

# Sifting through Interdependence

If there is one idea that has consistently influenced western foreign policy since the Cold War, it is the notion that extending interdependence and tightening economic integration among nations is a positive development that advances peace, stability, and prosperity.<sup>1</sup> As a post-Cold War idea guiding U.S. and European foreign policy, there is much to be said for it. The absorption of Eastern Europe in both the European Union and NATO helped consolidate market democracy. Globalization led to unprecedented growth in western economies, and facilitated the ascent of China and India, among others, taking billions of people out of poverty. Access to the international financial institutions also offered emerging powers the strategic option of exerting influence through existing institutions rather than trying to overturn them. Some policymakers and experts believe that this process holds the key to continuing great power peace and stability.

Until recently, countries have acted as if increasing and freewheeling economic interdependence is a force for good in itself. Yet over the past five years it has become increasingly apparent that interdependence and integration carries strategic risks and challenges with it. These include a much greater level of volatility in the global economy, potentially destabilizing vulnerabilities in the U.S.–China bilateral relationship, tensions in Asia that stem in part from the reliance of small economies upon China, and an existential crisis in the European Union. Nations have begun to hedge against some of these risks by reining in some types of economic interdependence and by adopting national security policies to counterbalance them. For example, South East Asian nations have deepened their strategic ties to the United States to offset the effects of economic interdependence with China, and Western countries are placing restrictions on the activities of Chinese technology companies.

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Thomas Wright is a fellow with the Managing Global Order project at the Brookings Institution. He can be reached at [twright@brookings.edu](mailto:twright@brookings.edu) and on Twitter at [@thomaswright08](https://twitter.com/thomaswright08). He would like to thank Antoine DeSaint Phalle, Bruce Jones, Rob Keane, Hans Kundnani, Darren Lim, Angie Ro and Nicole Yeo for discussions on the ideas in this article and for commenting on earlier drafts.

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**Two factors have caused states to reassess the benefits of interdependence and integration.**

**What will interdependent competition look like?**

Two factors have caused states to reassess the benefits of increasing interdependence and ever deepening integration. The first is that the tremendous increases in economic interdependence and integration have produced complexities in the global economy that create the conditions for major crises, such as the Eurocrisis and the 2008 international financial crisis, which may be beyond the capacity of states to manage effectively. The second is that states are increasingly engaged in

geopolitical competition with each other, albeit in an interdependent world. China, the world's second-largest economy, is a geopolitical competitor of the United States, Japan, and India, and it also has significant disputes with many of its neighbors in South East Asia. The United States and Russia once again have a competitive relationship—particularly over Syria, where a proxy war seemed possible in August 2013, but also more broadly. In a stagnant global economy, nationalism is on the rise in many countries, albeit to differing degrees. Post-Cold War integration and interdependence was pursued at a time when geopolitical competition between the major states was low and the prospect for cooperation seemed great. The key strategic question now is: what will happen if security becomes a more prevalent consideration of state behavior? What will interdependent competition look like?

States are seeking to carve out spheres of independence for themselves to hedge against the risks of interdependence, and these efforts are likely to accelerate over the next decade. These spheres of independence will be imperfect and porous, but they likely mark the first step in a strategy to preserve the state's autonomy in the face of greater volatility and uncertainty. Critically, this effort will not involve reducing trade ties. Modern trade is integral to national economic health and incredibly complex. States will still struggle over expanding free trade as they always have, but they will be deterred from protectionist measures to roll back the status quo. In some cases, states will seek to hedge against the risks of certain types of trade, such as asymmetric trade with a potential rival, but this will entail countervailing security and economic ties rather than reducing trade itself. Primarily, the spheres of independence will focus on those aspects of interdependence that are perceived to pose a systemic threat to the nation's interest (e.g. capital flows, financial imbalances, energy interdependence).

In this article, I focus on three areas where interdependence will pose strategic challenges for actors involved to manage: the bilateral relationship between the United States and China, East Asia as a region, and the global economy. The challenge facing the United States and other countries will be to manage the integration process effectively, encouraging the positive elements while rolling back or mitigating the negative. Done right, strategically managing integration and interdependence should produce a stronger and more sustainable international order. Toward this end, I make a series of recommendations including U.S.–Chinese cooperation to explore ways to selectively reduce each other's leverage on a mutual basis, continued U.S. rebalancing

toward Asia to mitigate the effects of asymmetric regional interdependence, reforming international financial institutions to include regulation of financial markets, and greater flexibility in European integration.

