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IMPACT OF THE GLOBAL FINANCIAL CRISIS 2007-08 ON THE US AND CHINA: IMPLICATIONS FOR GLOBAL POLITICS

Abstract

The Global Financial Crisis 2007-08, originated from the sub-prime mortgage crisis in the US, dipped the world economy to a level worst since World War II. Both the developed and developing economies were hit by the crisis although in varying magnitudes. The present article makes an attempt to compare impact of the crisis on the US and China. It shows that China was less affected by the crisis although structural flaws have made both countries exposed to such crisis. It concludes that although the crisis will diminish the power of the US, it will neither replace the US with China as the next super-power nor lead to a bi-polar world led by the US and China; rather it will lead to a fragmented, multi-polar world.

1. Introduction

The Global Financial Crisis of 2007-08, triggered by the sub-prime mortgage crisis in the US, soon spilled over other developed countries. The crisis in turn hit the real economy of the developed world as well as the developing ones depended on them. Eventually in 2009, the world economy faced recession with the lowest growth rate since World War II.[1] The crisis shook the foundations of the US economy, the single superpower of the present day world and the place of origin of the crisis itself. On the other hand, China, which would be world's largest economy by 2050[2], could not remain unscathed even though it could avoid the immediate shocks. Examining the impact of the crisis on the US and

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[1] International Monetary Fund, *World Economic Outlook Update*, 28 January 2009, available at: http://www.imf.org/external/pubs/ft/weo/2009/update/01/pdf/0109.pdf, accessed on: 12 May 2011.
[2] According to the forecast of Goldman Sachs.

China is of great significance since they are considered to be the two most important countries in shaping the global economy as well as global politics in the foreseeable future.

Against this background, the present article makes an effort to assess the impact of the crisis on the US and China and find out its implications. The paper tries to respond to the following important questions: What was the impact of the Global Financial Crisis 2007-08 on the US and China? Is there any structural weakness in the US economy which has given rise to such a crisis? Is Chinese model of development immune from such crisis? Do the crisis give rise to any new development regarding economic and political strength/weakness of the US and China? What will be the implications of the crisis on global politics including the US and China? The article accordingly, has been divided into seven sections. After this introductory section, section 2 and 3 assess the impact of the Global Financial Crisis 2007-08 on the US and Chinese economy respectively while section 4 and 5 examine whether there is any structural flaw in the US and Chinese economy respectively which can cause the results seen during the Global Financial Crisis 2007-08. Section 6 analyses the interdependence of the two economies. Based on these analyses, section 7 attempts to analyse some implications of the financial crisis on global politics with focus on US and China. Finally, the discussion ends with some concluding remarks.

2. Impact of the Crisis on the US Economy

The US economy had been growing sluggishly for a long time. Particularly, after the crash of 'dot-com' bubble, the declining trend has become more noticeable. The recession, termed as Great Recession by many, made the situation worst in six decades. In 2009, the US real GDP fell most sharply since the World War II.[3]

In recent years, personal consumption expenditure and private residential investment have become the two driving forces of US economic growth while private non-residential investment and exports remained undersized. During this downturn, both personal consumption expenditure and residential investment faced the deepest contraction since World War II. Non-residential investment and export also scored a record fall.[4] All these resulted in the record contraction of the US economy.

Since the Global Financial Crisis 2007-08 was caused by the crash of housing bubble in the US, residential investment is expected to witness a boom in recent years followed by the crash. And, this is what happened in the US. Since the crash of dot-com bubble, residential investment had been growing at a much

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[3] Bureau of Economic Analysis, Department of Commerce, United States, available at: http://www.bea.gov/national/index.htm#gdp, accessed on: 08 April 2011.
[4] *Ibid*.

higher rate compared to non-residential investment which indicates the creation of the housing bubble. It then started falling in 2006 marking the crash of the new bubble that led to a record contraction in this sector in both 2008 and 2009.

A striking feature of the US economy was that Personal Consumption Expenditure (PCE) had been a driving force of economic growth despite the fact that US median household income is stagnant or falling over the years. A major fact behind this contradictory scenario was that the US households were maintaining their consumption by taking loans. The crash of the housing bubble reduced the US households' capacity to maintain debt-financed consumption since in recent years mortgaging house had become a significant source of loan for them. This led to the record decline of PCE during the Global Financial Crisis 2007-08.

Record fall also in the non-residential investment reflects significant loss of confidence among the US investors on the one hand and credit freeze on the other. These two factors led to halt in setting up of new firms/units, shut down of existing firms/units and reduction in production level. The significant downturn in private domestic investment had naturally reduced domestic production. Production of private goods producing industries, which accounts for about 20 per cent of GDP, reduced by 6.4 per cent (the second highest reduction since World War II) while that of private service producing industries, which is about 70 per cent of GDP, contracted by 2.1 per cent (highest contraction since World War II).[5]

In the US, finance sector is becoming dominant day by day and its contribution to GDP is increasing. And it is this finance sector that created the Global Financial Crisis 2007-08. It is interesting to note that finance sector registered positive growth rate in 2009 although financial institutions faced a large scale collapse during the Financial Crisis 2007-08. Several major institutions either failed, or were acquired under duress, or were subject to government takeover. These included Lehman Brothers, Merrill Lynch, Fannie Mae, Freddie Mac, Washington Mutual, Wachovia, and American International Group (AIG). However, especially after the bankruptcy of Lehman Brothers, faced with fear of credit freeze and collapse of the whole financial system, US government embarked on aggressive intervention in financial markets. As a result, finance scored well despite the collapse.

Many look for the root of the Global Financial Crisis 2007-08 in the weaknesses of financial regulatory structure of the US. As the Economic Report of the President 2010 says, "the Nation's financial regulatory structure…failed to keep up with the evolution of financial market. The current system provided too little protection for the economy from actions that could threaten financial

[5] Bureau of Economic Analysis, available at: http://www.bea.gov/industry/gpotables/gpo_action.cfm, accessed on: 08 April 2011.

stability and too little protection for ordinary Americans in their dealings with sophisticated and powerful financial institutions and other providers of credit." However, it is argued here that the root of such crises lies in the structure of a developed capitalist economy.

