

American and Chinese Power after the Financial Crisis

The United States has been widely blamed for the recent financial crisis. As the U.S. economy floundered and China continued to grow in the great recession of 2008–2009, Chinese authors launched “a flood of declinist commentary about the United States.”¹ One expert claimed that the high point of U.S. power projection was 2000. The Chinese were not alone in such statements. Goldman Sachs advanced the date at which it expects the size of the Chinese economy to surpass the U.S. economy to 2027. In a 2009 Pew Research Center poll, majorities or pluralities in 13 of 25 countries believed that China will replace the United States as the world’s leading superpower.² Even the U.S. government’s National Intelligence Council projected in 2008 that U.S. dominance would be “much diminished” by 2025.³ President Dmitri Medvedev of Russia called the 2008 financial crisis a sign that the United States’ global leadership is coming to an end, and even a sympathetic observer, Canadian opposition leader Michael Ignatieff, suggested that Canada should look beyond North America now that the “the noon hour of the United States and its global dominance are over.”⁴

One should be wary, however, of extrapolating long-term trends from cyclical events, while being aware of misleading metaphors of organic decline. Nations are not like humans with predictable life spans. For example, after the United Kingdom lost its American colonies at the end of the eighteenth century, Horace Walpole lamented its reduction to “as insignificant a country as Denmark or

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The Washington Quarterly • 33:4 pp. 143–153
DOI: 10.1080/0163660X.2010.516634

Sardinia.”⁵ He failed to foresee that the industrial revolution would give the United Kingdom a second century of even greater ascendancy. Likewise, Rome remained dominant for more than three centuries after the apogee of Roman power. Even then, Rome did not succumb to the rise of another state, but died a death of a thousand cuts inflicted by various barbarian tribes. Indeed for all the fashionable predictions of Brazil, China, or India surpassing the United States in the next decades, the greater threats may come from cuts from modern barbarians and non-state actors.

Of course, the financial crisis has had epochal effects on what might be called “the Wall Street model.” The poor performance of Wall Street institutions and Washington regulators has cost New York a good deal in terms of its soft power, or the attractiveness of its economic model. In terms of institutional change, the five major investment banks (Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley) are gone or changed in shape, and the financial mess they helped create produced a sharp recession and new demands for political regulation. Ironically, two years after the collapse which Europeans blamed on the United States, Washington moved more rapidly on reform than Europe which “has itself been nearly overwhelmed by a crisis of its own – caused by sovereign rather than personal indebtedness – and the United States has begun growing again, albeit uncertainly.”⁶

It is still too early to judge the long-term effects of the crisis on U.S. power, but the blow need not be fatal if, in contrast to Japan in the 1990s, Washington moves quickly to absorb the losses and limit the damage. The World Economic Forum still rates the U.S. economy as the world’s second most competitive (after Switzerland) because of its labor market flexibility, higher education, political stability, and openness to innovation, while China is ranked number 29.⁷ In areas like biotechnology, nanotechnology, and the second generation of the World Wide Web, the United States still leads. Nevertheless, while few expect China to surpass the United States in military power in the next two decades, many still see the crisis as transformative in economic and soft power relations. It is important, therefore, to focus on the implications of the crisis in order to analyze the power relations between China and the United States.

Soft Power in Twenty-First Century China

A number of observers see China’s soft power increasing in Asia and other parts of the developing world, particularly after the financial crisis. According to *The People’s Daily*, “soft power has become a key word . . . there is great potential for the development of China’s soft power.”⁸ The so-called “Beijing Consensus” on authoritarian government with a successful market economy has become more popular than the previously dominant “Washington Consensus” of liberal market

economies with democratic government in parts of the developing world. But to what extent are Venezuelans and Zimbabweans attracted to authoritarian government, or do they admire the growth of China's gross domestic product (GDP) over three decades, or are they just induced by the prospect of access to a large and growing market? Moreover, even if the authoritarian growth model produces soft power for China in authoritarian countries, it does not produce attraction in democratic countries. In other words, what attracts in Caracas may repel in Paris.⁹

There is no lack of Chinese interest in the idea of "soft power." Since the early 1990s, hundreds of essays and scholarly articles have been published in China on the topic. The term has also entered China's official language. In his keynote speech to the 17th National Congress of the Communist Party of China (CPC) on October 15, 2007, President Hu Jintao stated that the CPC must "enhance culture as part of the soft power of our country . . . a factor of growing significance in the competition in overall national strength."¹⁰

