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Transcript

China's Economic Dominance: The UK as a Mirror for the US?

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Roderic Wye:

My name is Rod Wye. I will be chairing this session. I'm an associate fellow with the Asia Programme here at Chatham House and I am very pleased to be able to introduce an excellent speaker to you. Arvind Subramanian from the Peterson Institute will be speaking on the subject of China's economic dominance, the UK as a mirror for the US. Arvind is a senior fellow at the Peterson Institute, and at the Centre for Global Development. He has published widely, and is the author of *Eclipse: Living in the Shadow of China's Economic Dominance*, should you wish to read further about it. There are flyers at the back of the hall.

He was assistant director in the research department of the IMF, where he worked on trade, development, Africa, India and the Middle East. And most recently has been selected as one of Foreign Policy's top global thinkers in 2011. So we are extremely privileged to be able to have him here today.

Without further ado, I think I will hand you over to Arvind who will be speaking for about half an hour on the record and then taking Q&A, also on the record.

Arvind Subramanian:

First of all, thanks very much Rod for inviting me to come to Chatham House. It's a real privilege and an honour to be here. And as you can see, the book that I've written is called *Eclipse: Living in the Shadow of China's Economic Dominance*. I thought at this forum here in the UK, I thought I'd try and draw out the parallels between the current transition that perhaps we're witnessing with the transition that we saw many years ago when the UK handed over its power to the US.

So the theme of the book is very much, is dominance. It reminds me of when I first came to the UK as a graduate student with my wife, we were watching something called the Jasper Carrott Show. I don't know whether it still exists or not. And I remember watching this kind of little vignette where Prince Charles is pacing up and down, up and down and a pregnant Lady Diana says, 'Darling, darling, what's the matter? What's the matter?' And he says, 'Darling, I want to give my children all the things that I never had.' And she says, 'What, darling?' And he says, 'India, for example.' So that's the kind of dominance that we're kind of talking about here.

So let me begin with the kind of main motivation for this, which is that I've been very much influenced by what happened in 1956, you know, the famous Suez crisis. I come here not to remind you of past glory, or whatever, or past

lost glory. But I've been very influenced by what happened then because I see a lot of parallels between '56 and what's happening today. And Harold MacMillan famously said after what happened in 1956, that the British action at Suez was the last gasp of a declining power. Perhaps in 200 years, the US would know how we felt.

And to some extent, you see strong resonance of that idea that this, you know, US dominance is really here to stay for a very long time. And captured in what I think is the central American conceit... Larry Summers, one of the most brilliant of people, expresses these things very eloquently. He said when he departed, when the Soviet Union collapsed, instead the Harvard Business Review proclaimed in every issue that the Cold War was over and that Germany and Japan had won. Now we have the same thing with respect to China.

I think the central American conceit is that, yes China is growing. Yes, China can become very dominant. But seriously, they're no challenge to us. And as long as we take the right actions, economic pre-eminence is ours to lose and not China's to gain. And in some ways, I think my book is here to challenge that almost American hubris and complacency.

So that's how I started thinking about this, and I won't go into this. So let me say what the four main messages of my book are. The first is that China's economic dominance is more imminent, larger in magnitude and much broader in scope than anyone currently believes or imagines. And I'm going to dwell a little bit on one aspect of this dominance which is the currency dominance in a little while. Which is my second kind of point, which is that I think that the RMB is going to eclipse the dollar within 10 years.

Now, you might ask the question, so what? So what if China becomes economically dominant? And it's true that, you know, a country grows, it's not a zero-sum game. One country grows, it's good for the world economy. There's enough space for China and the US and Europe. So the question is, so what? And my response to that is that, I mean there is an important policy 'so what?' question, which is that... will the current economic system that we've seen, that we have after World War II, largely crafted by the Americans, will that open economic and trade system survive China's dominance?

And so I think this is a kind of central issue that certainly preoccupies people in Washington and around the world. And my answer to this question is that I think there's a high probability that because of the nature of China, its economy and trade, that China will have an incentive to preserve the system. However, I think my main point is that we need some insurance against the

possibility that some tail risk of China becoming what I call an unbenign economic hegemon, in which case we need some insurance. And I want to make the strong case that multilateralism is the insurance that the world has vis-a-vis China.

