollar, Kudrin said in Lecce, Italy, in a television interview today after meeting with finance chiefs from the Group of Eight nations. The fundamentals of the dollar are still in ''good shape.''*

*Russia's central bank said on June 10 some reserves may be moved from US Treasuries into International Monetary Fund debt, reiterating comments made last month by Kudrin. That drove Treasuries and the dollar lower. Kudrin said yesterday that Russia's announcement on May 26 to buy US$10 billion of IMF bonds did not represent ''a significant change'' in his country's stance on the dollar. The dollar declined against a majority of the most-traded currencies as Brazil and Russia joined China in saying they would shift some US$70 billion of reserves from US Treasuries into multicurrency bonds.*[12]

If some foreign investors cash in their dollar investments, more of American funding needs over the next five years—which will amount to several trillion US dollars, on top of the roughly US$11 trillion of debt already outstanding—will have to be found from its own insurance companies and mutual funds. Funding America's debt may require returns on American assets to rise significantly, as much to maintain the everyday confidence of world markets in the international value of the dollar as to attract the necessary additional funding from other major surplus countries, led by Japan, the Gulf states, and China. Given growing investor fears that the only way out for America will be currency debasement and inflation, these higher returns would have to be after inflation, or real returns. If American real interest rates rise significantly, the cost of servicing, say, US$15 trillion of American debt could increase within five years to as much as 10 percent of American GDP, taking up one-quarter of the combined Federal and State spending budget and making an even bigger financial hole for America to climb out of.

The point made by the CEO of the China Investment Corporation is that Americans have to become realistic, and face up to where they are. China's recent proposal of a new world currency to replace the dollar is an expression of China's refusal to go on buying dollars to finance excessive American spending. The United States can't conduct its relationship with China from a position of dominance any longer. Neither can it choose to walk away. It has to stay committed and listen to what China, and other emerging countries, are saying. Because China holds the whip hand over American financing, and is shaping up to be the leader of both the developing world and Asia, Chinese influence over all aspects of world affairs will go on increasing. China is already showing the strength and self-confidence to use its position to set new agendas and rally a broad international consensus behind them. That is one reason why this book's title is *China and the Credit Crisis*.

The last time America thought that its dominance might be challenged was by Japan in the early 1980s, when the Japanese economy was booming and America was just starting to recover from the deep recession caused by the second oil shock of 1979. But Japan's stock market and economy collapsed, and the Japanese economy turned out to be a house of cards. Is the same true of China's?

I examine the impact of the financial crisis and the global downturn on the Chinese economy, and conclude that, as a result of the difficult, painful, and fundamental reforms carried out (starting a decade ago in the Chinese banking sector), of the huge size of China's pool of savings, and of the limited exchangeability of the Chinese currency and the restrictions on flows of capital into and out of China, the Chinese economy can withstand the external economic shock caused by a collapse in demand for its exports. In fact, thanks to the massive economic stimulus organized by the Chinese Government late in 2008, financed from China's huge savings, China will be the first large economy in the world to emerge from the economic slowdown of 2008. But I argue that China's high savings rate will be slow to change, due in part to China's demographics, as well as to the inertia of custom. A widely anticipated and desired big shift towards private spending as a driver of China's growth may not happen as quickly as developed countries hope.

In 1944 the 44 countries allied in the World War against Germany and Japan, led by the United States, Britain, and the Soviet Union, met at Bretton Woods in scenic New Hampshire, America, to work out a new governance architecture which could support the massive task of reconstruction and development that faced the world at the end of the war. The participants in the Bretton Woods conference established several multilateral bodies to govern affairs between countries. Possibly the most important of these bodies was the IMF, set up as the central global body to oversee and maintain the world's financial architecture. From the beginning, the United States had by far the largest stake in the IMF which, with an 85 percent voting majority required to pass a new resolution, and with support from its close allies Britain, Canada, and other European countries, became a blocking stake which today stands at just under 17 percent.

As the fall of the Soviet Union and the US's own economic success propelled the latter into a position of even greater dominance, it became increasingly intolerant of the limits placed upon its discretionary power by the multilateral organizations founded in the surge of altruism and hope which marked the end of the war. These organizations gradually started to fall into neglect, with resolutions ignored and funding unmet. But as the United States now weakens, a place is being found once again for the multilateral organizations as organs of global government and guardians of the developing world. Chapter 4 examines the wind of change which the crisis is blowing through the United Nations (UN), the IMF, and the World Bank. There could be no better sign of the shock effect of the financial crisis on world affairs than the IMF Reform Committee's report of March 2009, which concluded that thorough reorganization of the IMF was called for. It was only in April 2008 that this organization, noted for its staid caution and conservatism, had agreed, after years of foot-dragging, to a minor change in voting rights which modestly favored China, Korea, Mexico, and Turkey at the expense of the United States, Britain, and Germany. But when financial disaster struck Wall Street in September 2008, a Reform Committee was immediately established to examine how the IMF should be reorganized. The Reform Committee's report noted that:

