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'Chimerica' is Headed for Divorce

By Niall Ferguson | NEWSWEEK

Published Aug 15, 2009

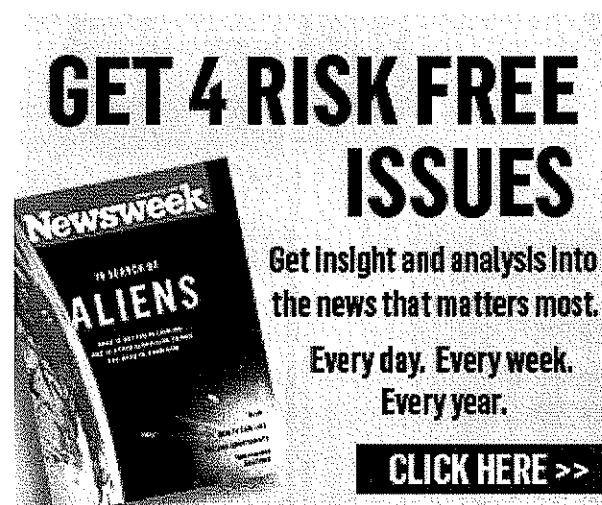
From the magazine issue dated Aug 31, 2009

When does a rising power become a threat? There is seldom a single moment. A century ago, AngloGerman antagonism was still a relatively new phenomenon; an alliance between the two empires seemed plausible as late as 1899. Likewise, the United States took time to identify Japan as a serious rival in the Pacific region; it was not until the 1930s that relations really soured. In both cases, the perception of a strategic threat was slow to grow. But grow it did—and ultimately it led to war. Could the same be happening to the United States and China today? Are we imperceptibly but inexorably slipping from cooperation to competition?

Back in early 2007, it seemed as if China and America were so intertwined they'd become one economy: I called it "Chimerica." The Chinese did the saving, the Americans the spending. The Chinese did the exporting, the Americans the importing. The Chinese did the lending, the Americans the borrowing.

As the Chinese strategy was based on export-led growth, they had no desire to see their currency appreciate against the dollar. So they intervened consistently in currency markets, and as a result, they now have international reserves totaling \$2.1 trillion. About 70 percent of these are in dollar-denominated securities, and a large proportion of these are in U.S. government bonds. The unintended effect of this was to help finance the U.S. current-account deficit at very low interest rates. Without those low long-term rates, it's hard to believe that the U.S. -real-estate market would have bubbled the way it did between 2002 and 2007.

For a time Chimerica seemed like a marriage made in heaven: both economies grew so fast that they accounted for about 40 percent of global growth between 1998 and 2007. The big question now is whether or not this marriage is on the rocks. America's highly indebted consumers just can't borrow anymore. The U.S. savings rate is soaring upward, and U.S. imports from China have slumped, down 18 percent between May 2008 and May 2009. Of course, that doesn't mean the Chinese are going to stop buying dollars. They dare not allow their currency to appreciate when so many jobs in the export sector are under threat. But it does



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mean that they are questioning the Chimerica strategy.

It's a bit like one of those marriages between a compulsive saver and a chronic spender. Such partnerships can work for a certain period of time, but eventually the penny-pincher gets disillusioned with the spendthrift. Every time Chinese officials express concern about U.S. fiscal or monetary policy, it reminds me of one of those domestic tiffs in which the saver says to the spender: "You maxed out on the credit cards once too often, honey."

Let's look at the numbers. China's holdings of U.S. Treasuries rose to \$801.5 billion in May, an increase of 5 percent from \$763.5 billion in April. Call it \$40 billion a month. And let's imagine the Chinese do that every month through this fiscal year. That would be a credit line to the U.S. government of \$480 billion. Given that the total deficit is forecast to be about \$2 trillion, that means the Chinese may finance less than a quarter of total federal-government borrowing—whereas a few years ago they were financing virtually the whole deficit.

The trouble is that the Chinese clearly feel they have enough U.S. government bonds. Their great anxiety is that the Obama administration's very lax fiscal policy, plus the Federal Reserve's policy of quantitative easing (in layman's terms, printing money), are going to cause one or both of two things to happen: the price of U.S. bonds could fall and/or the purchasing power of the dollar could fall. Either way the Chinese lose. Their current strategy is to shift their purchases to the short end of the yield curve, buying Treasury bills instead of 10-year bonds. But that doesn't address the currency risk. In a best-selling book titled *Currency Wars*, Chinese economist Song Hongbing warned that the United States has a bad habit of stiffing its creditors by letting the dollar slide. This, he points out, is what happened to the Japanese in the 1980s. First their currency strengthened against the dollar. Then their economy tanked.

What is China's alternative if it seeks a divorce from America? Call it the empire option. Instead of continuing in this unhappy marriage, the Chinese can go it alone, counting on their growing economic might (according to Goldman Sachs, China's gross domestic product could equal that of the United States by 2027) to buy them global power in their own right. In some ways they've already begun doing this. Their naval strategy clearly implies a challenge to U.S. hegemony in the Asia-Pacific region. Their investments in African minerals and infrastructure look distinctly imperial too. And now the official line from Prime Minister Wen Jiabao is to "hasten the implementation of our 'going out' strategy and combine the utilization of foreign exchange reserves with the 'going out' of our enterprises." That sounds like a Chinese campaign to buy up foreign assets—exchanging dodgy dollars for copper mines.

At the same time, crucially, the Chinese need to have their own domestic consumers step up to take the place of over leveraged Americans. China's economy is, above all, a manufacturing concern; if no one is going to the shopping malls, China's companies are just building their inventories. So a post-Chimerican China needs to be not only an empire, but also a consumer society. This will boost China's internal market as well as trade with its Asian neighbors, and will spur the development of an Asian economic bloc.

The global implications of this divorce are huge. Imagine a new Cold War, but one in which the two superpowers are economically the same size. Or, if you prefer an older analogy, imagine a rerun of the Anglo-German antagonism of the early 1900s, with America in the role of Britain, and China in the role of imperial

Germany. This is a better analogy because it captures the fact that a high level of economic integration does not necessarily prevent the growth of strategic rivalry and, ultimately, conflict.

We are a very long way from outright warfare, of course. The tectonic plates of geopolitics don't move that fast. But the danger signs are there. In a succession of official and semi-official statements, Chinese spokesmen have signaled their interest in a substitute for the dollar in the form of International Monetary Fund Special Drawing Rights, or even gold. At the very least, a gradual increase in the share of euros and yen in Chinese reserves must surely be in the cards. But they could go further than that. It's not impossible that, at some point within the next five to 10 years, the Chinese will feel ready to remove their capital controls and allow their own currency, the renminbi, to develop as a freely convertible international currency. At that point, the Chimerican marriage will be over. Not too surprising, really. As the name implied, such an unbalanced relationship was always something of chimera.

Ferguson, a NEWSWEEK contributor, is author of [The Ascent of Money: A Financial History of the World](#).

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