And the second 'so what?' question I think is something for the United States. I think if you think back about what happened in the Suez episode in 1956 to the United Kingdom, I think America is similarly vulnerable. It's vulnerable to the exercise of Chinese dominance and a repeat, a kind of literal repeat of the Suez episode is not a high probability event. But enough parallels between what happened in 1956 and today – sufficient parallels – for the US to wake up and be concerned, if not a little bit alarmed.

So these are my main messages in the book. And I want to elaborate on some of them over the course of the next ten to 15 minutes.

So as an economist and as someone who kind of cannot get away from quantification, so what I do in this book is I actually create an index of dominance. It's a really hairy exercise, full of pitfalls, not least because quantification is reductive, the underlying phenomena that we're trying to measure are actually very rich, and even the way one implements this in terms of the quantification is seriously problematic. But I kind of wade into this territory and I say, 'Well, if you look back at history and if you think about it a little bit, there are three key determinants of economic power.'

One is that resources for power come from how big an economy is. So GDP is a natural measure of how powerful a country might be. And we know that trade, not just in terms of Pax Britannia, but after 1945 the power to control access to a big market has been a big source of power for the United States, for the European Union, used both as carrot and as stick. So I posit that trade is an important determinant of power.

And then I also posit that external financial strength is a big determinant of power. You know, I always say that IMF, amongst economists, IMF tends to stand for... it's mostly fiscal. It's all about fiscal issues. But I tend to think of IMF as, if you're a debtor, you're at the receiving end of the relationship: if you're a creditor, you're at the giving end. And therefore, external financial strength – and we see many, many manifestations of that today – is an important source of power.

Now I won't bore you with all the details. You can think of other ways of doing this, but essentially what is key to the quantification that I do, because I project this index going forward, is that my central base case scenario requires China to grow not at the current 10, 10.5, 11 percent but to slow

down considerably to below seven percent. And if China grows at that, and in my base case the United States grows at 2.5 percent. So take my word that as long as the differential in aggregate growth rates between China and the United States is somewhere close to this ballpark, all the things that I'm saying in terms of the quantification do go through.

Now, *The Economist*, when they reviewed my book said the book comes to radical conclusions but the assumptions are quite conservative. So I'm not rigging these numbers in my favour in order to generate dramatic outcomes. Because as you can see, I forecast China to slow down considerably – by about 40 percent relative to where it is today.

So then I come to my first finding, which is that Chinese economic dominance is more imminent than anyone currently believes. Now let me explain this chart a little bit. This is my index of dominance. I charted back to 1870 and in some ways it passes the smell test, because the UK in 1870 is the biggest power and the shift, the transition in the sense between the UK and the US happens around 1913, you know, World War I, when in Barbara Tuckman's famous words, when the United States became England's larder, arsenal and banker. And that's what happened around World War I. And you can see that this index kind of tracks that reasonably well.

And then it tracks US pre-eminence after World War II, and you can see in 2010, which is where we are today, the index of the two countries are very similar. So Chinese economic dominance is almost as big as American dominance.

So, points I want to make here. First is that when people react to the message in the book, the first question they ask is, 'Ha ha. This Chinese pre-eminence might be somewhere in the future. Is this plausible? The message that China is already economically dominant.' And my answer to that is, you can see manifestations of Chinese dominance even today. Three examples.

One: no Taiwanese Embassy exists in Africa. They've all been closed down, because China is providing FDI, aid, all kinds of assistance, and in return of course, it's made these political demands.

Manifestation number two: In this whole European crisis, where are all the eyes turned for help? Well, Germany in the first instance, because Germany has to write the cheques, but if Germany can't write the cheques, all eyes turn to China because only China now it seems... It's not the US, the US no longer has the wherewithal to provide support, not even the IMF, but China is where... And I say somewhere in my book that when Hu Jintao went to Spain a couple of years ago, the Spanish Prime Minister effused and said, 'Oh,

China is our best friend.' It seemed a little odd for... Spain-Chinese relations were never top on my radar list of countries being close together. But there it was.

The third, in my view, even more important manifestation of dominance is China's currency policy. I happen to take the view that the Chinese undervalued exchange rate not just affects the United States – that's where you hear all the clamour and noise – but actually it affects many, many emerging market and developing countries because they compete with China to a much greater extent than the US does. And the world has not been able to do anything about Chinese exchange rate policy. If that isn't a sign of economic dominance, it's difficult to find what might be.

