Postscript

America Resurgent or America Vulnerable?

We are not now that strength which in old days
Moved earth and heaven; that which we are, we are;
One equal temper of heroic hearts,
Made weak by time and fate, but strong in will.

—Alfred Lord Tennyson, *Ulysses*

Angst about the economic future of the United States has three causes. First, in the aftermath of the recent global financial crisis, the fiscal and debt situation looks especially dire. Tax cuts, two wars, and the inexorable growth in long-term entitlements, especially related to healthcare and the response to the crisis, have combined to create serious doubts about the public-sector balance sheet. And if account is taken of the contingent liabilities that might be accumulating because of the vulnerability of the financial system, the picture looks grim.

The second and arguably more serious cause for concern is the country's structural problem arising from a combination of stagnating middle-class incomes, rising inequality (particularly pronounced at the very top of the income spectrum), declining mobility, and more recently, the apparently declining prospects for even the college-educated. A beleaguered middle class is emerging that, understandably, does not want to move down the skill spectrum but whose prospects of moving up through education and skill acquisition are increasingly affected by competition from India and China. There is the serious risk that some of the cyclical problems from the recent crisis add to, and become part of, the structural malaise. These include high levels of unemployment, the rising number of long-term unemployed, and the rising number of people who have dropped out of the labor force either directly or by becoming claimants of disability benefits.

Lawrence Katz metaphorically captured the structural malaise. In an interview with Edward Luce of the *Financial Times* he said: "Think of the American economy as a large apartment block. A century ago—even 30 years ago—it was the object of envy. But in the last generation its character has changed. The penthouses at the top keep getting larger and larger. The apartments in the middle are feeling more and more squeezed and the basement has flooded. To round it off, the elevator is no longer working. That broken elevator is what gets people down the most."[1]

The third concern relates to long-run growth. Countries at the economic frontier tend to chug along at a certain "trend" rate of growth, which I have assumed to be 2.5 percent for the United States and unaffected by the crisis. That assumption might also be unwarranted. Carmen Reinhart and Kenneth Rogoff (2010) suggest a negative correlation between the high levels of debt that the United States is approaching and growth (a correlation that is strengthened if private levels of debt also remain high). Long-term unemployment, and the attendant skill attrition and loss of human capital, combined with reductions in the labor force participation rate also exert a downward impact on growth.

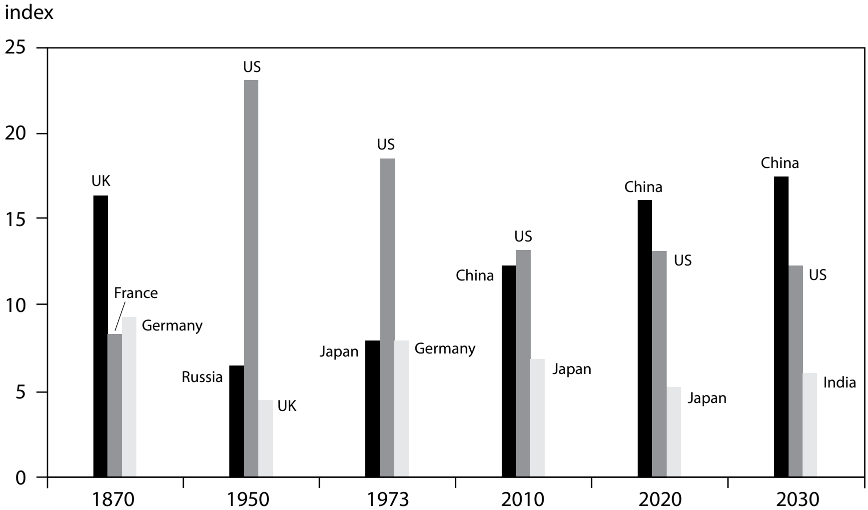
The United States, in short, has a fiscal problem, possibly a growth problem, and the most intractable of all, a distributional problem, relating to the middle class. These can cumulatively lead to a downward spiral. But that is not inevitable. Indeed, after 1993, thanks to some policy reform, but especially because of finding new sources of growth, the United States was able to address its budgetary problems, turning deficits into large surpluses, and reversing, albeit for a limited time, the previous trend of stagnating median incomes.

