

FOREIGN AFFAIRS

S E P T E M B E R / O C T O B E R 2011



The Inevitable Superpower

Why China's Dominance Is a Sure Thing

Arvind Subramanian

Volume 90 • Number 5

The contents of *Foreign Affairs* are copyrighted. ©2011 Council on Foreign Relations, Inc. All rights reserved. Reproduction and distribution of this material is permitted only with the express written consent of *Foreign Affairs*. Visit www.foreignaffairs.org/permissions for more information.

The Inevitable Superpower

Why China's Dominance Is a Sure Thing

Arvind Subramanian

TO DEBTORS, creditors can be like dictators. Governments in financial trouble often turn to the International Monetary Fund as supplicants, and acting at the behest of its own major creditors, the IMF often imposes tough conditions on them. After the Asian financial crisis of the late 1990s, Mickey Kantor, U.S. trade representative under President Bill Clinton, called the organization “a battering ram,” because it had served to open up Asian markets to U.S. products. During the 1956 Suez crisis, the United States threatened to withhold financing that the United Kingdom desperately needed unless British forces withdrew from the Suez Canal. Harold Macmillan, who, as the British chancellor of the exchequer, presided over the last, humiliating stages of the crisis, would later recall that it was “the last gasp of a declining power.” He added, “perhaps in 200 years the United States would know how we felt.”

Is that time already fast approaching, with China poised to take over from the United States? This is an essential question, and yet it has not yet been taken seriously enough in the United States. There, this central conceit still reigns: the United States' economic preeminence cannot be seriously threatened because it is the United States' to lose,

ARVIND SUBRAMANIAN is a Senior Fellow at the Peterson Institute for International Economics and at the Center for Global Development. This article is adapted from his forthcoming book *Eclipse: Living in the Shadow of China's Economic Dominance* (Peterson Institute for International Economics, 2011). © Peterson Institute for International Economics.

and sooner or later, the United States will rise to the challenge of not losing it. China may be on its way to becoming an economic superpower, and the United States may have to share the global stage with it in the future. But, the argument goes, the threat from China is not so imminent, so great, or so multifaceted that it can push the United States out of the driver's seat.

Thus, the economist Barry Eichengreen concludes in his recent history of different reserve currencies, *Exorbitant Privilege*, "The good news, such as it is, is that the fate of the dollar is in our hands, not those of the Chinese." And in December 2010, as he was leaving the White House as President Barack Obama's national economic adviser, Larry Summers said, "Predictions of America's decline are as old as the republic. But they perform a crucial function in driving the kind of renewal that is required of each generation of Americans. I submit to you that as long as we're worried about the future, the future will be better. We have our challenges. But we also have the most flexible, dynamic, entrepreneurial society the world has ever seen." In other words, if the United States can get its economic house in order, it can head off the Chinese threat.

But such views underestimate the probability that China will be economically dominant in 20 years. And they reveal a one-sided, U.S.-centric perspective: that world dominance will be determined mostly by the actions of the United States, not those of China. In fact, the outcome of this race is far more likely to be shaped by China.

THE WORLD IN 2030

BROADLY SPEAKING, economic dominance is the ability of a state to use economic means to get other countries to do what it wants or to prevent them from forcing it to do what it does not want. Such means include the size of a country's economy, its trade, the health of its external and internal finances, its military prowess, its technological dynamism, and the international status that its currency enjoys. My forthcoming book develops an index of dominance combining just three key factors: a country's GDP, its trade (measured as the sum of its exports and imports of goods), and the extent to which it is a net creditor to the rest of the world. GDP matters because it determines

the overall resources that a country can muster to project power against potential rivals or otherwise have its way. Trade, and especially imports, determines how much leverage a country can get from offering or denying other countries access to its markets. And being a leading financier confers extraordinary influence over other countries that need funds, especially in times of crisis. No other gauge of dominance is as instructive as these three: the others are largely derivative (military strength, for example, depends on the overall health and size of an economy in the long run), marginal (currency dominance), or difficult to measure consistently across countries (fiscal strength).

