The Perils of China-centric Globalization

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The last thirty years have witnessed the creation of an integrated global economy. However, what began as a project for globalization has gradually been transformed into a project of "China-centric globalization." This phenomenon has grave economic and geopolitical implications for the U.S. It also carries major implications for other countries, though those implications obviously vary according to country-specific economic and political details.

China-centric globalization is characterized by three features: (1) The emergence of China as the global center of manufacturing—the so-called "factory for the world"; (2) The creation of a new dollar zone shared by the U.S. and China, and supported by China's adoption of a pegged dollar exchange rate; and (3) The emergence of a massive U.S. trade deficit with China, combined with the transfer of a significant chunk of U.S. manufacturing capacity there.

Table 1. **U.S. trade statistics and the emergence of China-centric globalization**
(X=goods exports, M=goods imports, GDP=gross domestic product)

	[X+M]/GDP	[X-M]/GDP	China X/X	China M/M	China[X-M]/[X-M]/
1960	6.7%	0.1%			
1980	17.0%	-0.1%	1.8%	0.1%	N.A.
2000	20.2%	-4.5%	2.0%	8.1%	18.8%
2010	22.0%	-4.4%	7.1%	18.8%	42.2%

Source: Economic Report of the President, Congressional Research Service, Census Bureau and author's calculations.

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China-centric globalization is an extension and evolution of corporate globalization, which in turn evolved out of the post-World War II free trade era. This evolution is visible in U.S. trade statistics, as shown in Table 1. The first stage of this evolutionary process ran from 1945–1980, and constituted what is known as the “free trade” era. This period was characterized by rising trade openness, measured by goods exports and imports as a share of GDP, with roughly balanced trade. The second stage ran from 1980–2000, and constituted the era of corporate globalization which was marked by a continuing rise of trade openness, but now with rising goods trade deficits as a share of GDP. The third has run from 2000 to the present day and constitutes the era of China-centric globalization. It has generated a continuing rise in the goods trade deficit as a share of GDP, plus an increase in the share of U.S. imports from China.

Globalization was always problematic for both national security and national shared economic prosperity. China-centric globalization only makes it more so. Why is this the case? First, because it aggravates the impacts of globalization on both national security and shared prosperity. Second, because it constrains U.S. economic policy space. Thus, it has hindered U.S. attempts to escape the Great Recession by limiting capacity to address the trade deficit via exchange rate adjustment, and it promises to block any future attempts to recalibrate globalization so as to make it more equitable and environmentally sustainable.

Manufacturing and economic security

The U.S.–China economic relationship has been marked by transfers of technology and manufacturing capacity to China, significant financial investment in China, and the emergence of a huge trade deficit that over the years has made China the largest foreign holder of U.S. government debt. These developments have raised widespread economic and national security concerns about the impact of China-centric globalization.

One principal concern has been the erosion of U.S. manufacturing owing to the trade deficit with China and the diversion of investment from the United States to China. The argument is that decline of manufacturing threatens prosperity via reduced long-run productivity growth. That is because manufacturing has historically enjoyed faster productivity growth than other sectors of the economy and may also have positive external effects on productivity growth in those other sectors.[1] Furthermore, a reduced manufacturing sector undermines the capacity to export and increases reliance on imports, thereby risking the creation of a structural balance of payments deficit that can constrain growth and employment. Lastly, loss of manufacturing jobs can have negative short-run growth effects, because manufacturing jobs have historically paid higher wages, manufacturing is a large job multiplier, and manufacturing has traditionally had a higher rate of unionization (which exerts a positive impact on overall wage structure and income distribution).

What does this look like in practice? According to the calculations of economist Robert Scott, the U.S.–China trade deficit caused the loss or displacement of 2.3 million jobs between 2001 and 2007.[2] These adverse job effects were felt in all 50 U.S. states, affected all categories of manufacturing employment, and adversely impacted displaced workers who suffered an average income loss of $8,146 per year.

Erosion of the manufacturing base also entails national security risks. That is because a shrunken manufacturing base and increased reliance on imported manufacturing goods (either final goods or intermediate inputs) can threaten the ability of the U.S. to adequately equip a modern military and fight a lengthy war. Such dependence would create a potential national security risk for the U.S., regardless of the foreign country providing the imports. But it becomes especially significant given the extent of U.S. dependence on China—and given China's uncertain geopolitical relationship with America.

