Is power really shifting to China?

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That economic and financial power is shifting from west to east – and specifically to China – has become a mantra of our age, repeated so often and so insistently that it appears to be widely regarded as self-evident. Frequently, it is accompanied by the assertion China is set irreversibly on the path to global pre-eminence, if not domination. It is only a matter of time, it has even been suggested, before China rules the world.

Much less often is it asked exactly what China's power consists of, how it might be exercised and for what purposes. It seems simply to be assumed that such a large and populous country, with an economy that has grown so big so fast, must have both the will and the capacity to impose its writ on the rest of the world. Yet that assumption, and the premises that underlie it, are open to serious question.

Undeniably, three decades of double-digit growth have endowed China with impressive economic scale. It is the world's second biggest economy, creditor nation and importer, its largest exporter and, by some measures, its most important manufacturing centre. It has the biggest current account surplus and foreign exchange reserves – at more than $3,000bn, roughly one third of the global total. And it is the world's biggest consumer of such commodities as aluminium, iron ore and copper.

However, those achievements need to be set in perspective. A hundred years ago, well before it became a global superpower, the US had already been the world's biggest economy for a decade and accounted for a fifth of world

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GDP, considerably more than twice as much as Germany and Britain, the next largest economies, combined. On the most generous purchasing power parity (PPP) measure, China's GDP today is only two thirds that of the US – and less than half at nominal exchange rates - and its growth rate is set to slow in the coming years.

Furthermore US income per caput a century ago was the highest in the world, almost 10 percent more than that of Britain, its closest rival. China's per caput income today is barely one sixth of the US level on a PPP basis, and only one tenth at nominal exchange rates, and ranks about 90th in the world league table. Relative to other countries, China now is a vastly poorer country than the US was then.

In any case, economic size does not, of itself, confer international clout. Japan, at its economic apogee in the 1980s, had the world's second largest GDP, a huge current account surplus, bulging foreign exchange reserves, world-beating technology and a formidable manufacturing sector. Yet, despite widespread predictions that it was set to become a dominant global power, it never translated those strengths into matching political or diplomatic influence, let alone leadership. It is also worth recalling that two centuries ago, when China was the world's biggest economy, with a GDP bigger than the whole of western Europe, it remained largely closed off from the world.

It is true that the west's ability to influence China – insofar as it has ever existed – is in decline. But that is at least partly because the financial crisis of 2008 has sapped the west's economic vigour and political and moral authority. No longer is China prepared to be lectured on its behaviour by those who once treated it as a precocious pupil, when their own affairs are in disarray and when, in Europe's case, they have periodically implored China to bail them out.

China's success so far in riding out the crisis has inspired in it greater outward self-confidence, sometimes even hubris. Beijing has been emboldened to stand its ground more firmly in dealings with the rest of the world, in both bilateral and multilateral forums, from climate change talks to the G20, the International Monetary Fund and the World Trade Organization. If China was ever amenable to bullying or coercion, it is noticeably less so now. Indeed, today it is more often China that stands accused of doing the bullying, notably by stridently advancing contentious territorial claims in the South China Sea and by taking a hard, even belligerent, line against those neighbours who dare to dispute them.

How far China's increasingly assertive behaviour reflects a genuine increase in its own power – rather than just a diminution in the west's influence - is a question that will be examined later in this paper. What is clear, though, is that its recent conduct marks a sharp break with the past. For most of the last 30 years, China's foreign policy has been determined overwhelmingly by domestic economic need and by its rulers' conviction that their political legitimacy hinged on keeping growth and living standards steadily rising. They placed a premium on maintaining stable external relations, so as to keep export markets open and inward investment, vital supply lines and technology transfer all flowing, while China got on quietly with the business of getting richer. Throughout that time, Deng Xiaoping's famous dictum about keeping a low profile and never taking the lead in foreign affairs was scrupulously observed.

This measured approach to international relations was inspired by hardheaded calculation of self-interest. It did not fundamentally resolve any of China's long-standing frictions, grievances or disputes with the rest of the world, particularly with its Asian neighbours. But it prevented those tensions from escalating into violent confrontations, both because they would have distracted Beijing's attention from pressing domestic challenges and because China's rulers were concerned not to jeopardize the economic and industrial development that was their own overriding priority.