If slump in investment and production is one important aspect of recession, another important aspect is the rise in unemployment and fall in household income. As was said before, this recession has taken a great toll on the US labour market. Unemployment rate rose to a high level (9.3 per cent in 2009) comparable only to the recession of early 1980s, taking the Great Depression as an exception.[6] Among the 15.4 million workers, who lost their jobs between January 2007 and December 2009, only 49 per cent were reemployed in January 2010.[7] What is worse, the deterioration in labour market continued even after the recession was officially over. In 2010, the unemployment rate further rose to 9.6 per cent although all other indicators showed improvement in that year. Reemploying this huge number of displaced workers and at the same time creating employment for the new entrants in labour market still remains a great challenge for the US. As in the case in output, manufacturing sector suffered most in terms of job loss too. According to a survey of the US Department of Labor, manufacturing accounted for the largest number of displaced workers and reemployment rate was also lowest for this sector.[8]

The recession has taken a great toll on the US household income which had been already falling since 2000. The housing bubble raised the real median family income to some extent in 2006 and 2007 but the following burst brought it down to a level lowest in the last 12 years. However, the root of the stagnant or falling household income does not lie in the recent recessions. It is rather rooted in the structure of the US economy.

Thus, the Global Financial Crisis, which almost collapsed the finance sector of the US economy, in turn hit the real economy severely in terms of output, wage and employment and caused great sufferings for the households.

3. Impact of the Crisis on the Chinese Economy

It was well before the Global Financial Crisis 2007-08 that many analysts predicted that by 2050 China would become the largest economy of the world surpassing the US. Growth dynamics of the two countries before and during the crisis supports the prediction. However, it should be mentioned that comparative

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[6] Bureau of Labor Statistics, United States Department of Labor, available at: http://www.bls.gov/cps/prev_yrs.htm, accessed on: 19 April 2011.
[7] Bureau of Labor Statistics, United States Department of Labor, News Release, 26 August 2010, p. 3, available at: http://www.bls.gov/news.release/pdf/disp.pdf, accessed on: 19 April 2011.
[8] *Ibid*.

strength of Chinese economy becomes more visible if one focuses on purchasing power instead of nominal value. Purchasing Power Parity (PPP) measurement nearly doubles the size of the Chinese economy as prices for many goods and services are significantly lower in China than in the United States and other developed countries.[9]

Unlike the G-8 countries including the US, instead of recession, the Global Financial Crisis cost China a drop in its double-digit growth. Nevertheless, the growth rate was close to double digit (9.2 per cent). Furthermore, in 2010, just after the crisis, China managed to achieve double-digit growth (10.3 per cent) again, and elevated its position from the third to the second largest economy of the world beating Japan. According to IMF, during the current global downturn, China will account for about 60 per cent of global growth.[10]

In contrast with the US, personal consumption plays a smaller role in China's economy and its share in GDP has been declining over years.[11] The share of investment and export in GDP are increasing at the cost of personal consumption where much of the investment is undertaken to facilitate export. In fact, three decades of reform has made China an export-led economy. Another important feature of China's economy is the dominance of Foreign Direct Investment (FDI). In China, Foreign Invested Enterprises (FIE) account for over 30 per cent of China's industrial output and over 50 per cent of her total export. Whalley and Xin estimated that these FIEs account for over 40 per cent of China's recent economic growth.[12] Hence, it is imperative to see the impact of the Global Financial Crisis on China's FDI and export to assess the impact of the Global Financial Crisis on her economy.

Growth rate of total investment in China dropped to some extent in 2008, but just in the next year it rebounded to a high level. But the figure of total investment does not give a clear picture of the impact of the Global Financial Crisis on China's investment, as it also includes government investment. During the crisis the most prominent part of Chinese government's stimulus effort was the central government's official investment initiative.[13] China's investment scenario becomes different if FDI remains in focus. With a surge in global FDI

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[9] Wayne M Morrison, "China's Economic Conditions", *CRS Report for Congress*, United States, 11 December 2009, p. 7.

[10] Evan S Medeiros, "Is Beijing Ready for Global Leadership?", *Current History*, Vol. 108, No. 179, September 2009, p. 254.

[11] Future of US-China Trade.Com, available at: http://www.futureofuschinatrade.com/fact/us-china-trade-data-household-consumption share-of-GDP, accessed on: 27 April 2011.

[12] John Whalley and Xian Xin, "China's FDI and Non-FDI Economies and Sustainability of Future High Chinese Growth", *NBER Working Paper*, No. 12249, May 2006, p. 18.

[13] Barry Naughton, "In China's Economy, the State's Hand Grows Heavier", *Current History*, Vol. 108, No. 179, September 2009, p. 278.

flow,[14] China saw a record growth in FDI inflow in 2007. This record growth of China continued in 2008 despite a 16 per cent decline in global FDI flow caused by the Global Financial Crisis. But the lagged impact of diminishing global FDI on China became clear in 2009 when global FDI flow declined by another 37 per cent[15] while China's FDI inflow fell to the previous level of 2006.[16] As the global economy started to recover in 2010, global FDI flow also recovered slowly and consequently China's FDI inflow rebounded to a level much higher than 2009.[17]

In 2008, although China's FDI inflow kept growing, economic downturn in major destination countries cut the demand of her export drastically. As a result, Chinese export growth dropped significantly from 19.8 per cent in 2007 to 8.4 per cent in 2008. But in 2009 not only China's FDI inflow fell drastically, the major destination countries of her export also faced recession. Consequently, China witnessed a record fall in her export with a negative growth rate (-10.3 per cent).