Now, there is an interesting issue here which Martin Wolf commented on my book a couple of weeks ago. He has this very interesting phrase called 'premature China as a premature superpower'. So there is an interesting discussion to be had here in terms of whether a country... because remember, the previous two superpowers were superpowers when they were amongst the richest countries in the world. China is not today, nor is it going to be over the horizon that I'm covering. So can a country that's not amongst the richest, can it be a superpower? And what forms can that take?

So the term that I use is that China will be a *precocious*, not a premature superpower, because China will not be a poor country. It will not be the richest country. It will be a kind of very rich middle income country. Do the thought experiment. Can a Korea today, if it had China's size, could it dominate the world? And that's kind of where China will end up in terms of my projections.

So more imminent in terms of timing. Greater in magnitude. So when I project this to 2030, the skyscraper shantytown image in 2030 resembles the US in 1973 and the UK at the height of empire in 1870.

I say provocatively in the book, you know, we're no longer talking G7, G8, G20. We're not even talking G2. We're talking G1 - unfortunately for the Americans, with the identity of the one not being the United States of America.

So that's kind of the scenario that's possible in terms of if these patterns of growth hold going forward, and it's simple to understand where this comes about. It comes about because it's a combination of demography, the fact that China's so big in terms of number of people, and convergence – the fact that China has been growing quite rapidly. So a country that is four times the number of people, that has half the per capita GDP of the United States, is going to be twice as big.

And on top of that, China as I'll show you later is actually a very big trader and it also is the kind of, it controls the finance spigots of the world. So the combination of these four factors is what is going to create this sense of China being dominant in terms of economic magnitude.

Now, broader in scope. I wrote a piece in the *Financial Times* two and a half weeks ago, I think, where I said that the RMB will eclipse the dollar by the end of this decade or soon thereafter. And it provoked a storm of controversy. There was an online debate on *The Economist*, with me defending the proposition that this would happen and others kind of taking the opposite view. And at the end of this debate, I lost this debate comprehensively. There were three fourths of those who kind of followed the debate, said there's no way the RMB will eclipse the dollar. But I continue to believe that this will happen. And let me try and convince you why that might be the case.

We know, for example that in order for the RMB to become a reserve currency – sorry, I should say, I didn't emphasise that I'm arguing not that the RMB will become a reserve currency, I'm arguing that it will become the *premier* reserve currency, eclipsing the dollar within ten years. And we know for this to happen, China will have to make lots of policy changes, because at the moment the RMB is not convertible. Foreigners don't have easy access to that.

And there's a reason why – because China follows a growth strategy that's based on keeping interest rates controlled, the financial system controlled, the exchange rate controlled. And so if China is going to continue with these policies, there's no way that what I'm saying can come to pass, because it's a prerequisite that the Chinese currency becomes convertible and foreigners have easy access to it.

And the argument is that the status quo will strongly impede any attempts by the Chinese authorities to liberalise all these things which are prerequisites. So, yes, these changes will be politically difficult, because the vested interests have an interest in preserving the status quo.

So why do I maintain what I maintain? This is where I think the history of the sterling-dollar transition is really very interesting. Now, if you think about what the kind of received wisdom on the sterling-dollar transition is, and Paul Krugman, who studied this at great length has a nice paper in '84 when he says, 'Surely the impressive fact here is the inertia.' The UK, sterling remained the dominant currency until World War II, even though the US economy surpassed that of the UK around 1872, 1873. So the inertia of about 50 to 60 years between economic dominance and currency dominance, and

when you project that to today, it looks like RMB dominance is way down the future.

Now, I actually think that that's a misreading of history. I think Catherine Schenk has a very nice – I think she presented some work here at Chatham House – and she has a very nice book on this. And the interesting thing, my reinterpretation of history is the following. That if you think that currency dominance is not determined by the size of an economy, but by how important a trader a country is, and how strong it is in terms of its external financial strength, then lag between the dollar's rise and the rise of American economic dominance is only ten years.

And why do I say that? If you look, for example. The US economy surpassed the UK around here, and that's why we get this 60, 70 year lag, but actually as I said earlier, in a broader sense, the economic dominance only happened around World War I. And actually by the 1920s, the dollar was the primary reserve currency, and thereafter it fluctuated only because of the politics of empire. There was the Imperial Preference in 1932. There was the Sterling Area just before World War I. And that prolonged the use of sterling. Otherwise, sterling was kind of dead as a premier reserve currency around this period, and given that it lost dominance in the economy, the lag is only ten to 15 years.