Then, about three years ago, something suddenly changed. Abruptly casting aside previous assurances that its rise would be peaceful and harmonious, China started to assert itself more forcefully abroad – indeed, to throw its weight around in a sometimes truculent and menacing fashion. Yet, strikingly, it has continued in parallel to seek closer economic integration and co-operation with Japan and other political adversaries, agreeing last autumn to launch negotiations with Tokyo and Seoul on both a trilateral free trade area and on the creation of a 16-nation Regional Comprehensive Economic Partnership.

The exact reasons for this perplexing shift, and whether it is permanent or temporary, are still much debated. But the consequence is a strangely bifurcated and contradictory foreign policy, one part inspired by coolly pragmatic rationalism and the other by raucously aggressive nationalism. Or, perhaps, it is really two different policies. Either way, it is hard to avoid the impression that China is suffering from a confusion of purpose and is far from decided about what its place in the world should be.

China's foreign policy exhibits incoherence in other, less dramatic, ways. One is evident in its growing investments in energy and natural resources around the world, the main channel of its inter-action with other developing countries, particularly in Africa and Latin America. That muscular expansion is sometimes portrayed as a strategy to achieve national energy and resource security and has sometimes been criticised elsewhere as a carefully planned, state-led neo-colonialist "land grab" aimed at locking up supplies of vital commodities.

The reality is rather different. The drive actually owes far less to any national master plan than to the empire-building ambitions of China's state-owned resources companies, which have been compelled by scarce supplies, price caps and other market distortions at home to look abroad for profitable expansion. In practice, much - in some cases most - of their offshore output is not shipped back to China, but is sold or swapped offshore. And since most of the commodities in question are fungible, China could meet its needs just as securely and probably more cheaply by buying all of them on international markets, rather than by extracting them itself. Even if all of them were shipped back to China, it would have absolutely no impact on the global supply-demand balance, because every barrel of oil pumped from Chinese-owned reserves makes another barrel of oil available on the open market. Unless, of course, China monopolized the entire world's supplies, which it is very far from doing.

These observations lead into a deeper discussion of the scale and nature of China's global power. Its military capacity is certainly growing, to the point where it is sufficient to intimidate smaller east Asian neighbours and at least partially to counter-balance US military superiority along its own shorelines. But it is likely to be many years before China can deploy that capacity and project hard power effectively far from home. Its armed forces' combat capability, last tested almost 35 years ago, also remains unproven. On that occasion, it will be recalled, they were resoundingly defeated by Vietnam, a country a fraction of China's size.

China clearly resents America's military presence on its doorstep and never tires of sniping at American "hegemony" and broadcasting its ambition to end it. Yet, paradoxically, Beijing is also uncomfortably aware that constraints on its own military capacity oblige it for the foreseeable future to continue to rely heavily on the US to maintain international security and to protect its own vital economic supply lines. To paraphrase Mao Zedong, the power that comes out of the barrels of China's guns is still quite limited.

In reality, China's ability to wield global influence rests mainly on three foundations. The first is the power to say no. That is not a trivial matter. China's economic weight makes its co-operation, or at least assent, increasingly important, if not indispensable, to the success of a growing range of international initiatives or endeavours – in spheres as diverse as climate change, multilateral trade negotiations, North Korea and the Middle East. All the more so at a time when economic and financial turmoil and a crisis of self-confidence have weakened the west's vigour and capacity to lead.

However, China is not alone in commanding increased negative power: in the World Trade Organisation, for example, other, sometimes much smaller, developing countries have wielded it repeatedly in an effort to gain advantage in the Doha round. That trend reflects deep geo-political changes in the world order, and particularly in the multilateral system, of which China's rise is only one, albeit important, element.

The second foundation of China's power is its well-funded chequebook, which undoubtedly buys influence, particularly in dealings with developing countries. But such largesse is not unique to China, nor is its political effectiveness certain. Japan, too, has pumped large amounts of aid and investment into developing countries, particularly in east Asia, for many years without achieving conspicuous success at winning friends or influencing people. Furthermore, as will be explained shortly, China's apparently massive financial resources do not in practice endow it with a bottomless goldmine out of which to bankroll the limitless pursuit of overseas political agendas.

