G2 in G20: China, the United States and the World after the Global Financial Crisis

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Abstract

The post-global financial crisis world will be increasingly dominated by China and the United States. What the *de facto* G2 do, together, independently or in conflict, will increasingly define the global bounds of the possible. Both countries want to embed their bilateral diplomacy in the multilateralism of the G20. The problem for the emergent G2 in G20 global architecture is that economic relations between China and the US will be increasingly difficult to manage. The large economic imbalances between the two countries, in which China buys American debt and Americans buy Chinese goods, will endure. Before the crisis, the codependence these imbalances created was a source of stability in Sino–American relations. After the crisis, they will be a source of frustration and conflict, as the second half of 2009 showed. To manage economic relations between China and the US effectively, the G20 agenda will have to move from crisis management to strategic planning for the global economy. The G20 will also have to become more institutionalized, but in a way that resembles more a nonexecutive board of directors of a multinational firm than a management committee of C-level executives.

Policy Implications

- The world will be characterized by a *de facto* China–US G2 after the financial crisis.
- Despite new commitments from both countries, large-scale China–US economic imbalances will persist.
- Dueling protectionism and economic nationalism are the biggest potential medium-term threats to China–US relations.
- Nesting the *de facto* G2 in the *de jure* G20 is the best hope for managing China–US tensions.
- The G20 should be institutionalized as the board of directors for overseeing the Bretton Woods system, not as a replacement for it.

The global financial crisis (GFC) was born in the United States of too loose money and too lax regulation, aided and abetted by China's willingness to provide credit to America seemingly without limit. Now that the worst of the crisis is mercifully past, how different will things be when we finally reach the new normal? *Plus ça change, plus c'est la même chose*. The 'post-financial crisis' era label will be justified for a world characterized by a discredited American brand of buccaneering capitalism, slower global growth, step function increases in unemployment and poverty, public debt mountains and protectionism in the west, and self-doubt about export-led development in emerging markets.

But the geopolitical trajectory of the post-financial crisis era will be the same as it was before, towards a world dominated by interactions between the US, still the most powerful country, and China, the biggest and fastest growing rising power. A *de facto* G2 is emerging almost by default, even though neither China nor the US will give their relationship this grandiose title. Instead both sides are investing unprecedented resources in their bilateral diplomacy, headlined by the new Strategic and Economic Dialogue, led by Secretary of State Hillary Clinton and Treasury Secretary Timothy Geithner for the US and State Councilor Dai Bingguo and Vice Premier Wang Qishan for China, all accompanied by a phalanx of cabinet-level colleagues.

At the same time, both China and the US are committed to embedding their bilateral diplomacy in multilateralism, with the G20 as their preferred vehicle. The G20 is globally representative yet small enough to make consensual decision making feasible. It is the first important grouping to embody China's major power status, without asking China to play a global leadership role it is not yet ready to embrace. The G20 allows the US to encourage China to become a 'responsible stakeholder' while also providing ballast against what Americans view as European obduracy.

Nonetheless, what China and the US do – alone, together, in regional and multilateral forums or in conflict with each other – will increasingly define the global bounds of the possible from fixing finance and restoring trade to tackling climate change and energy security. 'Without a strong G2, the G20 will disappoint', as the World Bank's American President Robert Zoellick and its Chinese Chief Economist Justin Yifu Lin said on the eve of April 2009's G20 summit in London (Zoellick and Lin, 2009).

There is, however, a problem at the core of this nascent G2 in G20 architecture. After a decade of wary but stable

Global Policy (2010) 1:1 doi: 10.1111/j.1758-5899.2009.00014.x

coexistence, China–US relations are poised to turn increasingly conflictual. Niall Ferguson goes too far in suggesting we are on the verge of a replay of the British–German geopolitical rivalry that led to the First World War (Ferguson, 2009). China–US frictions seem likely to remain limited to the economic sphere with only a small chance of their spilling over into the security realm. But after the financial crisis, Sino–American economic frictions will be more intense and more important than ever before.

The China–US economic imbalances many now cite as a root cause of the financial crisis also created the codependence that held their bilateral diplomacy together over the past decade. China was happy to buy up piles of dollars and Treasury bills so long as Americans used the money to buy massive quantities of goods assembled or made in China. The US was willing to live with ever greater trade deficits with China so long as the low interest rates made possible by China's hunger for dollars kept the consumer-driven American economy humming.

Now China is committed to becoming more American by consuming more and the US is resolved to become more Chinese by consuming less. But the obstacles to doing so are immense and success will likely be measured more in decades than in months. Over the past year, China has bought up even more US Treasury bills to re-peg the renminbi to the dollar while sniping about the fragility of the dollar. An even greater portion of America's trade deficit is with China, an outcome most Americans are very uncomfortable with.

For the foreseeable future, the stubborn persistence of these massive Sino–American imbalances will be a constant source of tension between the world's two most important countries. The events of the second half of 2009 – trade disputes, big differences over the way forward on climate change, American charges of Chinese currency manipulation and Chinese agitation for a new global currency to replace the dollar – graphically demonstrate the challenges facing China, the US and the world.

