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Rewriting the world order: China's footprint on the credit crisis and international affairs

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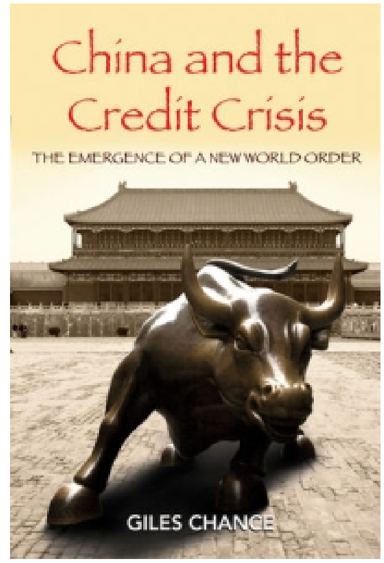

As the 2008 financial crisis draws to a close, a cottage industry on the anatomy of the meltdown has sprung to life.

While conventional wisdom about how the crisis started is being written, some of the common themes that have emerged: the mushrooming of exotic financial instruments driving the subprime mess to the point of no return; anaemic financial regulations that failed to keep up; the systemic failure of unbridled capitalism and free markets; and some say, the personal failure of "The Maestro" himself, former Fed Chairman Alan Greenspan.

But as with most economic phenomena, it is difficult to pinpoint a single cause or even how a mix of factors might have set off the fuse. But before the ink is dry, Giles Chance, author of "*China and the Credit Crisis – The Emergence of a New World Order*" (http://as.wiley.com/WileyCDA/WileyTitle/productCd-0470825073.html), introduces an interesting perspective to the table.

According to him, we are missing the elephant in the room: China.

What China did

His bold thesis is that without the emergence of China, the crisis would not have happened. This does not mean that China caused the crisis, but that the shock triggered by the sheer scale and impact of this juggernaut economy hurtling on speed onto the global stage created the *precondition* for the crisis to occur.

More importantly, the credit crisis has now created a tipping point for global power to shift from the West to the East, thus changing the world order in fundamental ways not seen since the end of the Cold War.

Chance, now a visiting professor at the Guanghua Business School at Beijing University, is a veteran China hand who has witnessed, up close, the country's dramatic developments by helping many foreign companies and investors navigate its byzantine system since 1989.

To him, policy-makers in the West, especially the US, have failed to appreciate the so-called "China effect" on the workings of the global economy, and hence, misjudged their policy responses.

Their biggest sin was to misread the fall in prices (of goods and labour) triggered by the scale of China's supply shock as its cheap exports flooded the world.

Inflation had "disappeared". There were signals to start worrying about the deflationary trap – and most did not. As such, they lowered interest rates in a bid to stimulate growth and absorb unemployment.

Chance argued that if policy-makers had better understood the "China effect", they would not have been that concerned with the falling prices and would recognise it as a one-off ahistoric phenomenon. Instead of lowering interest rates, they might then have kept rates higher to encourage savings and investor prudence.

The "China effect" also led to a build-up to the crisis in another way – via the capital markets. Thanks to its powerful export engine, the vast trade surpluses amassed by China made it the biggest buyer of US debt. This helped to drive up asset prices and dampened yields. It then triggered a high-octane, high-risk "search for yield", adding to the pressures which led to the 2008 crash.

There is a ring of truth to Chance's view, though it is a fresh and untested perspective in the debate about the origins of the crisis. The poor understanding among policy-makers about China's impact on the global economy certainly resonates, and Chance has provided some examples.

One-way street

Just how far off the mark was the US in understanding China?

Take what former US President Bill Clinton said in early 2000 on the expected benefits to the US economy from China's entry into WTO in 2001:

> "*Economically, this agreement is the equivalent of a one-way street….For the first time, our companies will be able to sell and distribute products in China made by workers here in America, without being forced to relocate manufacturing to China, sell through the Chinese government or transfer valuable technology – for the first time*."

The one-way street ended up pointing at the other direction. It was the US that turned out to be the big market for China.

But the question remains: Even if policy-makers were armed with the right lens to interpret the "China effect" before the 2008 crisis, would it still have been averted?

This is where Chance's thesis seems a tad too speculative and spiked with too many "what ifs"? Suppose that interest rates were kept higher, would that have encouraged more Americans to save instead of investing in dubious assets, given that the overall economy was robust and its outlook strong?

To what extent was the easy and reckless credit culture in the US was driven by low interest rates?

To what extent was it also fuelled by the securitisation trend, corporate irresponsibility, and a foolhardy optimism infecting everyone from bankers to consumers that good times will keep rolling and there is no such thing as a hitting rock-bottom?