China's third, and arguably most effective, source of economic power is the authority to grant or withhold access to its domestic market. Beijing has been increasingly ready to use that authority to get its way with foreign governments and businesses – and to punish those that obstruct it. Among other things, it has sought to make foreign companies' freedom to operate in China conditional on their handing over sensitive proprietary technologies;

tolerated, if not actively encouraged, consumer boycotts of Japanese products, severely reducing Japanese companies' exports to China and causing them to suspend production there; and adeptly exploited European governments' willingness to be bought off piecemeal with export orders so as to keep them from uniting behind a coherent China policy.

Such tactics, however, also face limitations. For a start, some of them impose costs on China's own economy, both directly and by creating uncertainty and unease among foreign investors. Furthermore, arbitrarily restricting foreign access to China's market is inconsistent with the demands of the consumption-driven economy that its rulers say they want, though have so far failed to deliver. Such practices also fly in the face of the liberalization envisaged by the various bilateral and regional trade negotiations in which China is engaged. Finally, the leverage they procure is only as strong as China's growth rate and international confidence in its economic potential: if China slowed down or stumbled – as a number of economists think it may in the next few years – that leverage could quickly lose its potency.

Meanwhile, other supposed sources of Chinese power are commonly overstated – and several are actually sources or symptoms of vulnerability. China's more than $3,000bn. of foreign exchange reserves is one. They are often held up as emblematic of the country's economic strength and of its emergence as a self-assured heavyweight global player.

Yet that is not a view apparently shared by many of China's rich, who seem to lack confidence in the future of its economy. Evidence, official as well as unofficial, suggests that wealthy individuals are smuggling ever larger sums abroad, while a survey of Chinese millionaires found in 2011 that more than half wanted to emigrate in search of a better life.

Contrary to received wisdom, China's foreign exchange reserves are only partly a reward for economic success; they can also be viewed as the product of distorted policies that have inhibited its economic performance. Their value has been swollen by large balance of payments surpluses that have built up since earlier this century. These stem partly from net export earnings and capital inflows. But their principal cause is structural: a persistent excess of domestic savings over investment. Put another way, the external surpluses have been acquired at the price of repressing Chinese living standards.

There are several reasons for China's exceptionally high savings ratio. They include lack of a comprehensive social security system, which induces households to make precautionary savings to pay for retirement and ill-health; failure to tax and require dividend payments by state-owned enterprises; and a high savings rate by the government itself. Though Beijing acknowledges the need to tackle these challenges, it is moving only gradually to do so.

The reserves are dead money as far as China's own development is concerned, contributing little or nothing to national prosperity. They cannot, in practice, be spent at home because converting them into renminbi would either trigger higher inflation or put strong upward pressure on the exchange rate – both outcomes that the government is anxious to avoid. They have, therefore, to be invested abroad.

However, contrary to scare stories peddled by some foreign commentators, China's chief concern is not with using its reserves to get its way with foreign governments. Its guiding priority, on all the evidence, is to maximise secure and stable prudential returns over the longer term. To date, indeed, it has proven a decidedly cautious – if not always canny – investor abroad, acutely wary of political entanglements.

For example, China has declined repeated requests to bail out the Eurozone. Far from perceiving an opportunity to gain influence in Europe, it has resisted being drawn into a complex and sensitive political imbroglio which it neither fully understands nor feels able to control. Yet, as a sizable holder of Euro-denominated assets and a big exporter to the Eurozone, Beijing also has a substantial stake in the survival of the single currency. It has therefore resigned itself to leaving the International Monetary Fund and Eurozone institutions to sort out the mess and to channeling any further assistance through them.

Similarly, if China were to seek to strong-arm Washington by dumping all its dollar securities, it would sow havoc on financial markets and seriously damage its own wealth by sending the value of its dollar holdings plummeting. That, in turn, would expose its rulers to ferocious criticism at home. The doctrine of Mutual Assured Destruction, developed by military strategists during the Cold War, continues to exert a powerful logic in the field of international finance.

China has been seeking to diversify its foreign investments by stepping up acquisitions of tangible assets abroad. That has aroused fears in parts of the US and Europe that China will launch a wave of takeovers of their corporate crown jewels. But such concerns look exaggerated. China still accounts for a tiny fraction of western economies' inward FDI. It also knows that acting too aggressively could provoke a protectionist backlash. Furthermore, most Chinese takeovers in the west reflect industrial weakness rather than strength: they are intended to make up for its companies' deficiencies in areas such as technology, design, marketing and distribution. And since Chinese buyers have a reputation for over-paying for foreign assets, the sellers may be getting the better deal financially.

