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Preserving the Open Global Economic System: A Strategic Blueprint for China and the United States

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We should keep a low profile and bide our time... .
—Deng Xiaoping (circa 1990)

The heart of the art of diplomacy is to grant graciously what you no longer have the power to withhold.
—Edmund Burke

INTRODUCTION

In June, the new Chinese leader, Xi Jinping, meets with President Barack Obama in the southern California desert compound of Sunnylands for their first summit since Xi ascended to the presidency earlier in 2013. The session lacks the epochal dimension of Richard Nixon's trip to China in 1972, but there is much promise in the air. Xi has traveled extensively in the United States with Vice President Joe Biden and has been speaking frequently of "a new type of great power relationship" between the United States and China. What he means by that is less than clear. But the new president's comments present a historic opportunity for the Obama administration to think more strategically about the relationship and capitalize on, rather than fear, the rise of China to a position of economic dominance, rivaling and challenging the United States.

Considerable commentary about the US-China relationship focuses on historical precedent, especially those unstable times in the past when a rising power challenged an existing or declining power. Graham Allison and Joseph Nye of Harvard University's Kennedy School of Government have spoken of the dangers of the "Thucydides Trap," alluding to the Greek historian's description of war resulting from a rising Athens challenging a previously preeminent Sparta.[1] Others cite the

1. Graham Allison, "Thucydides's trap has been sprung in the Pacific," *Financial Times*, August 21, 2012, www.ft.com/intl/cms/s/0/5d695b5a-ead3-11e1-984b-00144feab49a.html#axzz2Ucb98TuN.

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conflict that resulted from Japan's challenge to European powers in Asia in the first decades of the 20th century. And MIT economic historian Charles Kindleberger ascribes the collapse of economic cooperation between World Wars I and II to a similar shift in economic power from the United Kingdom to the United States.[2]

China is challenging the United States on a number of political, military, and economic fronts, while cooperating cautiously in some areas like North Korea. A major source of tension stems from the cyber-attacks and espionage, reportedly by the Chinese military, on the US defense infrastructure. All these subjects are to come up at Sunnylands.

The two countries should strike a Power-for-Purpose Bargain: The United States would give up power in existing multilateral institutions in return for China taking on greater global leadership to preserve the system's real purpose.

But in the economic sphere, the paramount challenge for Obama and Xi is to overcome what might be called the Kindleberger Conundrum: the preservation of the open, rules-based multilateral economic system against the background of the historic shift in which the rising power (China) might be unwilling to sustain it at a time when the declining power (the United States) is increasingly unable to single-handedly shoulder the burdens of leadership. The two nations must overcome their mutual wariness, not simply on specific policies but on how they view their systems and their roles in the world.

This Policy Brief argues that the open global economic system that has served the world—and especially China—can be preserved provided the rising power (China) and declining power (the United States) adopt the right perspective and take the right actions. Contrary to a bleak reading of precedent, there is reason to be optimistic about the prospects for an open global economic system. The two countries should strike a Power-for-Purpose Bargain: The United States would give up power in existing multilateral institutions in return for China taking on greater global leadership to preserve the system's real purpose.

Deng Xiaoping, the founder of modern China's role as an economic powerhouse, famously said about 20 years ago that "we should keep a low profile and bide our time." But history has speeded up the time of China's ascension faster than Deng might have envisioned. China is a regional superpower soon to become a global superpower, though a precocious (i.e., still not rich) one. By virtue of its economic success alone, even beyond Deng's wildest dreams, China will have to focus on its international role and responsibilities even as it faces up to its domestic challenges far ahead of the time-frame envisaged by Deng. China has simply become too big to have an either-or choice.

There is reason for hope that its evolution will be positive. China's international leadership in sustaining an open economic system, far from being inconsistent with its domestic responsibilities, may well amount to a self-interested insurance policy that minimizes the external threats to Chinese economic development. That key recognition—global leadership as self-interested insurance—must and can inform China's worldview as it considers its global role, and the United States should encourage such an understanding.

Among the steps that the United States and the West should encourage is for China to contribute to a stronger and bigger International Monetary Fund (IMF). Beijing should see this contribution as an insurance policy against global financial instability, which would eventually be very costly for its own export-dependent economy. Another step would be for China, at last, to open its markets to foreign goods, services, and capital, reducing the prospects of trading partners closing theirs, which could again be harmful for China's development prospects. A third step would be domestic action by China on climate change, which could be the down payment for initiating cooperation to avert outcomes that could be devastating for China.

For its part, the United States must also adjust its role and how it deals with China. First, Washington must move beyond familiar exhortations for China to become a "responsible stakeholder." In a thoughtful recent speech, Robert B. Zoellick, the former president of the World Bank, who coined that phrase, argues for the United States and China to explore a new "Great Power Relationship," an apparent allusion to President Xi's call for a redefinition of US-China ties.[3] But the United States has more to do.

Leaders in Washington and elsewhere in the developed world must blend their strategies of defense and offense in shaping the incentives facing China. On the one hand, they must take out their own insurance policy against China by forging an alliance with other countries in the region and beyond, including those that see themselves threatened by China. Such a strategy might loosely be described as taking a "multilateral

2. Barbara Tuchman (1962) famously captured this shift by describing the United States during World War I as Europe's "larder, arsenal, and bank."

3. Robert B. Zoellick, A New Type of Great Power Relationship? Speech delivered at Shanghai Forum, Fudan University, May 2013.

approach" (or establishing a coalition of the willing) rather than dealing with China on its own or in smaller groups.

On the other hand, the United States must not be afraid to empower China. For example, the United States could work to give China power and influence in international financial institutions comparable to what the United States and Europe currently enjoy. It could actively promote the rise of the renminbi as an international currency.

China will have to lead more, articulate its vision for the global economic system that engenders trust amongst partners, and show greater willingness to make concessions in order to achieve the long-term gains that would reinforce its self-interest.

Some of this empowering will be costly: More power to China might mean less for the United States. But it will increase China's stakes in the open system and reduce its incentives to work outside or create parallel structures. If the Chinese currency becomes a reserve currency, China will have less incentive to expropriate foreigners or otherwise engage in behavior that would undermine the status of its currency. If it has a greater say in the World Bank, it is more likely to lend to Africa in a manner that is consistent with multilateral norms and less inclined to be a dodgy aid provider on its own. And if it can have a say in shaping international rules, its incentive to create exclusionary arrangements of its own in Asia will be attenuated.

In sum, China will have to lead more, articulate its vision for the global economic system that engenders trust amongst partners, and show greater willingness to make concessions in order to achieve the long-term gains that would reinforce its self-interest. And the status quo powers must also give—by giving up some of their power—so as to enable China to lead more. For the United States, enlightened self-interest might well reside in graciously accommodating its relative decline and China's relative ascendancy.

WHERE WE STAND TODAY: DISTINGUISHING THE CYCLE FROM TREND

Before addressing the new economic relationship between China and the United States, the underlying assumptions about economic shifts and the associated power shifts must be examined. The repeated evocation of a G-0 world in which leadership and cooperation are undersupplied, threatening the integrity of the open economic system, also merits evaluation. In other words, the following questions may legitimately be asked: What's the problem? Why the fuss?

First, in the short run there has been a readjustment in the economic prospects of the United States and China, which has led to a reassessment of the US-decline-China-ascendant narrative. The United States is, at last, rebounding from the global financial crisis, enjoying a revival that is being projected forward based on other developments such as the discovery of natural gas (as argued inter alia by Wosepka, Levine, and Zhen 2012) and reverse offshoring of manufacturing. The Chinese economic model, propelled by investment and exports, appears to be running out of steam and possibilities. Combined with concerns about a possible middle-income trap,[4] China's economic prospects have seen downward revision.