### The U.S.–China Bilateral Relationship

Any treatment of modern interdependence must begin with the United States and China. Not only are they the two largest economies in the world, but they are also geopolitical competitors. Interdependence between these two countries continues to reach new heights across multiple areas. For example:

- In 2012, the United States imported \$425.5 billion of goods from China, up from \$321 billion in 2007, and \$125 billion in 2002. The United States also exported \$110 billion worth of goods to China in 2012, up from \$63 billion in 2007, and \$22 billion in 2002. The U.S. trade deficit with China is \$315 billion, up from \$258.5 billion in 2007 and \$103 billion in 2002.<sup>2</sup>
- At the end of May 2013, foreign investors held \$5,678 trillion in U.S. debt which, according to the Congressional Research Service (CRS), is “the largest share of privately held public debt attributed to foreign holdings since these estimates have been compiled.”<sup>3</sup> Of that, China holds approximately 23 percent, the largest of any foreign holder. (Japan is the second-largest, with approximately 19.5 percent.)<sup>4</sup>
- Educational exchange between the United States and China is rapidly increasing. China is the fifth most popular destination for U.S. students studying abroad, and the number of U.S. students studying there has more than doubled between 2004-05 and 2010-11, the last year for which data is available.<sup>5</sup> Meanwhile, China tops the chart of foreign students studying in the United States, with over 194,000 in 2011-12. This is more than a 300 percent increase since 2005-06, over 25 percent of the total number of foreign students, and almost twice the number of the second-ranking country, India.<sup>6</sup>

Senior policymakers seem to believe that interdependence will reduce tensions between the United States and China. Interdependence is the key reason why China’s President Xi Jinping called for “a new model of major country relationship.”<sup>7</sup> As former Secretary of State Hillary Clinton put it, “Interdependence means that one of us cannot succeed unless the other does as well. We need to write a future that looks entirely different from the past.”<sup>8</sup> Chinese Premier Li Keqiang speculated “I don’t believe conflicts between big powers are inevitable...Shared interests often override their disputes.”<sup>9</sup>

The United States and China are highly interdependent with each other, but they are also geopolitical competitors in the Asia–Pacific.<sup>10</sup> To a significant extent, the United States and China are competing for regional influence, including whether the United States can remain the hub of the regional security order, how maritime territorial

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disputes in the South China Sea and East China Sea are to be resolved, and whether the United States can project power quickly into the region. China and the United States are also at odds on several issues that could escalate into a crisis including Taiwan and the future of the Korean peninsula.

Thus, the U.S.–China relationship is best understood as one of interdependent competition. It is unique in modern history. We have to look back to the period before World War I for cases of such levels of interdependence between great power competitors. The Western world was largely independent of the Soviet bloc during the Cold War, and interwar Europe was much less interdependent than it was a quarter of a century earlier.<sup>11</sup> The apparent tradeoff between the common interests generated by interdependence and the tensions stoked by geopolitical competition make it difficult to predict where U.S.–China relations are headed.

Even if interdependence continues to grow, it will not remove the causes of U.S.–China security competition. Each side is more likely to believe that the other will compromise on issues where they differ, but they will be unwilling to compromise themselves.<sup>12</sup> Take Taiwan as an illustration: it is inconceivable that either China or the United States would abandon their respective positions and accede to the will of the other for the sake of economic inducements. In fact, in practical terms, it is hard to imagine any controversial area where a U.S. president would back down from a formal commitment for economic reasons. Rather, the danger is that Washington and Beijing could miscalculate by assuming that the other side is more commercially minded than they are. So, interdependence and geopolitical competition will continue to exist. When the two come into conflict, geopolitical calculations will be uppermost in policymakers' minds. The question that they are coming to grips with is: what impact will interdependence have? Does it always help the cause of peace, or are there occasions when it will hurt?

The key to understanding the strategic effects of interdependence on the bilateral relationship is to understand that it is not a monolithic force. Some types of interdependence will encourage cooperation and decrease tensions. Others will have the opposite effect, increasing tensions and friction. How can we tell the difference between the two? The positive type of interdependence is one where the benefits are shared and it is difficult for either side to turn it into leverage that can be used to inflict disproportionate damage on the other. To use the language of international relations theory, there is symmetric vulnerability. The negative type of interdependence is one where one side gains disproportionate leverage over the other and could seek to use this leverage as an economic weapon at a time of crisis. If one side has an asymmetric vulnerability that the other side tries to exploit, it might also retaliate in another area—horizontal escalation—in which it holds an asymmetric superiority. This increases the risk of miscalculation and a spiraling crisis.