Table 2 captures the increased U.S. dependence on imported manufactured goods over time. In 1980, non-petroleum goods imports were equal to 30.5 percent of U.S. manufacturing GDP. By the peak business cycle year of 2000, this ratio had risen to 78 percent, and by 2007 it was 96.3 percent. Over the same period (1980–2007), Chinese goods imports rose from 0.6 percent of non-petroleum imports to 19.7 percent, and they rose from less than 0.2 percent of manufacturing GDP to 18.9 percent. In 2007, the peak year of the last business cycle, goods imports from China were therefore almost one-fifth of total U.S. manufacturing output.

Citing figures from the U.S. Business and Industry Council, Sheila Ronis reports that between 1997 and 2004 import penetration for aircraft increased from 15.2 to 24.5 percent; for aircraft engines and engine parts from 40 to 51.6 percent; for relays and industrial controls from 24.1 to 46 percent; for analytical laboratory instruments from 29.9 to 44.7 percent; for metal-cutting machine tools from 58.6 to 72 percent; for turbines and turbine generators from 25.4 to 49.4 percent; and for speed changes, high speed drives and gears from 38.5 to 63.1 percent.[3] These declines in U.S. manufacturing capacity coincide with the implementation of the strong dollar policy in 1997 and the subsequent onset of China-centric globalization.

This loss of manufacturing capacity has both static and dynamic security implications. At the static level, it potentially undermines the U.S. ability to provision the military and provide security. At the dynamic level, it threatens the future strength of the U.S. economy because manufacturing is a critical source of productivity growth, and a smaller manufacturing base implies smaller future gains from productivity improvements. This dynamic threat promises to increase as China moves up the manufacturing value chain and displaces increasingly advanced sectors of the U.S. economy.

A second concern is off-shoring of R&D facilities to China and other emerging economies. Off-shoring of R&D is worrying because it stands to reduce the flow of future innovations, thereby diminishing future economic strength and prosperity. It also adds to China's own economic strength.[4] A survey by China's Ministry of Commerce reported that by June 2004 multinationals including GE, Intel and Microsoft had set up over 600 R&D centers in China, involving expenditures of more than $4 billion.[5] Between 1992 and 2004, China more than doubled its expenditures on R&D, from 0.6 percent of GDP to 1.3 percent, and almost all of this expenditure has been funded by foreign investment.[6] Moreover, much of this R&D has been focused in the high-tech industry, and it is attracted by strategically designed Chinese policy.[7]

Table 2. **Composition of U.S. trade and its relationship to U.S. manufaturing GDP**

(M=goods imports)

	Non-petroleum M/ manufacturing GDP	China M/Non-petroleum M	China M/manufacturing GDP
1980	30.5%	0.1%	0.0%
2000	78.0%	9.1%	7.1%
2007	96.3%	19.7%	18.9%

Source: Economic Report of the President, Bureau of Economic Affairs and author's calculations.

The growth of China's manufacturing capacity has clearly strengthened its ability to support a large, fully equipped modern military. Much modern manufacturing technology is either directly dual-use in nature, or lends itself to a learning process that enhances indirectly a country's military potential. In this sense, foreign direct investment in non-military manufacturing facilities can potentially undermine national security.

Financial security

Trade deficits must be financed, and the financing of the U.S. trade deficit with China has contributed to the build-up of large Chinese holdings of U.S. financial assets. These large Chinese financial holdings raise concerns about a financial security threat. While this threat should not be overstated, China's holdings of U.S. debt still provide reason for concern, especially as they would give China another point of leverage during a geopolitical crisis or showdown with the U.S.

From a financial security perspective, the danger is that China might disrupt U.S. financial markets by engaging in strategic selling of its holdings, which in turn could injure the U.S. economy.

As of May 2013, Mainland China and Hong Kong held $1,453.7 billion of U.S. Treasury securities, representing 35.5 percent of all foreign official holdings of such securities. In December 2012, federal debt held by the public (i.e., excluding holdings of Social Security, the Federal Reserve, etc.) was estimated to be $9,909.1 billion, so that China and Hong Kong own 14.7 percent of the total. These holdings pose both an economic cost and a financial security threat.

With regard to cost, the debt entails interest payments to China that are a form of tax on the U.S. economy. To the extent that these payments go unspent, the drain of income puts deflationary pressure on the U.S. and global economy. To the extent they are spent, that is good for demand and stimulates production, but it also means that U.S. output in effect goes to China rather than to increasing U.S. economic well-being. As with household debt, there is a real cost to becoming an international debtor, as a country must pay over part of its income as interest.

