A Partnership of Equals

How Washington Should Respond to China's Economic Challenge

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Summary: Beijing is shirking its responsibilities to the global economy. To encourage better behavior, Washington should offer to share global economic leadership.

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To be an economic superpower, a country must be sufficiently large, dynamic, and globally integrated to have a major impact on the world economy. Three political entities currently qualify: the United States, the European Union, and China. Inducing China to become a responsible pillar of the global economic system (as the other two are) will be one of the great challenges of coming decades -- particularly since at the moment China seems uninterested in playing such a role.

The United States remains the world's largest national economy, the issuer of its key currency, and in most years the leading source and recipient of foreign investment. The EU now has an even larger economy and even greater trade flows with the outside world, and the euro increasingly competes with the dollar as a global currency. China, the newest member of the club, is smaller than the other two but is growing more quickly and is more deeply integrated into the global economy. Its dramatic expansion is therefore having a powerful effect on the rest of the world. (China is often paired with India in such discussions, but India's GDP is less than half of China's. The value of the annual growth of China's trade exceeds the total annual value of India's trade. China will dominate its Asian neighbor for the foreseeable future.)

China poses a unique challenge because it is still poor, significantly nonmarketized, and authoritarian. All three characteristics reduce the likelihood that it will easily accept the systemic responsibilities that should ideally accompany superpower status. The integration of China into the existing global economic order will thus be more difficult than was, say, the integration of Japan a generation ago. The United States and the EU would like to co-opt China by integrating it into the regime that they have built and defended over the last several decades. There are increasing signs, however, that China has a different objective. In numerous areas, it is pursuing strategies that conflict with existing norms, rules, and institutional arrangements.

Some take this lightly, viewing it as simply the usual free-riding and skirting of responsibility by a powerful newcomer cleverly exploiting the loopholes and weak enforcement of existing international rules to pursue its perceived national interests. After all, they say, even the United States and the EU do the same on occasion, as do other major emerging-market economies. And to be sure, there is no evidence that China's challenges to the current economic order derive from any cohesive or comprehensive strategy concocted by the country's political or intellectual leadership. Despite calls in Beijing for "a new international economic order" and talk of how a "Beijing consensus" might supplant the so-called Washington consensus, to date China's proposed alternative approaches do not add up to a revisionist challenge to the status quo.

Nevertheless, the situation is worrisome. Given its status as a powerful newcomer benefiting from an efficient economic order, China actually has a profound interest in seeing that the international rules and institutions function effectively. It should be trying to strengthen the system, whether the present version or an alternative version more to its liking.

Moreover, Chinese recalcitrance seems to be increasing rather than decreasing over time. At the outset of its economic reform process, in the late 1970s, China was eager to join (and to replace Taiwan in) the International Monetary Fund (IMF) and the World Bank. These institutional ties subsequently played important, and apparently welcome, roles in China's early development success. Later, Beijing not only endured lengthy negotiations and an ever-expanding set of requirements in order to join the World Trade Organization (WTO) but also used the pro-market rules of that institution to overcome resistance to reform among die-hards inside China itself.

But a country's attitudes can change dramatically along with its circumstances. Russia, for example, was a supplicant for international capital and support after its bankruptcy in 1998 and with world oil prices near $20 a barrel, but it is aggressively pursuing a resumption of great-power status now that it has recovered and with oil over $100 a barrel. China appears to be undergoing a similar evolution, albeit with a more cautious leadership and an incremental style. It is also experiencing the same internal backlash against globalization as have the United States and many other countries. This attitudinal shift simply has to be reversed, even if doing so requires a fundamental adjustment of the international economic architecture.

TOWARD AN ASIAN BLOC?

On trade, China has been playing at best a passive and at worst a disruptive role. It makes no effort to hide its current preference for low-quality, politically motivated bilateral and regional trade arrangements rather than economically meaningful (and demanding) multilateral trade liberalization through the WTO. Since China is the world's largest surplus country and second-largest exporter, this poses two important challenges to the existing global regime.