### **Trade: Now a Positive Form of Interdependence**

There is a vast literature on the relationship between trade and conflict, with liberals arguing commerce creates shared interests in cooperation and realists arguing that it rarely evenly divides and can create vulnerabilities.<sup>13</sup> However, there is a new element in modern trade. The international trading system, with its vast supply chains, is so complex that no one can figure out how to manipulate it in such a way that would

disproportionately hurt the other side. As Stephen Carmel, a senior executive at Maersk Line, Ltd, one of the world's largest shipping companies, has put it:

To say that the world's economies are interdependent does not adequately, or even remotely, express the true nature of today's global economic activity. Vulnerabilities exist everywhere, the most serious being those obscured by the very complexity of the system...The demise of the meaning of the 'made in' label means we can no longer gauge with any accuracy where the incidence of a specific trade sanction will fall or where failures in the global supply chain may manifest themselves.<sup>14</sup>

Simply put, the United States and China have no way of significantly reducing trade with each other through protectionism without setting in motion a general unraveling of the global trading system that each relies upon. Thus, trade produces little leverage for either country; meanwhile, it gives each country a stake in the success of the other.

### **China's Holdings of U.S. Debt: Mutual Harm Not Enough**

Chinese holdings of U.S. debt is a leading example of negative bilateral interdependence. As detailed above, these reached record levels in May 2013. Analytically, there are two questions here: One is whether it is bad to have foreigners holding such a large share of a growing U.S. debt. The other is whether there is something special about China since, unlike Japan for example, it is not an ally of the United States. For reasons of space and because it merits an article to itself, I leave aside the question of whether growing debt is itself a national security threat. From a pure economics perspective, it is better to have foreign investors buy some U.S. debt than to have the burden fall entirely on U.S. investors. As the CRS puts it, "all else equal, foreign purchases of Treasury securities reduce the federal government's borrowing costs and reduce the costs the deficit imposes on the broader economy."<sup>15</sup>

With China, the question is whether *its* holding U.S. debt is stable from a national security viewpoint. While U.S. officials maintain that China's holdings exercise no influence over U.S. policy, some Chinese officials and analysts have hinted that they may consider such a strategy if China's sovereignty was threatened.<sup>16</sup> China's holdings are also politically controversial with the Chinese people.<sup>17</sup> Most analysts believe that China cannot use its holdings of debt as a weapon because China's economic interests would be badly damaged if it began to dump U.S. debt.<sup>18</sup>

This is true most, but not all, of the time. There are two scenarios in which it could destabilize U.S.–China relations.

The first is in a real political crisis between the United States and China. If the United States and China were on the brink of conflict over Taiwan or disputed islands in the East or South China Sea, Beijing may calculate that unloading U.S. debt would hurt the U.S. economy more than the Chinese economy, either in absolute terms or in the relative pain that each country could endure during the crisis (if the Chinese felt more strongly about Taiwan than the American people, for example, this balance would be in their favor). Even if China did not execute this strategy, giving the *impression* that it

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would be willing to do so could be effective, especially if Beijing were simply trying to deter the United States from taking an action (such as entering a conflict on the side of an ally) rather than compelling it to do something.

## Do Washington and Beijing want to maximize mutual leverage or reduce it?

The second scenario is if world markets lost confidence in U.S. treasuries and began to offload them. In such a case, the United States would highly value China's cooperation in continuing to hold U.S. debt and Beijing could seek to leverage it into political influence. China would otherwise serve its own economic interests by unloading its holding before the rest of the market does; indeed, it would need a strong incentive not to do so. In the past, the United States could invoke a security alliance to encourage its economic partners to take actions that were not in

their immediate economic interest for the wider good. But since the United States and China are competitors, not allies, that would not work.

The risks of China's vast holdings of U.S. debt should not be exaggerated, but neither should these be dismissed. There are specific scenarios in which it could prove destabilizing, and in the present environment—of increasing geopolitical competition and a volatile global economy—Washington and Beijing should take them seriously.