Now that its leaders have designated it 'the premier forum for our international economic cooperation', will the G20 be able to rise to meet these challenges (G20, 2009)? The leaders' forum was created on the fly in the heat of the post-Lehman Brothers fight to avert a global economic meltdown in the last quarter of 2008. As the worst of the crisis is now over and the world slowly moves towards recovery, the G20 will have to forge a new post-crisis agenda for global economic governance that will entail giving directions to the International Monetary Fund (IMF), World Bank and World Trade Organization (WTO) and to the UN, established institutions with long histories and entrenched operating procedures.

The G20 agenda will begin with post-crisis 'exit strategies', but it will soon have to expand to address the big challenges facing the global economy in the coming years. This agenda will include new global financial rules and increased international coordination of national regulations, reviving global trade and either completing the Doha Round or coming up with an alternative to it, adjusting the Bretton Woods institutions to the new power alignments of the 21st century and coming up with a global climate change deal that both the west and emerging economies can support.

One immediate challenge facing the G20 in furthering this ambitious agenda is the fact that the institution today is literally nothing more than its meetings and post-meeting communiqués. World leaders have lauded the fact that the G20 is lean and mean, unencumbered by the much maligned bureaucracy of conventional international organizations. But it is clear that the G20 will have to establish some institutional capacity.

There is no stomach for another Geneva. Instead, the likely path forward for the G20 is to create something more akin to a functioning board of directors that will guide, reform and oversee the Bretton Woods institutions than to a management committee of C-level executives for a new global economic government. But strong boards require strong chairs and supportive staff. In the case of the G20, China and the US will have to be prepared to act as *de facto* co-chairs against the backdrop of rotating formal meeting chairs and to help build a permanent support infrastructure enabling effective action. Both countries have powerful incentives to do so. The next several years will show if they have the collective will and capacity.

The *De Facto* G2

China and the US have been badly shaken by the financial crisis. The US increasingly resembles less Reagan revolution America and more *dirigiste* continental Europe. After decades of ever greater global reach, America's stretched foreign policy will have to be made more solvent by cutting costs without reducing ambitions. China's faith in development by export has been shaken. The Communist party government must also address mounting social problems like inequality and environmental degradation knowing that its legitimacy increasingly hangs in the balance.

Nonetheless, it is still almost inevitable that the US will continue to be the world's dominant geopolitical force well into the new century. Its economy is still driven by unparalleled American verve for Schumpeterian creative destruction. US military hegemony is unchallenged even if the struggle against Islamic extremism is exposing the limits of its weaponry and manpower. America's cultural and political reach will continue to dwarf that of other countries.

The immense capacity of the Chinese state coupled with the insatiable drive among its people for a better life and their innate business acumen makes it foolhardy to bet against the country's continuing global ascent. China must figure out a way to develop the vast interior without shackling the booming coastal regions. It must deal effectively with the challenges of mass urbanization on a scale the world has never seen. The government knows the old Barrington Moore dictum 'no bourgeois, no democracy', but it has no choice but to continue to improve standards of living for the average Chinese. And China's leaders know full well the limitations of their government system. But they are unwilling to sow the seeds of their own demise in the way Gorbachev's glasnost and perestroika did for the Soviet Union.

For all the problems facing China and the US, things look worse in Japan and Europe. The financial crisis exposed Japan's economic recovery from the lost decade of the 1990s as being more apparent than real, built on booming exports to the US and China rather than the reforms so desperately needed at home. The leading Japanese global brands like Toyota and Sony may continue to thrive, but they are the exception rather than the rule for the Japanese economy as a whole. The suffocating legacies of massive public debt, sclerotic regulation and an aging and shrinking population will likely consign Japan's next decade to a painful process of managing long-term economic decline.

Plummeting exports, burst housing bubbles and toxic bank assets in different mixes in different countries, coupled with piecemeal and sometimes anemic policy responses, have exposed the fragilities in the past two decades of rapid European integration. Although the European Union will remain the world's largest economic bloc long after the crisis (far bigger than the US), size should not be mistaken for strength. Europe's fundamental post-crisis tasks will likely be shoring up foundering domestic economies and repairing its creaking Union rather than projecting its influence on the global stage. Final approval of the Lisbon Treaty has given the European Union a president, but the challenges facing Herman van Rompuy are daunting.

Table 1. IMF global economic forecast, October 2009 (select G20 countries)

Economic output (annual % change)	2007	2008	2009 forecast	**2007–2009 slowdown**	2010 forecast
India	9.3	7.3	5.4	**−3.9**	6.4
China	13	9	8.5	**−4.5**	9.0
France	2.1	0.7	−2.4	**−4.5**	0.9
US	2	1.1	−2.7	**−4.7**	1.5
Brazil	5.7	5.1	−0.7	**−6.4**	3.5
Italy	1.6	−1.0	−5.1	**−6.7**	0.2
UK	3	0.7	−4.4	**−7.4**	0.9
Germany	2.5	1.3	−5.3	**−7.8**	0.3
Japan	2.4	−0.6	−5.4	**−7.8**	1.7
Russia	8.1	5.6	−7.5	**−15.6**	1.5

Source: IMF, 2009a.