First, China's refusal to contribute positively to the Doha Round of international trade negotiations has all but ensured the talks' failure. Beijing has declared that it should have no liberalization obligations whatsoever and has invented a new category of WTO membership ("recently acceded members") to justify its recalcitrance. Such a stance by a major trading power is akin to abstention and has practically guaranteed that the Doha negotiations will go nowhere. And since the global trading system does not stay in place, but is always moving either forward or backward, a collapse of the Doha Round would be quite serious: it would represent the first failure of a major multilateral trade negotiation in the postwar period and place the entire WTO system in jeopardy. China is not the only culprit in the Doha drama, of course. The United States and the EU have been unwilling to abandon their agricultural protectionism, other important emerging economies have been unwilling to meaningfully open their markets, and several poor countries have resisted contributing to a global package of reforms. But China, with its major stake in open trade, exhibits the sharpest contrast of all the major players between its objective interests and its revealed policy.

Second, China's pursuit of bilateral and regional trade agreements with neighboring countries is more about politics than economics. Its "free-trade agreement" with the Association of Southeast Asian Nations (ASEAN), for example, covers only a small share of its commerce with the countries in question; it is simply an effort to calm their fears of being swamped by their huge neighbor. Again, it is true that the United States and other major trading powers also factor foreign policy considerations into their selections of partners for regional and bilateral trade agreements. But they also insist on economic standards that largely conform to the WTO's rules. China is able to escape legal application of those rules by continuing to declare itself a "developing country" and by taking advantage of "special and differential treatment." But for a major global trading power to hide behind such loopholes provokes substantial international strains.

China is also hurting the global trading system by supporting the creation of a loose but potent Asian trading bloc. The network of regional agreements that started with one between China and ASEAN has steadily expanded to include virtually all other possible Asian permutations: parallel Japanese-ASEAN and South Korean-ASEAN deals; various bilateral partnerships, including perhaps a Chinese-Indian one; a "10 + 3" arrangement that brings together the ten ASEAN countries and all three Northeast Asian countries, and possibly even a "10 + 6" agreement that would broaden the group to include Australia, India, and New Zealand. All this activity is likely to produce, within the next decade, an East Asian free-trade area led by China.

Such a regional grouping would almost certainly trigger a sharp backlash from the United States and the EU, as well as from numerous developing countries, because of its new discrimination against them. Even more important, it would create a tripolar global economic regime -- a configuration that could threaten existing global arrangements and multilateral cooperation.

China's challenges to the global trading system are most visible in its opposition to the U.S. proposal, launched at the Asia-Pacific Economic Cooperation forum in 2006, for a free-trade area of the Asia-Pacific. The APEC initiative, immediately endorsed by a number of those smaller member economies that fervently want to prevent trade conflict between the group's two superpowers, seeks to head off the looming confrontation between an Asia-only trading bloc and the United States, which could draw a line down the middle of the Pacific. The initiative would eventually consolidate the many preferential pacts in the Asia-Pacific region and offer an economically meaningful Plan B for widespread trade liberalization if the Doha Round definitively fails. China has led the opposition to the idea, demonstrating its preference for bilateral deals with minimal economic content and its lack of interest in trying to defend the broader trading order.

TRASHING THE IMF?

China's challenge to the international monetary order, meanwhile, is at least as serious. Alone among the world's major economies, China has rejected the adoption of a flexible exchange-rate policy, which would promote adjustment of its balance-of-payments position and avoid a buildup of large imbalances. Under IMF rules, China has the right to peg its currency -- but it does not have the right to intervene massively in the foreign exchange market, as it has for the past five years, to maintain a hugely undervalued yuan and thereby boost its international competitive position. This violates the most basic norms of the IMF's Articles of Agreement, which require members to "avoid manipulating exchange rates ... in order to prevent effective balance of payments adjustment or to gain unfair competitive advantage." It is also a violation of the IMF's implementing guidelines, which explicitly proscribe the use of "prolonged, large-scale one-way" interventions to maintain competitive undervaluation.

The results are unprecedented for a major trading country. China's current account surplus has reached 11-12 percent of its GDP. By next year, its annual global surplus could approach $500 billion, approximating the value of the U.S. current account deficit. Its hoard of foreign currency exceeds $1.6 trillion and is by far the world's largest. These imbalances and the unprecedented flow of international funds that they require could trigger a crash of the dollar and a "hard landing" for the global economy, severely compounding the current global financial crisis.

