China Ranks Number One or Does It? Should We Care?

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In my talk, I address the five questions:

1. What does China Ranked #1 mean?
2. Is being #1 part of the "China Dream?"
3. Will China's economy dominate the 21st century?
4. Does economic dominance matter?
5. How should the US and the rest of the world respond to China's rising economic power?

In October 2014, the International Monetary published a report indicating that in purchasing power parity terms, China had passed the United States as the world's largest economy. The British weekly *the Economist* put this observation in historical perspective by showing that China ranked as the world's largest economy for all but the last two hundred years.
http://www.economist.com/news/finance-and-economics/21623758-chinas-back

Purchasing Power Parity (PPP) calculations recognize that income when translated into a common currency buys different amounts of goods in different countries based on the prices local residents pay for these goods. Thus, PPP can be useful for portraying income per capita across countries to measure how people's living standards vary across countries. Such calculations, of course, require a variety of assumptions regarding which goods and services to include and at what prices. Such details won't be my focus today because, in GDP per capita terms, China is a middle income country at roughly $7,000 per capita versus $52,000 in the US. When adjusted for purchasing power, China's income per capita rises to about $12,000 roughly the same level as Columbia, the Dominican Republic, and Jordan.

China's GDP is large because of its large population; so clearly, a very large population, given a middle level of income per capita yields much economic and political clout. Aggregate GDP at current exchange rates yields more pertinent information about a country's economic power than when expressed in PPP terms. Stated differently, to determine how many ships its military can buy or built, one needs to look at unadjusted GDP. From the perspective of the size of the Chinese market, again, unadjusted GDP is more constructive. At roughly $9 trillion, China's economy is just over half the size of the US economy.

In fall 2012, *New York Times* Opinion columnist Thomas Friedman asked the following: "Does Xi have a 'Chinese dream' that is different from the 'American Dream?' Because if Xi's dream for China's emerging middle class – 300 million people expected to grow to 800 million by 2025 - is just like the American Dream (a big car, a big house and Big Macs for all) then we need another planet."

At the Third Plenum of the 18th Party Congress in November 2013, President Xi Jinping answered Friedman's question.

"We must make persistent efforts, press ahead with indomitable will, continue to push forward the great cause of socialism with Chinese characteristics, and strive to achieve the Chinese Dream of great rejuvenation of the Chinese nation."

One might start by recognizing that all Chinese leaders have had some great vision or phrase that motivates their leadership.

> For Mao Zedong– "We the Chinese people have stood up" – after what many Chinese refer to as the "Century of Humiliation"
>
> For Deng Xiaoping – "Socialism with Chinese characteristics" and "To get rich is glorious" – after the destruction generated by "The Great Leap Forward" and the "Cultural Revolution."
>
> For Jiang Zemin – "Socialist market economy" – as the focus turned to ways to stimulate urban economic growth
>
> For Hu Jintao – "Harmonious Society" as the disparity in income between coastal China and the interior grew

Perhaps common to all of China's leaders is the view that China's "rightful" place should be at the top of the world's economic pyramid as some have argued it was for 18 of the past 20 centuries and noted above.

So, what might Xi Jinping's vision mean?

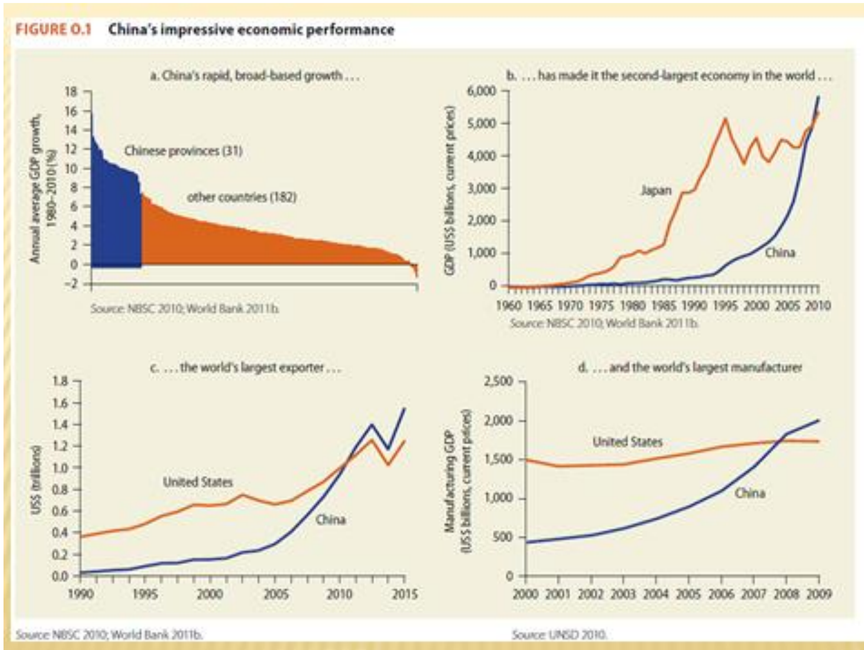
Orville Schell, the Director of the Center on US-China Relations at the Asia Society, argues that China's goal is to develop "A nation unified by nationalism and ruled by a single disciplined party that could galvanize China into meeting the historic challenge of becoming a wealthy and powerful, and thus respected, nation in the modern world."