The second relates to power and its manifestations. Here too, there is no clear narrative of an impotent America and all-powerful China. In the throes of the recent global financial crisis, especially in Europe, with the attendant possibility that large amounts of global resources would need to be mobilized, China with its $3 trillion in reserves appeared to be the key global player. This was reinforced by China playing host to a succession of European leaders hoping to tap Chinese money bags. It was also reinforced by the sidelining of America, with the US treasury secretary reduced to offering counsel not cash to Europe because of its fiscal situation.

But this picture was misleading. In the aftermath of the Lehman Brothers crisis, a number of emerging-market countries, loath to borrow from the IMF, nevertheless felt able and keen to enter into swap agreements with the US Federal Reserve. The US Treasury may have been a bystander during the euro area crisis but the Fed did provide about $80 billion to European central banks through swap facilities. And the dollar continued to be the safe haven for nervous international investors during times of turbulence: In the first six months of the crisis the dollar appreciated by about 15 percent against currencies of its trading partners.

On the trade front, the United States launched a major trade initiative with East Asian countries—the Trans-Pacific Partnership (TPP)—which was a manifestation of American power in two significant respects. It signaled that America would not hesitate to take actions that had the effect if not the aim of economically containing China.[5] More significantly, the fact that TPP would essentially involve broadly

4. See the *China 2030* report by the World Bank (2012) and also Aiyar et al. (2013).

5. By lowering trade barriers in Asian and US markets, but only to countries in the TPP, Chinese firms are discriminated against. It is the imposition of this cost that merits the term containment.

Table 1 Economic indicators for China and the United States

Indicator	Units	2010		2020		2030	
		United States	China	United States	China	United States	China
GDP (current US dollars)	Billions	14,658	5,878	18,763	11,892	24,019	22,440
	Percent of world total	23.5	9.4	20.6	13.0	17.2	16.1
GDP (PPP dollars)	Billions	14,658	15,162	18,763	26,915	24,019	47,779
	Percent of world total	16.8	17.4	14.4	20.6	11.8	23.5
Merchandise exports	Billions	1,289	1,578	1,734	3,171	2,333	6,368
	Percent of world total	8.5	10.5	7.1	12.9	5.9	16.0
Cumulative next external deficit	Billions	–5,792	1,993	–5,651	7,164	–4,309	3,382
	Percent of world total	–50.8	17.5	–31.6	40.1	–22.3	17.5
Per capita GDP (PPP dollars)	US dollars	47,284	11,303	55,491	18,985	66,519	32,980
	Percent of world average	368.1	88.0	319.6	109.4	266.5	132.1
CO_2 emissions	Million metric tons	5,644	8,262	5,777	10,128	6,108	12,626
	Percent of world total	18.0	26.4	16.4	28.8	15.0	31.1

PPP = purchasing power parity

Sources: Subramanian (2011); US Energy Information Administration (EIA) for CO_2 emissions.

asymmetric market opening—modest on the part of the United States, significant on the part of its partners—signaled a willingness, even need, by Asia for engagement with, and even embrace by, the United States. Asian attitudes reflected a wariness about increasing Chinese military assertiveness in the region. The unbenign exercise of Chinese hard power has elevated the attractions of American soft power. Thus, reports of the decline in American economic power appeared to have been exaggerated.[6]

A third manifestation of the murky status quo is that for all the talk of power shifts and growing wariness between China and the United States, there continues to be modicum of cooperation between them and a willingness to work through and within existing governance and power structures.

For example, to respond to the global financial crisis, in 2009 all countries agreed to quota increases in the IMF and changes in governance. Indeed, the notion of a G-0 was dispelled, even if temporarily, in the immediate aftermath of the global crisis where all countries, including China and the United States fashioned coordinated and mutually supportive macroeconomic responses and refrained from beggar-thy-neighbor trade and exchange rate policies. Additionally, in the trading system, although progress on liberalization has been stalled in the Doha Round of trade negotiations, China and the United States both adhere to the rules of the World Trade Organization (WTO), litigate against each other to correct perceived departures from them, and broadly comply with judicial verdicts handed to them (Hufbauer, Wong, and Sheth 2006). Most surprisingly, perhaps, has been China's attitude toward the leadership of the IMF and the World Bank. For all the perceived resentment at US and EU monopoly of these positions, China was an early supporter of Christine Lagarde and Jim Kim over their respective (and strong) emerging-market competitors.

But these cyclical developments, though important, should not obscure likely secular developments. The baseline projections in Subramanian (2011) that illustrated likely Chinese economic dominance, were not predicated on surging Chinese growth and collapsing American growth. The medium-term growth projections for China and the United States, 5.5 and 1.8 percent (per capita), respectively, had factored a significant slowdown in China and a return to historic trend for the United States. These relatively conservative assumptions when applied to today's situation—where China's economy is as large as that of the United States (measured in purchasing power parity dollars), China's merchandise trade is greater, and China is among the world's largest net creditors while the United States is the world's largest net debtor—still yield striking disparities between China and the United States in the future.

As shown in table 1, in the next two decades, China's economy will be twice as large, and its merchandise trade two-and-a-half times as large. These in turn would create the conditions for the renminbi to rival the dollar, although follow-up

6. Nye (2011) has argued that even at the height of American power, the United States rarely secured all the outcomes it wished for.

actions by way of opening up its financial and exchange rate markets will be necessary to make this rivalry a reality.

Indeed, there are nascent signs consistent with the rise of the renminbi. In recent research (Subramanian and Kessler 2012), we find that in the last two years, the renminbi has increasingly become a reference currency (defined as one that exhibits a high degree of comovement with other currencies). In East Asia, there is already a renminbi bloc, because the renminbi has become the dominant reference currency, eclipsing the dollar, which is a historic development. In this region, 7 currencies out of 10—South Korea, Indonesia, Malaysia, the Philippines, Taiwan, Singapore, and Thailand—more closely track the renminbi than the dollar. The dollar's dominance as reference currency in East Asia is now limited to Hong Kong (by virtue of the peg), Vietnam, and Mongolia. This reference role of the renminbi is slowly spreading beyond Asia.

Moreover, favorable cyclical developments in the United States have not had any impact on the "beleaguered middle class" problem—stagnant median wages, increasing inequality, declining mobility (Luce 2012)—that has afflicted the United States since the early 1980s. Even in this recovery, profits have increased, the share of the economic pie going to labor has declined, and the average household has recovered 45 percent of the wealth they had just prior to the crisis. Thus, a shift in the underlying determinants of hard power is likely, perhaps even inexorable.

In this context, and notwithstanding the fact that current cooperation has not collapsed, there is a key structural cause for future concern. The impending economic shift could lead to a structural undersupply of leadership. China will be an unusual economic superpower in that it will be dominant by way of size while still being handicapped by its status as a middle-income country. By 2030, the standard of living of an average Chinese citizen will still be only about 45 to 50 percent of that enjoyed by the typical American (see table 1). The previous two superpowers (the United Kingdom and the United States) were both amongst the richest at the time of their dominance. China's ability to lead will therefore be constrained by a preoccupation with economic and political challenges as reflected in Deng Xiaoping's famous exhortation quoted above. Or, as Charles Kindleberger might have put it: Might the open system be imperiled by a combination of American inability and Chinese unwillingness to sustain it?[7]

Moreover, the case can even be made that China and the United States are in fact engaged in low-grade, indirect economic skirmishing. Cooperation between the two coexists with narratives of deep mutual distrust. Kenneth Lieberthal and Wang Jisi (2012) argued of a rising "strategic distrust" between the United States and China. In their view, the Chinese model of economic and political development has been very different from any others in the world. The argument that China remains an outlier is that the state still plays an unusually important, even intrusive, role in the economy.

Against the common narrative of mutual distrust, cooperation between China and the United States needs to be fundamentally reevaluated and refashioned.