I computed this index going back to 1870 (focusing on the United Kingdom's and the United States' economic positions then) and projected it to 2030 (focusing on the United States' and China's positions then). The projections are based on fairly conservative assumptions about China's future growth, acknowledging that China faces several major challenges going forward. For starters, its population will begin to age over the coming decade. And its economy is severely distorted in several respects: overly cheap capital has led to excessive investment; the exchange rate has been undervalued, which has led to the overdevelopment of exports; and energy is subsidized, leading to its inefficient use and pollution. Correcting these distortions will impose costly dislocations. To take account of these costs, I project that China's growth will slow down considerably: it will average seven percent a year over the next 20 years, compared with the approximately 11 percent it has registered over the last decade. History suggests that plenty of economies—Germany, Japan, Singapore, South Korea, and Taiwan—grew at the pace I project for China after they reached China's current level of development. Meanwhile, I assume that the U.S. economy will grow at about 2.5 percent per year, as it has over the last 30 years. This is slightly optimistic compared with the Congressional Budget Office's latest long-term growth forecast of 2.2 percent, a forecast that the CBO lowers occasionally because of the negative impact of the country's accumulating public and private debt and sustained high unemployment on the U.S. economy.

The upshot of my analysis is that by 2030, relative U.S. decline will have yielded not a multipolar world but a near-unipolar one dominated by China. China will account for close to 20 percent of global GDP

(measured half in dollars and half in terms of real purchasing power), compared with just under 15 percent for the United States. At that point, China's per capita GDP will be about \$33,000, or about half of U.S. GDP. In other words, China will not be dirt poor, as is commonly believed. Moreover, it will generate 15 percent of world trade—twice as much as will the United States. By 2030, China will be dominant whether one thinks GDP is more important than trade or the other way around; it will be ahead on both counts.

According to this index and these projections, China's ascendancy is imminent. Although the United States' GDP is greater than China's today and the two countries' respective trade levels are close, the United States is a very large and vulnerable debtor—it hogs about 50 percent of the world's net capital flows—whereas China is a substantial net creditor to the world. In 2010, the United States' lead over China was marginal: there was less than one percentage point difference between their respective indices of dominance. In fact, if one weighed these factors slightly differently, giving slightly less weight to the size of the economy relative to trade, China was already ahead of the United States in 2010.

China's ascendancy in the future will also apply to many more issues than is recognized today. The Chinese economy will be larger than the economy of the United States and larger than that of any other country, and so will its trade and supplies of capital. The yuan will be a credible rival to the dollar as the world's premier reserve currency.

What is more, the gap between China and the United States will be far greater than expected. In 2010, the U.S. National Intelligence Council assessed that in 2025, "the U.S. will remain the preeminent power, but that American dominance will be much diminished." This is unduly optimistic. My projections suggest that the gap between China and the United States in 2030 will be similar to that between the United States and its rivals in the mid-1970s, the heyday of U.S. hegemony, and greater than that between the United Kingdom and its rivals during the halcyon days of the British Empire, in 1870. In

China's future economic dominance is more imminent and will be both greater and more varied than is currently supposed.

short, China's future economic dominance is more imminent and will be both greater and more varied than is currently supposed.

STRONG LIKE A BULL

MARTIN WOLF, the *Financial Times* columnist, has used the term “premature superpower” to describe China's unique ability to wield power despite being poor. According to my projections, however, by 2030, China will not be so badly off. Rather, its GDP per capita (in terms of purchasing power parity) will be more than half that of the United States and greater than the average per capita GDP around the world. Still, China's economic dominance will be singular: unlike in the past, when the dominant powers—the United Kingdom and the United States—were very rich relative to their competitors, China will be just a middle- or upper-middle-income country. And can a country be dominant even when it is not among the richest?

There are three plausible reasons for thinking that it cannot. First, a relatively poor country might have to subordinate its hopes of projecting power internationally to its need to address more pressing domestic challenges, such as achieving higher standards of living and greater social stability. Second, it might not be able to reliably raise the resources it needs to project power abroad. Military assets, for one thing, have to be financed, and poorer countries have more difficulty taxing their citizens than do rich countries. Third, a poor country can have only so much influence abroad if it does not have soft power, such as democracy, an open society, or pluralistic values. The leadership that comes with dominance lasts only if it inspires followers: only those who stand for something that commands universal or near-universal appeal are inspiring. Likewise, only a rich country—one on the economic and technological edge—can be a fount of ideas, technology, institutions, and practices for others.