The aforementioned *Economist* following President Xi's focus on "The great revival of the Chinese nation" argues that such a revival would require

- Continued economic growth
- A permanent escape from historical victimhood
- Meeting people's desire for a happy life
- Maintaining the communist party's central role in building a modern harmonious, and creative society
- Avoiding the mistakes made by the Soviet Union in the Gorbachev era

Jonathan Fenby, former editor of the *South China Morning Post* who has written eight books on China, asks whether China would change its economic and political model in pursuit of its vision. He points out that "President Xi says repeatedly, the PRC must be true to its past, both Maoist and Dengist."

So, is China's dream viable? China's economic performance over the past 30 years has been very impressive indeed –



- Real annual economic growth close to 10% - see upper left
- China is now the second largest economy in the world – see upper right
- China just became the world's largest exporter (lower left) and five years ago became the world's largest manufacturer (lower right)

Will these growth patterns continue? In 2013, The World Bank and China's Development Research Center published a marvelous document entitled *China 2030*. What's interesting about this heavy tome is that it is a joint effort by analysts at the World Bank and the Development Research Center of the State Council of the PRC, which reports to Li Keqiang, Premier and #2 leader in China. The table below indicates its growth rate history and prospects.

Indicator	1995-2010	2011-2015	2016-2020	2021-2025	2026-2030
GDP	9.9	8.6	7.0	5.9	5.0
Labor Force	0.9	0.2	-0.2	-0.2	-0.4
Labor Productivity	8.9	8.3	7.1	6.2	5.5

As the table shows, *China 2030* projects continuous rapid economic growth though not at the pace seen over the past 30 years. Since labor force growth will be declining in the very near future – a direct result of China's one child policy- continued economic growth depends directly on the productivity of the labor force. Sustaining such high productivity growth will be no mean feat; the roughly 5 to

7% annual labor productivity growth indicated in the table has been a rarity among middle income countries. Stated differently, the transformation from a middle income to a high income country has been both difficult to do and difficult to sustain.

China's rapid growth from low income country to middle income country has been experienced by many other countries including Brazil and Mexico. Typically such rapid growth features "infant" industry protection and state-led infrastructure investment and finances that disproportionately favor producers over savers. For East Asian countries, one can add export promotion into the mix.

Few countries, however, escape the middle income trap. Thus, the central question becomes: Can China's economic growth miracle continue? There are more skeptics than believers in the China 2030 scenario. Why? Because the policies that have been used to generate its rise to middle income will not work to propel China to become a high income country.

Michael Pettis, professor of finance and economics at Peking University, has characterized China growth in terms of stages.

Stage 1 reflects the changes introduced by Deng Xiaoping in the late 1970s and early 1980s. These include the elimination of laws that discouraged household production and the establishment of special economic zone experiments in places such as Shenzhen, Zhuhai, and Xiamen. These reforms were bolstered by Deng's credibility, prestige, and power and reinforced by his 1992 tour of Southern China.

China entered Stage 2 when national economy policy under Jiang Zemin turned to the creation of urban infrastructure and productive capacity in the 1990s and early 2000s. Household consumption was constrained with the resulting savings channeled at low interest rates through state owned banks to centrally identified projects.

This approach to economic development has continued in the last decade and might be described as Stage 3 – investment overshooting. Some of you might have heard of the building of ghost towns and roads to nowhere. These investments tend to reflect inefficient production and capital allocation designed to keep people employed. Some sceptics have argued that such directed investment, some of which occurred during the global financial crisis of 2007 – 2009 as a response to a precipitous drop in exports, has been designed to continue to foster the illusion of rapid growth. Their concerns reflect the mushrooming of debt created to fund these projects when combined with low income generation potential.

Pettis argues that the fourth stage requires both a need for much more efficient and transparent financial markets with reduced preferential access to cheap credit for the state and elites AND more transfers of wealth to households and small and medium size enterprises.

Most economies stagnate once they reach middle income levels because they are unable to change their institutions away from those that have both rewarded the institutional elite to establish legal, financial, and governance institutions AND practices that encouraged the creation of value rather than just its redistribution, which economists call "rent-seeking."

So what about China?