The Global Financial Crisis 2007-08 had taken a great toll on Chinese workers, especially the more discriminated rural migrant workers. The number of export orders dropped precipitously for several months after August 2008. As a result, thousands of factories in the coastal region, especially in the Pearl River Delta were closed.[18] Urban registered unemployment data shows that effect of the Global Financial Crisis 2007-08 on urban workers was modest, amounted to 0.6 million jobless, while a study of China National Bureau of Statistics suggests that 23 million or 16 per cent of rural migrant workers had lost their jobs due to the Global Financial Crisis 2007-08.[19] The Crisis had also taken its toll on the wage of Chinese workers. It caused about 10 per cent fall in monthly wage of a typical unskilled rural off-farm worker.[20] In summary, impact of the Global Financial Crisis on the Chinese economy was moderate compared to the US. But the crisis did affect the driving forces of the former which suggests that if such crises prolong, China cannot remain untouched.

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[14] UNCTAD Statistics, available at: http://unctadstat.unctad.org/ TableViewer/tableView.aspx?ReportId=88, accessed on: 05 May 2011.

[15] UNCTAD Press Release, 22 July 2010, available at: http://www.unctad.org/Templates/Webflyer.asp?docID=13643&intItemID=2068 & lang=1, accessed on: 05 May 2011.

[16] World Bank.

[17] "Foreign investment in China hits record in 2010", *The Daily Star*, Dhaka, 19 January 2011.

[18] Fang Cai and Kam Wing Chan, "The Global Economic Crisis and Unemployment in China", *Eurasian Geography and Economics*, Vol. 50, No 5, 2009, p. 518.

[19] *Ibid*., p. 520.

[20] Jikun Huang et al, "The Impact of Global Financial Crisis on Off-farm Employment and Earning in Rural China", *Policy Research Working Paper,* No 5439, World Bank, October 2010, p. 14.

4. Structure of the US Economy: Is it Prone to Crises like the Global Financial Crisis 2007-08?

a. US Economy after the "Golden Age of Capitalism"

After the golden age of capitalism in 1950s and 1960s, sluggish growth and financialisation have become the two major characteristics of the US economy, the most matured centre of capitalism. To many, this was of no surprise. Decades back, Keynes developed his theory of potential volatility of investment and of the potential instability of the capitalist growth process. For Keynes, any factor that "affect the expected rate of profit on investment and the degree of confidence with which the expectation is held", affects the level of investment.[21] Hence, building up of overcapacity in plants, decline in relative purchasing power of the working class and the subsequent expectation of fall in aggregate demand, limited expansion of foreign market — all these can slow down the real investment in an advanced capitalist economy.

Based on the works of Keynes, Alvin Hansen developed his 'Stagnation Thesis' and Hymen Minsky developed 'Financial Instability Hypothesis'. Stagnation thesis provides an explanation of the sluggish growth of the US and Financial Instability Hypothesis tries to explain financialisation of the US economy and its impacts.

For the US economy, the real investment obstructing factors, identified by Keynes, were evident since 1970s which were reflected by declining rate of utilisation of industrial capacity, falling share of wage and salary in GDP and tough competition among the advanced capitalist economies for foreign markets to sell their products.

Due to these obstructing factors, real sector investment fell on the one hand, and profit in manufacturing sector fell on the other. A number of studies suggest that this crisis of profitability in manufacturing sector led the US economy to financialisation.[22]

b. Evidence of Financialisation

Although there is not much debate about the financialisation phenomenon of the US economy, the definition of the term itself lacks a common agreement. Krippner, in "What is financialization" discusses the history of the term and pros and cons of various definitions. She defines financialisation as "a pattern of accumulation in which profit making occurs increasingly through financial

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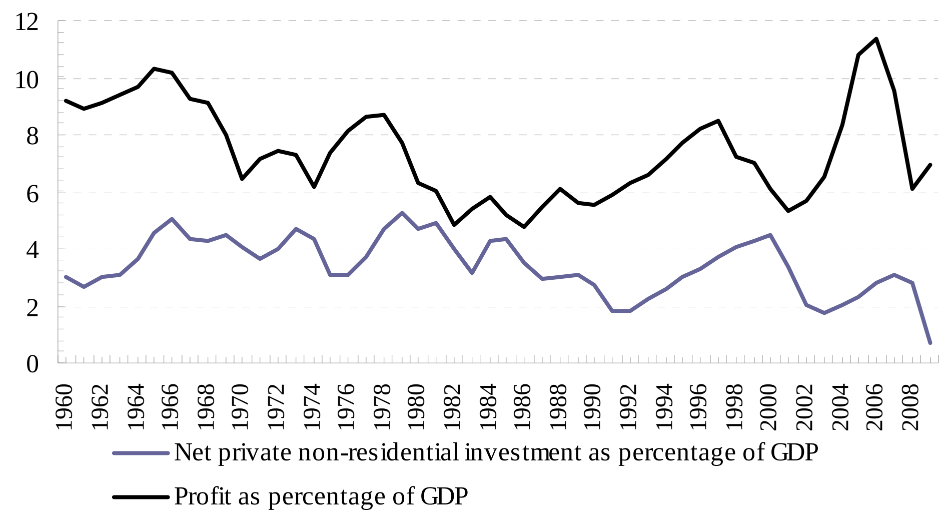
[21] James R Crotty, "Marx, Keynes, and Minsky on the Instability of the Capitalist Growth Process and the Nature of Government Economic Policy", 1986.

[22] Greta R Krippner, "The Financialization of the American Economy", *Socio Economic Review*, No 3, 2005, p.182.

channels rather than through trade and commodity production."[23] In her extensive work on evidence of financialisation in the US economy, citing the works of Block, she argues that although the usual approach of identifying long term shifts in the structure of an economy is to rely on evidence on changes in employment or in the mix of goods and services produced, this approach is not appropriate to look for the rise of finance. Because "the financial sector is not employment-intensive and its 'products' do not show up in transparent ways in national economic statistics."[24] Hence, to see the evidence of financialisation of the US economy, instead of examining the share of finance sector in GDP or employment, Krippner suggests examining "where profits are generated in the US economy?"[25] Supporting the argument of Krippner, Figure 1 shows the decoupling of profit from real investment in the US economy. Net private non-residential investment is falling while profit is rising. Increasing share of domestic profit of the US is, however, coming from financial sector (see Figure 2) which indicates financialisation of the US economy.