### Information Technology and Cyber-Risk

A second area where interdependence is having negative strategic effects is the integration of networks and information technology. The United States is concerned that China is using market openness to penetrate U.S. companies and technologies in ways that Beijing could strategically exploit at a time of crisis. In a 2013 interview, former director of the CIA and NSA (National Security Agency) Michael Hayden said, "if you've got a foreign company supply you with essential communications infrastructure and/or helping build your network, the detailed knowledge that company obtains can be a powerful intelligence tool for foreign security services to leverage off to map out and target your telecommunications network for espionage and other malicious purposes."<sup>19</sup>

Later in the interview, Hayden singled out Chinese technology giant Huawei, saying it represents an "unambiguous national security threat" to the United States and Australia. In 2012, a House Intelligence Committee Report into the activities of Huawei and ZTE, another Chinese telecommunications company, recommended that both be viewed with suspicion and be banned from mergers, acquisitions, and takeovers in the United States or from supplying vital components to the U.S. telecommunications infrastructure.<sup>20</sup>

Huawei and ZTE are meeting with stiff resistance in the United States, but they have had a more mixed experience elsewhere: Taiwan, Germany, India, and Australia blocked Huawei and/or ZTE from major contracts.<sup>21</sup> However, Huawei enjoyed the support of UK Prime Minister David Cameron in making a £1.3 billion investment in the United Kingdom (despite considerable concerns from Parliament), and the European Union as a whole continues to do business with it.<sup>22</sup> Unconditional interdependence would allow Huawei and ZTE to fully avail of all of the opportunities globalization offers—but there is widespread recognition that technology infrastructure is a special

case where “Trojan horse” concerns are real. Further integration is unlikely to ease tensions; it will only exacerbate them.

## Energy

The U.S. energy revolution may mean the United States is becoming less dependent upon the Middle East for oil, but China is moving in the opposite direction. As China’s economy grows, it has an almost insatiable demand for energy imports. The International Energy Agency (IEA) estimates that by 2035, Asian countries will account for 90 percent of the Middle East’s export of oil.<sup>23</sup> Approximately 80 percent of China’s oil imports already flow through sea lanes patrolled by the U.S. Navy.<sup>24</sup> China worries that the United States could choose to cut off these “lifelines” during a major crisis in an effort to change Chinese behavior. As Zhang Wenmu, a Chinese academic and strategist, put it, “China is almost helpless to protect its overseas oil import routes. This is an Achilles heel to contemporary China, as it has forced China to entrust its fate (stable markets and access to resources) to others...If one day, another nation(s) finds an excuse to embargo China, what can China do?”<sup>25</sup> As geopolitical competition between the two grows, so too does this fear.

For China, energy interdependence is dependence upon the U.S. Navy. Naturally, China finds this intolerable, so it is developing capabilities and a strategy to ensure access to these resources.<sup>26</sup> Part of it involves diversifying sources of supply. For instance, China recently signed a deal with Russia to import \$270 billion of oil over twenty years.<sup>27</sup> But diversification of supply won’t be enough, so China’s strategy also includes transforming the navy from one designed for costal defense to one that projects power, considers a forward presence overseas, and makes preferential agreements with resource suppliers. New naval capabilities may be acquired for defensive purposes, but its neighbors, including India and Japan, will also see it as a strategic threat. For the purposes of this article, the key point is that China’s naval ambition is influenced and shaped by energy interdependence. It is a desire to push back against the market for geopolitical reasons.

## Interdependence Depends...

There are aspects to bilateral interdependence between the United States and China, such as trade and educational exchange, which contribute toward mutual cooperation as well as understanding and are likely to endure. However, other aspects have raised concerns. Either the United States or China will see Chinese holdings of U.S. debt, cyber-interdependence, and energy interdependence as a significant source of threats. Some people will argue that this vulnerability is actually a positive since it can deter the other state from taking destabilizing actions. For example, if China were to invade Taiwan, the United States could respond by cutting off supplies of energy. Or conversely, if the United States were to support a unilateral declaration of independence by Taiwan, China could respond by offloading its holdings of U.S. treasuries.

There is reason to question such claims. Economic weapons alone rarely compel much smaller countries to capitulate, let alone large ones.<sup>28</sup> If the United States or China find themselves facing the threat of economic warfare, they are likely to seek to reduce their vulnerabilities and may retaliate in kind. The United States and China will

have to make a strategic choice: in the hope of achieving a greater degree of stability, do they want to use interdependence between them to maximize the leverage that each has over the other, or do they want to reduce this leverage (and some types of interdependence)? Thus far, neither country has answered this question.

### **Asymmetric Interdependence in East Asia**

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The Asia–Pacific region contains the world’s three largest economies, its most populous areas, outstanding territorial disputes, a mix of authoritarian and democratic regimes, and multiple security dilemmas. The International Monetary Fund (IMF) projects Asia will lead the recovery from the great recession.<sup>29</sup> Meanwhile, its geopolitical characteristics are unique in modern history: its economic activity is largely organized around China, while its security order is largely organized around the United States. There is very little precedent for such a dichotomous structure. Geopolitical competition in the first half of the 21st century is likely to see the Asia–Pacific region as its center of gravity.