Table 2. 2009–2010 fiscal stimulus and financial bailouts, percentage GDP (select G20 countries)

	Dicretionary fiscal stimulus	Financial assistance (excluding guarantees)	**Total crisis fighting**
UK	1.6	32.1	**33.7**
Japan	4.2	26.5	**30.6**
China	5.8	21.3	**27.1**
US	3.8	21.4	**25.2**
Russia	5.4	16.7	**22.1**
Brazil	1.2	13.3	**13.5**
India	1.2	9.6	**10.8**
Germany	3.6	4.2	**7.8**
France	1.5	2.7	**4.2**
Italy	0.3	0.7	**1.0**

Source: IMF, 2009b.

The rest of the emerging world, led by Brazil and India, may one day rise to stand with China as the new powers of the 21st century. But India is at least 15 years behind China and major doubts persist regarding its capacity to match China's infrastructure miracle of recent decades. Brazil has become a major player, but Chinese demand for Brazilian commodities has been the big story. The distinctly Latin American limitations of the Brazilian economy remain.

Reviewing the latest statistics on the global financial crisis is a sobering experience, with 2009 witnessing the first worldwide drop in output since the Second World War. Among the developed economies France and the US have led the way in limiting the carnage and charting a course to recovery (See Table 1). Among the BRICs, China and India have fared best, with China still expected to be the world's fastest growing major economy in 2009 and in 2010.

One reason for the relative successes of China and the US during the crisis is the speed and scale of their fiscal and monetary emergency stimulus programs, only matched by those of Japan and the UK where the case for stimulus was even stronger (Table 2). Barack Obama signed into law a nearly $US800 billion fiscal stimulus package after less than a month in office. The Chinese government announced its own massive fiscal injection in late 2008, almost as big as Obama's in terms of total dollars at market exchange rates. In contrast, critics continue to point to the relatively desultory efforts of the major European countries save Germany.

Turning to financial assistance, President Obama added more than a trillion dollars on top of the Bush administration's $700 billion financial bailout that began in November

Table 3. IMF general government debt forecasts, percentage GDP (select G20 countries)

	2007	2014	Increase 2006–2014
UK	44.1	99.7	**55.6**
Japan	187.7	239.2	**51.5**
US	63.1	112.0	**48.9**
France	63.8	95.5	**31.7**
Germany	63.6	91.4	**27.6**
Italy	103.5	117.3	**13.8**
China	20.2	21.3	**1.1**
Russia	7.4	7.3	**−0.1**
Brazil	67.7	62.2	**−5.5**
India	80.5	73.4	**−7.1**

Source: IMF, 2009b.

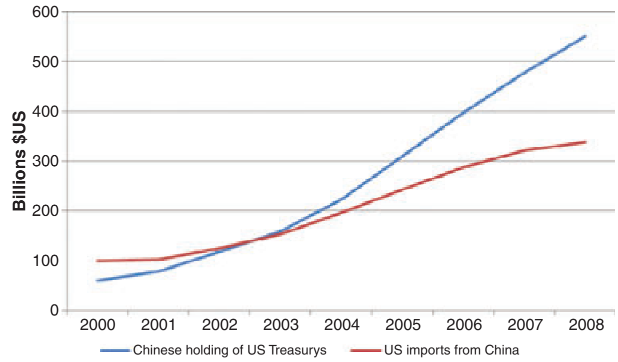

Figure 1. Trade and Treasurys before the crisis.
Sources: US Trade Statistics, 2009; US Treasury, 2009.

2008. Unprecedented activism by the Federal Reserve had increased its balance sheet by more than a trillion dollars (Bernanke, 2009). Despite the strength of its own banks during the crisis, the Chinese government led a lending spree by state-controlled banks with new loans in the first quarter of 2009 alone in excess of the entire government fiscal stimulus plan for three years and greater than total banks' loans for all of 2008, which were already the largest in Chinese history (Leow, 2009).

With governments now beginning to focus squarely on 'exit strategies' it is important to assess the long-run cost of crisis-fighting activism not only in China and the US but among the world's other major economies as well. Here, the IMF's projections for government debt are telling. Three features of Table 3 stand out.

First, Japan's parlous public finances will deteriorate still further. Japan is facing the prospect of having to deploy significant portions of GDP just to repay interest on its gargantuan public debt into the indefinite future, crowding out public investment and making major tax increases almost inevitable – against the backdrop of an aging and shrinking population with no appetite for large-scale immigration.

Second, despite its massive fiscal and monetary stimulus programs, China will exit the crisis with very little debt and with public finances in much better shape than most western and emerging economies. Among other things, this demonstrates the size of the fiscal war chest the Chinese government still has to deploy as it sees fit in its ceaseless striving for more growth, more jobs and more prosperity.

Third, skyrocketing public debt in the UK and the US will make these countries look decidedly continental European after the crisis. However, the US is in a better position to manage its public debt than either the UK or the continent. The reserve currency status of the dollar reduces the interest rate premium attached to American public debt and gradual inflation in the US will likely have less downward pressure on the exchange rate than would be the case for other countries.