Figure 1: Net Private Non-Residential Investment and Profit in the US, 1960-2009



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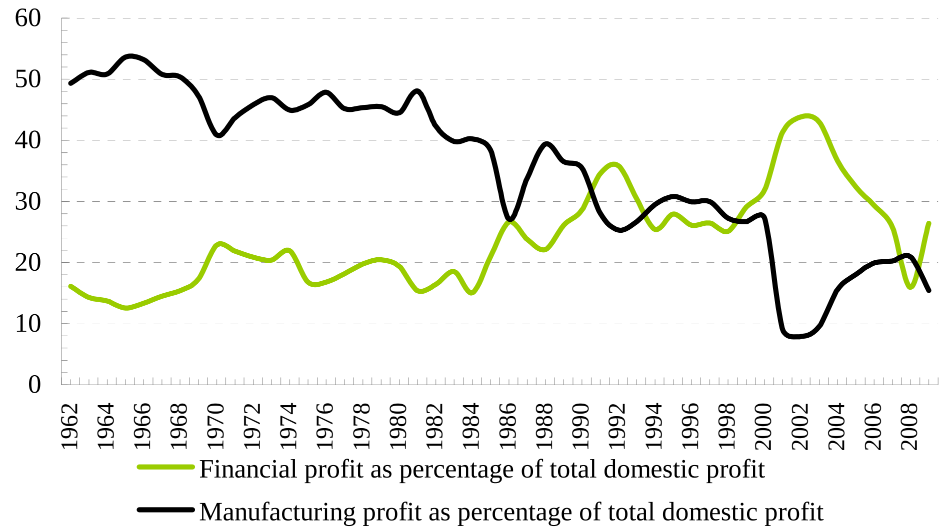
[23] Gerald A. Epstein, (ed.), "Introduction", *Financialization and the World Economy*, Northampton, MA: Edward Elgar, 2005.
[24] Greta R Krippner, (2005), *op. cit*., p. 175.
[25] *Ibid*.

Figure 2: Financial and Manufacturing Profit in the US, 1962-2009



c. Impacts of Financialisation

Thomas I Palley summarises the impacts of financialisation as follows: "(i) elevate the significance of the financial sector relative to the real sector, (ii) transfer income from the real sector to the financial sector, and (iii) increase income inequality and contribute to wage stagnation. Additionally, there are reasons to believe that financialisation may put the economy at risk of debt deflation and prolonged recession."[26] Each of these issues is dealt with in subsequent paragraphs.

Impact on Real Economy

A striking feature of the financialisation process of the US economy, as noted by Krippner, Stockhammer, Crotty and others, is that Non-Financial Corporations (NFC) are increasing their financial investment relative to real investment. A number of studies suggest that increased financial investment and increased financial profit opportunities are crowding out real investment.[27]

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[26] Thomas I. Palley, "Financialization: What it is and Why it Matters", *Working Paper*, No. 525, The Levy Economics Institute and Economics for Democratic and Open Societies, Washington, D.C., December 2007, p. 2.

[27] For a detailed account of such studies, see Ozgur Orhangazi, "Financialisation and Capital Accumulation in the Non-financial Corporate Sector: A Theoretical and Empirical Investigation on the US Economy: 1973-2003", *Cambridge Journal of Economics*, Vol. 32, No. 6, November 2008, pp. 863-886.

Stockhammer observes that higher financial profits together with the changes in corporate governance, led to a change in the priorities of NFC management. NFC management are giving more preference to financial investment and focusing more on short-term returns rather than long-term growth.[28] Crotty argues that such a view of the NFC management together with hostile product market conditions that held the profit rate of real investment down, has slowed down the rate of capital accumulation in the US compared with earlier periods.[29] Thus, financialisation is contributing in retarding the growth of the US real economy through crowding out real investment.

Speculation, Bubbles and Crises

Keynes, Minsky and others pointed to the inherent nature of the financial market that leads to speculation, and instability.[30] Keynes noted that the structure of finance periodically decouples the asset market from production which in turn leads to speculative bubbles followed by their inevitable bust and thus destabilise the whole economic system. The situation becomes worse when banking system also gets involve in this speculative process. He cautioned, "Speculators may do not harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation."

Arguing in a somewhat similar way, Paul Sweezy distinguishes modern finance from old day finance. He argues that the old day finance was a modest helper of production which generated speculative excesses in the late stages of the business cycle expansion and had no lasting effects on the structure and functioning of the economy. In contrast, the present day finance has been growing relatively independently, not in a period of expansion but in period of high level stagnation in which private industry is profitable but lacks incentives to expand. In his words, "the old structure of the economy, consisting of a production system sound by a modest financial adjunct, had given way to a new structure in which a greatly expanded financial sector had achieved a high degree of independence and sat on top of the underlying production system."[31]

Data on the US economy supports this line of argument. Financial profit is increasing at a period when not only real economy is growing sluggishly but also

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[28] Engelbert Stockhammer, "Financialisation and the Slowdown of Accumulation", *Cambridge Journal of Economics*, Vol. 28, No. 5, September 2004, p. 727.
[29] James Crotty, "The Neoliberal Paradox: The Impact of Destructive Product Market Competition and 'Modern' Financial Markets on Nonfinancial Corporation Performance in the Neoliberal Era", cited in Gerald A. Epstein, (ed.), *Financialization and the World Economy*, quoted in Orhangazi, *op. cit*., p. 868.
[30] Gerald A. Epstein, (ed.), Introduction, *Financialization and the World Economy*, *Ibid*, 2005, p. 7.
[31] John Bellamy Foster and Fred Magdoff, *The Great Financial Crisis: Causes and Consequences* (Indian Edition), Kharagpur: India, Cornerstone Books, , 2009, p. 105.

the manufacturing sector is relatively declining. In such a situation of detachment from real economy, modern finance is increasingly depending on debts. It is in this background that debt explosion took place in the US at the same time financial profit is increased. As expected, this debt financed growth of finance periodically gave rise to speculative bubbles which eventually busted and destabilised the whole economy. Examples of such bubbles and subsequent crisis abound – savings and loan crisis in 1990s, dot-com bubble crash in 2000 and sub prime mortgage crisis in recent years.