Previous surplus countries, notably Germany in the 1960s and 1970s and Japan in the 1970s and 1980s, have also resisted making necessary and inevitable adjustments to their currency pegs. But no earlier imbalances have ever approached the current Chinese one in terms of its share of the country's GDP. Moreover, all of these countries eventually agreed to conform to the international rules.

To date, however, China has resisted all entreaties to alter its behavior. Its announced move to "a managed floating exchange rate based on market supply and demand" in July 2005 has still not produced any significant rise in the trade-weighted value of its currency, despite the recent acceleration of the yuan's appreciation against the dollar, nor has it prevented continued huge surpluses in China's external accounts. The number of interventions in the currency markets that China has undertaken to block faster appreciation of the yuan has at least doubled since that time.

China has actually questioned the basic concept of international cooperation in dealing with these problems, claiming that a country's exchange rate is "an issue of national sovereignty" (rather than a quintessentially international concern in which foreign parties have an equal interest). It has objected even to the IMF's consideration of the issue. Its actions have raised an implicit threat that it might promote the creation of an Asian Monetary Fund, further eroding the global role of the IMF, and may seek a regional or even global role for its national currency over the long term. These monetary steps intensify the challenge to the global trading system because large exchange-rate misalignments are a potent stimulus for protectionism in deficit countries, as indicated at present by the numerous bills in Congress to address the China currency issue with trade sanctions.

On energy (China will shortly become the world's largest consumer of energy), the challenge China poses is less frontal, but only because there exists no body of agreed global doctrine, rules, and institutions. There are at least two conflicting energy regimes, the (periodically effective) producer cartel embodied in the Organization of the Petroleum Exporting Countries and the (very loose and incomplete) consumer anticartel embodied in the International Energy Agency. China is creating problems for both with its drive to line up "secure sources of supply" through long-term contracts with selected producing countries. It is unwilling to rely solely, or even primarily, on market mechanisms, attempting to insure itself against both output interruptions by the producers and the market power of other large consumers.

Here, as elsewhere, China is hardly alone in its behavior. But as the driving force behind the single most important commodity market in the world, the country has a particular interest in (and responsibility for) forging systemic responses rather than trying to carve out exceptions and special privileges for itself. China appears to be either unaware of the abject failure of such strategies in the past or confident that its contemporary clout will suffice to sustain its contractual arrangements even in difficult periods, and it is pursuing such strategies with respect to other raw materials as well as oil and gas.

On foreign aid, China may have already become the largest national donor (depending on how "aid" is defined), and it is posing a direct challenge to prevailing norms by ignoring the types of conditionality that have evolved throughout the donor community over the past quarter century. Beijing rejects not only the social standards (on human rights, labor conditions, and the environment) that have become prevalent but also the basic economic standards (such as poverty alleviation and good governance) that virtually all bilateral and multilateral aid agencies now require as a matter of course. As with its trade and commodity pacts, China's "conditionality" on aid is almost wholly political: insistence that the recipient countries support China's positions on global issues, in the United Nations and elsewhere, and funnel their primary products to China as reliable suppliers.

NEW RULES OF THE GAME

What these policies demonstrate is that China's international mindset has not kept pace with its breathtaking economic ascent. China continues to act like a small country with little impact on the global system at large and therefore little responsibility for it. Such a lag in perceptions is not difficult to understand, particularly as it regards a conservative leadership still following Deng Xiaoping's directive to maintain a low international profile. The central thrust of contemporary Chinese foreign policy is not to assume a large role in the world but to avoid international entanglements that could disrupt the country's ability to focus on its huge domestic challenges. Moreover, the speed at which China has risen is difficult for even the most experienced observers to comprehend. (The pattern is similar to the one that accompanied Japan's growth from the early 1970s into the 1980s, when its meteoric rise also triggered sharp global reactions, while Tokyo maintained a passive and reactive stance on almost all international issues.)

Even the strongest defenders of the current world trading system would concede that at least some of China's criticisms are valid. At best, the Doha Round will achieve only marginal liberalization of world trade after almost a decade of effort. The IMF has failed to enforce its own rules and is being forced to downsize. The World Bank has lost any clear direction. The G-7 (the group of highly industrialized states) has adopted a mutual nonaggression pact among its members, making its criticisms of outsiders such as China seem hypocritical. And by failing to adapt their governance structures to the dramatic changes in the relative economic power among nations, the international economic institutions have lost much of their legitimacy. The fact that some Chinese attitudes are understandable and some Chinese concerns legitimate does not lessen the significance of the challenge but rather suggests some of the logical components of an intelligent response.