The Persistency of China–US Imbalances

Putting together all we know about the economics of the crisis, the world does appear to be moving towards a *de facto* G2, almost by default. The China–US economic relationship is very big and very tight. But it is also the most imbalanced bilateral economic relationship in human history.

The headline statistics are by now well known concerning the pre-crisis mushrooming of Chinese government purchases of American Treasury bonds and American consumption of Chinese goods (see Figure 1). China increased its holding of US Treasury bills more than fivefold to well over $US500 billion from 2000 to 2008. Over the same period, American imports of Chinese goods more than trebled to over $US300 billion.

The codependence inherent in these imbalances is equally well understood. China kept its currency from appreciating rapidly against the dollar by buying dollars and dollar-denominated paper, which kept US interest rates low and American debt-financed consumption booming. American red ink and a relatively strong dollar kept Chinese goods flying off American shelves and made possible year after year of extraordinary and even accelerating growth in China.

Economists long decried these imbalances as 'unsustainable'. But neither China nor the US wanted to stop the party while the music was still playing – their economies benefitted too much from them, in the short term at least. Then the music stopped.

Now both sides have made solemn declarations about how they will change – China by consuming more, saving less and exporting less; the US by consuming less, saving more and exporting more. Secretaries Clinton and Geithner made clear on the eve of the first Strategic and Economic Dialogue meeting in July 2009 the heavy lifting both countries need to do:

> As we move toward recovery, we must take additional steps to lay the foundation for balanced and sustainable growth in the years to come. That will involve Americans rebuilding our savings, strengthening our financial system and investing in energy, education and health care to make our nation more productive and prosperous. For China it involves continuing financial sector reform and development. It also involves spurring domestic demand growth and making the Chinese economy less reliant on exports. Raising personal incomes and strengthening the social safety net to address the reasons why Chinese feel compelled to save so much would provide a powerful boost to Chinese domestic demand and global growth (Clinton and Geithner, 2009).

Translating these lofty aspirations into action will be a Herculean task, as the rise and rise of Sino–American imbalances since the crisis hit attests (see Table 4). In the first eight months of 2008, the US trade deficit with the rest of the world (excluding China) was $US291 billion. In the first eight months of 2009, the corresponding deficit was $167 billion, a drop of 43 per cent in one year – and something many have pointed to as the GFC's silver lining. But over the same period, the US trade deficit with China only declined by 16 per cent to $144 billion. The US trade deficit with China is now almost as big as the US deficit with the rest of the world combined.

Between August 2008 and August 2009, Chinese holdings of US Treasury bills grew by more than two hundred billion dollars to almost $US800 billion, an increase of 39 per cent over 12 months. Over the same year, Treasury holdings by the rest of the world increased by only 25 per cent. Today, China holds about one-quarter of all Treasury bills.

Table 4. Trade and Treasurys during the crisis (all figures are billions of US dollars)

US trade deficit with:	January–August 2008	January–August 2009	% decrease
China	171.0	143.7	16%
Rest of world	290.6	166.6	43%
US Treasurys holdings by:	August 2008	August 2009	% increase
China	573.7	797.1	39%
Rest of world	2114.7	2651.7	25%

Sources: US Trade Statistics, 2009; US Treasury, 2009.

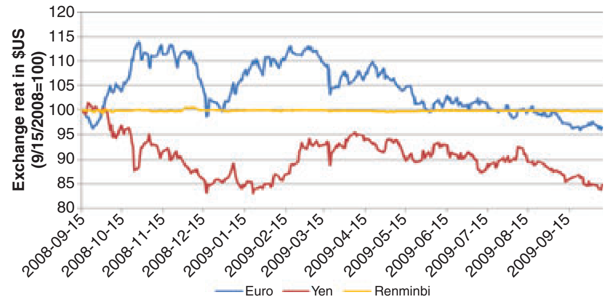

Figure 2. Floating dollar, fixed renminbi.
Source: St Louis Federal Reserve, 2009.

These statistics belie the notion that the crisis itself is resolving the problem of Sino–American imbalances. Why has plummeting American demand and near zero interest rates neither reduced the US–China trade deficit nor stemmed the inflow of Chinese capital? Part of the answer is no doubt the repatriation of US assets from abroad to shore up balance sheets at home. Part of the answer also lies in the notion that the dollar remains a relatively safe haven during a global storm.

But the frozen dollar–renminbi (RMB) exchange rate over the past year is probably the biggest news, following the orderly and celebrated appreciation of the RMB over the previous three years by about 20 per cent against the dollar. The global financial crisis has battered the global currency markets from pillar to post over the past year. Mounting US public debt and rock-bottom interest rates have begun to take their toll on the global strength of the greenback. Despite all this turmoil, the dollar–RMB exchange rate literally has not moved (see Figure 2).

A persistent US trade deficit with China, rising Chinese T-bill holdings, no movement in the dollar–RMB exchange rate, all as the whole economic world was turned upside down overnight by the global financial crisis – it is not surprising that after almost a decade of behind-closed-doors softly, softly economic diplomacy, the first half of 2009 witnessed a rising tide of public mudslinging between China and the US. America took the lead, but China was quick to follow.