China has always had an attractive traditional culture, but now it is entering the realm of global popular culture as well. The enrollment of foreign students in China tripled over the past decade, and the number of foreign tourists has also increased dramatically. China has created several hundred Confucius Institutes around the world to teach its language and culture, and China Radio International has increased its broadcasts in English to 24 hours a day.¹¹ In 2009–2010, China invested \$8.9 billion in "external publicity work" including a 24-hour Xinhua cable news channel designed to imitate al Jazeera.¹²

China has also adjusted its diplomacy. A decade ago, it was wary of multilateral arrangements and was at cross purposes with many of its neighbors. Subsequently, it has joined the World Trade Organization, contributed more than 3000 troops to serve in UN peacekeeping operations, has become more helpful on non-proliferation diplomacy (including hosting the Six-Party Talks on North Korea), settled territorial disputes with its neighbors, and joined a variety of regional organizations with the East Asian summit being only the latest example. This new diplomacy has helped to alleviate fears and reduce the likelihood of other countries allying to balance a rising power.¹³ According to one study, "the Chinese style emphasized symbolic relationships, high-profile gestures, such as rebuilding the Cambodian Parliament or Mozambique Foreign Affairs Ministry."¹⁴

But there are limits to Chinese soft power.

Greater threats may come from death by a thousand cuts from non-state actors than rising powers.

In 2006, China used the anniversary of the naval explorations of its great Ming Dynasty Admiral Zheng He to create a narrative that justified its modern naval expansion into the Indian Ocean. But that did not produce soft power in India, where suspicions of Chinese naval ambitions led to a climate of mistrust.¹⁵ Similarly, China tried to enhance its soft power by successfully staging the 2008 Olympics, but its domestic crackdown in Tibet, Xianjiang, and on human rights activists undercut its soft power gains.

In 2009, Beijing announced plans to spend billions of dollars to develop global media giants to compete with Bloomberg, Time Warner, and Viacom “to use ‘soft power,’ rather than military might to win friends abroad.” But China’s efforts were hindered by its domestic political censorship. For all the efforts to turn Xinhua and China Central Television into competitors for CNN and the BBC, “there is no international audience for the brittle propaganda.”¹⁶ India’s Bollywood films command far greater international audiences than do Chinese films. “When Zhang Yimou, the acclaimed director was asked recently why his films were always set in the past, he said that films about contemporary China would be neutered by the censors.”¹⁷

Thus it is not surprising that a poll taken in Asia late in 2008 found China’s soft power less than that of the United States, and concluded that China’s “charm offensive” has not been that effective.¹⁸ This was confirmed by a BBC poll of 28 countries in 2010 that showed a positive Chinese image only in Africa and some parts of Asia, such as Pakistan, while in most of the Americas, Asia, and Europe it was neutral to poor.¹⁹

Despite being blamed for the financial crisis, U.S. soft power remained greater than that of China as measured by both The Chicago Council on Global Affairs and BBC polls. Great powers try to use culture and narrative to create soft power that promotes their advantage, but much of it is created by civil society rather than government. American soft power rests on a variety of resources that range from Hollywood to Harvard; from Madonna to the Gates Foundation; from Martin Luther King’s speeches to Barack Obama’s election. It is not easy for governments to sell their country’s charm if their narrative is inconsistent with domestic realities. In that dimension, except for its economic success, China still has a long way to go.

Economic Interdependence and Power

Some analysts believe that China’s impressive success in overcoming the financial crisis and its increased holdings of dollars have greatly increased its power over the United States. But a careful analysis looks more closely at interdependence and power. Interdependence involves short-run sensitivity and long-term vulnerability.²⁰ Sensitivity refers to the amount and pace of the effects

of mutual dependence; that is, how quickly does change in one part of the system bring about change in another part? For example, in 1998, weakness in emerging markets in Asia had a contagious effect that undercut other emerging markets as distant as Brazil and Russia. Similarly, in September 2008, the collapse of Lehman Brothers in New York quickly affected markets around the world.

A high level of sensitivity, however, is not the same as a high level of vulnerability. Vulnerability refers to the relative costs of changing the structure of a system of interdependence. Vulnerability produces more power in relationships than does sensitivity. The less vulnerable of two countries is not necessarily the less sensitive, but rather the one that would incur lower costs from altering the situation. In 1998, the United States was sensitive but not vulnerable to East Asian economic conditions. The financial crisis there cut half a percent off the U.S. growth rate, but with a booming economy the United States could afford it. Indonesia, on the other hand, was both sensitive and vulnerable to changes in global trade and investment patterns. Its economy suffered severely and that in turn led to internal political conflict. Vulnerability also involves degree. In 2008, given the bubble conditions in its subprime mortgage market and its growing deficits, the United States proved more vulnerable than it had been when its market was flourishing a decade earlier.