China is Asia’s largest economy and the largest market for most of its neighbors. According to a report by the United Overseas Bank (UOB) of Singapore, China accounted in 2011 for 11.5 percent of ASEAN’s total exports—more than any other single nation and more than the EU—a number up from 3.9 percent in 2000.<sup>30</sup> Moreover, as John Wong of the East Asia Institute has put it, China’s production network means that its economy “operates not just as an engine of growth for the [East Asia] region but also as a catalyst of regional economic integration.”<sup>31</sup> China is also the world’s largest consumer of many natural resources and commodities including steel, oil, gas, and aluminum. Its economic growth created a commodities boom, which was the primary reason countries like Australia did not fall into recession after the financial crisis.<sup>32</sup>

The rise of the China-centric economic order has generated fears among its neighbors that China would use its disproportionate economic power to upend the status quo and create a new regional order organized around Beijing’s interests and preferences.<sup>33</sup> China has been willing to use economic sanctions when its interests are threatened, including on bananas and tourism in a dispute with the Philippines over the Scarborough Shoal, on rare earth metals in a dispute with Japan over the arrest of a Chinese fisherman in 2010, or with popular protests and boycotts of Japan in response to its purchase of the Diaoyu/Senkaku Islands in September 2012.<sup>34</sup>

China’s neighbors have also been concerned by the impression Beijing has given that China should get its way more as its economy grows. For instance, many remember the comment by then-Foreign Minister Yang Jiechi who remarked in 2010 at the ASEAN Regional Forum in Hanoi that “China is a big country and other countries are small countries, and that’s just a fact.”<sup>35</sup> These fears find their roots in traditional realist critiques of asymmetric interdependence. In his seminal work, *The Structure of International Trade*, Albert Hirschman showed how a similar economic imbalance in the 1930s created dependencies that enabled Germany to coerce and pressure smaller states in Central Europe.<sup>36</sup> According to this logic, if other states become dependent on China, China can threaten to cease trade ties in an effort to coerce the smaller state. Because it is so much larger than most of its neighbors, China has almost all the

leverage. It can cut off one of its smaller neighbors and feel little effect. Also, the mere fact that trade with China is so important will lead to the creation of pro-China interest groups and constituencies in the smaller state, or so the argument goes.

The fears of a Hirschman-style scenario rose after 2008 when China was perceived to have adopted a more assertive foreign policy, which included pursuing maritime territorial claims, using smart sanctions against companies or countries that defied China on Taiwan, Tibet, or other core interests, and reminding its neighbors that they should accommodate China's interests. With a more assertive foreign policy, maybe China would try to use its economic power as leverage? However, having recognized the risk of an asymmetric economic order early on, China's neighbors set about trying to balance its negative effects.<sup>37</sup> As a 2008 RAND report said, even before China's assertive turn, "high levels of economic interactions and positive views of China are not strongly correlated."<sup>38</sup>

The region's attempt to balance asymmetric interdependence with China has four pillars. The first is to deepen security ties with the United States. Australia, Japan, the Philippines, and South Korea all sought to deepen their U.S. alliances, which Washington facilitated through the rebalance (or pivot) strategy.<sup>39</sup> Non-ally countries like Indonesia, Vietnam, and Burma have also engaged with Washington, which many interpret as partly designed to counterbalance Chinese influence.

The second pillar is to deepen security ties with other Asian nations. A report by the Center for a New American Security (CNAS) elucidates this, saying the regional security environment "is no longer solely defined by the U.S. hub-and-spoke alliance system. Instead, a more diverse array of bilateral security ties is emerging among Asian countries. Regional actors are integrating with each other in unprecedented ways, from India training Vietnamese submariners to Japan's first security agreement outside the U.S.-Japan alliance (signed with Australia) to countries turning to their neighbors for arms."<sup>40</sup>

The third is to deepen regional institutions and architecture, including ASEAN-centered dialogues and processes as well as bilateral FTAs with other Asian nations. Southeast Asian states increasingly recognize the need to pool their resources in order to be considered a legitimate counterweight to regional counterparts and powerhouse economies, like China and India. Thus, Southeast Asian nations are working toward the fulfillment of the ASEAN Free Trade Area and the creation of an ASEAN Economic Community (AEC) by 2015. ASEAN is also at the center of regional architecture through the ASEAN Regional Forum, the ASEAN Plus Defense Ministerial Meeting (ADMM+), and the East Asian Summit (EAS).