Impact on Wage and Employment

As mentioned before, manufacturing sector in the US is facing crisis of profitability while financialisation process is crowding out real investment. All these imply less employment opportunity provided by the real sector of the economy. On the other hand, finance sector provides fewer employment as it is less employment-intensive by nature. Some analysts contend that financialisation leads to retarded wage and employment growth and increased inequality. Data on the US wage and employment growth proves this claim to be true. It is mentioned earlier that the US wage and salary as percentage of GDP is declining. Except for a small rise in the late 1990s, real wage has been sluggish for decades. In a study it was found that to compensate this stagnant income, typical (median income) household has increased its number of jobs as well as working hours. Nevertheless, the real (inflation adjusted) income of typical household fell for five years in a row through 2004.[32] It is interesting to note that among these five years, three years (2002-2004) were years of expansion. Moreover, this decline in real income took place at a time when the productivity of the workforce measured as output per hour went up by 15 per cent.[33] All these statistics indicate that the structure of the US economy is retarding the wage and employment of its workforce.

Naturally the question arises: with this stagnant or falling income, how could the US households increase consumption in such a pace that it became the driving force of the US economic growth? Is it the financial assets held by the households that helped them increase consumption despite stagnant income? The answer is: No. Data shows that in the US the richest 5 per cent population holds about 70 per cent of all financial wealth.[34] It means that the lion's share of

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[32] Lawrence Mishel, *Economy Up People Down*, Economic Policy Institute, 31 August 2005, available at: http: //www .epi.org/publications/entry/ webfeatures_econindicators_income20050831/, accessed on: 15 April 2011.
[33] *Ibid*.
[34] Edward N. Wolff , "Changes in Household Wealth in the 1980s and 1990s in the U.S," in Edward N. Wolff (ed.), *International Perspectives on Household Wealth*, Elgar Publishing Ltd., 27 April 2004, p. 30, available at: http://www.econ.nyu.edu/user/wolffe/ WolffWealthTrendsApril2004.pdf, accessed on: 16 April 2011.

financial profit fails to reach the average households. Hence, the only option left for the households is debt. The US household debt is increasing significantly since 1980s and exploded in the recent decade. Why the US households are borrowing so much? The main reason is mainly to maintain their living standard. However, part of the household debt explosion can be explained by easy access to credit and inducement of financial speculators, especially in the period after dot-com bubble crash. Another contributor to this rise of consumption is the rising income of the richest part of the population. The crises, wage cut and lay-offs do not hit this richest portion. Rather, it was found that income of top 5 per cent has increased while that of all the rest quintiles have declined in 2003-04.[35]

Hence, it is not the over consumption of the US households which has increased the vulnerability of the economy as well as the households. Rather the structure of the US economy has pushed them into such vulnerability. The financialisation process has just aggravated the situation. Thus the economic structure of the US has made the economy prone to crises like the Global Financial Crisis 2007-08 and has left the households in a vulnerable situation.

5. Is China Immune from Such Crises?

a. Privatisation of Chinese Economy

After three decades of reform, Chinese economy now resembles more a capitalist economy than a socialist one, where almost all economic activities are now market-oriented. In 1999, China's Ministry of Finance announced a two-step reform programme to reduce the proportion of state owned shares in total capital from 62 per cent to 30 per cent.[36] As a result, the great majority of value added in all the important manufacturing sector is now produced by private firms while some strategic sectors like finance, energy and transportation remains to be dominated by the state.[37]

In contrast with the US economy, Chinese economy is characterised by low consumption and high saving which is a consequence of low income and high inequality among the households. China's household disposable income as a share of GDP fell by 5 percentage points between 1992 and 2003 and another 4 points in 2004.[38] On the other hand, among the East Asian countries, China recorded the second highest increase in inequality over the period from 1990s to

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[35] Lawrence Mishel, *Economy Up People Down*, *op. cit*.

[36] Shu Y. Ma, "China's Privatization: From Gradualism to Shock Therapy?", *Asian Survey*, Vol. 48, No. 2, March-April 2008, p. 202.

[37] Martin Hart-Landsberg, "The U.S. Economy and China: Capitalism, Class, and Crisis", *Monthly Review*, Vol. 61, No. 9, February 2010, available at: http://www.monthlyreview.org/100201hart-landsberg.php, accessed on: 12 April 2011.

[38] Richard Katz, "Does China Face a 'Lost Decade'?", *Current History*, Vol. 107, No. 710, September 2008, p. 271.

early 2000s.[39] This low income coupled with insufficient government spending leads to low consumption and high saving among the Chinese households. Hence, to achieve growth, China has no alternative but to depend on foreign markets. This is a major fact behind China's adoption of export led growth model .[40] In China, the ratio of export to GDP increased from 16 per cent in 1990 to over 40 per cent in 2006. Even investment, the second driver of Chinese economy, is largely driven by exports as much of the Chinese investment is undertaken to facilitate export activity. According to one estimate, external demand directly and indirectly drives about 65 per cent of all domestic investment in China.[41]

b. A Model of Dependence?