That said, even if dominance is generally inconsistent with poverty, one can be dominant without being among the richest countries. Even a middle-income power, which China is likely to be by 2030, can be internally cohesive, raise resources for external purposes (such as military expenditures), and possess some inspiring national ideals. In fact, despite China's relatively low per capita GDP today, it is already

dominant in several ways. China convinced the African countries in which it invests heavily to close down the Taiwanese embassies they were hosting. With \$3 trillion in foreign reserves, it has offered to buy Greek, Irish, Portuguese, and Spanish debt to forestall or mitigate financial chaos in Europe. (“China is Spain’s best friend,” said Spanish Prime Minister José Luis Rodríguez Zapatero in April on the occasion of the Chinese president’s visit.) China has also used its size to strengthen its trade and financial relationships in Asia and Latin America: for example, trade transactions among several countries in both regions can now be settled in yuan.

Above all, China’s exchange-rate policy has affected economies throughout the world, hurting developing countries as much as the United States: by keeping its currency cheap, China has managed to keep its exports more competitive than those from countries such as Bangladesh, India, Mexico, and Vietnam. Yet these countries have stood on the sidelines, leaving Washington to wage a crusade against Beijing on its own—and for that reason, it has not done so very successfully. China, meanwhile, has been able to buy off the opposition. Although many countries chafe at seeing their competitiveness undermined by an undervalued yuan, they remain silent, either for fear of China’s political muscle or because China offers them financial assistance or trading opportunities. Even within the United States, few groups have really been critical. China is a large market for U.S. companies, and so it is the liberal left, not the holders of U.S. capital, that has condemned China’s exchange-rate policy, on behalf of U.S. workers.

Even if China is unlikely to muster anytime soon the kind of dominance that naturally inspires or might be necessary to build international systems and institutions like those the United States created after World War II, Beijing is already exercising other forms of dominance. For example, it can require that U.S. and European firms share their technology with Chinese firms before granting them access to its market. And it can pursue policies that have systemic effects, despite opposition from much of the world. Its policy of undervaluing its exchange rate is a classic beggar-thy-neighbor strategy that undermines the openness of the world’s trading and financial systems while also creating the conditions for easy liquidity, which

contributed to the recent global economic crisis. Chinese dominance is not looming. In some ways, it is already here.

DROWNING BY NUMBERS

CAN THE United States reverse this trend? Its economic future inspires angst: the country has a fiscal problem, a growth problem, and, perhaps most intractable of all, a middle-class problem. Repeated tax cuts and two wars, the financial and economic crisis of 2008–10, the inexorable growth of long-term entitlements (especially related to health), and the possible buildup of bad assets for which the government might eventually be responsible have created serious doubts about the U.S. public sector's balance sheet. High public and private debt and long-term unemployment will depress long-term growth. And a combination of stagnating middle-class incomes, growing inequality, declining mobility, and, more recently, falling prospects for even the college educated has created big distributional problems. The middle class is feeling beleaguered: it does not want to have to move down the skill ladder, but its upward prospects are increasingly limited by competition from China and India.

The United States' continued strength comes from its can-do attitude about fixing its economic problems and its confidence that sound economic fundamentals can ensure its enduring economic dominance. Most notably, the United States affords unique opportunities for entrepreneurship "because it has a favorable business culture, the most mature venture capital industry, close relations between universities and industry, and an open immigration policy," according to the Global Entrepreneurship Monitor, an academic consortium that studies entrepreneurial activity worldwide. In a 2009 survey, GEM ranked the United States first in the world in providing such opportunities. Nearly all the major commercially successful companies that have made technological breakthroughs in the last three decades—Apple and Microsoft, Google and Facebook—were founded and are based in the United States. In fact, it was by finding new and dynamic sources of growth in the 1990s that the United States was able to head off the economic challenge posed by that era's rising power, Japan. Today, optimists argue that the United States can



replicate that experience with China. It is true that if the U.S. economy were to grow consistently at a rate of 3.5 percent over the next 20 years, as it did in the 1990s, investor sentiment and confidence in the dollar as a reserve currency could be buoyed.