On the US side, Geithner let slip in his confirmation hearing that China 'manipulates' its currency. Understanding that this could trigger a legislative process requiring US retaliation against China, President Obama quickly sought to recover the situation by saying his Treasury Secretary had misspoken.

Chinese reaction to Geithner's diplomatic faux pas was nonetheless sharp and swift. Wen Jiabao worried out loud about China's dollar-based holdings, saying that, in light of the GFC, 'of course we are concerned about the safety of our assets' (Wines, 2009). A week later, the Governor of the Bank of China, Zhou Xiaochuan, proposed a new global reserve currency 'that is disconnected from individual nations and is able to remain stable in the long run, thus removing the inherent deficiencies caused by using credit-based national currencies' (Anderlini, 2009a). He did not mention the American dollar by name, but the focus of his worries was clear to all.

The public dueling over the dollar's weakness and control of the renminbi soon died down because both sides knew they were playing with fire. But the roots of China–US imbalances are deep and structural. And they have also been exacerbated by the policies that Presidents Hu and Obama put in place to fight the global financial crisis.

In response to the crisis, the US has compensated for large-scale deleveraging by consumers and firms with unprecedented government spending to revive American demand. Even though the Obama administration has talked about reforms in education, energy and health as investments, significant increases in America's productive capacity remain uncertain and a long way off. In the short term more American demand means more imports from China.

The Chinese government offset the slump in global demand with large-scale investments and bank lending for public infrastructure projects and to large state-owned or state-controlled companies. The rate of investment in China is rising from an already very high 40 per cent of GDP towards an unheard of 45 per cent (Anderlini, 2009b). Unless and until Chinese consumers start buying more of what Chinese firms produce, exports, above all to the US, will be the principal way to translate investment into economic growth.

When it comes to the longer term, reducing China–US imbalances requires nothing less than changing the economic DNA of both countries, with Americans needing to become more Chinese by consuming much less and Chinese needing to be more American by saving much less.

For the foreseeable future, the biggest domestic economic challenge facing the US will be what Obama calls 'fiscal sustainability'. But just stabilizing US public debt after the full effects of the Obama administration's crisis-fighting measures are felt would require tax cuts or spending increases of nearly one-third of central government spending, or 7–9 per cent of US GDP (Auerbach and Gale, 2009).

Americans have repeatedly shown that they will punish politicians for smaller increases in taxes or cuts to spending than the US' crisis-generated debts demand. Beyond identifying inefficiencies in current spending (and hence potential savings), it is hard to see how the US could cut expenditures by this much. Retirement and health care liabilities are the two biggest ticket items. Cutting costs in either remains critically important, but politically virtually impossible.

What about tax increases, focusing on measures that would also reduce incentives to borrow money? The volume of home mortgages in the US is about as big as the entire economy, but every dollar spent on servicing mortgage debt on residential real estate (including second homes) is fully tax deductible. As housing prices ran up in the 2000s, Americans added another 10 per cent of GDP to housing debt, this time in the form of credit card equivalent home equity lines of credit secured against homes, with much lower interest rates than regular credit cards – and with all debt interest fully tax deductible. It is doubtful whether even President Obama has the political capital to wean Americans off the motherhood and apple pie of government-subsidized borrowing to realize the American dream of homeownership.

China's challenge is the mirror image of that facing the US. Whereas Americans borrow because they are confident about the future, Chinese citizens save for a rainy day. Members of close-knit extended families save because it is family rather than the state that will look after them when they get sick, old or lose their jobs. Even if Chinese citizens wanted to spend and borrow more, the retail financial sector needed to service a consumer society is at best rudimentary in China.

The Chinese government has the capacity to build an effective social safety net and to change the regulatory environment to favor the growth of retail banks, credit cards and insurance targeted at consumers. But the government has preferred to invest in infrastructure, state-owned enterprises (SOEs) and state-controlled companies, with state-owned banks a preferred intermediary.

This strategy makes political as well as economic sense for the Chinese government. Focusing on driving productive capacity ever higher allows the Chinese government to deliver on its implicit guarantees of full employment and higher living standards for all its citizens. The government also knows that the history of democracy runs through the development of a large consumerist middle class. Chinese leaders learned well the lessons of Gorbachev's glasnost and perestroika, and they will not lightly walk down what might be considered the former Soviet Union's naive path to openness.

Protectionism and Nationalism

Given the mismatch between the rhetoric of 'rebalancing' and the harsh realities of persistent imbalances, a blame game of mutual recriminations is an altogether too tempting way out for both China and the US. The second half of 2009 showed just how tempting it is, particularly amid the great hardships that the crisis has imposed on regular Americans and ordinary Chinese. The challenge for both countries is to keep a lid on these economic tensions, while understanding that releasing some energy by blaming each other is probably inevitable if not indispensable.