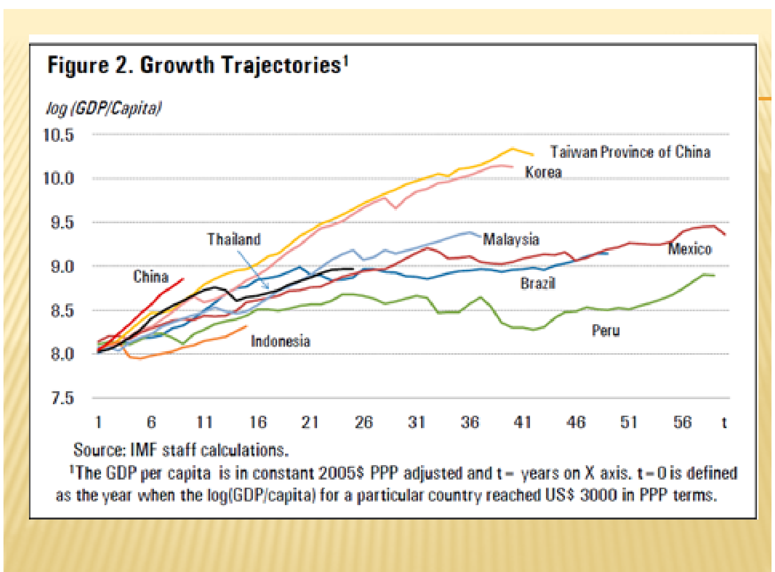


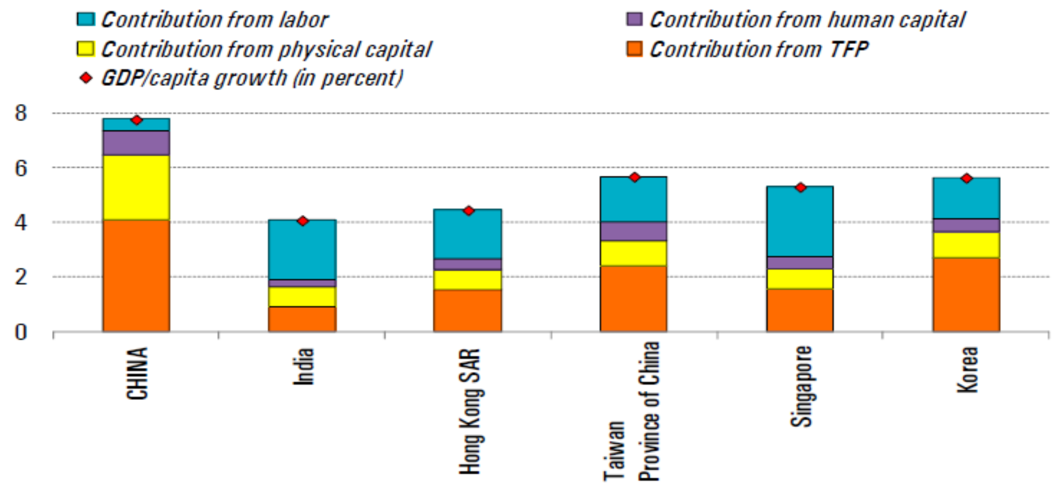
Figure 2. Growth Trajectories[1]

Source: IMF staff calculations.

[1]The GDP per capita is in constant 2005$ PPP adjusted and t = years on X axis. t = 0 is defined as the year when the log(GDP/capita) for a particular country reached US$ 3000 in PPP terms.

The vertical axis shows that China is still relatively low in terms of GDP per capita. Taiwan and Korea have escaped the middle income trap. The other Asian and Latin American countries shown in this IMF chart have not.

Figure 5. Growth Success in Asia



Source: IMF staff calculations.

Note: For the four tigers, the starting date is 1970, by which time GDP per capita had exceeded US$ 3000 in PPP terms in each country. For the later growth miracles, China and India, the reference period is chosen to start roughly with economic liberalization: 1970-2009 for China, 1980-2009 for India.

From the above figure produced by the IMF, we can see that more than half of China's economic growth has come from the increased productivity of both its labor and capital, also called total factor productivity (TFP - the orange block.) Even Singapore and Korea, with well-developed financial and legal institutions, have smaller TFP growth than China; thus, China's productivity growth rate must decline. As noted above, the contribution from physical capital (the yellow block) is also likely to decline. Given the lack of growth in the labor force, it seems to me even a 4% annual growth rate will be difficult for China to sustain.

This is not just my opinion. In 2007, Premier Wen Jiabao highlighted the four "Uns" of China's (stage 3) growth model; that is, economic growth was unsustainable, uncoordinated, unbalanced and unstable. His successor Li Keqiang has made similar points.

The Third Plenum of the Chinese Communist Party in November 2013 flashed some optimistic signs with proposed reforms consistent with improved factor allocation mechanisms and social capital. These included land reform, household residency requirement reform (aka Hukou reform), environmental repair, interest rate liberalization, more market based pricing, fewer subsidies especially for water and energy, a larger role for private enterprise relative to the state, and the rule of law with an unbiased judiciary. Some of these potential changes will be met with great resistance. If implemented, short term measured economic growth will slow, but as Premier Li recently put it "Chinese economic statistics are 'man made' and, apart from the numbers for electricity use, bank lending and rail freight, are 'for reference only." Gives you great confidence, doesn't it?