So I'm applying that lag today and saying, similarly, the lag will only be ten to 15 years as of today.

Essentially what I'm saying is that... So, one, in terms of sure economics, the fundamentals of economic heft defined very broadly, the Chinese economy is there already. But I think more importantly, my counter to those who say, 'China will never make the changes necessary,' my argument is that one, there is a set of countervailing forces building up in the Chinese economy that wants to change the status quo, that wants to internationalise the RMB, and actually you see many, many signs of that already happening.

Once the economic heft shifts decisively, for example, over the next ten years, intra-Asian trade with China as the hub is going to be so big, there's no reason why that trade will not be denominated in RMB rather than dollars. And once that happens, trade will be settled in dollars, then people will start holding dollars, and there will be pressures on China to change to accommodate these changes.

A powerful set of countervailing forces is building up that will challenge the status quo. And above all, I think that the RMB internationalisation will be the political economy exit for China, in the sense that no matter when China

changes its policy, there's going to be political opposition from the status quo. You know, the exporting interests will benefit from the cheap currency policy, the firms who get cheap credit. At that stage, the Chinese will say, 'Yes, we have these problems, but in return we get... what do we get? The number one currency in the world, the RMB.' So the symbolic nationalist gains from having an international currency will have to trump whatever economic opposition there will be from domestic interests.

Now moving to the kind of more policy focus of what the book is arguing. Will the open economic system survive China's rise? I think that's a big question for all of us who think about what's going to happen to the international system. And my contention, or series of propositions... For Chinese policy-makers, delivering the process of convergence, ie attaining reasonable standards of living, is critical for Chinese policy-makers. In fact, it's central to their legitimacy. They have to keep delivering high rates of growth and higher standards of living.

That process is far from finished. Today, China's standard of living, even on my optimistic estimate, is about one quarter that of Europe or the United States. And China's convergence, this process of development, has relied and will continue to rely critically on trade.

So why would China want to bite the hand that feeds it, almost? And that's why I argue that China's need for an open economic trade system is going to be almost existential in contrast to that of the United States, which bequeathed the system because of the history of the war, because of enlightened self-interest, foreign policy considerations and so on, which many of you know better than I do. But in the case of China, it could be much more existential. Just to give you a sense of... and also, China is becoming the hub of globalisation and that's going to create the incentives to maintain an open economic system.

Just a simple set of numbers. I compare, for example, how big a trader China is today to how big a trader the UK was at the height of empire. And of course the US at the height of Pax Americana. And what you find is that China is a very big trader. It's an unusually large trader. And people forget that small countries tend to trade more, which is why in some ways the UK being the top trader in 1870, apart from the fact that it was achieved, as I say; Britannia ruled the waves by, to some extent, waiving the rules. I mean, apart from that, the fact that China being such a big economy and yet being so reliant on trade is very unusual. So it's comparable to what the UK was and so that is

going to be a powerful kind of motor of self-interest to ensure that the system, that China has an interest in keeping the system open.

But there is still risk, as the financial analysts would say. Because history counsels caution. I mean, the great pamphlet by Norman Angell said that war could never happen because Europe – Germany and the UK and all of Europe was so intertwined that you could see no war. And yet we know that World War One happened. And similarly I think we can't be sure...

Moreover, I think China has done enough to give rise both to doubts about what it might do once it becomes dominant, and perhaps more generously, we're still not clear what China wants from the system. It's yet to articulate its vision for the economic system.

And so my central contention is that if you think about multilateralism as a protection for the weak against the strong, I think the world, including the United States, will have to change its mindset from being the strong hegemon to start to think in terms of how it can be on the side of the weak to seek protection against the future strong hegemon, namely China.

I don't by any means intend to convey the impression that China will be a malign hegemon or that the US was always a benign hegemon. Far from it. But the fact is China will have power and just as the US misused its power in the last few years, China too might be tempted to do so. And it's that contingency that we need to guard against.

And my view on this is that the way this happens, the way multilateralism would work – and it's something that I think Europe needs to also kind of come onto this a little bit more seriously – take the Chinese exchange rate for example. The world has been unable... certainly the US acting alone has not been able to change China's policy. Many, many developing countries have felt the impact of China's exchange rate policy, but they don't say anything in public, partly because they have their own concerns with China, their own interests with China.