In truth, though China may believe that the west is on the ropes economically, it still has no choice but to invest the bulk of its reserves there, because that is where the world's largest, most open and most liquid markets are. The only way it can decisively escape that dilemma and break free of dollar "hegemony" is by making the renminbi convertible.

In the past few years, it has been taking steps in that direction, by seeking progressively to "internationalize" the renminbi. They include expanding the use of the currency for international trade, launching a "Dim Sum" bond market and the authorization of renminbi deposit-taking in Hong Kong and of limited purchases of domestic Chinese bonds by Japanese investors.

On the face of it, the results to date are impressive. The value of trade settled in renminbi and of offshore deposits in Hong Kong has grown rapidly, albeit from a small or non-existent base. Some large western companies, such as Britain's Tesco supermarket group and Jaguar, the luxury car maker, are said to be using the renminbi increasingly in trade with the mainland.

On closer examination, however, not all is quite as it may appear. The renminbi is still used only for bilateral trade with China, not to settle third-party transactions, and then significantly more for imports than for exports. Some companies say privately that they use the currency, not by choice, but only because of strong pressure from their Chinese trade partners or the authorities to do so.

Circumstantial evidence suggests that at least some of the interest in using the renminbi is actually linked to exchange rate speculation, not to genuine commercial or financial transactions. Though the evidence is not conclusive, some market participants have discerned a close correlation between the level of offshore deposits and expectations of changes in the renminbi exchange rate. Authoritative sources also say that a "material" proportion of renminbi trading on the Hong Kong market is actually "round-tripping" by mainlanders intent on evading taxes by fabricating bogus import and export deals or by falsifying invoices.

Whatever the truth of the matter, "internationalization" can only go so far while strict capital controls keep the renminbi unconvertible and restrict the amounts of the currency freely available outside China. However, taking the giant step to convertibility and, ultimately, making the renminbi acceptable as a reserve currency that could challenge the popularity of the dollar and the euro would require Beijing to overcome some daunting hurdles and inhibitions.

Countries with widely-used reserve currencies need to be prepared to run current account deficits in order to ensure that they are available in sufficient quantities to meet international demand. That, however, would challenge Beijing's prevailing inclination to view the maintenance of surpluses as a necessary buffer to shield its domestic economy from the impact of externally-generated financial disruption and systemic shocks.

Even more important, convertibility would need to be preceded by a fundamental and far-reaching overhaul of China's immature domestic financial system, to remove administered interest rates, enlarge its bond market and strengthen its financial institutions. Otherwise, lifting exchange controls could unleash massive capital flows that would severely destabilize the system and possibly even swamp it entirely.

Some observers have suggested that modernization of the financial system is the real underlying agenda of the reformers pushing renminbi internationalization. Taking their cue from the *gaiatsu* tactics practised by progressive Japanese policy makers, they may hope to induce change at home by steadily ratcheting up pressure from outside.

However, re-engineering China's financial system would be not only technically challenging. Far more important, it faces huge opposition from the many powerful vested interests that profit handsomely from the status quo. They include the large state-owned banks and companies that dominate much of China’s economy and their patrons, champions and protectors in the ruling Communist party.

That, no doubt, one of the main reasons why Wen Jiabao, China’s outgoing prime minister, though talking the language of economic and financial reform, had very limited success in implementing it. Li Keqiang, his successor, has spoken in similar terms. It is still unclear whether Mr Li and the rest of China’s new top leadership will be any bolder in turning words into actions.

So, against this background, what are the prospects of China becoming a future global leader? And what might that mean? Obviously, it cannot mean the kind of overarching and unchallenged leadership that the US provided in the aftermath of World War Two. The world has changed too much since then for any other country to re-create that role. It means, rather, launching constructive and imaginative initiatives intended to generate global public goods, from which others can benefit, and mobilising international support for them.