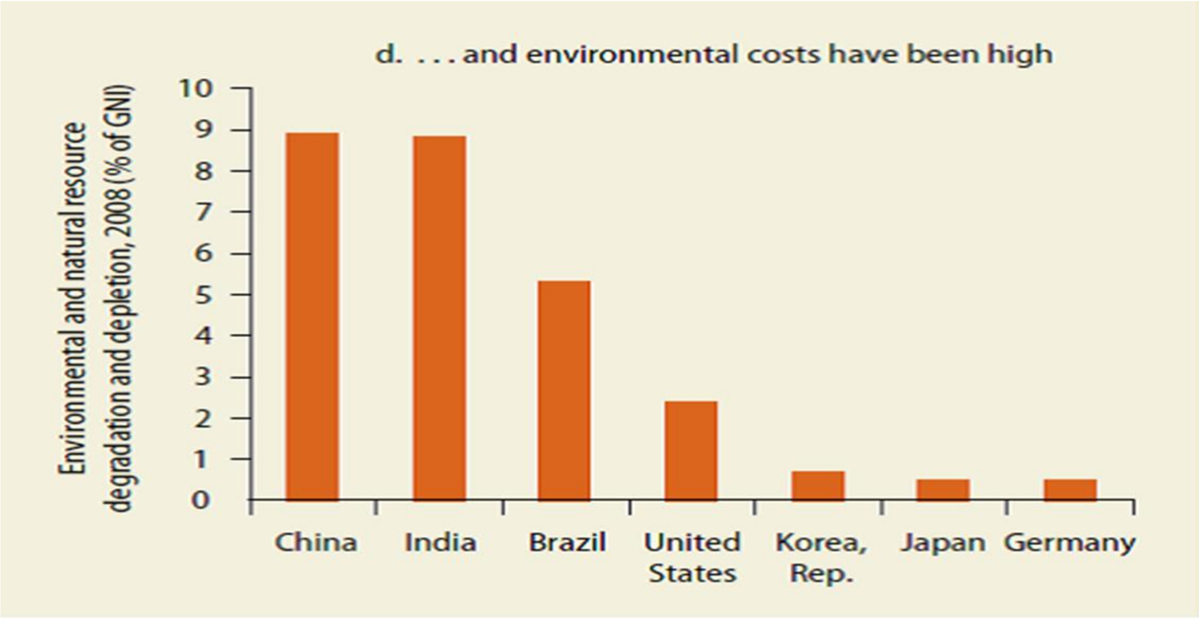
The Fourth Plenum held last October focused on implementation of the rule of law. The primary target for policy was local and regional officials who have deviated markedly from policy established by the Communist Party at its national conferences. Some describe this as the rule of law with Chinese characteristics; others have stated explicitly that "party leadership and the social rule of law are identical." Clearly, such interpretations of the "rule of law" differ markedly from those we espouse in the West.

Claremont McKenna College political scientist and 2004 Povolny Lecturer Minxin Pei in a book entitled *Trapped Transitions* argues that dismantling a command economy is far from trivial, especially if leaders do not want to repeat the Russian example of the past quarter century.

Furthermore, there are a host of environmental constraints that China must address including:

- China has 22% of the world's population but only 6% of its fresh water
- 80% of China's water resides in the south while 60% of its population lives in the north
- 40% of rivers in the north are of grade V or higher, and the scoring is like golf: higher is definitely not better.
- China has begun to transfer water from south to north through three major intra-country canals; it also continues to build dams for hydroelectric power generation. Such projects are both very capital intensive and population disruptive.
- 16 of the 20 most polluted cities in the world are in China (World Bank Report)

Developing economies typically generate environmental pollution which robs people of their health and the economy of some productivity. China is no exception; as shown below, the World Bank estimated that such pollution costs roughly 9% of GDP per year.



Source: World Bank 2011b.

China also faces a host of governance problems and other headwinds including

- Fragmented authority that makes it difficult to implement national environmental protection policies at the local level, especially since political rewards and promotions are related to economic growth and employment at provincial and prefecture (metropolitan) levels.
- In addition, urban finance depends crucially on land development as local governmental officials buy rural land cheaply and sell development rights. Environmental degradation has not been a primary concern for local officials; however, this seems to be changing.
- To implement many of the reforms presented at the 3rd Plenum, President Xi will have to find ways to overcome the strong interests and incentives for existing officials at various governmental levels.
- Demographic trends suggest that China will be one of the first countries to grow old before growing wealthy; the burdens of serving its elderly population will be significant. As a start, China has decided to relax the one-child policy initiated by Deng Xiaoping as part of 1980s reforms. Nevertheless, for the millennial generation (roughly, those born in the last

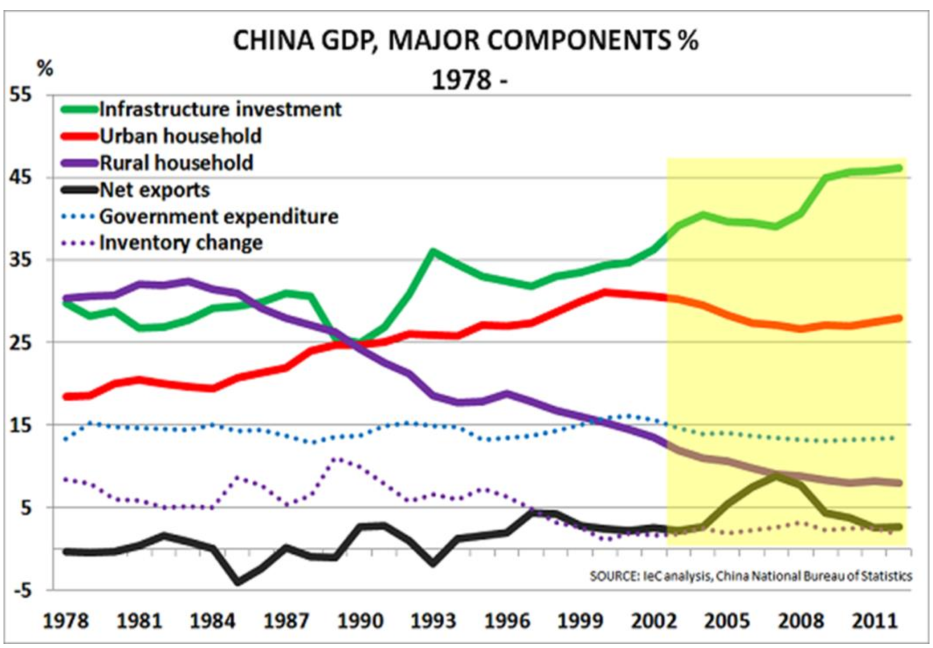
two decades of the 20th century), each worker may have to support two parents and four grandparents – huge burden.