Indeed, one of the strong beliefs in the United States is that that episode can be repeated, thereby heading off the threat to the nation's preeminence from a rising China. If the United States can fix its education problem and if it can correct its looming fiscal deficits, the argument goes, then the fundamentals are there to ensure continuing economic dominance. These fundamentals are captured in the 2009 survey by the Global Entrepreneurship Monitor, which ranked the United States ahead of other countries in opportunities for entrepreneurship "because it has a favorable business culture, the most mature venture capital industry, close relations between universities and industry, and an open immigration policy" (as quoted in Nye 2010). Supporting this is the fact that nearly all the major commercially successful companies that have embodied breakthroughs in technology continue to be US-based and founded, like Microsoft, Google, Apple, and Facebook. Moreover, the culture of innovation and entrepreneurship are conducive to America playing a crucial role in building and sustaining the global networks that are sources of power in today's fractured world (Slaughter 2009).

But confidence in America's strengths, even if warranted, conflates the absolute with the relative. Imagine a best-case scenario where the United States bounces back from the recent recession, rediscovers new sources of growth (say, in green and information technologies), reverses the trend stag-

1. Edward Luce, "The Crisis of Middle-Class America," *Financial Times*, July 30, 2010.

Figure P.1 Economic dominance in a scenario where America is resurgent, projection to 2030



Notes: This index is a weighted average of the share of a country in world GDP, trade, and world net exports of capital. The weights are 0.6 for trade; 0.35 for GDP (split equally between GDP measured at market and purchasing power parity exchange rates, respectively); and 0.05 for net exports of capital. The United States and China are projected to grow at 3.5 percent and 5.9 percent (in purchasing power parity dollars) per year, respectively, between 2010 and 2030. All other countries are assumed to grow as in the convergence scenario described in chapter 4.

Source: Author's calculations.

nation of median household incomes, restores mobility and the prospects of attaining the American dream, and overcomes domestic political bickering to address its long-term fiscal challenges, thereby also reducing its long-run foreign indebtedness.

Let us put some numbers on these optimistic developments and see what the consequences for economic dominance might be. Suppose US growth were to average 3.5 percent over the next two decades (which would be very high by historical standards and match growth during the booming 1990s) instead of the 2.5 percent currently projected. Suppose too that the US current account deficit were to be considerably reduced as a result of bold fiscal actions.

What difference would these numbers make to the economic dominance numbers depicted in figure P.1. The answer is that while the magnitude of differential between China and the United States changes a little, the picture of Chinese dominance remains broadly unaltered.

Regardless of the disparity in dominance conveyed by the picture, could an America that grows at 3.5 percent really be dominated by a China even if it grows at 7 percent? The arithmetic difference between a growth rate of 3.5 versus 2.5 percent is not meaningful, but the practical difference might well be. A 3.5 percent growth rate, by virtue of being significantly above the long-run trend, would embody a dynamism and engender an optimism that would have a material effect on investor sentiment, confidence in the dollar as a reserve currency, and in the US model more broadly. After all, it was through strong growth that the United States saw off the threat from Japan in the early 1990s.

Indeed, the US-Japan dynamic of the early 1990s is helpful in understanding the US-China dynamic going forward. But it is the differences that stand out. The first, and most obvious, difference is that Japan, unlike China, never had the size to rival the United States. Perhaps an even more important point relates to relative dynamism. Back in the 1990s, the United States surged while Japan stagnated. Going forward, though, by virtue of being relatively poor, China will, barring a collapse, have more dynamic potential than the United States. To put it starkly, the US-Japan growth differential in the 1990s was about 2 percent in favor of the United States. Even with the United States growing at 3.5 percent, the differential will be 3.5 percent in China's favor. China might, in Alexander Gerschenkron's famous characterization, reap the advantages of "backwardness."