The final pillar is to diversify sources of economic growth, including through the Trans-Pacific Partnership (TPP) and deepening economic ties with the European Union. This effort to build strategic ties and additional economic interdependencies with states other than China is a conscious strategy to counterbalance the effects of asymmetric regional interdependence.

These four components constitute a significant effort to mitigate the negative strategic effects of a China-centric regional economic order by anchoring the United States at the center of a regional security order. Their behavior suggests a preference to maintain the dual order—an economic order generally organized around China, and a security order organized around the United States. However, it is unclear whether these

two orders can continue to coexist indefinitely or if one will cause the erosion or collapse of the other. The past five years allows us to draw some tentative conclusions.

First, little evidence exists that China has been able to use its economic position to push countries into accepting a China-led security order or simply to push the United States out of East Asia. The mere presence of a counterbalancing strategy is evidence of that. Moreover, as described earlier, the trade system is so complex and interconnected that it is extremely difficult to manipulate without damaging one's own economy. China could use economic sanctions over a political crisis, for example, but over the medium- to long-term, economic sanctions are a double-edged sword since China relies upon its neighbors for commodity imports, export markets, and foreign direct investment. The benefits of being the center of the regional economic order are, to date, more symbolic or theoretical than a means of coercing another neighboring state.

Second, U.S. engagement is critical to ensuring that China cannot use asymmetric interdependence to overturn the existing order. Given the choice between maintaining their independence or growing economically, nations will almost always choose the former. However, these countries must have a willing partner in the United States to remain independent. If the United States is not fully engaged in Asia and not willing to accommodate the desire of Asian nations to hedge against an economically powerful China, those nations may have no choice but to accept Chinese regional leadership. Similarly, if China continues to grow and the region becomes fully dependent upon it far beyond current levels, they may be able to leverage this position into diplomatic influence that could pry countries away from the security order. U.S. leaders must understand that asymmetric interdependence in East Asia is of strategic benefit to China, but the United States can mitigate its effects through deep regional engagement on military, political, and economic matters.

Third, while it is true that U.S. allies have not flipped over to China simply for economic ties, asymmetric interdependence could still constrain U.S. strategy in ways that are advantageous to China. As we have seen above, if China tries to use its economic influence to coerce a U.S. ally in a dispute involving a vital interest, Beijing will not back down. However, the situation may be more complicated for U.S. allies that are not directly involved in the dispute in question. For example, if the United States intervened in a severe crisis between China and Taiwan, or China and Japan over the Diaoyu/Senkaku Islands, it may need the cooperation of other Asian allies to project power in a timely manner. Since these allies are not directly involved in the dispute, they may think twice if interfering involved angering China on something it deemed to be a core national interest. Beijing could be willing to undertake radical action, such as economic warfare, even if it hurts China too. The mere prospect of this scenario would complicate U.S. planning and military operations.

Fourth, geopolitics is also impairing regional integration and interdependence. Take energy as an example. As major energy consumers, China, India, and Japan have an interest in cooperating with energy suppliers to achieve better terms, or in working together to guarantee continued access to energy supplies. At least that is the logic of interdependence and integration. However, geopolitical tensions between China and Japan as well as between China and India make such collaboration highly unlikely. Similarly, geopolitical concerns will limit the extent that nations will open up their

communications infrastructure to Chinese companies, just as was discussed earlier, in the U.S.–China bilateral relationship.

We should expect Asian nations to continue to develop strategic ties to offset China's role at the center of an Asian economic order. But another risk looms large in East Asia: a sustained downturn in China's economy would constitute a significant shock to the region as a whole. Chinese commodities demand is already decreasing and will fall much further. Chinese imports will likely plummet. This will lead to some unraveling of regional economic interdependence, not because of policy choices but simply because the key drivers of economic integration—the insatiable demand for closer ties—would disintegrate. This will reduce China's leverage over its neighbors. If a more humble foreign policy (and a rollback of the post-2008 assertiveness) accompanies this reduction, however, it may also have the ironic, commensurate effect of decreasing the incentive for closer security ties with the United States. In turn, the weakening of the Chinese-centered economic order could also heighten Chinese nationalism in response to worsening economic conditions and a rise in regional geopolitical tensions.