To deal with the situation, Washington should make a subtle but basic change to its economic policy strategy toward Beijing. Instead of focusing on narrow bilateral problems, it should seek to develop a true partnership with Beijing so as to provide joint leadership of the global economic system. Only such a "G-2" approach will do justice, and be seen to do justice, to China's new role as a global economic superpower and hence as a legitimate architect and steward of the international economic order.

The present U.S. approach seeks to entice China to join the existing global economic order. Washington's fondness for the status quo is understandable given its basic success and the prominent role it accords Washington. But China is uncomfortable with the very notion of simply integrating into a system it had no role in developing. Both Chinese officials and Chinese scholars are actively discussing alternative structures for which China can be present at the creation. At one particularly contentious point in its negotiations to enter the WTO, the Chinese ambassador reportedly thundered, "We know we have to play the game your way now, but in ten years we will set the rules!" The existing system, moreover, has become increasingly sclerotic, and it might well be that the only way to overcome the enormous resistance to change (manifested in positions such as Europe's refusal to wind down its excessive quotas and give up some of its IMF executive-board seats) is to undertake a fundamental overhaul.

Current U.S. policy also purports to include tough enforcement measures to punish noncooperation: Washington has taken Beijing to the WTO for dispute settlement on a number of occasions and has tried to mobilize the IMF and the G-7 to penalize China for its undervalued currency. But Washington's criticism of Beijing has not been translated into any serious retaliatory pressure because too many Americans receive too many benefits from their actual or potential dealings with China for policymakers to jeopardize the relationship and because other key countries are also unwilling to confront China. Abandoning the present position and adopting a less confrontational approach might be the only way to persuade China to start cooperating.

THE BIG TWO

In part, the strategy proposed here would treat old issues in new ways, recasting conflicts as opportunities for progress. The United States and China could agree to construct their regional trade agreements in ways that support, rather than impede, subsequent multilateral liberalization -- and even permit eventual linkage between the regional bodies. Failures to offer significant new market-opening opportunities in the Doha Round would be addressed not as legitimate mercantilist behavior but as threats to the WTO that would jeopardize both countries' stake in an open world economy. Competitive currency misalignments would be treated as deviations from IMF norms that hurt all trading partners, especially poor countries. Washington would concede that its errant fiscal policy has contributed to the overvaluation of the dollar, just as Beijing would concede that undervaluation of the yuan has reflected inadequate Chinese internal demand and excessive government intervention. The United States could escort China into the International Energy Agency to help organize the response of consuming countries to high oil prices.

More far-reaching steps might involve the creation of new international norms and institutional arrangements to govern issue areas that are important but currently unregulated, such as global warming and sovereign wealth funds (SWFs). To date, China has steadfastly refused to even contemplate binding constraints on its greenhouse gas emissions. So has the United States, but that stance seems likely to change dramatically after the presidential election in November, no matter who wins. An emissions regime, however, may well lead to the installation of trade barriers in participating countries against carbon-intensive products from nonparticipating countries. Moreover, global warming cannot be seriously addressed without China, which has become the world's largest polluter. Unless Washington and Beijing find ways to cooperate in attacking the problem together, the result could be a trade war between them and little or no action on the environment.

China has already indicated some skepticism about the adoption of new international guidelines, even if voluntary and nonbinding, regarding the structure and investment activities of SWFs. But the United States is championing such codes in order to permit continued foreign investment and head off the risk of protectionist domestic reactions. Since the U.S. economy is especially dependent on Chinese capital, without some new agreement a frontal clash could develop over this issue, triggered either by China's rejection of proposed new guidelines or by the United States' rejection of Chinese investments in particularly sensitive areas.

Whether in dealing with old or new issues, the basic idea would be to develop a G-2 between the United States and China to steer the global governance process. Other major powers, such as the EU and, on some issues, Japan, would of course need to be deeply involved as well. The new rules, codes, or norms could frequently be implemented through existing multilateral institutions, such as the IMF and the WTO. Some of them might work better through new worldwide organizations created to deal with truly new issues, such as a global environmental organization to manage climate-change policy. But effective systemic defenses against international economic challenges in today's world must start with active cooperation between its two dominant economies, the United States and China.