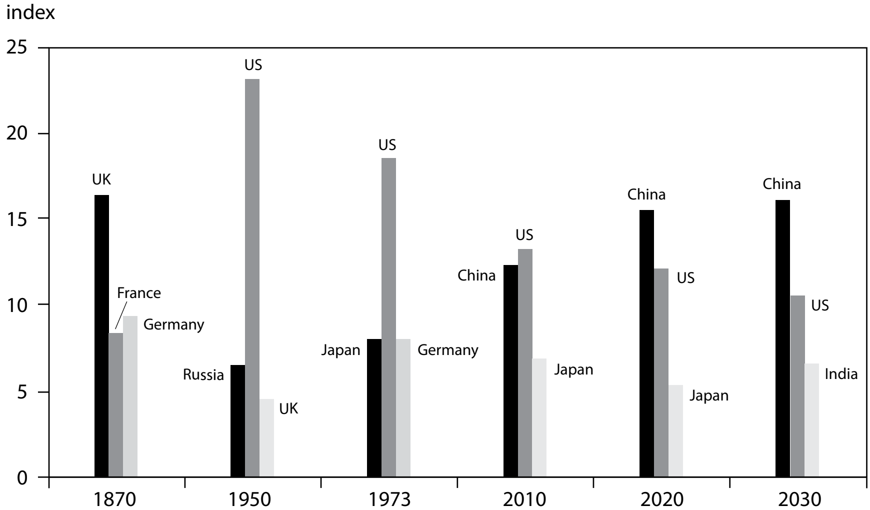
Quite apart from the question of whether the United States can grow at 3.5 percent and for a sufficiently long period—remembering that even in the 1990s, the high growth momentum did not last more than a decade—there are other crucial differences between the 1990s and the future. The United States headed into the 1990s with considerably less government debt than it will in the future: in 1990, the ratio of debt held by the public to GDP was about 42 percent while the latest projected figure for 2020 by the Congressional Budget Office is close to 100 percent. The external position of the United States was also less vulnerable then: for example, in 1990, foreign holdings of US government debt was 19 percent, today it is close to 50 percent.[2] Moreover, in the 1990s it was considerably farther away from the date of entitlement reckoning than it is now and will be over the next decade.

The most crucial difference might relate to America's middle class problem. Over the last 20 years, the related pathologies that have come together to create this problem may have become more entrenched, more intractable, and less easy to solve. In that case, even the 3.5 percent growth rate may not be adequate to preserve the attractions of, and confidence in, the United States and the US model, which at its core is based on the hope of a better future not for a few but for the many.

The dominance consequences can be checked under other scenarios. Under the convergence scenario discussed in chapter 4, the differential was 4.5 percent (7 percent for China and 2.5 percent for the United States). With America growing at 3.5 percent—the resurgent America scenario—the differential is narrowed to 3.5 percent. One should not rule out a growth collapse in China, where the differential with the United States is narrowed, say, to

2. David Walker, "Comeback America: The Nation's Fiscal Challenge and a Way Forward," Comeback America Initiative, available at http://tcaii.org.

Figure P.2 Economic dominance in a scenario where Chinese growth collapses, projection to 2030



Note: This figure is identical to figure P.1 except that the United States and China are projected to grow at 2.5 and 4.9 percent (in purchasing power parity dollars) per year, respectively, between 2010 and 2030.

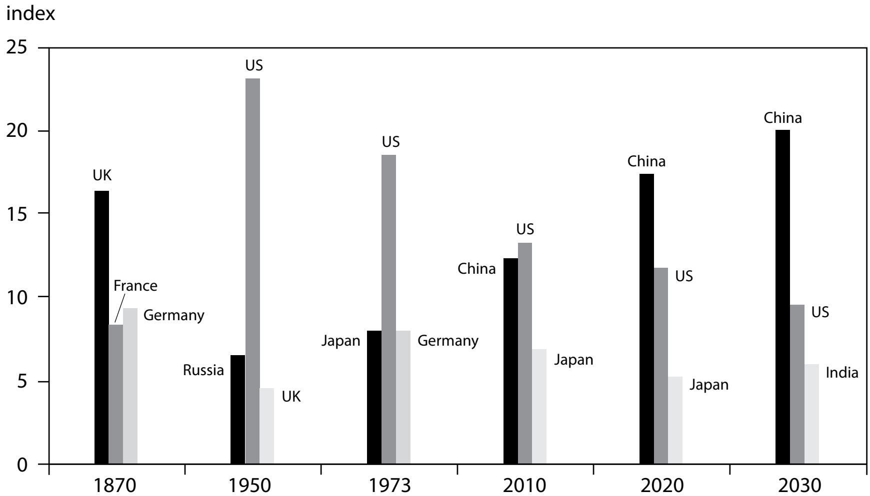
Source: Author's calculations.

2 percent a year; nor should one rule out, however, a China that manages to sustain reasonable momentum in its growth, in which case the differential with the United States is 5.5 percent.

These latter two scenarios are depicted in figures P.2 and P.3, respectively. Not surprisingly, even under a growth-collapse scenario, China maintains its dominance, although less so than under the convergence scenario. And in a resurgent China scenario, its dominance by 2030 starts to look similar to the United States not in 1973 but in 1950.