Symmetry refers to situations of relatively balanced, as opposed to unbalanced, dependence. Being less dependent can be a source of power. If two parties are interdependent but one is less so than the other, the less dependent party has a source of power as long as both value the interdependent relationship. Manipulating the asymmetries of interdependence is an important dimension of economic power. Perfect symmetry is quite rare; so most cases of economic interdependence also involve a potential power relationship.

In the 1980s, when President Ronald Reagan cut taxes and raised expenditures, the United States became dependent on imported Japanese capital to balance its federal government budget. Some argued that this gave Japan tremendous power over the United States. But the other side of the coin was that Japan would hurt itself as well as the United States if it stopped lending to the Americans. Japan's economy was little more than half the size of the U.S. economy, and that meant the Japanese needed the U.S. market for their exports more than the United States needed Japan, although both needed each other and both benefited from the interdependence.

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A similar relationship has developed today between the United States and China. The United States accepts Chinese imports, pays China in dollars, and China holds the U.S. dollars and bonds, in effect making a loan to the United States. China has amassed \$2.5 trillion of foreign exchange reserves, much of it held in U.S. Treasury securities. Some observers have described this as a great shift in the global balance of power because China could bring the United States to its knees by threatening to sell its dollars. But in doing so, China would not only reduce the value of its reserves as the price of the dollar fell, but it would also jeopardize U.S. willingness to continue to import cheap Chinese goods, which would mean job loss and instability in China. If it dumped its dollars, China would bring the United States to its knees, but might also bring itself to its ankles.

Judging whether economic interdependence produces power requires looking at the balance of asymmetries, not just at one side of the equation. In this case,

The global reaction to the financial crisis may still hurt Chinese power in the medium term.

the asymmetries reveal a “balance of financial terror” analogous to the Cold War military interdependence (mutually assured destruction) in which the United States and the Soviet Union each had the potential to destroy the other in a nuclear exchange but never did. In February 2010, angered over U.S. arms sales to Taiwan, a group of senior military officers called for the Chinese government to sell off U.S. government

bonds in retaliation, but their suggestion was not heeded.²¹ Instead, Yi Gang, China’s director of state administration of foreign exchange, explained that “Chinese investments in U.S. Treasuries are market investment behavior and we don’t wish to politicize them.”²² If they did, the pain would be mutual.

Nonetheless, this balance does not guarantee stability. Not only is there the danger of accidents with unintended consequences, but one would expect both countries to maneuver to change the framework and reduce their vulnerabilities. After the 2008 financial crisis, the United States pressed China to let its currency float upward as a means of reducing the U.S. trade deficit and the dollar imbalance. At the same time, China’s Central bank officials began making statements about the United States’ need to increase its savings, reduce its deficits, and move toward a long-term future in which the dollar would be supplemented by the International Monetary Fund (IMF) issuing special drawing rights as a reserve currency. But China’s growl was louder than its bite.

China’s increased financial power may have increased its ability to resist U.S. entreaties, but despite dire predictions about the power of Chinese creditors, it has had little effect on its ability to compel the United States to change its policies.²³ While China took minor measures to reduce the increase in its

holdings of dollars, it was not willing to take the risks of making its currency fully convertible for domestic political reasons. Thus, the yuan is unlikely to challenge the dollar's role as the largest component of world reserves (over 60 percent) in the next decade. Nonetheless, as China gradually increases domestic consumption rather than relying on exports as its engine of economic growth, Chinese leaders may begin to feel less dependent than they are now on the U.S. market as the source of employment, which is crucial for their internal political stability. Political bargaining may in time reflect perceived shifts in the degree of symmetry.

While neither the United States nor China is willing to destroy the balance of asymmetries that locks them together, the United States has allowed a gradual increase in Chinese influence in international fora, as well as greater influence for other emerging economies. Thus, the G-8 forum (where four of the eight countries are European) has been supplemented by a G-20 summit that includes economies representing 80 percent of world product. Such meetings have discussed the need to "rebalance" financial flows, altering the old pattern of U.S. deficits matching Chinese surpluses. Such changes would require politically difficult shifts in domestic patterns of consumption and investment, with the United States increasing its savings and China increasing domestic consumption.

Though such changes are not likely to occur quickly, it is interesting to note that the G-20 has agreed that Europe should reduce the weight of its votes in the IMF, and that China and other emerging economies should gradually increase theirs. This again shows the importance of the limitations on economic interdependent power. China could threaten to sell its holdings of dollars and damage the U.S. economy, but a weakened U.S. economy would mean a smaller market for Chinese exports, and the U.S. government might respond with tariffs against Chinese goods. Moreover, as other emerging economies, such as India and Brazil, find their exports hurt by an under-valued Chinese currency, they may use a multilateral forum like the G-20 to reinforce the U.S. position against China.²⁴ Neither side is in a hurry to break the symmetry of their vulnerability interdependence, but each continues to jockey to shape the structure and institutional framework of their market relationship.