The bottom line is that the United States, China, and China's neighbors have an interest in a strong Chinese economy that creates and deepens regional interdependencies, even if they are asymmetric. The strategies outlined above can counterbalance these asymmetric interdependencies. It is an imperfect and vulnerable structure, but preferable to the likely alternatives.

### **Volatile Interdependence in the Global Economy**

For the past two decades, the United States championed the process of globalization, and especially the deregulation and integration of the world's financial markets. This effort included the 1999 repeal of the 1933 Glass–Steagall Act. This Act prevented the merger of commercial and investment banks; relaxed capitalization requirements for banks; deregulated derivatives; and pursued a foreign economic policy advancing the so-called Washington Consensus, which encouraged other countries, particularly those in IMF programs, to open their economies to investment and trade and introduce pro-market structural reforms. This period of deregulation accompanied, and probably contributed to, a massive increase in global economic interdependence and integration. Capital flows exploded; banks became too big to fail. Financial instruments became so complex that even the chief executives of the banks that designed them could not understand them.<sup>41</sup> This deepening interdependence and greater integration produced growth, but it also increased volatility and made the global economy more crisis prone. Indeed, the two-decade period saw major crises in Mexico in 1994, East Asia in 1997, Russia in 1998, and the United States as well as Europe in 2008.

Liberal international theory placed great faith in the process of globalization as a means to create a mutually beneficial global economy, open up societies, and provide the conditions for inter-state peace. But for the first time since the Cold War, the driving narrative behind the global economy is no longer how to increase the openness of markets and economies. Instead, it is how to repair the global economy so it produces growth but is not susceptible to catastrophic crises.

To take one prominent example that illustrates the changing climate, *Financial Times* correspondent Martin Wolf wrote a book in 2004 called *Why Globalization*

Works—but today he is one of the strongest critics of unfettered deregulated financial markets.<sup>42</sup> Cornell University Professor Jonathan Kirshner observed that much of the world does not see the crisis as a black swan—that is, a rare and unpredictable event—but as a direct consequence of the particular model of global capitalism that has been pursued.<sup>43</sup> The G-20 averted a full scale collapse in 2008 and 2009, but the risk remains. Indeed, some of the problems that drove the 2008 crisis have gotten worse—for instance, the consolidation of too-big-to-fail banks means they are even bigger now than before. As then-University of Chicago Professor and now head of India’s Central Bank Raghuram Rajan put it, “There are deep faultlines in the global economy, faultlines that have developed because in an integrated economy and in an integrated world, what is best for the individual actor or institution is not always best for the system.”<sup>44</sup>

In this environment, world leaders are looking for ways to insulate themselves from future volatility and crisis. Some of this is multilateral. Countries have agreed on tougher standards for bank capitalization (like Basel III, which regulates capital adequacy, stress testing, and market risk) despite the opposition of the financial industry. They created a Financial Stability Board with responsibility for regulation. Some of it is “minilateral,” or small groups of countries: France, Germany, and some other European nations have come out in support of a Tobin Tax (a tax on conversions from one currency to another, suggested by James Tobin in 1972) or other mechanisms to reduce capital flows, although the practical problems with this proposal are legion. And some of it is national: as Harvard University’s Michael Spence observed, emerging markets are undertaking a series of steps to hedge against future instability, including placing significant parts of their financial sectors under national control, building reserve currency holdings, and limiting the openness and exposure of their financial systems.<sup>45</sup>

**Hedging against globalization has not included limiting international trade.**

One highly significant feature of hedging against globalization is that it has not included limiting international trade. Actors have made no move toward the protectionism of trade tariffs and barriers.<sup>46</sup> As described earlier, trade today is so complex that it is almost impossible to manipulate without shooting one’s own economy in the foot. Moreover, trade is widely seen as part of the solution, not part of the problem—the years ahead may even

strengthen the positive case for trade. Hans Kundnani, of the European Council on Foreign Relations, has argued that the next wave of technological innovation, such as 3D printing, “could change the [way] manufacturing works and lead to a wave of reshoring,” which would remove one of the grievances of domestic interest groups opposed to trade.<sup>47</sup> In general, agreeing on new trade deals will prove difficult for the same reasons they always have, but we will not likely see a major rollback of existing agreements. Instead, the new protectionist sentiment is focused on ways of hedging against the real risks that emerge from other parts of the financial system, such as too-big-to-fail banks and dangerous forms of financial innovation.