A key feature of China's export led growth model is that it is highly dependent on foreign Trans-National Corporations (TNC). These TNCs account for 20 per cent of GDP, 57 per cent of total export, 60 per cent of total import and 66 per cent of FDI.[42] A number of studies suggest that TNCs have played a significant role in China's fast growth.[43]

Although striking, the above statistics do not give a full picture of China's dependence on TNCs. Initially, China exported mainly labour intensive low technology products such as textile and shoes. But from mid 1990s, China apparently became a major exporter of higher value added high technology products such as consumer electronics, office equipment and communication equipments. And, in the process, China became enmeshed in 'East Asian Transnational Production Network'.

TNCs operating in East Asia led China and other East Asian economies to be linked and collectively reshaped through the establishment and intensification of their cross-border production network. The cross-border production network of the TNCs led East Asian countries other than China to redirect their overall export activity away from the US and EU to China. At the same time, it led China to shift its export destination away from East Asia towards the US and EU.

In the transformation process, China has turned to the region's final production platform while other East Asian countries play the role as supplier of

[39]Asian Development Bank, Key Indicators 2007, p. 4., available at: http://www.adb.org/documents/books/key_indicators/2007/pdf/Key-Indicators-2007.pdf, accessed on: 08 April 2011.
[40] Richard Katz, "Does China Face a 'Lost Decade'?", *op. cit*., p. 271-272.
[41] Jephraim P. Gundzik, "What a US Recession Means for China", *Asia Times Online*, 27 September 2006, available at: http://www.atimes.com/atimes/Global_Economy/HI27Dj01.html, accessed on: 07 May 2011.
[42] John Whalley and Xian Xin, "China's FDI and Non-FDI Economies and Sustainability of Future High Chinese Growth", *op. cit*., p. 5, 18 & 19.
[43] See for details, *Ibid.*

parts and components. To put it simply, instead of exporting final goods to the US and EU, other East Asian countries export parts and components to China. China assembles the parts with its cheap labour and export the final goods to the US and EU. Branstetter and Lardy noted that China's value addition was only 15 per cent of the value of exported electronics and information technology products.[44]

This transformation of export activity of China and other East Asian countries and China's role as the region's assembly platform is proved by the following two facts. First, China's increased share of the US deficit is matched by a decline in the share of the rest of East Asia.[45] Second, in East Asia, China is the only country that runs a regional trade deficit in parts and components.[46]

Thus, behind the robust growth scenario, Chinese economy has become dependent on foreign countries in three ways. First, it has to depend on demand in foreign markets, especially in the US and EU, to maintain exports and overall economic growth. Ligang Liu found that a 1 per cent decline in economic growth in the US, the EU and Japan is likely to decline the growth of China by 0.73 per cent.[47] Second, it has to depend on foreign TNCs to run its export oriented manufacturing activity. Third, it has been stuck in TNCs' cross-border production network.

In sum, China's present growth policy has made its economy increasingly dependent on foreign capital, foreign companies and foreign markets. And this dependency has made it impossible for China to keep herself immune from crises like Global Financial Crisis 2007-08.

6. US-China Economic Interdependence

It is not surprising that in the globalised world, the two competitors, the US and China are economically interdependent in many ways. China is United State's second largest trading partner, its third largest export market and its largest source of import. Similarly, the US is China's second largest trading partner and second largest export destination.[48] US import from China provides

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[44] Lee Branstetter and Nicholas Lardy, "China's Embrace of Globalization", *NBER Working Paper* No. 12373, July 2006, p. 38, available at: http://courses.nus.edu.sg/course/ecshua/eca5374/China%27s%20embrace%20of%20globalization.pdf , accessed on: 10 May 2011.

[45] Martin Hart-Landsberg, "The U.S. Economy and China: Capitalism, Class, and Crisis", *op. cit.*

[46] Martin Hart-Landsberg and Paul Burkett, "China, Capitalist Accumulation, and Labor", *Monthly Review*, available at: http://www.monthlyreview.org/0507mhlpb.htm, accessed on: 12 April 2011.

[47] Ligang Liu, "Impact of the Global Financial Crisis on China: Empirical Evidence and Policy Implications", *China and World Economy*, Vol. 17, No. 6, 2009, p.1.

[48] Wayne M Morrison, *China's Economic Conditions*, *op. cit*., p. 1 & 14.

US consumers with a variety of low-cost goods.[49] On the other hand, China considers US economic growth critical as economic downturn in the US is likely to reduce Chinese exports to US and thus retard China's economic growth.[50]

However, interdependence of these two countries goes far beyond bilateral trade relations. China has been the largest annual purchaser of the US treasury securities in recent years[51] which are used to finance the US federal budget deficit. China's share of total foreign holding of the US treasury securities rose to 24.3 per cent.[52] Such purchase of China helps the US government to finance budget deficit without increasing interest rate and thus without hampering economic activities. With continued budget deficit, the US wants China continue purchasing US securities. Even the US$70 billion bail-out programme was built on the assumption that China would purchase a part of the government debt.[53] Hillary Rodham Clinton, the US Secretary of State stated during her visit to China in February 2009 that she appreciated greatly "the Chinese government's continuing confidence in the United States Treasuries." She also urged the government to continue buying the US debt.[54] This reflects how badly the US needs China to purchase government debt. China, however, is not purchasing the US government debt out of benevolence. It is doing so to increase its foreign exchange reserve which helps in keeping low value of RMB. Moreover, China is gaining political leverage over US through this purchase.[55] The US is also concerned about this fact but the country seems to have no other option, at least in present economic structure.