Beware the Policy Implications of Misleading Projections

China's current reputation for power benefits from projections about the future. Some young Chinese use these projections to demand a greater share of power now. Feeling stronger, they demand greater accommodation of what they consider their "core interests" in Taiwan, Tibet, and the South China Sea. Some difficulties that arose between the United States and China in late 2009 and early 2010 may have been attributable to such perceptions.

Such projections should be viewed with some skepticism. China still lags far behind the United States economically and militarily, and has focused its policies primarily on its region and on its economic development. Even if China's GDP passes that of the United States around 2027 (as Goldman Sachs projects) the two economies would technically be equivalent in size but not in composition. China would still have a vast underdeveloped countryside, and it will begin to face demographic problems from the delayed effects of the one child per couple policy it enforced in the twentieth century.

Moreover, as countries develop, there is a tendency for growth rates to slow. Assuming six percent Chinese growth and only two percent American growth after 2030, China would not equal the United States in per capita income until sometime in the second half of the century. Since per capita income provides a measure of the sophistication of an economy, aggregate economic size will not necessarily mean that China will economically surpass the United States in 2027. During the past decade, China moved from being the ninth largest exporter to the largest in the world, but China's export-led development model will probably need to be adjusted as global trade and financial balances become more contentious in the aftermath of the recent financial crisis. That means that the financial crisis may eventually hurt Chinese power in the medium term by reducing the rest of the world's willingness to effectively allow China to free ride on open global markets without liberalizing its own exchange rates, interest rates, and markets. And although China holds huge foreign currency reserves, China will have difficulty increasing its financial leverage by lending overseas in its own currency until it has a deep and open financial market where interest rates are set by the market and not the government.

Unlike India, which was born with a democratic constitution, China has not yet found a way to solve the problem of demands for political participation (if not democracy) that tend to accompany rising per capita income. The ideology of communism is long gone, and the legitimacy of the ruling party depends upon economic growth and ethnic Han nationalism. Some experts argue that the Chinese political system lacks legitimacy, suffers from a high level of corruption, and is vulnerable to political unrest should the economy falter. Whether China can develop a formula that can manage an expanding urban middle class, regional inequality, and resentment among ethnic minorities remains to be seen. The basic point is that no one, including Chinese leaders, knows how China's political future will evolve and how that will affect its economic growth.

The current generation of Chinese leaders, realizing that rapid economic growth is the key to domestic political stability, has focused on economic development and what they call a "harmonious" international environment that will not disrupt their growth. But generations change, power often creates hubris, and appetites sometimes grow with eating. Many observers report an intense

nationalism in the younger generation. Reinforced by misperceptions about the power effects of the financial crisis, such attitudes could lead to policy miscalculations in both Beijing and Washington. As Kenneth Lieberthal notes, “there is an overall feeling in China that there is a narrowing of the gap in power with the United States that is belied by reality. Nevertheless, there is a sort of national hyperbole in China.”²⁵ Ironically, as Chinese come to believe that the global crisis has led to American decline, they are more likely to treat U.S. efforts at compromise as signs of weakness rather than conciliation, and thus make policy accommodation more difficult.

Moreover, Asia has its own internal balance of powers, and in that context, many states continue to welcome an American presence in the region. Chinese leaders have to contend with the reactions of other countries, as well as the constraints created by their own objectives of economic growth and the need for external markets and resources. Too aggressive a Chinese military posture could produce a countervailing coalition among its neighbors that would weaken both its hard and soft power. A poll of 16 countries around the world found a positive attitude toward China’s economic rise, but not its military rise.²⁶

The fact that China is not likely to become a peer competitor to the United States on a global basis does not mean that it could not challenge the United States in Asia, and the dangers of conflict can never be completely ruled out. But Bill Clinton was basically right when he told Jiang Zemin in 1995 that the United States has more to fear from a weak China than a strong China. Given the global challenges that both China and the United States face, they have much to gain from working together. But hubris and nationalism among some Chinese, as well as unnecessary fear of decline among some Americans, make it difficult to assure this future. Extrapolating the wrong long-term projections from short-term cyclical events like the recent financial crisis can lead to costly policy miscalculations.

Misperceptions about the financial crisis could lead to policy miscalculations in both Beijing and Washington.

Notes

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