- Finally, total debt in China has mushroomed since 2007. At 217% of GDP, China's debt/GDP is well above virtually all other developing countries. Furthermore, its 83 percentage point growth since 2007 is only exceeded by Greece, Portugal, Singapore, and Ireland – with the latter two related to their roles as centers for financial capital.

So, Chinese policy makers have some difficult choices to make. They can follow the stated strategic direction set at The Third Plenum (November 2013) and begin to implement sweeping economic reforms that increase the role of markets, rebalance economic forces to increase consumption and reduce dependence on repressed finance, exports, and investment.

Or they can follow the suggestions of The Central Committee Work Conference (December 2013) which emphasizes maintenance of stability and "keeping growth steady."

China can't have it both ways as suggested by the following chart.



- The Green line reflects infrastructure investment approaching 50% of GDP is unprecedented with much of it unproductive.

- The Orange line over the last decade featured stagnant urban household consumption (as a share of GDP) and the Light Purple line indicates declining rural household consumption.

As the state-owned newspaper China Daily put it recently:

"People always say China's economic growth model is export-and investment-driven. But if you look at the data for the past two or three years, it is becoming solely investment-driven. Exports in 2012 made a negative contribution to GDP growth, and if you deduct speculative funds disguised as trade payments, you'll find that exports were a drag on growth again in 2013. As the economy increasingly relies almost solely on investment, any slowdown in investment could curtail growth."

- To implement its strategic initiatives, China must increase consumption and services, and reduce income inequality which implies reduced economic growth.
- To implement its tactical initiatives, China must maintain high economic growth based on productivity growth in exports and manufacturing.
- To rebalance the economy, China must loosen control of markets and reduce rewards for China's entrenched business and governmental elites or as portrayed here, make the fight against corruption a primary objective. Certainly in headline terms, President Xi has made this a high priority.

In the past year, China has made some positive steps to rebalance its economy. For example,

- Shanghai announced its economic plan for the 2015 without any reference to an economic growth target – a first in recent Chinese history.
- Premier Li declared war on air pollution, especially as it affects Beijing. According to an article in last week's *Economist* since the beginning of 2013, Hebei province, with 7 of China's 10 most polluted cities in 2014 and whose factories generate much of the pollution that affects Beijing, has shut down 18,000 polluting factories; it's economic growth rate has fallen significantly.

In a recent *Foreign Affairs* article, political scientist David Lampson characterized the tension Chinese leaders face as follows:

"The outside world faces a deeply conflicted China, one that is uncertain how to measure its power, weigh interests, and control its citizens and economic entities, as well as deal with its neighbors, powers at great distance, and failed states."

Some view President Xi's government as the strongest since Deng Xiaoping's; thus, it might be able to implement the strategic directions cited at the 3rd Plenum. One of its first actions has been to consolidate power by charging some of its critics with corruption. The "rule of law" prescriptions at the 4th Plenum last October reinforce this approach. Whether this just serves to remove political opposition to Mr. Xi or serves as an essential step towards effective reform remains unclear. It could be that China wants to follow some version of Singapore's combination of economic liberalism and political authoritarianism, which has served that relatively homogenous island economy of 5.5 million incredibly well.

Figure 1: China's GDP Outlook with and without Reform

Sources: Chinese National Bureau of Statistics, Rhodium Group estimates. Projections begin after 2013.

This chart from an Asia Society Policy Institute Report indicates how much implementation of proposed economic reforms matter. With reforms identified in the 3rd Plenum conference, the forecasts posited in China 2030, at 5+ percent growth per year, might be achievable. Without such reforms, 4% growth might be a very optimistic assumption.

Now, let's turn to China's potential influence on the rest of the world. One way to obtain a sense of China's influence comes through the notion of economic dominance.

- Countries that have economic power tend to be able to use it in their sphere of influence (reflected by trade relations and military/ foreign policy interests)
- Countries that attempt to extend their influence without sufficient economic wealth eventually fail to do so.

So what are the desirable characteristics of an index of economic dominance? Such an index should

- Be reasonably simple and easy to understand
- Use readily available data for calculation and validation
- Provide a compelling method of projection into the future
- And finally, use justifiable weights for factors

Arvind Subramanian of the Peterson Institute of International Economics wrote a marvelous book entitled *Eclipse: Living in the Shadow of China's Economic Dominance* in which he explores several different measures of economic dominance including income, wealth, resource availability, military strength, role in world trade, role in world finance, and reserve currency status and settles on three key factors as central drivers of economic dominance.

% of world GDP measured as an average of market and PPP exchange rates (35 to 60% weight) - Even under a more optimistic growth rate for the US and a less optimistic one for China, sometime prior to 2030, China's aggregate GDP will most likely pass that of the US and the European Union.