China, the biggest beneficiary of the open global economic system, nevertheless resents the fact that its rules have been shaped (sometimes rigged) by the United States (Shambaugh 2013). The United States, for example, has not ratified changes in the voting arrangements in the IMF that would give emerging markets such as China more say. For similar reasons, it has been reluctant to countenance an increase in the lending capacity of the World Bank (Kapur and Raychaudhuri 2013). As a result, and with a view to exercising its new-found power, China is creating parallel economic structures: the BRICS bank and bilateral development assistance to rival the World Bank and regional trade initiatives such as the Regional Comprehensive Economic Partnership to parry American forays into Asia.

For the United States, distrust is engendered by Chinese actions on a number of fronts, economic and noneconomic. China follows a mercantilist trade policy, has a closed financial and exchange rate system and still pervasive state-owned enterprises, tolerates and even encourages piracy and counterfeiting of Western intellectual property, encourages technological indigenization at the expense of foreigners, and limits the supply of certain special commodities (rare earths) on which its trading partners and rivals depend. In the security area, China is increasingly expanding naval power on seas that America regards as vital interests. And the scope and persistence of cyber-espionage and cyber-based attacks on foreign, especially US, targets raise serious questions about its aims and intentions.

So, in the American narrative, China takes advantage of the openness of others while remaining closed itself, a combination that is inconsistent with global leadership. This perception has led the United States to pursue initiatives such as the TPP and the Transatlantic Trade and Investment Partnership

7. In principle, the European Union, which has an important economic presence, can be a potential ally of the United States in leading the system. But that will depend critically on it coming out of the current crisis with sufficient economic dynamism to remain a superpower and with greater cohesion to be able to project this power. Whether Europe will be able to do so remains an open question.

(TTIP). These aim to pursue liberalization, but it cannot be denied that they have the effect if not the aim of discriminating against China and hence pressurizing it to respond.

Against this common narrative of mutual distrust, cooperation between China and the United States needs to be fundamentally reevaluated and refashioned.

WHAT CHINA MUST DO: LEAD OUT OF SELF-INTEREST

But why should we worry for the open economic system of freely flowing trade, finance, and ideas, in the first place? China should have a stake in preserving it for a simple reason. China's rapid economic transformation over the last three decades has been predicated crucially on openness. That rapid economic transformation is still far from complete because China's standard of living is still only 20 to 25 percent that in industrial countries. Completing that transformation is critical for the political legitimacy of China's policymakers. In these circumstances, disrupting the open system would amount to biting the hand that has fed China and its rulers.

Indeed going forward, the Chinese agenda for reforms, as elaborated in the government-imprimatured *China 2030* report, would be entirely consistent with an open system: China's domestic needs are in fact outsiders' wants. For example, the nontransparent practices of the state enterprises and the financial repression and closed nature of China's capital account are a big concern for foreign firms trying to access the Chinese market and for firms around the world trying to compete with an undervalued Chinese currency. The more China reforms the state enterprises and the state-owned banks, the easier for foreigners to do business. Similarly, the report calls upon China to move more toward an innovation-based economy, which would require stronger protection of property rights, another key demand of outsiders. China needs to reduce its pollution and move toward a more carbon-efficient economy, which would allow China to play a constructive role in global climate change efforts. In all these cases, tensions will undoubtedly arise from a differing sense of urgency about specific actions, but across the board, there is no fundamental conflict between what China needs to do domestically and what it needs to do to sustain an open system.

All this assumes that China's domestic development agenda can drive or inform China's external actions and responsibilities. But a stronger case for China's international leadership can stem from seeing how external developments can determine or even threaten China's domestic development. Taking actions to avert these threats or minimize their risks in China's own interest would itself constitute global leadership.

External Threats to China's Development and Self-Interested Insurance

At least three possible external factors can seriously affect or undermine China's domestic development: global financial instability, protectionism, and climate change. In each of these areas, China may need to act and contribute to strengthen the international system and/or initiate new international cooperation as insurance policy against adverse domestic consequences.

Global Financial Instability

The crisis of 2008 illustrated how vulnerable China was to external financial instability. In late 2008 and early 2009, China's exports collapsed and at least 20 million to 40 million people were in threat of being internally displaced. In the event, China was able to avoid social instability and disruption because it had the financial strength to implement a macroeconomic package of offsetting stimulus that stabilized the economy quickly. Going forward, China's ability to repeat this policy response, at least on the same scale and effectiveness cannot be taken for granted. China must also act to minimize the risks of such events recurring.

At least three possible external factors can seriously affect or undermine China's domestic development: global financial instability, protectionism, and climate change.

More broadly, the global economic system has become more vulnerable to financial crises because of an increase in the magnitude and volatility of capital flows. In addition, a tectonic shift has occurred in the identity of potential international borrowers and creditors in the future. More larger countries and yesterday's creditors are tomorrow's potential borrowers. Some such as Greece and Ireland have needed emergency financing from the outside, and others such as Italy and Spain came close until the European Central Bank stepped in decisively in the fall of 2012.

One possible conclusion is that to fight future crises and ensure that they don't devastate the economy, the IMF will need considerably more lending capacity than it currently possesses. Edwin Truman (2012), for example, argues that the IMF's quotas and other lending arrangements (the New Arrangements to Borrow) need to be doubled. With the United States essen-

tially sidelined because of its own economic and fiscal weakness, only China, with its $3 trillion in reserves, is now capable of providing the resources to create a bigger IMF. This would require China to contribute substantially to the IMF.

China's leaders may not have to face voters periodically but they will have to justify making these contributions domestically. They will be pressed to answer such questions to their own people: Why should we invest our billions to rescue much richer countries, banks, and individuals when there is poverty at home? Wouldn't this amount to immoral hazard?

One way they can take their population along would be for Chinese leaders to say that the returns from rescuing the rich are that China staves off the economic instability that might otherwise boomerang on China and Chinese exports. China would essentially be helping itself by enabling foreigners to buy Chinese goods and services. Of course, China will also have to be rewarded with greater say in how international institutions such as the IMF are run (more on this below), but supporting the global financial system is fundamentally in China's self-interest.

Protectionism

China's economic transformation requires that global markets, especially in industrial countries, remain broadly open. So far, there has never been any serious threat of protectionist retreat in rich countries that would jeopardize China's trade and development. That has allowed China to take open markets for granted. But going forward China can no longer be sanguine on this score. The challenges for an open system from the "decline of the West" should not be underestimated. If growth does not recover, income distribution continues to worsen, and economic opportunities shrink, the intellectual and political consensus in favor of open markets will come under threat. There are already ominous portents.

In the United States, for example, five leading intellectuals (of which three are Nobel Prize winners) with impeccably cosmopolitan credentials—the late Paul Samuelson, Alan Blinder, Paul Krugman, Larry Summers, and Michael Spence—have expressed concerns, albeit different ones, about the impact of globalization on the US economy. They have all been careful not to advocate protectionist remedies but their concerns could lend legitimacy to such policies. Not least because the political support for free trade agreements has declined considerably amongst the public. Most strikingly, a November 2010 Pew poll showed that only 28 percent of traditionally free trade-minded Republicans expressed such support, down 15 percentage points from the previous year.

The more prolonged and persistent the economic difficulties in the West, the greater the political and intellectual pressures will be to start retreating behind protectionist barriers. Moreover, these pressures will be fed by the (correct) perception that Western markets are more open than China's. If China's future opening is slow, the United States, over time, might be increasingly tempted to play the unfairness card based on the disparate levels of policy openness: Why should our markets be more open than that of a rival and equal, especially if that rival is pursuing protectionist policies?

Thus, frustrated by an unwillingness on China's part to open its economy, lacking the carrots to overcome this unwillingness, spurred by a weak economic climate and shifting intellectual certitudes, and goaded by perceptions that China is not making its fair contribution to keeping markets open, the United States might be tempted to then threaten to close its own market to China unless China further opens its own.