Effective leadership of any kind has several components. The first is a clear idea of where you want to lead. Here, China’s ambitions, if they exist, remain obscure. It clearly harbours suspicions of existing international institutions and architecture, which it regards as shaped too much to suit western interests. Yet it has not set out directly to challenge or undermine them, generally playing by the rules of organisations such as the UN, IMF, the World Bank and the WTO; nor, conspicuously, has it articulated any clear or compelling vision of an alternative world order – other than one that grants it respect and enable it to fulfil its national needs.

The rest of the world may know, or may think it knows, what it wants from China. However China itself appears still far from certain what it wants from the world - and a great deal surer of what it does not want. That does not make it an easy partner for others to work with.

Second, effective international leaders need willing followers. Much as they may criticise its policies, allies of the US view themselves as being basically on the same side and bound by dense economic, political, military, cultural and historical ties. But China can count on few close and stable international alliances.

Third, effective leadership requires trust. But China suffers from a double trust deficit. It is deeply suspicious of many other countries, starting with the US; and they in turn mistrust China, due to the opacity of its government system, widespread uncertainty about its true intentions and the sense of national victimhood that regularly, though unpredictably, erupts into displays strident nationalism. These have all hindered China's repeated efforts to develop "soft power", a resource that also depends vitally on the ability to project to the world national values, ideals and quality of life that others can identify with and aspire to emulate.

China has spent billions of dollars on cultural diplomacy and initiatives such as Confucius Institutes, designed to improve its "soft power" image around the world. Whatever that spending has achieved has been undermined by the country's recent aggressive assertiveness in its own region. Browbeating and bullying your neighbours may make them fear you; but it does not win their affection or respect. Xi Jinping, China's new president, may talk about the "Chinese Dream". But how many non-Chinese yearn to share it?

The final component of international leadership is a willingness to shoulder significant costs – political, financial and economic – and to look beyond narrow short-term national advantage, in the belief that doing so will be outweighed by longer-term rewards. But China, preoccupied with meeting pressing domestic challenges, shows little inclination to accept such a role. Its world view remains heavily inward-directed and its foreign policy shaped overwhelmingly by domestic priorities and interests.

Furthermore, outward braggadocio and bullyboy tactics suggest a lurking sense of insecurity, rather than robust self-confidence in Beijing. China's rulers have long relied on strident nationalism as one of the main foundations of their claim to popular legitimacy, and the shrill xenophobia currently displayed towards Japan and other countries in east Asia appears to hint at a leadership that feels itself on the defensive, rather than firmly in control of events.

That is not a particularly promising platform from which to seek to engage with the world. But perhaps it would be more appropriate to twist the lens and ask, not whether China will or should become more active and involved in international co-operation – but whether the pursuit of its core national interests will make it increasingly hard for it to avoid doing so.

One reason it may be pulled in that direction is that its steadily growing integration with the global economy and, in particular, its widening spread of foreign assets, especially energy and raw materials, will provide strong incentives. Though these may supply directly little of China's own consumption, they represent an increasing share of its capital stock and employ, directly and indirectly, large numbers of its citizens abroad, many of them located in politically unstable parts of the world. Such growing foreign exposure inevitably plays into events at home.

The popular uprising in Libya is a case in point. It caught China, arguably even more than the west, unprepared. Its hasty subsequent evacuation of 30,000 Chinese nationals there and the threat to $20bn worth of contracts was strongly criticised at home, particularly by nationalistic elements who have argued that cutting and running is no way for an emerging superpower to behave.

We do not know what lessons China has drawn from this episode. However, we do know the pattern of history based on both US and British precedent. As both nations discovered, companies' pursuit of mineral resources in far-flung locations tends inexorably to create pressures that, like it or not, draw their national governments into foreign political, diplomatic – and, indeed, military – entanglements.

Will China be able to resist the logic of those pressures? And if it cannot, does it possess the diplomatic skills, experience and political intelligence needed to cope with the consequences? Or will self-interest lead it to seek closer co-operation and partnerships with others? And how could such deeper involvement be reconciled with Beijing's proclaimed policy of "non-intervention" in other countries' internal affairs?

At present, the answers to those questions can only be guessed at. But at a time when so much attention is focused on China's impact on the rest of the world, it needs to be kept in mind that the reverse is also true, and that the world is having a much bigger impact on China than ever before in history. That may not be a decisive factor in shaping China's evolving foreign policy. But, for better or worse, it seems certain to play a role.