For most of the world, globalization has been a process of Americanization. But globalization is increasingly about

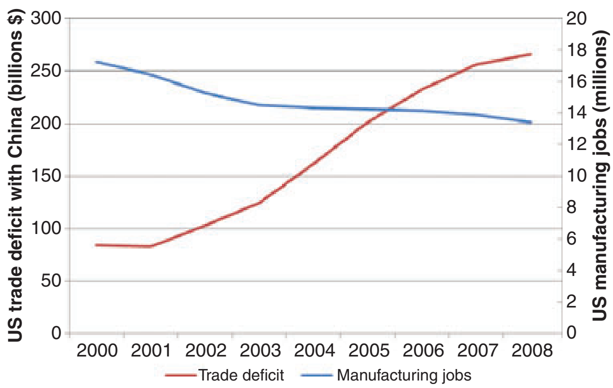

Figure 3. Chinese trade, American job losses.
Sources: US Trade Statistics, 2009; US Bureau of Labor Statistics, 2009.

China for Americans, and many do not like what they see. Americans draw a simple inference from the data on trade with China and jobs in America: the flood of cheap Chinese imports has cost millions of good American manufacturing jobs (see Figure 3).

It does not matter that manufacturing is now only a small fraction of total American employment, or that economists attribute job losses more to technological change than to trade. Middle America is hurting and blames China for its woes. This was true before the crisis when American unemployment was less than 5 per cent. It is doubly true with the specter of lingering double-digit unemployment haunting America even as the financial sector returns to health.

Here is how US Senator Sherrod Brown painted the picture for his Midwestern swing state in March 2009:

> The Ohio manufacturer has a minimum wage to pay his workers. He has clean air and workplace and product safety standards by which to abide, helping to keep his workers healthy and productive and his customers safe. The Chinese manufacturer has no minimum wage to maintain and is allowed to pollute the local water sources and let workers use dangerous and faulty machinery. The Ohio manufacturer pays taxes, health benefits, and social security. He typically allows family leave and gives WARN notices when there is a plant closing. The Chinese manufacturer often allows child labor. The Ohio manufacturer receives no government subsidies, and the Chinese manufacturer often receives subsidies for the development of new technologies, or for export assistance. The Chinese manufacturer benefits from China's manipulation of its currency, which gives up to a 40 per cent cost advantage (Brown, 2009).

Chinese authorities are equally concerned about the damage America can do to the Chinese economic miracle. Here the story is about American weakness – US public debt, looming inflation, the weakness of the dollar and the long-term viability of Chinese holdings of dollars, dollar-denominated assets and dollar-denominated debt.

The specter of the US inflating away its public debt is at the center of Chinese criticisms of the American economy, particularly since it would only add to upward pressure on the RMB against the dollar in nominal terms, decreasing in the short term at least the competitiveness of Chinese exports to the US. For its part, the Chinese government knows that there are diminishing returns from its ever higher rates of investment. China has been able in recent decades to fight the classic communist foes of overcapacity and inefficiency through booming exports. But this will be harder to do in the future.

The last time there was anything approaching such a politically volatile bilateral economic was in the 1980s when the US claimed that unfair Japanese trade competition was destroying American jobs – the last time US unemployment was over 10 per cent. The challenges facing post-GFC China–US relations are considerably more formidable.

Japan was democratic, capitalist and an ally of the US. China is none of those things, raising American suspicions on each count. Japan was a partner, acquiescent if not willing, in the US plan to drive up the value of the yen, which doubled in value against the dollar in the second half of the 1980s. China continues to assert its sovereign autonomy where the exchange rate is concerned, and its RMB has tracked the dollar in lock step over the past year despite the dollar's wild ride and now big slide against other major currencies. It may well be in China's long-run interests to reduce its dollar holdings given what are likely to be persistent low rates of return. But China cannot afford a run on the dollar because its asset holding would take a bath. Nor can China afford its American export market to slow down because this would be bad news for jobs and wages at home.

The second half of 2009 witnessed the almost inevitable context of enduring imbalances and economic tensions between China and the US – the breakout of a mini trade war. The US fired the first shot when Obama chose to do what George W. Bush had been unwilling to do – to use section 421 of American trade law and an obscure element of China's WTO accession agreement to impose heavy tariffs on Chinese imports into the US for the mere reason that they were adversely affecting American production and American jobs. In this case the product was tires, the tariffs were up to 35 per cent and the lobby pushing action was the United Auto Workers union.

But more important was the precedent the action set. China and the world had been anxiously waiting to see if

Obama in office would resist the protectionist temptations and back down from his sometimes quite protectionist rhetoric on the campaign trail. In the tires case, Obama blinked. This apparently has emboldened American textile and steel producers and workers to consider a similar appeal to Obama.

China's retaliation was swift. The Chinese government took the US to the WTO claiming that it is dumping chicken and auto parts on the Chinese market, taking aim at two sectors of the American economy benefitting from US government subsidies in the wake of the financial crisis. A month later they added nylon to American products potentially dumped on the Chinese market.

Neither side wants these brushfires to rage out of control. But it is likely that moves to counteract climate change in the US will soon fan the flames. The climate change legislation making its way through Congress includes what amounts to carbon tariffs on countries that do not enact binding restrictions on their emissions – an idea that has received high-level support from Chancellor Merkel and President Sarkozy in Europe.

But China has already said it will have no truck with green tariffs, saying that they violate WTO rules. China's position (allied closely with India) remains that it should not be expected to pay for 200 years of western emissions and that large-scale financial and technology transfers to facilitate alternative energy production must be a central element in any global climate change deal.