Moreover, concerns about China's trade policies have not been confined to rich countries. The Chinese export juggernaut is a source of concern across the developing world. Brazil, India, Mexico, Korea, South Africa, among other emerging-market countries, chafe under China's mercantilist exchange rate policies. Most of the antidumping actions taken by developing countries have been against Chinese imports. And one of the dirty secrets of the Doha Round is that its collapse is due in part to the reluctance of emerging-market countries to liberalize their economies and expose themselves to Chinese competition.

What must China do? Both to ensure that industrial-country markets remain open and to address the concerns of other developing countries, China must take the initiative to keep markets open. It can do so in different ways. One possibility is for China to start a new multilateral initiative (a "China Round") in the WTO to rescue or more likely replace the Doha Round (Mattoo and Subramanian 2012a). This new initiative would aim to put on the table for negotiations the key issues of concern for China (security of access to investing abroad, climate-change related trade actions) and its trading partners (exchange rate policies, barriers in services and government procurement, state capitalism) in a way that the Doha Round did not.

But any new initiative will have to break from the past in one key respect. Hitherto, the industrial countries have always been the protagonists, either negotiating amongst themselves or pushing for opening in the developing world. This time, China must take the lead in launching such an initiative because they now have a big stake in ensuring that rich countries don't retreat into protectionism, which would undermine their growth dynamism.

Economic power is shifting toward the rest and China in particular. But those acquiring the power will have to work harder to ensure that the shift does not undermine open markets. For China, it is a story of noblesse oblige but based on self-interest.

Climate Change

The other major threat to China's development is climate change. Nearly, all the estimates of the costs of climate change suggest that China, along with other developing countries, stand to lose more than industrial countries.

William Nordhaus (2011) has calculated the social cost of carbon, which measures the cost from an additional unit of global emissions, and estimated that these costs are significantly greater for China, India, and other developing countries than they are for the United States or Europe. For example, the social cost of carbon for China is about three times that of the United States and nearly four times that of Europe. For India, the corresponding multiples are nearly two and three, respectively. These greater costs for China and India result from the greater growth prospects and their greater vulnerability to damage from climate change. Also, coastal cities such as Shanghai are especially vulnerable to sea-level rise, and water scarcity remains a major worry.

It is clear therefore that the stakes of the large developing economies are enormous. Indeed, the deepest fear of developing countries should not be that they will be asked to contribute too much to climate change but that industrial countries will contribute too little. The rich countries, reluctant to cut emissions, may opt to take inaction by the large developing economies as justification for attempting to adapt to climate change instead of taking aggressive actions to avert it. It would be catastrophic for developing countries if based on these differential impacts and costs of climate change industrial countries pragmatically, if cynically, concluded that it would be better for them to adapt to climate change than act to prevent it.

In fact, Kirk Hamilton (2011) captures the relative benefits and costs of mitigation for developing and industrial countries well. Using one of the standard integrated assessment models (IAM), he finds that the mean benefit-cost ratio for developing countries to do their efficient share of mitigation is 3.8, while this ratio if they finance all mitigation (including that in OECD countries) is still 2.7. For OECD countries the mean benefit-cost ratio for financing all mitigation (including that in developing countries) is an unattractive 0.5. Setting ethics and politics aside, the stark bottom line is that it is strongly in the interest of China (and large) developing countries to mitigate climate change—much more so than is the case for OECD countries.

Simon Kuper was onto this possibility when he wrote in the *Financial Times*, "We in the West have recently made an unspoken bet: we're going to wing it, run the risk of climate catastrophe, and hope that it is mostly faraway people in poor countries who will suffer."[8] It is therefore the large and vulnerable developing countries that must go on a war footing to campaign for action, including by today's rich countries, to avert catastrophic climate change.

But for China (and India) to articulate the new narrative, to credibly become the new demandeurs, they must back up their rhetoric with real contributions. These contributions are elaborated in greater detail in Mattoo and Subramanian (2012b), but the key point is that these contributions—which will not be costless for China—should be seen as an insurance or down payment for contributions by others to help achieve a cooperative outcome—averting climate change—that would safeguard China's own economic development.

Indeed, there are emerging signs of China's intention to act on climate change. China has set up seven carbon-trading schemes—in five large cities, including Beijing and Shanghai as well as two large provinces—with a view to extending them nationally from 2015. Moreover, in February 2013, the Chinese Ministry of Finance reported that China will proactively introduce a set of new taxation policies designed to preserve the environment, including a tax on carbon dioxide emissions.[9] The Ministry of Finance experts suggested levying a carbon tax in 2012 at 10 yuan per ton of carbon dioxide, with the tax rising to 50 yuan per ton by 2020. In terms of pricing carbon, China might be ahead of the United States.

WHAT THE UNITED STATES MUST DO ON DEFENSE: THE HEDGE OF MULTILATERALISM, THE SIREN CALL OF REGIONALISM

Why Multilateralism?

The United States and China's larger partners need to deploy a strategy that must simultaneously take account of the possibility that China might be a not-so-benign economic hegemon while reinforcing its incentives to act to preserve an open economic system.

Notwithstanding all the coincidence of interests between China and the world, the world cannot be woolly eyed. There remains a distinct possibility of an eventual unbenign exercise of dominance by a hegemonic or near-hegemonic China. This possibility, of course, is kept alive by acts of omission and commission on China's part. China has yet to articulate its vision for the international system, which has sowed doubts

8. Simon Kuper, "Climate Change: Who Cares Anymore?" *Financial Times*, September 17, 2011.

9. See "China to Introduce Carbon Tax: Official," Xinhua, February 19, 2013, http://news.xinhuanet.com/english/china/2013-02/19/c_132178898.htm.

in the minds of partners. Does it believe in a strong IMF and WTO? As a large donor, does it subscribe to the existing norms of and conditions associated with lending to the poor?

Acts of commission include China's current policy actions: It has maintained a mercantilist exchange rate policy, inflicting beggar-thy-neighbor costs on partners despite a chorus of opposition from them; its protection of intellectual property rights remains far from strong; it acts as if it wants to monopolize access to key natural resources by investing and controlling them at source; and more broadly, its model of state capitalism continues to confound and exclude foreign investors. All of these have been a source of conflict with trading partners.

The possibility of the misuse of hegemony would not be unique to China. It was famously said of the United Kingdom that Britannia ruled the waves by waiving the rules. And even the United States occasionally succumbed to this temptation. In 1955, it excluded agriculture from General Agreement on Tariffs and Trade (GATT) disciplines. In the early 1970s, it unilaterally blew up the Bretton Woods system when it became a suffocating straitjacket on domestic US policies. In the 1980s and 1990s, it cajoled and coerced developing countries to take on costly obligations, for example, relating to intellectual property and capital flows. Misuse of hegemony is intrinsic to hegemony in the dark Nietzschean view that "power is never held in innocence;" it is also intrinsic because of the infinite capacity for countries to succumb to the delusion that John Adams memorably warned about: "Power always thinks it has a great soul."

History also suggests that the best defense against hegemony is multilateralism, which offers a modicum of protection for the weak against the dominant power. And by keeping China tethered to the multilateral system, in which the United States and other major countries can exercise some countervailing influence, it offers the best insurance against the unbenign exercise of hegemony by China.

Multilateralism would work as a defense against China in several ways: in shaping rules, in promoting adherence to them, and more broadly in defining legitimate behavior. Increasingly, on trade issues where bargaining is based on the mercantilist logic of exchanging market access concessions, the balance of negotiating power will be with China rather than its partners for two reasons: China's growing market size and the fact that its trade barriers are substantially greater. Multilateralism ensures that there will be enough combined heft amongst China's trading partners such that negotiating with China can be more balanced. Take market opening, for example. China might be willing to open its markets in return for the United States, European Union, India, and Brazil opening theirs. A multilateral negotiation amongst these large trading countries could conceivably lead to meaningful opening. But China's willingness to open up in a similar manner in negotiations just with the United States or European Union or with some less weighty combination is far from clear.