Given other powers' sensitivities, of course, it would be impolitic for Washington and Beijing to use the term "G-2" publicly. But for the strategy to work, the United States would have to give true priority to China as its main partner in managing the world economy, to some extent displacing Europe. Nothing less is likely to attract China or engage the United States sufficiently to create the effective leadership that the world so desperately needs.

Some initial steps have already been taken in this direction. After I floated the idea of a G-2 in late 2004, Robert Zoellick, in his new capacity as deputy secretary of state, which he undertook in February 2005, launched initial discussions with Chinese counterparts. In 2007, Treasury Secretary Henry Paulson escalated the engagement to what is now known as the U.S.-China Strategic Economic Dialogue, which involves the leaders of ten or so cabinet agencies in each country. The beginnings of an institutional framework for a working G-2 have thus already been put in place, and patterns of cooperation are already developing on topics such as the environment and international finance. But it is not nearly enough for China to be seen as a "responsible stakeholder." It must be seen, and accorded full rights, as a true leadership partner.

Such a relationship between a rich developed country and a poor developing one would be unprecedented in human history -- as is there being a poor economic superpower, which is what China is. There are enough examples of similar cooperation on specific issues, however, to suggest that converting U.S.-Chinese disputes into systemic management issues can be extremely effective. In the late 1970s, for example, the United States was applying countervailing duties to scores of Brazilian products because Brazil's export subsidies accounted for almost half the value of all of its foreign sales. A frontal assault on the subsidies was politically unacceptable in Brazil, but the two countries agreed to cooperate closely in negotiating a new subsidy code for the General Agreement on Tariffs and Trade (the precursor to the WTO): this agreement turned out to be simultaneously the linchpin of a successful Tokyo Round of trade talks, a basis for adding an injury clause to the U.S. countervailing-duty law, and a foundation for phasing out the Brazilian subsidy policy.

Are the United States and China ready for such a substantial reorientation? Washington would need to accept China as a true partner in managing global economic affairs, the development of an intimate working relationship with an Asian country rather than its traditional European allies, and constructive collaboration with an authoritarian political regime rather than a democracy. All these changes would pose substantial challenges for U.S. policymakers and would likely encounter domestic political resistance.

China is rapidly approaching a moment when its chosen strategy of integration into the world economy will force it to assume increased responsibility for the successful functioning of that economy. China's own interests, in other words, should lead it to accept an invitation from the United States to help steer the system in a mutually acceptable direction. The Chinese today are hotly debating whether their country should proceed unilaterally or work within the international system, and an offer of true partnership could tilt the outcome of that debate decisively and constructively, raising the possibility that China could continue its upward trajectory without provoking the clashes that previous rising powers have.

If China is reluctant to get too close to the United States -- say, because of continuing controversies over security issues -- alternative institutional arrangements are of course available. The EU could be a member from the outset of a G-3, a group of the current global economic superpowers. The new G-5, recently created by the IMF to conduct its intensified multilateral consultative process, which adds Japan and Saudi Arabia (to represent the oil producers) into the mix, is another possibility. The central need is to embrace China in the context of a new and effective leadership grouping in light of its critical role in the world economy and its legitimate desire to be engaged in systemic management at all relevant stages of the process.

Under seven successive presidents, the United States has chosen to engage, rather than confront, China, taking the eminently sensible view that provoking an unnecessary confrontation would be profoundly contrary to U.S. interests. Given the signs that China's economic advance will continue, the same logic suggests that Washington should make every effort to engage Beijing as a true partner in steering global economic affairs. At a minimum, creating a G-2 would limit the risk of bilateral disputes escalating and disrupting the U.S.-Chinese relationship and the broader global economy. At a maximum, it could start a process that might, over time, generate sufficient trust and mutual understanding to produce active cooperation on crucial issues.

Right now, the prospects of such active cooperation are uncertain. But in addition to their differences, the two countries share many common interests, and their global economic positions are converging rather than diverging. Developing a partnership of the sort outlined here will not be easy and will take much time and effort. But the issues at stake are so important that even partial success would be worthwhile, and the only way to gauge the idea's feasibility is to try it. The upcoming negotiations to create a global strategy to counter global warming offer a compelling opportunity for just such an experiment.