So there's a big collective action problem here. And my central contention is that you need these, all these with a similar interest in bringing China into the system to tether China. So you need, in a sense, in a bargaining sense, the heft on the other side of the bargaining table where China is on the other side. And that economic heft cannot come about either by the US acting alone or the EU acting alone. It has to come together with all of China's trading partners coming together. And that's the sense in which I think multilateralism is important.

A corollary of that I think is that, you know, I think we should start thinking very seriously and cautiously and with great reticence about promoting the bilateral avenue. Either with China, because I think the bargain would be very uneven, or even kind of aimed at China – what I call a hostile regionalism. My own country, for example, India, is negotiating free trade agreements with all the countries around China. At some point China will see this as hostile, as indeed some of the other initiatives. And if China were to return the favour by negotiating its own bilateral agreements, the world could be headed for a kind of fragmented, discretionary, non rules-based system like in the inter-war years.

And that we need to guard against. I see multilateralism as the way forward. I think one can see multilateralism kind of in a slightly negative light, vis-a-vis China. But I think one can also see multilateralism as a kind of positive way of tethering China.

Take the European crisis, for example, the Eurozone crisis. My own view is that at some stage if all hell breaks loose within the Eurozone, the Eurozone will require external resources. Because even Germany will not have either the political will or the economic ability to transfer these resources. I think you will need the IMF, ie resources from abroad. The one country with those resources is China.

I think China will have an interest in, well, it will be forced to think about providing these resources. Then the choice it faces is, should I provide these resources bilaterally to Spain and Italy and Portugal and extract political concessions in return? Or should this be channelled through the IMF multilaterally? And normatively I think that should happen, but I think in return China should get a seat at the table.

Just to give you a sense of how anomalous the current situation is, especially I want to say this in front of a European audience... Larry Summers always says that in any financial institution, creditors should call the shots and not the debtors. Well, I say what's good for the goose is good for the gander. Today, Europe is no longer a potential creditor to the International Monetary Fund. It is an actual, potential, even actual debtor to the International Monetary Fund. And so the US might be, too. So I say, therefore, that we need a radical revamping of IMF governance in which China has as much veto power as the United States and the European Union.

And I think that would be desirable because it would give China an incentive to work multilaterally rather than bilaterally. And it would kind of address what I think is huge imbalance in governance in these international institutions.

Sorry, my final set of thoughts. I began with a UK-US kind of parallel. I want to end with that.

I don't know how many of you kind of know what happened in 1956, but essentially when the UK needed financial resources, and it turned to the US, the US said, 'No way. We will not even allow you to get your own resources at the IMF unless you withdraw from the Suez Canal zone,' and the UK had no choice but to do so.

Now the question is, what are the kind of parallels and similarities and I think there are obvious differences between '56 and what's happening today. I mean, there's no reason why a dollar depreciation should be as harmful to the US as sterling depreciation was then. Remember, the UK in 1956 was desperate to avoid sterling devaluation because the Commonwealth countries had a lot of their assets in sterling, so a sterling devaluation would have devalued those assets and further severed ties between the Commonwealth and the UK. And politically, the UK did not want that to happen.

So there are differences, but I think the overall deeper parallel between the UK-US episode in '56 and today is that the US today confronts as much generalised economic weakness as the UK did in 1956. It's not just that the US is growing slowly. That's one part of it. It's not just that the US faces this massive fiscal crisis, looming the entitlements crisis, which is also true.

I think what is not recognised is that the US has a massive middle class problem, a structural problem that's gotten worse over the years. You know, median incomes have stagnated. Income differentials have widened and a professor at Harvard Larry Katz says that the US is like an apartment block that was the envy of the neighbourhood 15-30 years ago. Today the penthouses have grown bigger. The middle floors have gotten squeezed. The basement is flooded, and above all, the elevator from the basement no longer works.

That structural weakness afflicts America, and then of course we have, combined with a generalised economic weakness, is this emergence of a credible competitor. Just as the US was, well not just a critical competitor. The US was numero uno then.

But today the US confronts a competitor that, let me remind you, will have the world's largest economy – one and a half times the US – will be the world's largest trader – one and a half times the US – will control the finance spigots being the largest creditor. And that might even issue the world's premier reserve currency. So that is, I think, the economic dominance that looms ahead for the United States. Thank you.