*. . . the world needs a multilateral institution at the centre of the world economy to help anchor global financial stability. The International Monetary Fund needs to increase its legitimacy and effectiveness in addressing today's global challenges. Few of the requirements outlined are being met.*[13]

The crisis may be revitalizing global governance. The IMF may become a forum where the developed and developing worlds can meet to debate the shape of the world's new economic landscape. Six of the nine members of the 2009 IMF Committee which recommended a big change and enhancement of its role were from the developing world: the finance ministers of South Africa, Indonesia, Mexico, and China; a former IMF deputy director who is an ethnic Egyptian; and an Indian Nobel Prize winner in economics. The Committee's report may eventually fundamentally restructure the IMF, dismissing much of the legacy influence exercised by Europe and the US, and bring it back to its central role, as conceived by the original 1945 blueprint, as a keystone in the global financial architecture. In this role, the IMF could be a powerful guardian of the interests of the developing world led by China and India.

For years, critics of using one country's currency as the dominant means of exchange and as the store of value in an international monetary system have pointed to the inherent impossibility of meeting domestic economic and financial currency needs at the same time as the international requirements for a world currency. Since 1971 a world monetary system based on nothing but the good faith and self-interest of the United States has worked, but at the cost of large disruptions in the global economy. The sudden collapse in demand resulting from America's financial crisis in 2008 has now given rise to huge injections of government credit which have been backed by enormous issues of US dollars to stimulate growth. As the largest foreign holder of American debt, China has expressed its concern that these large money issues could put the dollar firmly on the road to losing its status as a store of value for Chinese savings. Chapter 5 discusses China's proposal to replace the US dollar as the global savings and transacting currency, by replacing it with a global super-currency. Although predictably the proposal has not received much American interest (apart notably from Nobel Prize winning economist Joseph Stiglitz), other countries, including Brazil and Russia, have come out in strong support of such a notion. Does the idea have merit and could Chinese support make it happen? As the United States is not currently in a position to kick difficult ideas into the long grass, the idea of a new global currency probably won't go away. Could this be another area where Americans will be forced to make important compromises?

## China and International Relations

The next part of the book examines the effect of the crisis on China's relationships with three key global constituencies: the United States, Asia, and the rest of the emerging world. Hillary Clinton's China visit in February 2009 has already highlighted the seriousness with which the Obama Administration views China. The US is going to go on bumping into China everywhere, and Americans recognize that. For their part, the Chinese have long been ready to view the US as their natural global partner. Now Americans themselves are coming to terms with the realization that they have to do business with China as equals on the global stage. The US may attempt to make a virtue out of a necessity by developing the China relationship as an exclusive, G2-style team which can decide the important global issues on its own. The Chinese, however, will see their relationship with the US not so much as a world government, but rather as a relationship with their most important global partner which has vital global implications.

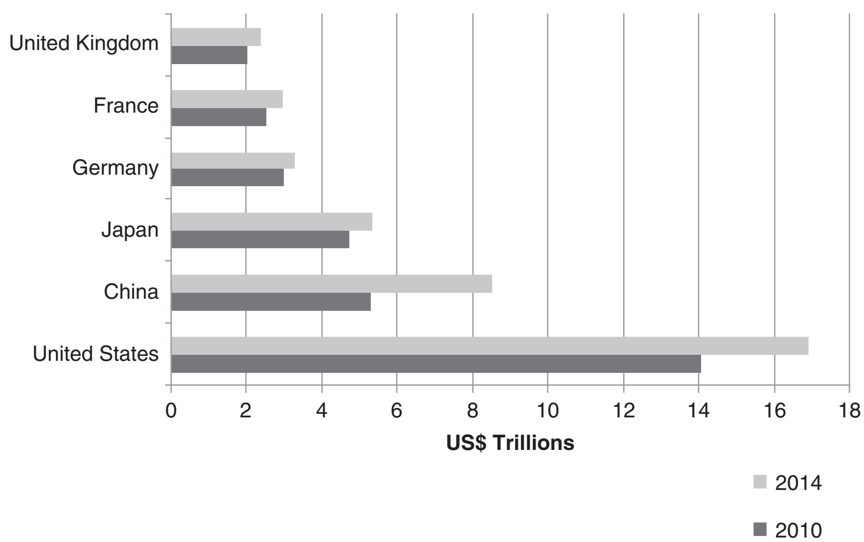
The importance for China's international relations of the link with the US certainly extends to China's position in Asia, which is the subject of Chapter 7. The competition for Asian dominance between India, Japan, and China is heating up. India feels it owes nothing to China in terms of size and antiquity of culture; its economy is beginning to grow as fast, and it has the great advantage over China of being the world's largest English-speaking democracy, ruled by law. Japan, still easily the richest Asian country, and still, the world's second largest economy, has been the US's anchor partner in the Pacific since the end of the Second World War. The Japanese feel they don't have to pretend to be the dominant Pacific power, because they are. By offering in March 2009 to lend US$100 billion to the IMF as a necessary quick boost to the IMF's financial firepower, Japan was quick to show its economic power to China. Both India and Japan look down on undemocratic, sprawling China for deeply felt cultural reasons. Both resent and fear China's grasping efforts to control East Asia. Keeping its relations on track with its two Asian rivals may constitute China's toughest foreign policy challenge. Tensions between India, China, and Japan will likely rise. It is here that the greatest threats to world peace may lie in the next 50 years. China's relationship with the United States will prove of great significance in keeping a balance between the three great Asian powers.