Add to these new stresses over trade the specter of rising nationalism surrounding foreign investment. China's sovereign wealth funds and its large parastatal companies wanted to buy American firms before the crisis. But the backlash in America was intense – most vividly in the congressional firestorm in the summer of 2005 that led CNOOC to withdraw its bid for the small American oil and gas company Unocal. Since then, China has kept a low profile in the market for corporate control in the US, opting for minority stakes in shadow banks like the private equity firm Blackstone over more visible acquisitions of manufacturing firms and their quintessentially American middle-class jobs.

With American asset prices battered by the crisis, China worried about the security of its T-bill holdings because of American public debt, and with the Chinese currency likely to continue appreciating against the dollar, the economic incentives are high for China to go on a foreign direct investment buying spree in the US. But it is hard to imagine that the reception in the US would be favorable.

In China, tight government control of its domestic market has always created high hurdles for American firms wanting to establish footholds in China – with the ability to void potential foreign investments if they threaten 'national economic security' (*Wall Street Journal*, 2006). American firms salivate at the prospect of satisfying the needs of China's growing middle class, and they have been willing to go to great lengths to get inside the Chinese market. Wal-Mart is now China's biggest retailer, but the infamously anti-organized labor firm was willing not only to let its Chinese workers unionize but also to let them hold meetings of the Chinese Communist party on Wal-Mart premises (Fong, 2006). GM is China's biggest car maker, but its joint venture is still controlled by its Chinese partner. American banks continue to expend immense effort trying to open branches in China, but getting anything more than a small minority stake has proved impossible.

All these tensions in the China–US economic relationship will play out against the backdrop of mutual national security anxieties that may increase as the US reassesses the limits of its global engagement and China continues to expand its external reach and military capacity. China insists its security objectives are wholly defensive, and principally focused on securing its land borders with its nearly 20 neighbors. But security hawks in the US Pentagon continue to pore over China's defense spending, which they believe is rising too rapidly and is too focused on blue water naval power to be only about securing the mainland.

US military expenditures are roughly half the global total, dwarfing those of China. But as Table 5 shows, China's military spending has been rising much more quickly than America's, not only because China's economy is growing more quickly but also because it is increasing the portion of GDP it spends on the military.

The very good news, however, is that potential flashpoints that could trigger military confrontation between the US and China are few and apparently decreasing. Taiwan's economic integration with China continues to build stronger linkages between the island and the mainland. The US and China have cooperated more closely over curtailing North Korea's nuclear ambitions in recent years than many predicted. Tibet seems unlikely to assume the significance of Taiwan. China may not always cooperate with the US in the struggle against Islamic extremism, including the vexed issue of sanctioning Iran. But this is about diplomatic cooperation rather than a head-to-head security struggle.

Table 5. American military might, Chinese catch up (military expenditures in 2005 constants dollars)

	1999	2008	Dollar increase	Percentage increase
United States	329.4	548.5	219.1	67%
China	21.6	63.6	42.0	194%

Source: SIPRI, 2009.

China–US tensions are very real, and they certainly extend all the way up the geopolitical totem pole to rivalry for global control in the early decades of the new millennium. But in 2010 and the years immediately following, economics is likely to be the big story in Sino–American relations. Trade tensions are inevitable and feelings of economic nationalism in both countries are rising. What both countries must do is to ensure that small economic spats act as pressure release valves rather than as catalysts for escalation. China and the US understand this imperative. The question is how best to manage it.

G20: From Forum to Institution

Exemplified by their Strategic and Economic Dialogue, China and the US are devoting unprecedented energies to their bilateral relationship. But both countries have also gone out of their way to signal their intention that Sino–American relations should be embedded in multilateralism. China and the US know that their relations have global ramifications and that it is better for all concerned to get global buy in on the way forward rather than presenting Sino–American outcomes as a fait accompli to the international community. Both China and the US also know that involving other countries offers a potential dampener to bilateral tensions.

But how should the G2 be internationally embedded? Some suggest that a regional focus fits the emerging realities of an Asia-Pacific century. In this vision, the moribund Asia Pacific Economic Cooperation (APEC) forum would be revived and expanded into an Asia-Pacific Community bringing together all the major players on both sides of the Pacific, including China and the US. While Australia is a strong proponent of this idea, neither China nor the US seems to have much enthusiasm for it. In fact, China seems more interested in the possibilities of a more powerful Asia-only institution, building on the recent dynamism of ASEAN-based regionalism, to act as a counterweight to the European Union and the North American Free Trade Area.

Sino–American reticence about building a meaningful international institution spanning the Pacific is in part the product of their apparent preference for multilateralism over regionalism. In the dark days of the autumn of 2008, of course, radical multilateralism was all the rage. British Prime Minister Gordon Brown led the charge in talking up the notion of root and branch Bretton Woods II reform.

But the idea of creating a whole new set of institutions to replace the post-Second World War system of the IMF, World Bank and the World Trade Organization lost out to the all-hands-on-deck practicalities of responding quickly and decisively to the crisis. After the crisis, the notion of a radical new Bretton Woods agreement is unlikely to resurface in the same form if for no other reason than the mountainous obstacles to generating consensus among all the world's sovereign states.