With regard to financial security, China's financial holdings give it significant power and leverage over U.S. financial markets. China's Treasury holdings were slightly larger than the Federal Reserve's holdings, which stood at $1,213 billion as of February 23, 2011. At that date, the total value of Federal Reserve assets was $2,537 billion, making China's holdings equal to approximately 50 percent of the Federal Reserve's balance sheet. That means China can affect U.S. financial conditions just as profoundly as the Federal Reserve can.

From a financial security perspective, the danger is that China might disrupt U.S. financial markets by engaging in strategic selling of its holdings, which in turn could injure the U.S. economy. This renders the U.S. economy potentially hostage to Chinese policymakers and for that reason constitutes a national security risk.

However, this threat can easily be overstated. First, China is constrained from undertaking such actions, because it would incur losses on its asset holdings if it sold them to drive down bond prices and drive up U.S. interest rates. China would also suffer economic damage if the U.S. economy were hit because of China's dependence on exports. As Maynard Keynes famously observed: "If I owe you a pound, I have a problem, but if I owe you a million, the problem is yours."

Second, the U.S. has significant defenses against financial aggression. U.S. debts to China are denominated in dollars and represent a promise by the Treasury to pay dollars at date of maturity. Consequently, the Federal Reserve can always create money and buy any debt that China chooses to sell. Such action by the Federal Reserve would have implications for inflation, the exchange rate and global financial markets, but it would blunt any immediate damage caused by Chinese selling. The recent financial crisis and interventions of the Federal Reserve have shown the power of the Fed, and that power can also be used to check hostile financial actions by China.

Lastly, the U.S. Treasury has emergency powers to freeze Chinese holdings in the event they are being used to undermine national security. Such freezes have been invoked before in dealings with dictatorships in Iran, Iraq and Libya, and they could be used again in case of a crisis with China.

For all these reasons, the financial threat is not as serious as it is sometimes portrayed. But it is still real, and gives China the power to cause costly financial disruption. History also provides a lesson about the power of finance. In 1956 the Eisenhower administration used its creditor powers to pressure Britain to withdraw from the Suez Canal and hand it over to Egypt. The U.S. is in danger of giving similar power to China.[8]

Geopolitical security

Whereas significant attention has been directed at the issues of manufacturing and financial security, much less has been given to the issue of geopolitical security. Here, China-centric globalization has major ramifications that impact every region of the globe (East Asia, Africa, Australia, Latin America, and Europe), and these implications appear little appreciated.

The key feature is that the post-Cold War world is marked by a new form of geopolitical competition. In the Cold War era, the currency of competition was military and ideology. In the new era, the currency of competition is economic power that fashions durable commercial alliances. China-centric globalization gives China economic and financial power to build these alliances, while it also undermines that of the U.S., and by doing so dramatically weakens U.S. geopolitical power and security.

China's geopolitical financial challenge

In addition to the financial security threat, China-centric globalization also creates a geopolitical financial challenge. First, China's financial wealth gives it increased power in multilateral institutions like the IMF and World Bank. It also gives China financial power to woo domestic elites, a power that was recently on display in Canada with China's purchase of the energy firm Nexen. Regardless of the economic merits of that transaction, it showed China's capacity to deploy financial resources and affect domestic politics by exploiting differences of interest within Canada. Second, it gives China increased geopolitical influence and power via its ability to grant credit and foreign aid. This increased power is not just vis-à-vis developing countries. It also affects developed economies, as evidenced in China's courtship of Eurozone crisis countries (particularly Greece) during the current crisis.

East Asia and the global supply chain

China-centric globalization has also dramatically impacted U.S. geopolitical standing in East Asia. Here, the critical change has been the restructuring of the global supply chain.

Globalization has always raised supply chain security concerns because sourcing from outside one's borders is intrinsically more dangerous. The traditional threat metrics consist of the vulnerability of the foreign supply chain (often proxied by distance); the extent of foreign supplier diversification (proxied by the number of supplier countries); and the extent of quantitative reliance on foreign suppliers (proxied by imports as a share of manufacturing output). Greater distance, fewer supplier countries, and greater quantitative reliance all increase the potential national security threat.