A similar argument carries over to enforcement and the incentives to adhere to previously agreed rules. China's incentive to abide by multilateral rules will be stronger than to abide by a series of bilateral agreements because the reputational costs of being seen as errant is much greater in the former context. The opprobrium of being a deviant from multilateral norms is China's great fear, rendering multilateralism the best weapon the world can deploy against a dominant China.

These arguments for multilateralism have an important corollary for the United States and other countries. They imply less recourse to bilateral and regional dealings with China and with each other. The more countries elevate the role of bilateralism in dealings with China, the less China will be anchored in the multilateral system, and the more exposed countries will be to the exercise of Chinese dominance. One operational consequence, also advocated by Lieberthal and Jisi (2012), is to expand the US-China strategic economic dialogue to include the larger countries in the world—Europe, Japan, Brazil, and India for a start—whose heft can be an effective counterweight to that of China.

Costs and Benefits of US Megaregionalism

These arguments in favor of multilateralism and against regionalism and bilateralism apply across the board in the fields of currency, finance, and trade. But they carry particularly important implications in the field of trade because of the current environment when the Doha Round appears dead and regional initiatives are flourishing. The Obama administration has embarked upon two megaregional initiatives—the Trans-Pacific Partnership and the Transatlantic Trade and Investment Partnership. Could the case be made that these are risky demarches with modest economic benefits and possibly substantial risks.

Economic Benefits of TPP and TTIP

It is unlikely that either TPP or TTIP will confer large (as in macroeconomically significant) economic benefits. Why so?

In the case of the TPP, the modest gains for the United States stem from the asymmetric market opening. It is well-known that most of the economic/welfare gains from trade liberalization stem from a country's own liberalization. In the TPP, the United States is unlikely to undertake significant opening itself, hence US consumers don't stand to reap large gains. The economic gains to the United States will accrue in the form of rents to American producers in partner-country markets that are opening up preferentially. One (probably opti-

mistic) estimate by Peter Petri and Michael Plummer (2012) finds that the gains to the United States in 2025 from a TPP that includes Japan, Mexico, Canada, and Korea will be about 0.4 percent of GDP, three-quarters of which is accounted for by Japan liberalizing its economy, especially its services sector.

In the case of the TTIP, the economic gains of any plausible deal are unlikely to be large but for different (and subtler) reasons. Conventional trade barriers in both the United States and Europe—with notable exceptions such as government procurement and maritime transportation, which are likely to remain exceptions—are relatively small, and where they are significant, their scope is narrow (as in agriculture). For these reasons, TTIP cannot generate large economic gains measured as a share of the US economy.

What about the gains from regulatory harmonization or convergence? TTIP will focus to a great extent on addressing differences in regulation across the two jurisdictions (Schott and Cimino 2013). In agriculture, the European Union favors strict safety and sanitary regulations—sometimes beyond what is called for by science. In relation to data, the European Union favors stricter standards to safeguard privacy and private rights while the United States favors market-driven solutions. France seeks to protect its artistic heritage by way of an "exception culturelle" to free trade. In relation to protecting wines and spirits, the European Union favors high levels of protection for certain geographical appellations.

Now, the economic/welfare calculus of regulatory convergence—if indeed that is going to happen under TTIP—is complicated. If to start with, each country's tradeoff between regulation and liberalization represents some kind of revealed collective preference, any departures that changed that tradeoff will not have unambiguous consequences.

If the European Union relaxes its safety regulations to allow more US beef, EU beef eaters will benefit but will also lose because they have in some sense been exposed to more risk (which is a cost); after all, that is why they had the stricter regulation in the first place (unless of course the regulation was pure protectionism even to begin with). Similarly, if the United States strengthens protection for geographical appellations, more French bubbly will benefit some American consumers, but there will also be costs because access to new world bubbly will be curtailed. The bottom line is that by definition, the nature of integration between the United States and European Union will result in modest overall net gains especially if the benefits of regulations are properly accounted for.

The Costs: Why Regionalism Aimed at China Is Different

In the old debate between the regionalists and the multilateralists, the divide was not about the end-point: All parties wanted global free trade. Rather, the divide was whether regional agreements would be, in Jagdish Bhagwati's words, a "building bloc" or "stumbling bloc" towards that final goal, with the regionalists falling in the former category and the multilateralists in the latter.

Advocates of regionalism have long relied on the competitive dynamic it creates: If two countries negotiate preferential reductions of barriers, one or several outsiders will be hurt. These outsiders will then have an incentive to negotiate preferential agreements themselves. This process would continue until the goal of global free trade is achieved, or so went the the Bergsten-Zoellick theory of regionalism as promoting competitive liberalization.

Regionalists would point to the evident success of regionalism in being able to achieve deeper liberalization—in many or most cases, border barriers are eliminated in goods and services, and in some behind-the-border barriers are also addressed. But with China these arguments have less force.

Consider four ways in which the TPP might play out. In the first, the United States embarks on a process of deep integration with a number of Asia-Pacific countries without China. To avoid the dangers of hostile regionalism (i.e., excluding China), TPP countries could subscribe to the principle of open regionalism: Countries that embrace the terms of the agreement get all its benefits but don't if they stay out.

The problem with this approach is the following. China would never agree to just fall in line with rules in the negotiation in which it has not participated. For example, if TPP members negotiated rules against undervalued exchange rates, China would probably stay away. If so, this would hardly achieve the objective of disciplining problematic Chinese policies, which are key to maintaining the open character of the trading system.

In the second scenario, suppose that the United States invites China to the TPP negotiating table to be part of the process of creating the rules. Would this really be superior to negotiating with China multilaterally, where the European Union, Brazil, and India would also be at the table? If the problem of a rising China is that it will have a lot of bargaining power by virtue of its economic size and dominance, then a multilateral process will add more negotiating heft on the other side of the negotiation. How can it not help to have Brazil and India and Europe as part of the group putting pressure on China to create better rules and to adhere to them? Of

course, there is no guarantee that Brazil and India will always be on the side applying pressure on China, but where important interests are at stake they might be willing to do so.

There is a much worse, third scenario. China could construe TPP as an act of hostile regionalism.[10] It can offset its own disadvantage relative to American competition in Asia-Pacific markets by negotiating free trade agreements of its own with these countries. Indeed, that is what it is doing. China has negotiated agreements with four countries already, and the Regional Comprehensive Economic Partnership (RCEP) between the Association of Southeast Asian Nations (ASEAN) and six other countries (Australia, Japan, New Zealand, Korea, India, and China) is aimed at widening this circle of free trade agreements to parry similar American efforts.

But such agreements negotiated by China also impose a cost on American and European firms because in Chinese markets they are now disadvantaged relative to Asian firms. De facto, TPP and TTIP combined with Chinese responses to them amount really to an elaborate trade war by proxy. TPP could thus provoke China into playing the regionalism game in a way that could fundamentally fragment the trading system. Down this path lies the folly of the interwar years.

The lesson is that the success of regionalism in reducing barriers and generating the competitive dynamic for further liberalization cannot be easily applied to China. The successes of regionalism—the North American Free Trade Agreement (NAFTA), Eastern and Central Europe—typically involved a big economic power—the United States, European Union, and Japan—negotiating with smaller countries. As such, it is the smaller countries that did most of the incremental liberalization because the larger countries held the balance of negotiating power and influence. With China, the power balance gets reversed, rendering many of the old arguments for regionalism obsolete.