These scenarios cast some doubt on the central American belief that US economic preeminence is America's to lose, that is, that American preeminence can be maintained if the country undertakes the necessary policy corrections. In a world where relative performance matters for dominance, whether the differential in growth between the United States and China will be 2 percent (if China's growth collapses) or 5.5 percent (in a resurgent China scenario) will be largely—not exclusively—China's to determine, depending on its decisions and actions. In contrast, the range of possibilities for the United States is much narrower. It is unlikely to grow significantly slower than 2 to 2.5 percent, even if crises lower those numbers for shorter periods. And it is extremely unlikely to grow faster than 3.5 percent. This narrower range of possibilities is in some ways the "curse" of being at the economic frontier—both the downside and certainly the upside potential are limited. China's range of

Figure P.3 Economic dominance in a scenario where China is resurgent, projection to 2030



Note: This figure is identical to figure P.1 except that the United States and China are projected to grow at 2.5 and 6.9 percent (in purchasing power parity dollars) per year, respectively, between 2010 and 2030.

Source: Author's calculations.

possibilities—which are up to China to exploit or forgo—are much greater. It is this contrast that implies that China's future dominance is more China's to gain than America's to lose.

A final point relates to an inherent asymmetry in the relative possibilities and performance that strengthen the case for Chinese dominance and for attenuated American control over affecting outcomes. The asymmetry is that when the pace of technology creation by the frontier countries is slow or limited, convergence in the poorer countries is largely unaffected because the existing stock of technology is already available for all to use. But if the pace of technological progress quickens in rich countries, new technologies can become quickly usable in countries such as China and India, providing a fillip to growth in these poorer countries as well. In this case, faster growth in the rich countries need not necessarily translate into faster growth relative to countries such as China and India.

In a "flattened" world of convergence, the location of technological progress thus begins to matter less. In fact, convergence is happening precisely because the "technology" of progress is becoming more replicable worldwide. Dissemination more quickly follows discovery. And this is true in both senses of "technology." Information technologies, for example, drive innovation and production in a physical sense. But they also globalize ideas and knowledge, including how best to run an economy—the mistakes to avoid, the examples to emulate, and the learning-by-doing-and-erring to attempt.

As long as a country has the human capital skills to use, even if it cannot produce new technologies, progress is likely. According to estimates by the National Science Foundation (NSF), in 2006, the number of science and engineering undergraduates in China (about 912,000) was nearly twice that in the United States. Over time, this differential is only likely to grow. Even adjusting for what are sizable quality differentials in the education being provided, China seems well-positioned to develop and absorb technology. For example, US peer-reviewed scientific publications, which were six times Chinese publications in 2002, were merely two-and-half times in 2008 because China had posted a 175 percent growth rate compared with 20 percent by the United States.

In other words, if the United States grows at 3.5 percent, one might have to bump up the growth projections for China as well because the technological progress underlying America's acceleration is China's to emulate and adopt as well. Put starkly, the asymmetry is this: Rich countries can fall behind, but their ability to stay ahead in growth terms is inherently limited by convergence and by the nature of new technologies and the ability of countries such as China to more quickly use them.

The United States cannot escape the inherent logic of demography and convergence. A country such as China that is four times as populous as the United States will be bigger in overall economic size once its standard of living exceeds a quarter of that of the United States (which has already occurred). A converging, growing China will ensure that the gap in overall size will only get larger over time.

The baseline scenario of a dominant China can be altered materially by a resurgent America (of course, aided by a faltering China). But the preconditions are demanding. Not just will the United States have to grow substantially faster than long-run trend but it must be seen as strong fiscally and, above all, able to reverse the pall of economic and social stagnation that has enveloped its middle class. Such an America will restore the American dream domestically but will also be essential to take the lead and play a key role in shaping and strengthening the multilateralism that was described in the previous chapter as the world's best insurance against an unbenign China in the future.

Suez Canal Revisited?

A resurgent America can be a strong and vibrant nation but not necessarily one that can easily exercise power and dominance over a rising China. So the possibility of more dire scenarios under which the United States is actually dictated to must also be considered. This book began with one such scenario, in which China used its economic dominance to attain noneconomic objectives reminiscent of the experience of the United Kingdom, which "lost" the Suez Canal in part when the United States exercised its power against an economically enfeebled and indebted Britain. The fantasy scenario of the United

States going to the IMF was inspired by the Suez episode of 1956. But are the implicit comparisons appropriate and relevant? It is useful to examine how some of the specific elements of the two events, one real, one imagined, did and might play out.