Some countries, such as continental European nations and large parts of Asia, want to hedge against risk. The Anglosphere economies are more inclined to preserve existing financial institutions and structures and the growth rates they are perceived to provide, although even they have introduced some restrictions on markets (e.g. the

Dodd–Frank Act to clean up U.S. financial regulation). But few states on either side have viable ideas about how to reduce the volatility in the system while maintaining the benefits that it provides. Thus, hedging measures are very limited in scope and are unlikely to dramatically change the character of the global economy.

Future crises will continue to occur, but they will become more difficult to manage. As Duke University professor Michael Mastanduno explains, “the United States is no longer in a position to dictate the terms...[It] no longer enjoys the same type of security leverage it once possessed.”<sup>48</sup> This is not to say that the other major economies will seek to undermine the global economy; it is merely to observe that these economies will not be inclined to set aside their own legitimate national interests and take on a disproportionate share of the burden to stabilize the global economy in a future crisis, as Japan and Germany did in the Plaza Accord of 1985. If problems emerge in managing the global economy, countries are more likely to seek unilateral options to hedge against increased volatility and the risks of interdependence.

**Future crises will continue to occur and will become more difficult to manage.**

While unfettered interdependence poses problems in the global economy, it has manifested itself in a very unique way in the Eurozone. The Eurozone suffers from both too much and too little interdependence. It has too much in the sense that it should never have pursued monetary union without integration on fiscal and banking policy, but it did so anyway for ideological reasons. It has too little in the sense that, now with a single currency, it needs to make further progress on that integration. The Eurozone will not likely pursue fiscal and financial union, nor will it seek to unwind the existing arrangement, so it appears destined for a long period of stagnation.<sup>49</sup> Germany is, and will remain, the most important power in Europe, using its geoeconomic strength to impose its preferences and protect its interests.<sup>50</sup> The inevitable consequence will be a two-tier Europe, with growing political opposition in countries disadvantaged by European integration.

### **Managing Interdependence: Sifting the Bathwater from the Baby**

As the world has hurtled toward ever closer interdependence and integration, the risks of this process have become more apparent and states have begun to hedge against them. During the Great Depression, this hedging included trade protectionism that proved to be catastrophic, but today trade is too complex and embedded in each nation’s economic model to be targeted for protection. Politicians may engage in symbolic actions, but a significant rolling back of world trade is extremely unlikely and undesirable. Instead, politicians are focusing on other areas including those parts of the financial system which can produce shocks and where geopolitical competition may create destabilizing vulnerabilities. For the most part, this is a sensible response to real risk, but it is important that the attempt to manage interdependence is carefully targeted and does not throw the baby out with the bathwater. Thus, policymakers should keep the following recommendations in mind.

First, the United States and China must engage in a dialogue about whether they should work together to reduce the leverage that each has over the other through various forms of interdependence, or if they want to continue on the current trajectory of maximizing each other's vulnerability. The working assumption from the Cold War is that mutual vulnerability is stabilizing, but (as argued above) there is reason to believe that the opposite may be the case. Mutually reducing leverage would include gradually unwinding financial imbalances, safeguarding each nation's technological infrastructure as much as possible, and making each nation more energy secure. At the same time, China and the United States would deepen their relations in positive areas of interdependence such as trade and educational exchange. The key is to find a stable equilibrium that will not lead to an inadvertent spiral at a time of crisis.

Second, the United States should continue its rebalancing to Asia—including a deepening of alliances and partnerships, increased economic engagement, support for regional institutions, and norm building—to provide East Asian nations with a viable option as they seek to hedge against a rising China. U.S. rebalancing, combined with strengthening intra-Asian ties, will help mitigate the effect of Chinese-led asymmetric interdependence. Without robust U.S. engagement, Albert Hirschman's prediction—that a dominant economic power can use its market access to bring neighboring states into its geopolitical orbit—may come true.

Third, states need a way of better managing interdependence in the global economy, including regulating the financial sector. While much has been accomplished since 2008, including the adoption of Basel III standards on banking capital standards, much remains to be done. This is not just a matter of strengthening surveillance through the IMF, although that would help. There also needs to be greater international cooperation and coordination to repair the faultlines in the global

economy. Possible options include increasing the capacity of the G-20 or expanding the role of the World Trade Organization or the International Monetary Fund.

A nuanced approach to interdependence will not lead to globalization unraveling. In fact, the world will remain, and will continue to become, more globalized and integrated than at almost any time in history. Crucially, this approach will put interdependence and globalization on more stable footing which will serve the world well as it faces what could become a competitive and volatile couple of decades.

**A nuanced approach to interdependence will not lead to globalization unraveling.**

## Notes

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