The institution that did flourish in the financial crisis was the G20, with a meteoric ascent in less than one year from an obscure venue for finance ministers and central bankers to compare notes into the premier forum for global economic governance. In its Washington and London meetings in November 2008 and April 2009, respectively, the disciplined focus of the G20 was on coordinating fiscal stimulus and financial bailouts.

The G20 began to evolve from crisis response into global economic governance in its Pittsburgh leaders' meeting in September 2009. The Pittsburgh communiqué addresses the kind of coordination-among-members issues that would traditionally be the domain of intergovernmental forums like the G8, led in this case by its Framework for Strong, Sustainable and Balanced Growth (G20, 2009).

The Pittsburgh communiqué, however, went much further. It made explicit statements about the obligations of external deficit (read the US) and external surplus (read China) countries to rebalance their economies for the good of the global system. The G20 also had no compunction about telling established multilateral institutions – all with very large memberships, large permanent staffs, permanent homes, treaty foundations and long histories – what they should do. The Pittsburgh communiqué outlined strategies for policy and institutional reform of the IMF and World Bank, for completing the Doha Round of WTO negotiations and for the UN-based post-Kyoto climate change regime that the G20 says must also embrace energy security.

China and the US both support this ambitious agenda that puts the G20 at the centre of global economic governance. For China, the G20 represents the leading edge of worldwide recognition of its status as a global power, draped in the less threatening cloth of a broader balancing between the old powers of the 20th century and the rising powers of the 21st century. The G20 is also big enough for the spotlight not to shine too brightly on China, allowing it to grow slowly into a global leadership role it remains uncomfortable about. For the US, the G20 represents a tangible reaching out to the new powers while also serving to lessen the influence of the big countries of old Europe, which seem increasingly not to see eye to eye with the US on a range of global issues. Both China and the US know that they will have *de facto* vetoes in the G20 without ever having to appear heavy-handed.

The emerging institutional architecture has the G20 sitting on top of the Bretton Woods institutions, in contrast with the more side-by-side approach of previous G groupings. The G20 will not replace existing institutions. But it will steer them, and where necessary reform them.

This is made possible because, for the first time, the G20 is globally representative and hence more authoritative and more legitimate than previous G groupings. It includes all the world's established as well as emerging powers, comprises most of the world's economic output and represents most regions, levels of development and sociocultural traditions. But at the same time, the G20's membership is sufficiently small to make possible the consensus decision making that is essential to effective global reform and coordinated action.

In terms of governance, the G20 will be more akin to a non-executive board of directors for the global system of governance than to an executive management committee. There is little stomach for the hard slog of creating a new treaty-based institution or for creating the kind of bureaucracies required by organizations charged with execution and implementation rather than strategic oversight and direction.

But effective strategic leadership from the G20 will require more institutionalization than the near vacuum that currently exists. Today, members of the G20 agree to the next hosts of its meetings, and those hosts then provide the infrastructure to conduct meetings and report their results. Hosts act as chairs of the group in a way that gives them even less power than the old six-month presidencies of the European Council of Ministers.

Moving forward, it would make sense to generate some continuity across G20 meetings and to strengthen the leadership role of meeting chairs by linking together the past, current and next chairs as an 18-month to 3-year triumvirate (depending on meeting frequency) in the way that organizations as diverse as the Council of Ministers and the American Bar Association have done. Like those organizations, the G20 will also need to develop a small core permanent secretariat to coordinate meetings, to help with the drafting of proposals and to be the repository of G20 discussions, decisions and actions.

The G20 should think of itself in the way the White House and 10 Downing Street were conceived – small, decisive, authoritative and sitting on top of and directing the established arms of government without micromanaging or replacing them. The G20 does not need its own capacity for research since it already relies heavily on the IMF and other multilateral agencies. Nor does it need to be engaged in policy execution and implementation that is the purview of existing institutions.

Conclusions

Written in the months before the full effects of the global financial crisis become clear, the US National Intelligence Council's Global Trends 2025 worried aloud about the onset of a transformed world of 'multipolarity without multilateralism'. Their concern was the hastening of a decentered post-American international system with several competing sources of power hamstrung by outmoded and ineffective global institutions and incapable of facing the major challenges of the new millennium (NIC, 2008, p. 81).

A year later, there is less reason for concern both about the potentially destabilizing effects of multipolarity and the absence of effective multilateralism. For the next decade and probably more, relations between China and the US will have a preponderant impact on the world. There are clear stress points in Sino–American relations, but these are likely to remain focused on business and the economy, and particularly the imbalances between the American and Chinese economies, rather than geostrategic rivalry.

China and the US have also decided that their *de facto* G2 should be firmly nested in a multilateral G20 that will sit on top of but not replace the existing institutions of global economic governance. The institutional innovation of the G20 may well end up being the most important silver lining to the crisis by creating an institution that charts the course to a better future for the global economy. Effectively harnessing the G2 in G20 architecture will be difficult. But it will likely prove essential to meeting the big global challenges of the first half of the 21st century.

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