First consider the incentives of the rising creditor country. In 1956, the withholding of financing for the United Kingdom by the United States—directly and indirectly via the IMF where the United States could muster a majority against the United Kingdom—had no serious consequence for the dollar and the US economy.

Today, the argument is that China's threat to not buy US treasury bonds or even to sell some of its existing stock is not credible because the consequence of China's action would be the very outcome—dollar decline and renminbi appreciation—that China has been steadfastly trying to prevent in order to sustain a mercantilist growth strategy and avoid large capital losses on the stock of foreign exchange reserves that it has acquired by running large current account surpluses for over a decade.[3] So remaining sanguine about the consequences of China wielding the creditor's weapon may be warranted by current conditions: At a time of a depressed US economy, the Federal Reserve might be only too happy to buy US treasuries dumped by China.

But the dynamic and credibility of wielding the financing weapon in the future could be very different from today's circumstances. Ten years on, it is quite easy to see China being less wedded to a weak renminbi. Indeed, if China proceeds on the path of renminbi internationalization it so clearly seems to have embarked upon, its ability and stake in maintaining a weak currency will be considerably weaker.

Moreover, in the case of the United Kingdom back in 1956, its financiers were more dispersed and included the private sector. In the case of the United States, China—and, crucially, the Chinese government—is the largest net supplier of capital to the United States, accounting for a large share of holdings of US treasury bonds, both in stock terms and as a financier of the flow deficits of the United States. Leverage over the United States is thus concentrated, not dispersed, and concentrated in the hands of those who can wield power. So when the current imperatives for a weak renminbi fade, China's ability to wield power will be considerable.

Second, consider the exchange rate policy of the indebted country. In 1956, Britain was desperately trying to maintain a fixed exchange rate peg and needed financial resources to do so, resources which the United States controlled. However, the United States today is not, and will not likely be in the years ahead, wedded to dollar fixity. Downward movements in the dollar are less of a problem, especially since the foreign liabilities of the United States are denominated in dollars and not in foreign currency.

3. For example, a 30 percent revaluation of the renminbi against the dollar would lead to valuation losses for China of about half a trillion dollars, or 10 percent of its GDP.

The United States in 2021 may have less to fear from a decline of the dollar, even a disorderly one but vulnerable it will be even if for slightly different reasons. Its vulnerability will arise from the combination of its fiscal fragility and the fact that it might be dependent on its potential rival to economic superpower status—the government of China—to keep supplying the foreign financing necessary to forestall that fragility.

So, the proximate vulnerabilities might be different: external in the case of the United Kingdom in 1956 and fiscal-cum-external for the United States in 2021. But the deeper parallel is this: The United Kingdom was vulnerable not just because it was a debtor but because its economy had weakened and another power had emerged. The United States is also weakening structurally, its government has become a chronically large debtor, its growth prospects have dulled, and critically, a credibly strong rival—that controls the finance spigots and that might also issue the premier reserve currency—has emerged. While not an adversary, this rival is not an ally either—unlike the United Kingdom and the United States in 1956. And it is one that has yet to sufficiently reassure the world about its internal politics and extraterritorial ambitions.

To clarify, the 2021 scenario described in the introduction is still a very low probability one. But stranger things have happened, as the recent global financial crisis showed. As John Maynard Keynes said, "the inevitable never happens, it is the unexpected always." And while the triggers may be very different than in this "handover fantasy," it is the economic fundamentals—which this book has shown are clearly moving against the United States and in favor of China—that create the vulnerability. That an economically dominant China will wield considerable economic power and that the United States will be vulnerable cannot be wished away as beyond the realm of possibility. Indeed . . .

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. . . on that February morning in 2021, after signing the agreement with the IMF, the president of the United States makes his way through the bracing cold air toward the cavalcade of black Lincolns that will carry him and his entourage back to the White House. As he steps into his limousine, the bells of the National Cathedral erupt in somber splendor. Self-aware and history-honed—not unlike his once-removed predecessor, Barack Obama—the president is reminded of the funeral procession of King Edward VII over a century ago, as described by Barbara Tuchman in *The Guns of August*: "The muffled tongue of Big Ben tolled nine by the clock as the cortege left the palace, but on history's clock it was sunset, and the sun of the old world was setting in a dying blaze of splendor never to be seen again."