China is the world's largest holder of foreign exchange reserve. It holds one third of world's total reserve.[56] US's large trade deficit with China as well as government borrowing has helped the latter to accumulate this huge reserve. Although the Chinese government does not make public the dollar composition of its reserve, many analysts estimate that the level to be around 70 per cent.[57] This huge dollar reserve of China has become a concern for the US. Because

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[49] *Ibid*., p. 1
[50] Kenneth Liberthal, "The China-US Relationship Goes Global", *Current History*, Vol. 108, No. 719, September 2009, p. 245.
[51] Wayne M. Morrison and Mark Labonte, "China's Holdings of U.S. Securities: Implications for the U.S. Economy", *CRS Report for Congress*, 30 July 2009, p.8, available at: http://assets.opencrs.com/rpts/RL34314_20090730.pdf, accessed on: 12 April 2011.
[52] *Ibid*.
[53] Kenneth Liberthal, "The China-US Relationship Goes Global ", *op. cit*., p. 246.
[54] Wayne M. Morrison, "China and the Global Financial Crisis: Implications for the United States", *CRS Report for Congress*, 17 August 2009, p. 8.
[55] *Ibid*., p. 9.
[56] *Ibid.*
[57] Wayne M. Morrison and Mark Labonte, *China's Holdings of U.S. Securities: Implications for the U.S. Economy*, *op. cit*., p. 5.

once China decides to change its reserve composition, huge sale of dollar would depreciate its value which will shock the US economy to a great extent. The effect on the US economy, however, will be moderate if it is done through gradual sale instead of sudden sale. Nevertheless, it remains a matter of great concern for US. However, the probability of such sudden sale is low. Because, China's reserve has become so huge that depreciation of dollar would cause a great loss of value for China as well. Moreover, it will appreciate RMB's value which is still very undesirable for export-dependent China.

Ironically, in recent days, huge US treasury security or dollar reserve seems to have become a headache for China itself. After the Global Financial Crisis 2007-08 has exposed the inherent instability of the US financial sector, China has become worried to some extent about the future of its huge dollar reserve.[58] Loss of confidence over dollar has led China to seek an alternative reserve currency. On 24 March 2009, the governor of the People's Bank of China published a paper where he called for replacement of US dollar as the international reserve currency with a new global system controlled by the IMF.[59]

7. Implications for Global Politics

Neo-liberalism is in Retreat

During last three decades, neo-liberal policies have swept the world. "States after state… have embraced, sometimes voluntarily and in other instances in response to coercive pressure, some version of neo-liberal theory and adjusted at least some of their policies and practices accordingly."[60] Neo-liberal policies is characterised by privatisation, free trade, export-led growth, financial capital mobility, cut in government expenditure, and cut in top tax rates etc. Financialisation of the US economy is one aspect of neo-liberalism while Chinese export-led growth model represents another. The US experience shows that financialisation created economic instability while China's experience reminds about unsustainability of export dependent growth. Other developed and developing countries also had similar experience. This has raised serious criticism about neoliberalism. Many, who are not blaming capitalism itself for creating crises like the Global Financial Crisis 2007-08, are blaming neo-liberal policies for the crisis and all the human devastation it created. As Joseph Stiglitz

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[58] China's worry has got expression in the words of Chinese Premier Wen Jiabao in a news conference on 13 March 2009 – "We lent huge fund to the United States and of course we are concerned about the security of our assets and, to speak truthfully, I am a little bit worried." Wayne M. Morrison and Mark Labonte, *China's Holdings of U.S. Securities: Implications for the U.S. Economy, op. cit.*, p. 9.

[59] *Ibid*.

[60] David Harvey, "Neo-liberalism as Creative Destruction", InterfacEHS, 2006, available at: http://www.interfacehs.sp.senac.br/images/artigos/79_pdf.pdf, accessed on: 10 May 2011.

observes, “For a quarter-century, there has been a contest among developing countries, and the losers are clear: countries that pursued neo-liberal policies not only lost the growth sweepstakes; when they did grow, the benefits accrued disproportionately to those at the top.”[61] Experiences of countries during the Global Financial Crisis 2007-08 are, however, neither new nor unique. Developed capitalist countries periodically face recession. For its inherent weakness, export led growth model has been proved to be unsustainable path of development.[62] Evidence is available in history – Germany in 1960s, Japan in 1970s, and East Asia in 1990s.[63] What is new this time, at least for the past few decades, is the spread and depth of the crisis. Observing all these, many believe that neo-liberalism is in retreat.[64] If it really happens, it might end the ideological superiority of the West, including the US. Search for a new economic structure might also bring change in global geopolitics.

Further Decline in the US Hegemony

Years before the Global Financial Crisis 2007-08, United State’s hegemonic power started declining.[65] The Global Financial Crisis 2007-08 has accelerated the process in various ways. First, it has damaged the United States’ ideological superiority by challenging the economic model it has been advocating all over the world. This has been expressed metaphorically by a Chinese leader’s comment –“The teachers have some problems.”[66]Second, the Global Financial Crisis 2007-08 has damaged US’ already weakening economic power. The US has been losing its economic primacy for years which is reflected in various economic indicators. The United States’ share of global GDP and global trade has declined from 30 per cent and 16 per cent respectively in 1999 to 23 per cent and 11 per cent in 2008.[67] The Global Financial Crisis 2007-08 has aggravated the situation. It has injured the US economy to such an extent that it will take years to repair. This has further declined the United States’ economic power which in turn has weakened her capacity to maintain her present hegemonic status. Third, the Global Financial Crisis 2007-08 has preoccupied the US with domestic economic problems like unemployment, government and household

[61] Joseph E. Stiglitz, “The End of Neo-liberalism?”, available at: http://www.project-syndicate.org/commentary/stiglitz101/English, accessed on: 10 May 2011.
[62] See, for details, Brian P. Klein and Kenneth Neil Cukier, “Tamed Tigers, Distressed Dragon”, *Foreign Affairs*, Vol. 88, No. 4, July-August 2009.
[63] Mathew J. Burrows and Jennifer Harris, “Revisiting the Future: Geopolitical Effects of the Financial Crisis”, *The Washington Quarterly*, Vol. 32, No. 2, April 2009, p. 27.
[64]Roger C. Altman, “Globalization in Retreat”, *Foreign Affairs*, Vol. 88, No. 4, July-August 2009, p. 5.
[65] *Ibid*., p. 6.
[66] “Capitalism at Bay”, *The Economist*, UK, 16 October 2008.
[67] Rosemary Foot, “China and the United States: Between Cold and Warm Peace”, *Survival*, Vol. 51, No. 6, December 2009-January 2010, p. 132.