Nonetheless, Chance's argument about China's emergence creating the opening for the crisis is worth exploring more deeply. After all, he devotes just one chapter to the question.

More importantly, his advice that we increase our understanding of China's peculiar impact on the global economy will be even more critical in the post-crisis world, especially with the global rebalancing that needs to take place to create a more resilient economic system. This depends crucially on what China does, and importantly, how the rest of world reacts to it. For instance, a key question is whether China can make a successful transition to a consumption-led economy, how long that might take, and what issues might crop up along the way.

Meanwhile, as Chance pointed out, the crisis will likely be the tipping point for a power shift from West to East.

Reshaping the world order

How might China's growing dominance likely reshape the world order?

Chance looked at three main areas. First, how China would influence the dynamics of global governance, including its impact on how multilateral institutions, such as the International Monetary Fund and World Bank, are run, thus institutionalising the winds of change. Second, how China's rise will shape its all-important relations with US, its role in Asia and the emerging world. Lastly, and perhaps most interestingly, whether we are moving towards the slow end of the US dollar's reign.

That the greenback will no longer be the world currency may seem unthinkable at this point. But as Chance pointed out, it had never been the natural order for the US dollar to reign supreme anyway. It was a legacy from the US' triumphant position after World War II. Several prominent economists have never been comfortable with it.

As far back as 1960, economist Robert Triffin had argued in front of US Congress against US dollar dominance.

His concerns: If the dollar acts as the world currency, the world would depend on a steady flow of dollars from the US to finance world trade and foreign reserve growth. This would, in turn, require the US to run large external deficits.

If the deficits become too large, other countries may lose confidence in the dollar's value. Yet if the US moves to reduce the external deficits to restore confidence in the dollar's value, then the dollar flow to the rest of the world will be reduced and global growth undermined.

These arguments still stand today. Even though the *renminbi* has gained strength and prominence, replacing the greenback with another national currency will not solve the problem.

Green but not with envy

According to Chance, a likelier scenario is to replace the US dollar with a *global* currency –perhaps the Special Drawing Right or any other arrangement. But even this is technically complex, not to mention, fraught with political and economic risks.

Politically, the US would fight tooth and nail to resist this. The fall of the dollar from its privileged perch would be comparable to the loss of influence suffered by Britain when the pound was dropped as the world currency at Bretton Woods.

However, can the US resist the tide of change brought about by the China's economic strength, its growing *de facto* and *de jure* influence in the likes of IMF and the widening acceptance of the *renminbi* as a major currency, especially as China establishes currency swaps with more countries.

Going along these lines, it is not inconceivable that one day, interest rates announcements by the US Fed will no longer have any effect on currency, stock and bond markets. These are among the possible scenarios highlighted by Chance that policy-makers would do well to prepare for, even if they seem far-fetched now.

Pax Sinica

Indeed, China's fast-growing heft in world affairs has attracted much attention recently. So it is not a question of whether China will become a superpower, but what sort of superpower.

To this end, Chance provides useful accounts on China's emerging role in Asia and developing regions such as Africa and Latin America. The country's growing activism in these far-flung regions is largely driven by China's appetite for natural resources and overseas investment markets.

It might also be interesting to see how China's actions might change the norms of foreign policy and international affairs by virtue of its dominance. It would have been a bonus if the book could have looked into that more closely.

What kind of a world order would *Pax Sinica* (http://en.wikipedia.org/wiki/Pax_Sinica) be? Many political regimes are tired of Western countries tying their aid to political strings such as Western conceptions of human rights. These countries will very likely cheer for a pragmatic benefactor in China.

But while it is easy to criticise the West for their interventionist and blundering moralism, would a pragmatic and amoral foreign policy that disregards the political consequences of sustaining unsavoury regimes in the name of sovereignty lead to a better world?

If China were to lead the world into the era of *Pax Sinica*, would it be obliged to wade into the difficult and ambiguous grounds of morality in foreign policy?

Could it afford to wage a mercantilist, mind-our-own-business brand of foreign policy given that problems are increasingly cross-border and solutions require greater coordination?

Leadership brings along responsibilities, and it is a mantle that China is reluctantly but slowly starting to don because of the sheer impact of its actions on the world.

Its growing self-confidence and immense pride in its own civilisation means that it is not likely to follow the script that we have been reading from since World War Two. Whether it is in G-20, IMF or how it conducts its relations with the US, how China eases into this new role will bear close watching.

And Chance's book is a good start for those who want to follow this story. Share on Facebook (http://www.facebook.com/share.php?u=http://knowledge.smu.edu.sg/article.cfm?articleid=1270)

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