But some key differences today should dampen any such hope. The United States headed into the 1990s with far less government debt than it will have in the future. In 1990, the ratio of public debt to GDP was about 42 percent, whereas the COB's latest projected figure for 2020 is close to 100 percent. The external position of the United States was also less vulnerable two decades ago. For example, in 1990, foreign holdings of U.S. government debt amounted to 19 percent; today, they are close to 50 percent, and a majority are in China's hands. In the 1990s, the country was also considerably further away from the date at which it would have to reckon with the cost of entitlements.

And then there is the United States' beleaguered middle class. Over the last 20 years, several related pathologies that have squeezed the American middle class, such as a stagnating median income, have

become more entrenched and more intractable. Even a 3.5 percent growth rate, which would be well above current expectations, may not be adequate to maintain confidence in the U.S. model, which is based on the hope of a better future for many.

In other words, the United States cannot escape the inexorable logic of demography and the fact that poor countries, especially China, are catching up with it. China, which is four times as populous as the United States, will be a bigger economy as soon as its average standard of living (measure in per capita GDP) exceeds one-quarter of the United States'. By some measures, including my own, this has already occurred, and as China continues to grow, the gap will only widen. A resurgent United States might be able to slow down that process, but it will not be able to prevent it. Growing by 3.5 percent, rather than 2.5 percent, over the next 20 years might boost the United States' economic performance, social stability, and national mood. But it would not make a significant difference in its position relative to China in the face of, say, a seven percent growth rate there.

These projections undermine the dominant belief that the United States' economic preeminence is its own to lose. It is China's actions that will largely determine whether the differential in growth between China and the United States is modest or great. China can radically mess up, for example, if it allows asset bubbles to build or if it fails to stave off political upheaval. Or it can surge ahead by correcting existing economic distortions, especially by moving away from an export-intensive growth strategy toward one that develops demand at home. The United States' range of action is much narrower. If the United States is unlikely to grow significantly slower than by 2.0–2.5 percent, it is even more unlikely to grow faster than by 3.5 percent. This is the curse of being at the frontier of economic development: both the potential downsides and the potential upsides are limited.

Even if the United States grows fast—say, by 3.5 percent—other countries, such as China, may grow faster, too, leaving the basic picture of their relative economic power unaffected. In fact, when the pace of technological innovation in leading countries, such as the United States, quickens, the new technologies become quickly available to poorer countries, providing a stimulus to their growth, too. Even more important than producing new technologies is having



the human capital and the skills to use them. According to the National Science Foundation, in 2006 there were nearly twice as many undergraduates in science and engineering in China as in the United States. This differential is likely only to grow. Despite having a considerably worse educational system than the United States, China seems well positioned to absorb new technologies. There were six times as many peer-reviewed scientific publications in the United States as in China in 2002—and just 2.5 times as many in 2008. The ability of rich countries to stay ahead in terms of growth is inherently limited because China is better able to absorb and use new technologies. China's technological sophistication is growing: the United States, Europe, and Japan export very few products that China does not also export. More generally, if growth in the United States slows, China's growth might be unaffected, but if it accelerates, China's growth might, too. Either way, the United States cannot pull away.

BACK TO SUEZ

EVEN A resurgent United States could not exercise power and dominance over a rising China. China is already able to do what the rest

of the world does not want it to do. Might it soon be able to get the United States to do what the United States does not want to do? Is another Suez crisis possible?

In 1956, with sterling under pressure because of Egypt's blockade of the Suez Canal, the United Kingdom turned to the United States for financial assistance, invoking their "special relationship." But U.S. President Dwight Eisenhower refused. He was furious that the British (and the French) had attacked Egypt after President Gamal Abdel Nasser nationalized the canal, just as he was campaigning for reelection as the man of peace who had ended the fighting on the Korean Peninsula. He demanded that the United Kingdom comply with a U.S.-sponsored UN resolution requiring the prompt and unconditional withdrawal of British troops. If it did not, Washington would block the United Kingdom's access to resources from the IMF. But if it did, it would get substantial financial assistance. The United Kingdom agreed, and the United States supported a massive financial package, including an unprecedented IMF loan worth \$1.3 billion and a \$500 million loan from the U.S. Export-Import Bank.