Meanwhile, by undermining the apparent financial solidity of Western countries and by default reinforcing the financial attractions of China, the credit crisis has given wings to the great project of Chinese unification. Hong Kong and Taiwan, China's most important trade and investment partners, have both played a vital role in China's development. Predictions of disaster in Hong Kong following the end of British rule in 1997 have not been borne out by events. Hong Kong has demonstrably prospered under Chinese rule—a fact which China hopes will not be lost on the Taiwanese. In Taiwan, the victory of the mainland-backed Kuomintang party in the Taiwanese elections in 2008 brought an end to threats of Taiwanese independence. Now that Shanghai and other cities on the mainland can provide a standard of living comparable to, or better than, Taipei, it is probably only a question of time before Taiwan formally joins the mainland. In March 2009, the Chinese Government announced that the world's longest sea-bridge would be built, to link the former colonies Macao and Hong Kong with the Chinese mainland, at an estimated cost of RMB 72.6 billion (around US$10.7 billion at exchange rates at the time of writing). This project is another massive step towards the goal of full unification. Its intended message to recalcitrant Taiwanese opponents to unification with China is, ''Why bother—we're too powerful, it's going to happen anyway, and look what the benefits are.'' Who can deny that?

## China's Internal Problems

Although China will soon be the world's second largest economy (see Figure 1.2), it contains more poor people than any country except India. This means that, while it can stand toe-to-toe with America as a large, financially strong, open economy, it is also one of the world's largest developing countries. China has an even closer relationship with the poor, developing world than it does with the rich, developed one. In 2008, China's government went to great lengths and expense in the Beijing Olympic Games to project both to its own people and worldwide an image of a powerful country with an ancient culture, which is returning to its natural position of global leadership. Yet, if you divide China's wealth by its population, the picture of economic

**Figure 1.2** Largest Countries by Size of GDP in 2010, 2014 (est.)

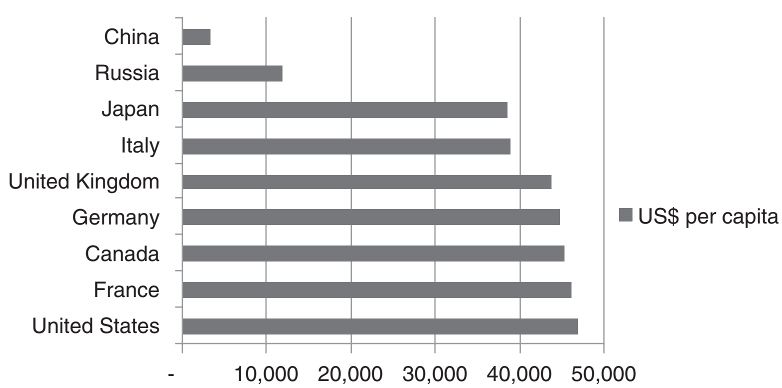



Source: IMF

strength changes quite dramatically. On a wealth-per-head basis, the World Bank in 2008 ranked China as a low middle-income country, along with 54 others, including Albania, Bhutan, Egypt, the Congo, Tunisia, and India.[14] By 2050 China's economy may be nearly twice as large as the US economy. But when adjusted for population, China in 2050 will still rank behind Mexico, Italy, and Brazil, and only just ahead of Turkey, Vietnam, and Iran. China is a huge and powerful country, but its enormous population is mostly very poor.