There is, of course, a final possibility, which is that TPP—and the combination of economic containment and Chinese pragmatism—might work. Seeking to avoid the impact of TPP and TTIP on its own exports and economic trajectory, China could come to the negotiating table either regionally (in the Asia-Pacific context) or multilaterally (in the WTO in Geneva). If this were to happen, it would signal that America continues to possess significant economic power.

10. Yang Yao, "America Pivot to Asia will provoke China," *Financial Times*, The A-List, February 12, 2013, http://blogs.ft.com/the-a-list/2013/02/12/americas-pivot-to-asia-will-provoke-china/#axzz2U9T1pqzR.

WHAT THE UNITED STATES MUST DO ON OFFENCE: EMPOWERING NOT CONTAINING CHINA

If multilateralism is one prong of a strategy to tether China, another prong is the carrot that the United States must offer as an offset to empower China in existing multilateral economic structures. The United States can empower China in the three domains of currency, finance, and trade. Although the exact mechanism and the costs and benefits to the United States might vary across these three domains, the underlying logic of empowerment—of reinforcing China's stake in the open economic system and reducing its incentive to create parallel structures—is common to all.

Costless Empowerment: Promoting the Renminbi's Rise as a Reserve Currency

China chafes under dollar hegemony. When the Governor of the People's Bank of China, Zhou Xiaochuan (2009), famously called for the special drawing rights (SDR) to replace the dollar, the actual proposal seemed of less significance that the underlying resentment that the dollar enjoyed reserve currency status, which has allowed the United States to use (and on occasion abuse) that status.[11]

It could be argued that perhaps China wants more than just the replacement of the dollar. According to a report by the Center for Strategic and International Studies (Murphy and Yuan 2009):

> A number of Beijing-based intellectuals believe the government should actively pursue renminbi internationalization with the eventual goal of achieving reserve currency status. This view is popular with the Chinese public, particularly its vocal netizens, and has as much to do with nationalism as economics. …CASS economist Wu Jinglian has backed PBOC governor Zhou Xiaochuan's call to reform the world's currency regime.[12] Wu believes China "should try to increase the influence of renminbi."[13]

11. It goes without saying the China's currency policy of the last decade amounted to China perpetuating dollar dominance. China was avaricious in its appetite for dollars to sustain a weak currency and thereby promote growth. But Chinese officials are aware that going forward, that policy would have to be abandoned if the renminbi is to become a serious rival to the dollar as a reserve currency.

12. Hong Qihua and Liu Dan, "Wu Jinglian Bolsters Zhou Xiaochuan: It's Time to Adopt a Supervision Mechanism on the Issuance of the US Dollar," SOHU.com (in Chinese), March 30, 2009, http://business.sohu.com/20090330/n263080295.shtml.

13. Another indicator of China's intentions for its currency is the encour-

China has also undertaken a series of actions that would pave the way for its currency to attain that status. In early May 2013, the State Council announced that "a plan to make the currency convertible under the capital account will be proposed this year, indicating that a blueprint for the long-discussed reform is in place."[14] The United States has an interest in supporting this goal of promoting the rise of the Chinese currency. First, even if the renminbi were to eclipse the dollar, that is not an outcome for America to fear. To be sure, there might be some loss of convenience and some dent to the perceived economic status for the United States. And for sure, the real cost of losing this status would be some increase in the borrowing costs for the United States. Estimates suggest that the fact of reserve currency status—that foreigners want to hold dollars for the convenience and safety that it provides—allows the US government to pay about 60 to 80 basis points lower interest on its borrowing than might otherwise be the case.

If multilateralism is one prong of a strategy to tether China, another prong is the carrot that the United States must offer to empower China in existing multilateral economic structures.

But there is also a cost to the United States from the dollar being the reserve currency. The fact that it could borrow cheaply played a role in the reckless policies of overconsumption that led to the financial crisis of 2008.[15] A reserve currency is like the bartender who plies the customer with alcohol. The alcoholic still bears responsibility for his actions, but free-flowing booze facilitates the indulgence. For this reason, one might say that it is not terribly costly to the status quo power—the United States—to empower China by promoting the latter's currency at the expense of its own. Despite the double-edged nature of a reserve currency, China might seek reserve currency status for the renminbi, largely for historic reasons, especially the perception of humiliation by the Western powers.

Second, the more the Chinese currency is internationalized the greater will be the demand for renminbi by foreigners and hence the more the renminbi is likely to appreciate, an outcome that the United States has been seeking for several years. Moreover, renminbi internationalization both requires and will set in motion reforms to China's financial and external sectors that is in the interest of China and the world. These reforms are resisted by the vested interests—exporters and domestic producers intent on preserving the benefits from an undervalued exchange rate and the state-owned banks who benefit from having the power to allocate cheap credit. Renminbi internationalization is a way of empowering the countervailing forces to facilitate the much needed reforms.

Third, and most important, if the renminbi ascends to become an international reserve currency, China might be reluctant to lose the prestige, and any associated benefit, that comes with that status by disrupting financial and trade relations in any serious way. China covets reserve status for its currency and, once achieved, is unlikely to undermine that through unbenign hegemony.

The world has therefore an interest in promoting renminbi internationalization as a form of strategic empowerment in this sphere. Achieving renminbi internationalization is largely in the hands of China's policymakers who need to open up China's financial system and make the renminbi convertible. But outsiders can help at the margin in the following two ways. To signal interest in recognizing China's growing global role, the world must move to include the renminbi in the basket of currencies that make up the SDR, the IMF's special currency. The SDR is unlikely to witness any significant increase in its role as an international currency, so inclusion of the renminbi will have no serious or substantive consequence. But its symbolic value could be important: It would show that the world far from stymieing China's international role is actively promoting it.

The United States and Europe in particular are reluctant to include the renminbi in the SDR basket on the technical grounds that it is still not fully convertible. They should instead adopt a strategic perspective and find creative ways around these technical requirements, recognizing that the act of including the renminbi in the SDR basket might actually accelerate the move toward renminbi convertibility.[16]

agement of other central banks (Brazil and Nigeria, for example) to hold renminbi.

14. People's Daily Online, "China cautiously hastens capital account reform," May 8, 2013, http://english.peopledaily.com.cn/90778/8237265.html.

15. C. Fred Bergsten, Currency Wars, the Economy of the United States, and Reform of the International Monetary System, twelfth annual Stavros Niarchos Foundation Lecture, May 16, 2013, Peterson Institute for International Economics, Washington.

16. For much of the post-SDR era, quite a few currencies, including nonconvertible ones such as the Iranian rial and even the French franc and sterling, were part of the SDR basket. But that changed and the basket was narrowed in 2000 to countries with "operational" freely usable currencies (FUC). To qualify as an FUC, the IMF uses two metrics: how widely it is traded and used to make payments. The renminbi in 2011 ranked 15th in terms of the currency composition of international debt securities and in 2010 ranked 17th in exchange market turnover. The IMF could waive these requirements just as it has routinely breached other conditions, when it has suited the larger countries—for example, on how much the IMF can lend to individual countries in crisis.

A second initiative that would again largely be of symbolic value would be for the United States and United Kingdom to offer to make New York and London, respectively, international financial centers for the renminbi. Hong Kong already plays this role and China and the United Kingdom have had discussions for extending this status to London. If New York were to be added to the list, it would reinforce the signal that the United States welcomes and is intent on promoting the rise of the Chinese economy and the renminbi.

Costly but Necessary Empowerment: Enhanced Power in International Financial Institutions

Promoting the Chinese currency has the benefit of creating a stake for China in the current system. It does not carry major costs for the United States. And it is also largely irrelevant for the world economic system, which is largely currency-blind: The benefits to the world do not depend on whether currency hegemony is the preserve of the dollar or the renminbi.

In relation to international finance, China needs to be empowered to create a greater stake in the system. But unlike on the currency issue, this empowerment will not be costless for the status quo powers and it will be helpful if not necessary in order to ensure greater stability in the global economic system.