Table 5.1 UK, US, Chinese, and European shares of world GDP measured in purchasing power parity dollars, 1870–2030 (percent)

Year	United Kingdom	United States	China	EU-27
1870	9.0	8.9	17.1	
1913	8.2	18.9	8.8	
1919	6.9	18.2	7.7	
1929	5.6	18.8	6.1	
1939	6.7	19.2	6.3	
1950	6.5	27.3	4.6	
1973	4.2	22.1	4.6	
1990	4.0	24.0	4.7	27.83
2000	3.9	26.7	8.0	23.89
2010	3.1	20.1	13.4	22.37
2020	2.6	17.5	16.8	18.47
2030	2.2	14.5	19.8	14.59

Note: Starting in 1990, average share of GDP in PPP and current dollars.

Sources: Maddison (2001); IMF, *World Economic Outlook*, April 2011; and author's and calculations.

Table 5.2 UK, US, Chinese, and European shares of world trade, 1870–2030 (percent)

Year	United Kingdom	United States	China	EU-27
1870	24.3	5.0	2.8	
1913	18.5	9.0	2.0	
1929	15.1	14.4	3.0	
1950	13.3	14.6	2.1	
1973	6.0	12.8	1.0	
1990	5.8	13.0	1.6	
2000	4.8	15.6	3.6	15.3
2010	2.7	10.6	9.8	9.3
2020	1.9	8.8	12.1	8.3
2030	1.4	7.3	15.0	7.0

Sources: Maddison (2001); World Bank, *World Development Indicators;* OECD Statistics; IMF, *World Economic Outlook,* April 2011; and author's calculations.

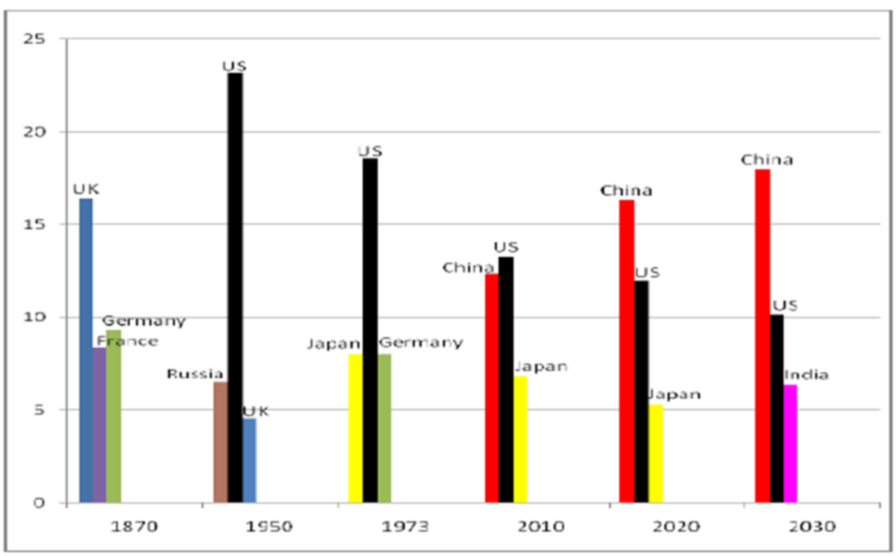
Table 5.3 UK, US, Chinese, and European shares of world net capital exports, 1870–2030 (percent)

Year	United Kingdom	United States	China	EU-27
1870	49.8	–0.7		
1900	40.2	10.2		
1913	55.8	0.6		
1929	22.6	35.6		
1939	–20.8	27.5		
1950	–62.8	34.0		
1973	0.9	17.1		
1980	–4.7	–0.2		
1990	–7.3	–52.6	0.0	
2000	–5.7	–50.4	4.1	
2010	–4.3	–50.8	17.5	–2.7
2020	–2.2	–31.6	40.1	–0.9
2030	–1.7	–22.3	17.5	–0.7

Sources: Maddison (2001); Taylor (2002); IMF, *World Economic Outlook*, April 2011; and author's calculations.

With a GDP share weight of 60%, world trade share weight of 35%, and net capital export share of 5%, economic power has shifted over the past 150 years from the UK to the US. Subramanian argues that it is only a matter of time before it shifts to China.

Figure 3 Economic dominance index from 1870–2030 for the top three countries



Notes: This index is weighted average of the share of a country in world GDP, trade, and in world net exports of capital. The index ranges from 0 to 100 percent (for creditors) but could assume negative values for net debtors. The weights for this figure are 0.6 for GDP (split equally between GDP measured at market and purchasing power parity exchange rates, respectively; 0.35 for trade; and 0.05 for net exports of capital.

Source: Subramanian (2011).

- Note the strength of the UK in 1870
- Note the dominance of the US in 1950 and 1973
- No country dominated in 2010
- Potential Chinese dominance by 2030

Does economic dominance matter? Yes, indeed it does.