The sharp contrast between increasing global power and influence on the one hand and domestic vulnerability on the other gives China two distinctly different personalities. One personality is the country with the world's largest foreign reserves which is starting to have a say in everything, and with whom Hillary Clinton wants to be a global partner. The other personality is that of the leader of the third world which contains more poor people than the combined populations of Western Europe and the United States, including between 100 and 200 million who live below the official bread line. Figure 1.3, below, which ranks the G8 countries by national income per head of population, shows China lagging well behind Russia and the other G8 countries, in contrast to Figure 1.2 above, which shows China as the world's second largest economy in absolute terms. This dual personality has large implications for how the country will use its power to develop

**Figure 1.3** G8 plus China—US$ per Capita 2008




Source: IMF

its global position. China sees itself as being in a unique position both to partner with the rich world on the one hand, and continue Mao's mission of leading the poor world on the other. China's need for natural resources and its desire to complete Taiwan's international isolation, rather than charity and a sense of world citizenship, have been the main considerations driving China's relationships with poor countries. China's drive into Africa since 2003 has been fast, ruthless, and highly effective in securing strategic access to the huge range and quantities of natural resources on which China relies for future development. Chapter 8 examines China's partnership with the other poor populous countries in Asia, Latin America, and Africa, and its leadership of the developing world.

## China's Growing Leadership Position

The final chapters of the book examine China's capacity and appetite for the role of global leadership which the crisis has forced on it, and the effect that the crisis has had on Chinese ideas, both about the West as a model for development, and about themselves. The Chinese have regarded the financial crisis as a Western phenomenon, which has hardly scratched their own financial system. Although they were dismayed in 2008 at the real economic damage done to their export industries by the collapse in demand in their main overseas markets, the United States and Europe, they saw an opportunity to advance their global status and economic capacity. But the failure in early June 2009 by one of China's most important natural resource companies Chinalco to complete a US$19.5 billion transaction with huge Western mining company Rio Tinto, which would have given the Chinese a significant stake in Rio Tinto as well as rights in some of Rio's most valuable mines, shows that China's global progress won't all be plain sailing. Can the Chinese persuade the West that their ascendancy is to be welcomed more than it is to be feared and resisted? Can they turn their economic muscle into sustainable leadership?

As the interaction of this huge and ancient country with the rest of the world spreads and deepens, a question arises as to what effect China's unique culture and values will have on other countries, particularly on those outside Asia. Will non-Asian countries come to regard China as more than a very large country with a big pile of money? Will Chinese values of harmony follow Chinese medicine overseas to bring Chinese culture to the benefit of mankind? Or will China be more changed by the world, than the world changed by China? The Jewish people, wherever they end up in the world, have been noted for keeping their blood pure and their customs intact by intermarriage. But it is said that China, who received Jewish influxes very early on into the north-west part of China where the Chinese trade routes with Central Asia and Europe originated, is the only country (with the possible exception of the United States) where the Jews have been completely absorbed culturally by their host country. Chinese civilization developed independently from Europe, and China probably sent many more messages along the ancient trade route to the West, the Silk Route, than it received. The remarkable work of the British biologist turned Sinophile Dr. Joseph Needham at Cambridge University in England, which was spread over half a century between 1940 and his death in the early 1990s, surprised Chinese as much as Westerners by demonstrating that Chinese technology dating from centuries before Christ was far in advance of anything known in the West, and probably inspired many Western technological developments previously thought to be of indigenous origin.[15] China developed a culture thousands of years ago which matched or exceeded that of the Romans in material terms, and challenged that of the Greeks in philosophical terms. The period of foreign incursion into China, from the 1830s until 1945, did not last long enough or go deep enough to destroy China's independent culture. Mao's Cultural Revolution went further in destroying the old Chinese ways of life, but only lasted for 12 years—not enough either to permanently eradicate millennia of Chinese civilization. Chinese attitudes to the West have changed since the crisis. Even though many of today's Chinese may be ignorant of their country's history, the ideas and attitudes of the Chinese today owe everything to their long history. Isolated by its language as much as its long habit of looking inward, China today remains starkly different from other non-Asian countries, creating plenty of opportunities—as global economic and social cooperation becomes ever closer—for misunderstanding and disagreement as well as mutual enlightenment and enrichment.

A person who had said in 1979 or even in 1989 that China would be the world's third largest economy in 2009 and a superpower to rank with the United States in terms of global influence, and that this huge change would be accomplished peacefully, would have invited frank disbelief. Yet the impossible has happened and is happening.

China's emergence created a precondition for the credit crisis. In turn, the credit crisis has acted as a tipping point for the shift from West to East. It will be no easier to predict the next 30 years than it was in 1980 to see what the world would look like in 2010. This book's premise is that this shouldn't stop us trying.

## Endnotes

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