China-centric globalization has increased this threat by making the U.S. global supply chain more vulnerable to interruption and more dependent on China. This is illustrated in Figures 1 and 2. Figure 1 contains a stylized illustration of the 1980s global supply chain that had the U.S. supplied by many East Asian countries (Japan, South Korea, etc.). This exposed the U.S. to dangers of distance, but the supply chain was relatively well diversified and the level of quantitative dependence was also low. Figure 2 shows the new supply chain that places China at the center in a role as product assembler. China receives inputs from East Asian suppliers, assembles them, and then ships the finished goods to the U.S. This middleman position gives China increased leverage.

Figure 1. **Stylized representation of the 1980s global supply chain**

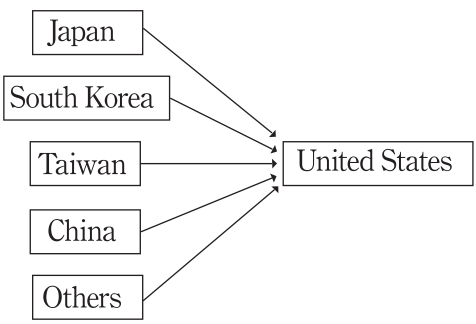
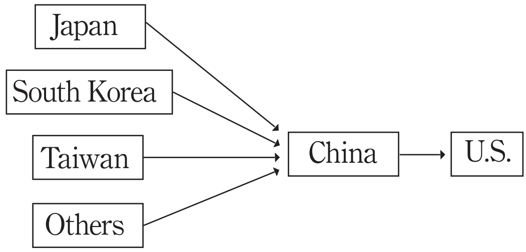


Figure 2. **Stylized representation of the 2000s China-centric global supply chain**



It also makes East Asian countries more dependent on China which increases China's regional power. Moreover, it projects China as the engine of regional economic growth, for which China gets significant diplomatic credit, when in fact the U.S. is the ultimate engine since demand for East Asian inputs is derived from U.S. demand for Chinese-assembled products.

China's resource diplomacy in Africa, Latin America, and Australia

China-centric globalization has also hugely increased China's geopolitical power with the natural resource exporting regions. The basic logic is that by making China the factory of the world, it has created the basis for new commercial alliances. The economic logic of these alliances is that China exports manufactured goods to these countries and in return receives imports of natural resources.

During the Cold War, the Soviet Union never could accomplish that because it was a resource exporter and was in competition with these countries. Consequently, it had little to offer economically and, instead, offered guns and ideology. The U.S. used to be the supplier of goods and buyer of resources but, as its manufacturing base has shrunk, it has been increasingly displaced by China. That places the U.S. in a weaker position versus China than it was versus the Soviet Union.

Resource exporters have benefitted from China's rise via increased raw material prices, access to cheaper manufactured goods, and from Chinese foreign direct investment (FDI). But they also suffer. First, China is undemocratic and its commercial practices promote the "natural resource curse," enshrining corruption and violations of human rights and labor standards, and thereby harming development.[9]

Second, China's mercantilist commercial policy and under-valued exchange rate undermine manufacturing development in resource exporting economies.

Third, higher resource prices are not a "free lunch"; they promote exchange rate appreciation that drives deindustrialization—the so-called "Dutch Disease." These problems are particularly acute for Latin America, which has a large population and is, in many ways, in development competition with China, which is an industrial rival.[10] China's low wages and policy of wage suppression inflict a further blow to Latin American development, attracting jobs away from the region and dampening wage growth in the region, something that is critical for domestic development.[11] The bottom line is that the new relationship between China and resource exporters has inexorable commercial logic, but it is not necessarily good for development.

The Trans-Atlantic relationship between the U.S. and Europe

Lastly, China-centric globalization also has implications for America's Trans-Atlantic relationship with Europe which has been the bedrock of the post-World War II international system. The structure of global production under China-centric globalization exerts a tendency to pull the U.S. and Europe apart by creating rivalries between them.

As mentioned above, China has already used its financial strength to woo Europe during the current Eurozone crisis. Second, with regard to trade, there has been some decline in the significance of trade with Europe for the U.S. as measured by the size of total trade relative to GDP. Third, and most importantly, the new economic structure tends to create a "prisoner's dilemma" situation between the U.S. and Europe. The two would do best by cooperating in their dealings with China, but the structure of China-centric globalization has them engaging in mutually injurious competition that benefits China.