- Because of the decline in Britain's economic power, the US was able to pressure the UK out of the Suez Canal in 1956.
- US economic power led to a shaping of the World Bank, International Monetary Fund, and General Agreement on Tariffs and Trade at the Bretton Woods Conference in 1944. Harry Dexter White, an infamous character who actually taught at Lawrence in the 1930s, bested British economist John Maynard Keynes in shaping these agreements, not because his arguments were more compelling, but because immense debt caused Britain to lose its economic influence.
- In 1971, the US was able to abandon the fixed exchange rates it helped set at Bretton Woods because it could. In fact, Secretary of the Treasury John Connelly speaking at an international monetary conference in Munich in 1971 reportedly said "Considerations of friendship were no longer enough for the United States to carry Europe's water. The dollar problem would have to be solved by European countries assuming more of the U.S. defense burden and opening further to U.S. exports."
- The US was able to set the terms for both GATT post World War II and its replacement, the World Trade Organization in the 1990s.
- China's entry into the WTO in 2000 was based on criteria set by the US and Europe

Things, however, are beginning to change:

- In April 2011, Spanish Prime Minister Zapatero proclaimed that "China is Spain's best friend."
- Furthermore, the US has not gotten its way in recent multilateral trade negotiations.
- I suspect that China would not accept the WTO terms if it sought entry today rather than well over a decade ago.

- The aforementioned suggest China's increasing influence over the next 15-20 years. Furthermore even reduced Chinese economic growth and resurgent US growth will only delay the change in the distribution of economic power.

What we do know is that economic dominance affects international policy and diplomacy in a variety of ways.

- Economist Richard Cooper argues that "Economic power…involves the capability decisively to punish (or reward) another party, according to whether that party responds in the desired way, combined with the perception that the possessor has the will or political ability to use it if necessary."
- 18th century British political philosopher Edmund Burke put it as follows: "The heart of the art of diplomacy is to grant graciously what you no longer have the power to withhold."

So now, let's return to an assessment of where China is likely to head over the next 15 – 20 years. Based on the reforms suggested at the 3rd Plenum in November 2013, the vision and a policy direction for the Xi regime includes

- A much larger role for market forces
- Rebalancing of the Chinese economy toward consumption and away from exports and infrastructure investment
- And as Premier Li Keqiang put it "the government should allow the market to do its job"
- President Xi, however, and not Premier Li, is in charge of the reform work group whose focus has been on maintaining economic stability and growth.

As noted previously, implementation of the strategic initiatives will be no easy task. Political opposition to reform will come from the State Owned Enterprises and urban elites who benefit from current policies including

- Government controlled prices. Market determined energy and water prices and interest rates will undermine the existing economic growth model.
- Government determined capital allocation: If markets move capital funding toward small and medium enterprises, there will be less funding available to

large state controlled enterprises, which sit on the paths to political advancement.

- Governmental focus on tangible investment and exports. A rebalanced economy means lower growth rates– especially if consumption's share of income rises dramatically.

Subramanian argues that China has become a major stakeholder in the world economy in general and expanded trade in particular. Furthermore, based on the policy recommendations made in *China 2030* and the strategic vision cited in the November 2013 Plenum

- China seeks mutual dependence with US, EU, and Japan.
- China wants to base policy on open markets, fairness in income distribution, mutually beneficial cooperation, global inclusiveness, and sustainable development.
- China wants to use its influence – positively through open markets.
- Shanghai's new Special Enterprise Zone reflects Deng's "crossing the river by feeling the stones" approach to market reform.

So let's go back to the notion of economic dominance and look at the last 140 plus years.

- 1870 – 1914 The United Kingdom was the hegemonic power with a rising US and Germany
- 1914 – 1945 Absence of a hegemonic power with the UK unable and the US unwilling to lead
- 1945 – 1989 US and USSR were rivals in the security sphere with US having hegemonic economic power as reflected by the character of various international organizations
- 1989 - 2008 US had clear hegemonic power with Europe on the rise (G-7) and more participants in the global economy (G-20)

So what does this say about the near future? – Will it be a G0, G1, or a G2 world? Financial crises in US and Europe leave room for the rise of China, India, and others.

British economic historian Niall Ferguson has argued that China and the US are now so co-dependent that he calls the arrangement Chimerica in which

- China produces and exports to the US by providing the funds to enable these purchases to take place
- As of November 2014, China held $1.25 Trillion of U.S Treasuries or roughly 10% of publically held treasury securities. China benefits from export led growth, financed by a high domestic savings rate, but payment of low or negative real interest, to sustain its high economic growth rate can't persist.
- The US benefits from the inflow of low interest capital and low-cost Chinese imports to sustain consumption despite the lack of domestic savings.

But destabilizing forces abound.

- China could rebalance it economy towards increased consumption, reduced capital outflows, and a focus on services & environmental cleanup. A recent report posted on *Xinhuanet* – a Chinese news service – indicated that in 2014 the growth of the service sector surpassed that of manufacturing. We'll see if this pattern continues.
- US could lose a major source of cheap capital and products as China has begun to curtail its purchases of US Treasuries and China's domestic interest rates have started to rise. In the past year, China has reduced such holdings by $66 Billion.
- Conclusion: Co-dependency is not a sustainable strategy.

Furthermore, recent Chinese actions raise new concerns about its intent. For example,

- China's new aircraft carrier (the Liaoning), featured on 4 "Chinese Dream" stamps, recently came in conflict with a U.S. naval cruiser (the USS Cowpens) in the South China Sea.
- China recently established an Air Defense Identification Zone over the East China Sea and claimed that aircraft flying in this zone must report to Chinese authorities.

- China recently landed a spaceship on the moon and successfully deployed a rover with a Chinese flag.
- Mr. Xi has begun to purge opponents and consolidate power to avoid a chaotic collapse.

So, what should the US, the EU, and the industrialized world do?