Now, imagine a not-so-distant future in which the United States has recovered from the crisis of 2008–10 but remains saddled with structural problems: widening income gaps, a squeezed middle class, and reduced economic and social mobility. Its financial system is still as fragile as before the crisis, and the government has yet to come to grips with the rising costs of entitlements and the buildup of bad assets in the financial system, which the government might have to take over. Inflation is a major global problem because commodity prices are skyrocketing as a result of rapid growth in emerging markets. China has an economy and a trade flow twice as large as the United States'. The dollar has lost its sheen; demand for the yuan as a reserve currency is growing.

Much as in 1956, when Washington was suspected of orchestrating massive sales of sterling in New York to force the British government to withdraw its troops from the Suez Canal, rumors are swirling that China is planning to wield its financial power; it has had enough of the United States' naval presence in the Pacific Ocean. Beijing starts selling some of its currency reserves (by then likely to amount to \$4 trillion). Investors grow skittish, fearing that the dollar might

collapse, and bond markets turn on U.S. government paper. The United States soon loses its AAA credit rating. Auctions for U.S. Treasury bonds find no buyers. To maintain confidence, the U.S. Federal Reserve sharply raises interest rates. Before long, interest rates substantially exceed growth rates, and the United States urgently needs cheap financing. It turns to oil exporters, but the friendly autocrats of yore have been replaced by illiberal democrats of various Islamic persuasions, ranging from moderate to extreme, and all with long memories of U.S. intervention in the Middle East. Much as for Greece, Ireland, and Portugal recently, seeking help from the IMF seems unavoidable: defaulting on U.S. debt obligations would be fatal to the effort to preserve what is left of the United States' global role.

But by this time, China, already the world's largest banker since 2000, controls the spigot. Although it, too, deems that an IMF bailout is necessary, it has a precondition: the withdrawal of the United States' naval presence in the western Pacific. The request has bite because China, as the IMF's largest contributor and a benefactor to many of its members, can easily block the United States' request for financing. By then, China may even have acquired veto power thanks to the governance reforms scheduled for 2018.

Some will say this scenario is pure fantasy. After all, the United States could easily withhold financing from the United Kingdom in 1956 because doing so had no serious consequences for the dollar or the U.S. economy. But if tomorrow, China sold, or just stopped buying, U.S. Treasury bonds, the dollar would decline and the yuan would appreciate—the very outcome that China has steadfastly been trying to prevent. China is unlikely to suddenly undermine its mercantilist growth strategy and risk large capital losses on its stock of foreign exchange reserves. Others might say that even if China were willing to do so, if the U.S. economy were depressed, the Federal Reserve might be only too happy to buy up any U.S. Treasuries dumped by China.

But all this leaves out that China's incentives might be very different in the future. Ten years on, China might be less wedded to keeping the yuan weak. If it continues to slowly internationalize its currency, both its ability to maintain a weak yuan and its interest in doing so may soon disappear. And when they do, China's power over the United States will become considerable. In 1956, the United Kingdom's

financiers were dispersed across the public and private sectors. But the Chinese government is the largest net supplier of capital to the United States: it holds many U.S. Treasury bonds and finances the U.S. deficit. Leverage over the United States is concentrated in Beijing's hands.

Of course, the prospects of a dollar devaluation would probably be less painful for the United States in this hypothetical future than the prospects of a weakening sterling was for the United Kingdom in 1956. Back then, a devaluation of sterling would have inflicted heavy losses on the currencies of the United Kingdom's former colonies that held large sterling-denominated assets. These colonies would have sold their sterling assets, weakening their economic links with the United Kingdom. Preventing this was important to the government in London in order to preserve what was left of the British Empire. A devaluation of the dollar would be less of a problem partly because the United States' foreign liabilities are denominated in dollars.

A repeat of the Suez crisis may seem improbable today. But the United States' current economic situation does leave the country fundamentally vulnerable in the face of China's inescapable dominance. The United Kingdom was playing with a weak hand during the Suez crisis not just because it was in debt and its economy was weakening but also because another great economic power had emerged. Today, even as the United States' economy is structurally weak, its addiction to debt has made the country dependent on foreigners, and its prospects for growth are minimal, a strong rival has emerged. China may not quite be an adversary, but it is not an ally, either. Macmillan's 1971 prophecy that the United States might decline "in 200 years" betrayed a mechanical interpretation of history: it projected enduring dominance for the United States, much like his own country had enjoyed. But China could accelerate the patterns of history—and make the United States confront its decline much sooner than Macmillan anticipated or even than most people expect today. 🌐