This is particularly evident in the aircraft industry in the competition between Boeing and Airbus. China has been able to use its state control over purchasing by Chinese airlines to manipulate Boeing and Airbus into patterns of disadvantageous competition. These patterns include forced technology transfer and shifts of manufacturing and assembly to China. That has cost jobs and investment, and it threatens the long-term prosperity of both of these key companies by potentially creating a commercial rivalry.

Trouble ahead

China-centric globalization is very problematic for the U.S. from both an economic and a geopolitical standpoint. The problems are not going away. In fact, they promise to get worse. The trade deficit with China, investment diversion to China, and China's exchange rate policy has already hindered U.S. economic recovery from the Great Recession of 2007-09. After falling in 2009, the goods trade deficit with China has increased steadily and now stands at record levels in both absolute terms and as a share of the total goods trade deficit.

Yet it has been very hard to get discussion of this issue on the policy table. There are several reasons for this. First, and foremost, is the fact that many large corporations have benefited from China-centric globalization and they control international economic policy discourse in Washington. As significant beneficiaries, they block any challenge to the status quo. That speaks to a grave weakness in the U.S. political system. Corporations have become the most powerful political actors, but their goal of global profit maximization is different from the goal of advancing the national interest.

Second, there is little understanding of the distinction between globalization and China-centric globalization. That fosters the misunderstanding that rolling back China-centric globalization is synonymous with rolling back globalization. As the foregoing suggests, however, this is decidedly not the case.

Third, globalization (which includes China-centric globalization) creates "lock-in," whereby economic arrangements are difficult to reverse except at considerable cost. That cost discourages change, and sustains current dynamics.

Finally, there is a conceit that there are no security dangers inherent in our economic dependence on China, because economic links will turn China into a democracy and democracies do not go to war with each other. History, however, shows that conceit to be very dangerous; in the late 19th century, there was a seismic shift in relations between Great Britain and Germany that ultimately led to World War I. Britain and Germany had monarchs who shared a common lineage, yet they still went to war. The differences between the U.S. and China are more pronounced; they are not close allies, have many areas of competition, and have different political systems. That speaks to the dangers of China-centric globalization, which has been allowed to develop with great rapidity and little public discussion of its implications and consequences.

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1. See Thomas I. Palley, T.I., "Manufacturing Matters: The Impact on Productivity Growth, Wages and Income Distribution," AFL-CIO *Economic Policy Paper* No. 35, 1999.
2. Robert E. Scott, "The China Trade Toll: Widespread Wage Suppression, 2 Million Jobs Lost in the U.S.," Economic Policy Institute *EPI Briefing Paper*, July 30, 2008.
3. Dr. Sheila R. Ronis, statement before the U.S.-China Economic and Security Review Commission, July 17, 2006.
4. China's rise as a high-tech manufacturing powerhouse is documented by Ernest H. Preeg in *The Emerging Chinese Advanced Technology Superstate* (Manufacturers Alliance/MAPI and Hudson Institute, June 2005).
5. See U.S. Embassy of the People's Republic of China, "Foreign Investors Eager to Move to China," January 23, 2006.
6. See Chris Buckley, "Let a Thousand Ideas Flower: China is a New Hotbed of Research," *New York Times*, September 13, 2004.
7. See Kathleen Walsh, "Foreign High-Tech R&D in China: Risks, Rewards and Implications for U.S. – China Relations," The Henry Stimson Center, Washington, DC, 2003.
8. One major difference is that Britain owed dollars to the U.S., which meant it could not print money to pay back its borrowing. The U.S. owes dollars to China and can always print money to repay those debts. That highlights the strategic and economic importance of not having foreign-currency-denominated debt.
9. For a discussion of the natural resource curse see Thomas I. Palley, "Lifting the Natural Resource Curse," *Foreign Service Journal* 80 (December 2003), 54–61. For a discussion of the economic and political benefits of labor standards see Thomas I. Palley, "The Economic Case for International Labor Standards," *Cambridge Journal of Economics* 28 (January 2004), 21–36, and "Labor Standards, Democracy and Wages: Some Cross-country Evidence," *Journal of International Development* 17 (2005), 1–16.
10. See Kevin Gallagher, *The Dragon in the Room: China and the Future of Latin American Industrialization* (Stanford, CA: Stanford University Press, 2010).
11. See Thomas I. Palley, "A New Development Paradigm: Domestic Demand-Led Growth," *Foreign Policy in Focus*, September 2002, http://www.fpif.org/.