Arvind Subramanian argues that western powers should

- Give up some voting power in the IMF and World Bank. There have been IMF proposals on the table to raise the voting shares for China, India, and Brazil from 8% since these three countries account for roughly 19% of global GDP and to replace two European IMF board seats with representatives from these three countries. As long as the US holds more than 15% of the voting power (it presently has 16.75%), it can veto any such actions. It has done so.
- Increase Chinese interest in sustained open trade as it is consistent with their interests. This might be done by incorporating China into discussion of the Transpacific Partnership treaty, also called TPP, which focuses on the rules for trade and investment in the Pacific region. So far, TPP partners have followed a "keep China out" strategy.
- In 2001, China wanted to enter the WTO and did so on terms set by the US and Europe. Although the West did not get everything that it wanted, China opened its economy and engaged in constructive dialogue through the WTO dispute resolution process.
- US and EU, however, have had limited success in getting China to change its exchange rate policy and to open of its capital markets.

Former IMF economist Eswar Prasad, who recently authored the *Dollar Trap*, a fascinating book on the sustainability of the dollar as a reserve currency, has argued that

- "The IMF needs China a lot more than China needs the IMF, and the prospect of the renminbi's inclusion in the SDR basket (of currencies) could be seen as a way for the IMF—and the international community that it represents—to exercise leverage over China in internalizing the global repercussions of its domestic policies."

Before a constructive Western strategy can be articulated, we must understand China's interests and determine if they can be accommodated in a way that inhibits its ability to become an economic hegemon. What are those interests?

- To not be dependent on the dollar; thus, it wants the RMB to have a world role (which will happen as China's share of trade and income continues to increase). Its efforts include the establishment of three new institutions to both develop the renminbi/yuan as an international currency and find ways to influence global capital flows that differs from the Bretton Woods institutions which have not adjusted. With available IMF funds limited by existing commitments (especially in Europe) and a stagnant governance structure, China has been developing substitute institutions to allocate global capital. China has put $190 billion into three global financing entities – the Brazil-Russia-India-China-South Africa (BRICS) bank, the Asian Infrastructure Investment Bank, and the Silk Road Fund.
- China has benefited from expanded trade and wants to continue its influence since this corresponds with its view of its appropriate place in world affairs.
- Since 1980, China has moved over 500 million people from rural to urban locations; over the next 15 to 20 years, it plans to move another 250 to 300 million people to urban areas. In my view, this herculean project will absorb much of China's political and economic energy. When trade crashed in 2008 and 2009, as noted above, China turned inward to build the infrastructure needed for both this transition and the movement of people and goods across challenging terrain. Much remains to be done to improve the livelihood of both urban and rural households.

Former US Secretary of the Treasury, Henry Paulson was instrumental in establishing the US-China Strategic Economic Dialogue (SED) in 2006 which sought to build trust on both sides and to provide a forum to address topics of common concern such as 1) the integrity of trade and product safety, 2) balanced economic development including financial sector reform, 3) energy efficiency and security, 4) environmental sustainability, and 5) bilateral investment. Paulson argues that the SED can be a valuable tool in combating protectionist sentiments. These meetings were held twice a year under the Bush administration but have been reduced to one summer meeting under President Obama. In my view, they need to be given a higher priority than that.

Additionally, I find Subramanian's suggestions for engaging China on a world-wide basis intriguing even if economic dominance were to be decades away. While the West – that is the combined influence of the US, the EU, and Japan - still has economic dominance, it should

- Take advantage of opportunities to tie China into expanded world trade (as this has enabled unprecedented growth and poverty reduction)
- Start a "China trade round" – parallel to the Tokyo round in the 80s and 90s.

Alas, now I need to answer the questions I posed at the outset. –

- What does China Ranked #1 mean? It means China has the largest GDP in purchasing power terms. This is not particularly meaningful.
- Is being #1 part of the "China Dream?" It probably does; at least one can interpret such as part of "the great rejuvenation of the Chinese nation."

So, will China's economy dominate the 21st century? Maybe and it does matter. China's economic growth path depends crucially on which of the following two directions it takes. Only the second path increases China's economic strength.

1) China pursues its nationalistic interests under the guise of a strengthened Communist Party governance structure or

2) China aggressively pursues its reform agenda and restructures its economy to be more market oriented and decentralized.

In answer to the final question I posed, China's global economic role will depend upon how the rest of the industrialized world and the US in particular respond to China's growing economic power. In light of Richard Cooper and Edmund Burke's observations, now when economic power seems broadly spread, would be a good time to further integrate China into existing global economic governance through institutions such as the IMF and the World Bank and its subsidiary regional development banks.

In the world of global finance, however, little has been done to provide a leadership role for China, hence its attempt to build a "BRICS" bank. Of course, it’s not clear to me why building an institution that gives either Russia or Brazil significant influence is an attractive idea.

It’s important to remember that China is a middle income country with an incomplete domestic transition program and many pressures, both demographic and political, that operate inside a not very transparent government.

On a positive note, the December 2014 agreement on climate change objectives between the US and China does offer some reason for hope. Let’s see what happens at the Paris conference on climate change this December.

Given all of the above, I don’t see China dominating for the forseeable future; however, my crystal ball doesn’t extend anywhere near close to the year 2100.

Thank you for your attention.