As noted earlier, because of the tectonic shift in the global economy of large countries becoming potential borrowers for emergency financing, the world needs a substantially fortified IMF.

With the United States essentially sidelined because of its own economic and fiscal weakness, only China, with its $3 trillion in reserves, is now capable of providing the resources to create a bigger IMF. Supplementary contributions from other Asian countries and the oil exporters might be necessary.

The empowerment strategy would be for the status quo powers to agree to the wholesale revamping of governance of international financial institutions in return for China's contribution to creating an IMF with substantially enhanced firepower. Today, the United States has 17 percent of the vote in the IMF and Europe close to 33 percent. Both have effective veto power in the IMF because important decisions require an 85 percent share of the vote.

If China were to become the IMF's major financier it should have veto power on terms equivalent to those of the United States and Europe (today it has less than 10 percent of the vote). The United States should work to ensure that all three have equivalent power, which would entail a dramatic increase in power to China and a dramatic curtailing of Europe's power commensurate with its transition from creditor to potential borrower status. At the moment, the United States is unenthusiastic, even mildly obstructionist, toward strengthening the IMF, stemming in part from the fear of its power being diluted. This is strategically short-sighted, smacking of de facto containment of China, when in fact empowerment seems the better course of action for the United States.[17]

Upgrading China's status would be legitimate and indeed be welcome for the world because they would both make the system more stable while also tethering China more firmly to it. If they persist with a de facto containment of the IMF in terms of governance—China might not contribute its resources to the IMF, which would be a loss for the economic system, or it could be tempted to more actively pursue regional solutions such as the Chiang Mai Initiative within Asia. This could eventually lead to undesirable fragmentation on the financial side. In short, empowering China would be costly but this cost must be paid for the benefits of the greater good of the system and increasing China's stake in it.

Similar arguments apply to the World Bank. China is now a major bilateral aid donor especially in Africa. China's loan commitments of $37 billion in 2010 were more than those of the World Bank ($14 billion), Inter-American Development Bank ($12 billion), and the United States Export-Import Bank combined for that year (Kapur and Raychaudhuri 2013).[18] In 2010, the World Bank agreed $11.4 billion worth of loans to some 36 African countries. Just one loan facility extended by China (to Ghana) was reportedly worth almost $13 billion alone. Since 2005, China has provided loan commitments upwards of $75 billion to Latin American countries. China has also been using its aid and foreign direct investment (FDI) as a means of securing access to natural resources such as oil (Sudan and Angola), copper (Zambia), and others (Congo).

Widespread worry has been expressed about China as a bilateral aid donor.[19] China, it is alleged, does not abide by the norms for aid giving (for example, in relation to recipient-country governance) set by the World Bank and other donors to the detriment of the aid recipient and other donors. Most

17. An important question beyond the scope of this Policy Brief is whether parallel changes need to be effected in the United Nations, especially the Security Council, to bring governance structures in line with contemporary realities. China needs to play a constructive role in these efforts.

18. In 2009 and 2010 China lent more money to developing countries than did the World Bank. While the World Bank made loan commitments of USD100.3 billion from mid-2008 to mid-2010 in response to the economic crisis, China Development Bank and China Export-Import Bank signed loans of at least USD110 billion over the same period (Kapur and Raychaudhuri 2013).

19. This worry is well captured in an op-ed in the *Financial Times* by the governor of the Nigerian Central Bank (Lamido Sanusi, "Africa Must Get Real About Chinese Ties," March 11, 2013, www.ft.com/intl/cms/s/0/562692b0-898c-11e2-ad3f-00144feabdc0.html#axzz2U8kKRYw0).

recently, for example, at the very time that Western donors were considering providing debt relief to the Congo, China was luring it into greater indebtedness by extending a large line of credit.

China, of course, is still a borrower from the World Bank and has little stake in how it is run. This must change for the same reason that China has the ability to become a large provider of concessional resources to the poorest countries. Moreover, the additional advantage might be to persuade China to funnel more of its assistance via the World Bank with better designed norms for lending or at least to apply moral pressure on China to face up to the tension between the standards that it promotes or defies when lending directly and those it would purport to uphold as an influential creditor and systemic stakeholder in the World Bank.

But here too, there is resistance from the status quo powers to countenance increases in the capital of the Bank (see Kapur and Raychaudhuri 2013). One consequence has been the move to create a BRICS bank. Devesh Kapur and Arjun Raychaudhuri (2013, 19) summarize the dilemma of the BRICS bank: "If the BRICS bank is to be a partnership of equals, then each country has to put in roughly equal amounts of capital. But then its size will be determined by its weakest member and it will be too small to matter. And if it is large enough to matter then either its membership will have to include existing major powers, which will make it similar to existing IFIs, raising the question why reinvent the wheel? If not, only one of the BRICS has the financial clout to make it happen—China. If so it is only reasonable that China will—as the US had done seven decades ago—ask for commensurate say in the institution's governance. And it's unclear if the others would accede to that. Nonetheless, the fact is that while the BRICS bank is clearly a second best option, it might come into being if only due to frustration of the emerging powers with the status quo."

Codifying Empowerment: Granting China Market Economy Status

In the case of trade, the issue is not so much one of empowering China. Rather the challenge is to recognize that China as the world's largest economy and trader is already empowered and avoid any attempt to contain China, which would have adverse consequences for the world. The implications for regional initiatives such as the TPP have been discussed earlier.

In short, in the trade arena, containment or even wary engagement via regional solutions will either prove counterproductive (because China can retaliate by fragmenting the trading system) or be ineffective (in failing to muster all the economic heft that will be necessary to "tame" China). Multilateralism with its implicit recognition that China is already empowered is the most effective way forward.

One specific, and relatively costless, act of empowering that the United States might consider on the trade side is to grant China "market economy status." At the moment, China does not have such status, which allows the United States to take certain trade restrictive actions under more permissive conditions than against other trading partners. At first blush, granting market economy status might seem like giving away one of the few chips that the United States has remaining in its trade armory. But this chip is really one whose value is small and in any case fast depreciating because China is slated to get market economy status in 2015 as part of the terms of its accession to the WTO. The choice for the United States is whether to have China attain that status as part of previous agreements or to accelerate getting that status as a sign of goodwill (extracting perhaps some small concession in return).

PARADOX: EMPOWERING AN ALREADY POWERFUL CHINA

Conferring more power on a China that is already gaining economic dominance seems a counterintuitive strategy for the United States as a diminishing power. How can this be justified?

The first reason is to make a virtue of necessity. The options for the United States are not unlimited. The experience of recent attempts to persuade China to change its exchange rate policy is instructive. All legislative initiatives (beginning with Schumer-Graham in 2005) have either foundered or been weaselly in content, and successive administrations have steadfastly shied clear of pronouncing China as a currency manipulator. And there is a deeper structural reason for this weakness.

The limited ability to persuade China to abandon its mercantilist strategy reflects in part growing Chinese dominance. Action against China does not command broad support in the United States: Labor may be in favor of tough actions against China's undervalued exchange rate, but capital—that is, US firms—are at best ambiguous. US firms located in China and exporting abroad might actually benefit from the undervalued exchange rate, and other US firms that are invested in or do business with China are vulnerable to Chinese retaliatory action, such as by being denied access to Chinese government procurement contracts. The balance of power in the US-China relationship is especially striking given that it was only about a decade ago that the United States was able to muscle China into radically opening its agriculture, goods, and services market as part of China's accession to the WTO.[20]

China has, of course, facilitated this strengthening of its own economic power by encouraging US FDI and influencing

20. Of course, it helped that China under Zhu Rongji wanted Chinese accession as a way of promoting domestic economic reforms.

American politics and political economy by building a stake for these firms in China. In the 1980s, Japan was the target of US trade action, but Japan was less successful in fending off trade measures taken against it. Japan did not have the economic heft that China currently enjoys, and by limiting US FDI in Japan, it had foregone the opportunity to create a constituency in the United States to speak up for Japanese interests.