debt etc[68] which has limited her political scope to play the role of a global hegemon. Such was the case during recent Libya crisis where the US took a passive role although it was a matter of great interest for her. However, all these implications do not mean that the world is going to see the end of the US hegemony in near future. As Roger Altman observes, "Although the United States' capacity to lead is now diminished and will continue to be so over the medium term, none of these rising powers is capable of full leadership."[69] The report *Global Trends 2025: A Transformed World*, published by the National Intelligence Council (NIC) of US also projects that by 2025, US will remain the preeminent single power but its gap with others will narrow.[70] It also indicates further decline but not the end of US hegemonic power.

China neither Capable nor Willing to Lead

There is a perception that China is going to be the next super power supplanting the US and the Global Financial Crisis 2007-08 has just accelerated the process. But various facts suggest that its probability is low, at least in near future. China is still a developing country although the most rapidly developing one. Living standard of Chinese people is far away from that of OECD countries. Although China's two digit growth rate looks lucrative, 8 per cent growth is necessary for the country only to avoid massive unemployment and resulting social unrest.[71] It indicates that China needs to grow far rapidly than at present to reach the level of development of the US and other OECD countries. Moreover, economic power, although a major factor, is not the only determining factor in distribution of power among countries. Other factors like ideological and intellectual superiority, military power, etc. play a vital role in attributing hegemonic power to a country. But neither China challenging the ideological superiority of the US, nor its military power is comparable with the US. Although China has increased its military budget in recent days and its military budget has become the second largest in the world, still it is one eighth of that of the US.[72] Hence, the prediction that China is going to be the largest economy within 2050 and the fact that the Global Financial Crisis 2007-08 has hit the US more than China do not necessarily imply transition of power from the US to China.

For decades, the primary objective of Chinese foreign policy has been to ensure peaceful development. The country does not want to challenge the current global rules, norms and institutions. Rather, it tries to master them in order to

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[68] Roger C. Altman, "Globalization in Retreat", *op. cit*., p. 6.
[69] *Ibid.*
[70] Mathew J. Burrows and Jennifer Harris, "Revisiting the Future: Geopolitical Effects of the Financial Crisis", *op. cit*., p. 33.
[71] Rosemary Foot, *op.cit.*, p. 126.
[72] *Ibid*., p. 133, 135.

advance its interest.[73] While being conscious about other country's intention to contain, constrain or otherwise hinder China's development, China wants to assure international community that its growing capability will not be an obstacle to other country's economic and social development. Nevertheless, China is dissatisfied with some attributes of current status quo. But, in these cases too, Chinese response has been to leverage the current system to address the concern instead of radically challenging it.

China's worldview mentioned above along with its consciousness about its level of development has made it reluctant to act as a global leader at least for the time being.[74] The country is concerned that at its present stage, such proactive role would divert its economic and political resources. Example of China's reluctance to lead abound. At the Washington G-20 summit in November 2008, when the whole world was waiting to see what China would do to mitigate the devastation caused by the Global Financial Crisis 2007-08, China's initial response was in essence "we will help the world by helping ourselves" and its 'contribution' was a 4 trillion RMB domestic stimulus package.[75]

Is the World heading towards Multi-Polarity?

If the US hegemony ends while China is neither capable nor willing to lead, then what shape the global politics is going to take after the Global Financial Crisis 2007-08? Based on the interdependence between the US and China, some analysts contend that there is a possibility of formation of G-2 involving the US and China. Pointing to the fact that the Global Financial Crisis 2007-08 has hit US more than China and thus brought these two countries to almost same level, they perceive that the Global Financial Crisis 2007-08 has made the formation of G-2 more plausible. But both the US and China have rejected the notion, although on different ground. Because of their economic interdependence stated above, it is unlikely for any party to challenge the other. But it is also true that they have deep rooted mistrust around various issues.

Then, the only option left is multipolarity. Most analysts predict that the future world is going to be a multipolar world. But what is the prospect of such a multipolar world? NIC's above mentioned report apprehends that "the multiplicity of actors on the international scene could either strengthen the international system, by filling gaps left by aging post-World War II institutions, or could further fragment it and incapacitate international cooperation. The diversity in both type and kind of actor raises the likelihood of fragmentation occurring over the next two decades, particularly given the wide array of

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[73] Evan S. Medeiros, "Is Beijing Ready for Global Leadership?", *Current History*, Vol. 108, No. 719, September 2009, p. 252.
[74] *Ibid.*
[75] *Ibid.,* p. 250.

transnational challenges facing the international community."[76] With the inherent nature of capitalism, where in most cases one can be better off at the cost of others, the second scenario, although undesirable, seems to be more likely.

8. Conclusion

The article shows that the Global Financial Crisis 2007-08 has hit hard the real economy of the US, while China being dependent on foreign markets could not keep itself untouched. The analysis of the structure of these two countries suggests that vulnerabilities of these two economies, although different, lie in their present economic structures. Hence, to avoid crises like the Global Financial Crisis 2007-08 and the resulting devastations, both countries need to reconsider their present development policies. The analysis of the structure of the two economies also suggests that the Global Financial Crisis 2007-08 did not give rise to any new trends regarding comparative strength of the US and China. It just has accelerated the past trends caused by their own economic structure. Finally, despite apparent initiatives of the international community to take concerted effort to face crises like the Global Financial Crisis 2007-08, the crisis is probably going to lead to a multi-polar and fragmented world in the future.

[76] Mathew J. Burrows and Jennifer Harris, "Revisiting the Future: Geopolitical Effects of the Financial Crisis", *op. cit.*, p. 37.