In international finance, too, weakness has constrained the options of the United States. The IMF would benefit from having greater resources but the United States is now unable to provide these resources because of its fragile fiscal position. China has all the money bags and the world and the United States needs them.

If the limited nature of options is a negative reason for empowering China, the positive one is that empowerment allows the world to take advantage of China's backwardness. It is a combination of the fact that China remains poor and that it needs free flowing trade and finance to escape that backwardness that allows the empowerment strategy to work. Empowerment creates a greater confluence between China's self-interest and that of the system.

And once that confluence is strengthened, the possibility of China exercising its dominance is reduced because China will be dealing not with countries bilaterally but with many countries multilaterally. Both the design of rules and ensuring China's compliance with them will be stronger in a multilateral rather than a bilateral context as described above.

The third argument in favor of empowerment is that China's future attitude to its own hegemonic status will be determined by how the status quo powers behave. After all, that was the lesson from the Carthaginian peace that was imposed on Germany after World War I. As John Maynard Keynes thunderously and presciently prophesied after the humiliating Treaty of Versailles, "Vengeance, I dare predict, shall not limp."

Even if China did not react to the current economic containment strategy by rearming itself in the manner of Germany, it could certainly act in a way that could fragment the economic system and make it less open and rules-based. China could pursue exclusionary regional free trade agreements with greater vigor, push for regional currency arrangements in Asia with the renminbi as the focal point, credibly strengthen rival financial institutions such as the Chiang Mai Initiative, and continue to be a dodgy aid provider in Africa. This would weaken multilateralism and ultimately the ability of the status quo powers to restrain China's hegemony.

Finally, the difficult US-China relationship cannot flourish if competition and hostility are the exclusive themes, a possibility raised by recent American decisions to reorient defense and strategic capability toward China. Pursuing a strategy of economically empowering China allows the United States to inject the cooperative elements and positive dynamic that might be necessary to balance moves in the noneconomic spheres.

IS THE UNITED STATES' INTERNATIONAL ENGAGEMENT HOBBLED BY ANACHRONISTIC DOMESTIC INSTITUTIONS?

Suppose the diagnosis is correct that the United States is weakening (in relative terms) and that recourse to multilateralism and even empowerment of other countries become more effective means of international engagement. Does the structure of US political institutions in which an insular Congress retains a key role in international decision-making become a liability for the United States?

Under Pax Americana, congressional authority over international matters worked to the advantage of the United States. It allowed the executive to harness Congress' role to tactical advantage in international economic relations. Congress was a credible bad cop to the administration's good cop. Often, the refrain of successive administrations to partners would be: "Please accede to this deal/demand because Congress will not agree to anything else." Or, "Please accede to this demand/deal or else Congress will authorize trade retaliation under its legislative authority, which we (the administration) will be unable to control." These threats/demands happened in relation to trade or in relation to expanding resources for the IMF and World Bank. And often this was a successful strategy because the United States generally held the balance of negotiating power and influence relative to its partners.

But when the United States has to turn from being wooed by to actively wooing others, an insular, instinctively unilateral Congress is no longer a credible bad cop defining the worst case options for US trading partners but rather a potential albatross around the neck of the administration, limiting its international options. In the past, when Congress saber rattled or set unusually high standards for international trade agreements, smaller countries had to take those threats seriously. Indeed, during the Uruguay Round of trade negotiations, the outside option of facing retaliation under laws enacted by Congress ("Special 301" in that instance) if they did not raise their intellectual property standards played a key role in countries such as Brazil and India reluctantly agreeing to higher multilateral standards in the WTO on intellectual property.

But in the case of China, congressional instincts could prove counterproductive. For example, Brazil and India could conceivably come together with the United States as part of a multilateral coalition to discuss exchange rate issues with China. But they would be loath to do so if it were to happen

after Congress has authorized trade retaliation against China for manipulating its currency. They would be seen as siding with a belligerent United States rather than a cooperative one. Congressional unilateralism might thus foreclose or weaken some multilateral options for the administration.

Another example relates to international financial institutions. If Congress refuses to expand the resources for the IMF (or the World Bank) because that would entail a diminution of US power and influence in that organization, or refuses to give up its monopoly on the leadership of the World Bank, China will try and strengthen alternative, and possibly rival, financial institutional structures (such as the Chiang Mai Initiative) or create new ones (such as the newly created BRICS bank). Indeed, between 2009 and 2013, the US administration did not even send to Congress the agreements reached with other IMF member countries (in 2009) to increase the IMF's lending capacity and change quotas. When Congress will actually pass legislation—which is fairly modest compared with the scale of changes proposed in this Policy Brief—is also unclear.

Put starkly, under US dominance, Congress limited the options for America's relatively weak partners in negotiations with a strong US administration; under Chinese dominance, Congress will limit the negotiating options for a relatively weak administration vis-à-vis a relatively strong China. These institutional structures can come in the way of successfully mobilizing a multilateral coalition to deal in the future with China or to changing international institutions in a way that could serve long-run US interests.

Perhaps what might be required—and this is radical and speculative prescription—is for the United States to make the next logical change in its domestic institutional arrangements inspired by the history of the change made under the Reciprocal Trade Agreements Act (RTAA) in 1934 (Irwin 2011). That change would be to transfer even more authority from Congress to the administration in the design and implementation of most international economic policies. The aim would be to facilitate and galvanize more multilateral approaches—less constrained by a unilateral, insular Congress—that will be necessary to deal with a dominant China.

CONCLUSION

In his famous Long Telegram from Moscow, George Kennan argued in 1947 that US policy toward the Soviet Union should be "that of a long-term, patient but firm and vigilant containment of Soviet expansive tendencies."

Today, the United States is in a different situation as a diminishing rather than established superpower. China poses a far different sort of rivalry or threat than the old Soviet Union. And it engages it in different and multiple realms—economics as much as security. What would a latter day Kennan have written from Beijing?

In light of China's own military buildup, the power wielded by the Chinese army domestically, and China's recent history of territorial assertiveness toward its regional neighbors, especially Japan, the missive from Beijing from today's George Kennan might possibly advocate military containment and supported the "pivot toward Asia" strategy of the Obama administration.

But containment is not the right strategy to pursue in the economic realm. Instead, the new "Great Power Relationship" (to use Zoellick's phrase) proposed here is one of the United States ceding some power to China in return for China increasingly shouldering the responsibilities of leadership. A key argument, perhaps an assumption, is that from a Chinese perspective these responsibilities need not be burdens because they would amount to self-interested insurance against threats to China's own long-term development.

Or to put it differently, the bargain is really about the United States trading off power for purpose. Power's real purpose—preserving the open, rules-based multilateral economic system that the United States bequeathed as a hegemon in the aftermath of World War II—might in fact be better served if Chinese economic power were harnessed to good ends.

To be sure, today, this bargain seems unrealistic. From an American perspective, there are doubts about whether China fundamentally shares these values or even if it does, whether China will act to sustain the principles of the current economic order at a pace dictated by domestic considerations rather than global imperatives. On the other hand, China remains unconvinced that the United States—and especially its domestic political institutions—can countenance the diminution in, and sharing of, power to allow for China's rise. This Policy Brief has tried to show that there is a way out of mutual distrust and suspicions.

The United States bequeathed an open rules-based multilateralism economic system after World War II even though as a hegemon it did not really need it. The irony may well be that, at a time of decline it needs that system as the best defense against a resurgent China. The further irony is that preserving that system will require the United States not to reassert the vestiges of its diminishing power to contain China but to relinquish power in favor of its rival-in-waiting. Or, to paraphrase Edmund Burke, the United States may have to graciously give up the power that it is gradually losing the ability to withhold.

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