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The Chinese are subsidizing the American way of life. Are we playing them for suckers—or are they playing us?

BY JAMES FALLOWS

The $1.4 Trillion Question

Guy Billout

Stephen Schwarzman may think he has image problems in America. He is the co-founder and CEO of the Blackstone Group, and he threw himself a $3 million party for his 60th birthday last spring, shortly before making many hundreds of millions of dollars in his company's IPO and finding clever ways to avoid paying taxes. That's nothing compared with the way he looks in China. Here, he and his company are surprisingly well known, thanks to blogs, newspapers, and talk-show references. In America, Schwarzman's perceived offense is greed—a sin we readily forgive and forget. In China, the suspicion is that he has somehow hoodwinked ordinary Chinese people out of their hard-earned cash.

FROM THE ARCHIVES:

"CASHING OUT"
(September 2007)
Is private equity just another bubble, or a sign of sickness in America's public stock markets? By Clive Crook

INTERVIEWS: "PRIVATE EQUITY DECONSTRUCTED"
(August 14, 2007)
Atlantic senior editor Clive Crook weighs in on the private-equity business—why it's booming, where it's headed, and what it means for American capitalism.

Last June, China's Blackstone investment was hailed in the American press as a sign of canny sophistication. It seemed just the kind of thing the U.S. government had in mind when it hammered China to use its new wealth as a "responsible stakeholder" among nations. By putting $3 billion of China's national savings into the initial public offering of America's best-known private-equity firm, the Chinese government allied itself with a big-time Western firm without raising political fears by trying to buy operating control (it bought only 8 percent of Blackstone's shares, and nonvoting shares at that). The contrast with the Japanese and Saudis, who in their nouveau-riche phase roused irritation and envy with their showy purchases of Western brand names and landmark properties, was plain.

Six months later, it didn't look so canny, at least not financially. China's Blackstone holdings lost, on paper, about $1 billion, during a time when the composite index of the Shanghai Stock Exchange was soaring. At two different universities where I've spoken recently, students have pointed out that Schwarzman was a major Republican donor. A student at Fudan University knew a detail I didn't: that in 2007 President Bush attended a Republican National Committee fund-raiser at Schwarzman's apartment in Manhattan (think what he would have made of the fact that Schwarzman, who was one year behind Bush at Yale, had been a fellow member of Skull and Bones). Wasn't the whole scheme a way to take money from the Chinese people and give it to the president's crony?

The Blackstone case is titillating in its personal detail, but it is also an unusually clear and personalized symptom of a deeper, less publicized, and potentially much more destructive tension in U.S.–China relations. It's not just Stephen Schwarzman's company that the *laobaixing*, the ordinary Chinese masses, have been subsidizing. It's everyone in the United States.

Through the quarter-century in which China has been opening to world trade, Chinese leaders have deliberately held down living standards for their own people and propped them up in the United States. This is the real meaning of the vast trade surplus—$1.4 trillion and counting, going up by about $1 billion per day—that the Chinese government has mostly parked in U.S. Treasury notes. In effect, every person in the (rich) United States has over the past 10 years or so borrowed about $4,000 from someone in the (poor) People's Republic of China. Like so many imbalances in economics, this one can't go on indefinitely, and therefore won't. But the way it ends—suddenly versus gradually, for predictable reasons versus during a panic—will make an enormous difference to the U.S. and Chinese economies over the next few years, to say nothing of bystanders in Europe and elsewhere.

Any economist will say that Americans have been living better than they should—which is by definition the case when a nation's total consumption is greater than its total production, as America's now is. Economists will also point out that, despite the glitter of China's big cities and the rise of its billionaire class, China's people have been living far worse than they could. That's what it means when a nation consumes only half of what it produces, as China does.

Neither government likes to draw attention to this arrangement, because it has been so convenient on both sides. For China, it has helped the regime guide development in the way it would like—and keep the domestic economy's growth rate from crossing the thin line that separates "unbelievably fast" from "uncontrollably inflationary." For America, it has meant cheaper iPods, lower interest rates, reduced mortgage payments, a lighter tax burden. But because of political tensions in both countries, and because of the huge and growing size of the imbalance, the arrangement now shows signs of cracking apart.

In an article two and a half years ago ("Countdown to a Meltdown," July/August 2005), I described an imagined future in which a real-estate crash and shakiness in the U.S. credit markets led to panic by Chinese and other foreign investors, with unpleasant effects for years to come. The real world has recently had inklings of similar concerns. In the past six months, relative nobodies in China's establishment were able to cause brief panics in the foreign-exchange markets merely by hinting that China might stop supplying so much money to the United States. In August, an economic researcher named He Fan, who works at the Chinese Academy of Social Sciences and did part of his doctoral research at Harvard, suggested in an op-ed piece in *China Daily* that if the U.S. dollar kept collapsing in value, China might move some of its holdings into stronger currencies. This was presented not as a threat but as a statement of the obvious, like saying that during a market panic, lots of people sell. The column quickly provoked alarmist stories in Europe and America suggesting that China was considering the "nuclear option"—unloading its dollars.

A few months later, a veteran Communist Party politician named Cheng Siwei suggested essentially the same thing He Fan had. Cheng, in his mid-70s, was trained as a chemical engineer and has no official role in setting Chinese economic policy. But within hours of his speech, a flurry of trading forced the dollar to what was then its lowest level against the euro and other currencies. The headline in the *South China Morning Post* the next day was: "Officials' Words Shrivel U.S. Dollar." Expressing amazement at the markets' response, Carl Weinberg, chief economist at the High Frequency Economics advisory group, said, "This would be kind of like Congressman Charlie Rangel giving a speech telling the Fed to hike or cut interest rates." (Cheng, like Rangel, is known for colorful comments—but he is less powerful, since Rangel after all chairs the House Ways and Means Committee.) In the following weeks, phrases like "run on the dollar" and "collapse of confidence" showed up more and more frequently in financial newsletters. The nervousness only increased when someone who does have influence, Chinese Premier Wen Jiabao, said last November, "We are worried about how to preserve the value" of China's dollar holdings.

When the dollar is strong, the following (good) things happen: the price of food, fuel, imports, manufactured goods, and just about everything else (vacations in Europe!) goes down. The value of the stock market, real estate, and just about all other American assets goes up. Interest rates go down—for mortgage loans, credit-card debt, and commercial borrowing. Tax rates can be lower, since foreign lenders hold down the cost of financing the national debt. The only problem is that American-made goods become more expensive for foreigners, so the country's exports are hurt.

When the dollar is weak, the following (bad) things happen: the price of food, fuel, imports, and so on (no more vacations in Europe) goes up. The value of the stock market, real estate, and just about all other American assets goes down. Interest rates are higher. Tax rates can be higher, to cover the increased cost of financing the national debt. The only benefit is that American-made goods become cheaper for foreigners, which helps create new jobs and can raise the value of export-oriented American firms (winemakers in California, producers of medical devices in New England).

The dollar's value has been high for many years—unnaturally high, in large part because of the implicit bargain with the Chinese. Living standards in China, while rising rapidly, have by the same logic been unnaturally low. To understand why this situation probably can't go on, and what might replace it—via a dollar crash or some other event—let's consider how this curious balance of power arose and how it works.

Why a poor country has so much money

By 1996, China amassed its first $100 billion in foreign assets, mainly held in U.S. dollars. (China considers these holdings a state secret, so all numbers come from analyses by outside experts.) By 2001, that sum doubled to about $200 billion, according to Edwin Truman of the Peterson Institute for International Economics in Washington. Since then, it has increased more than sixfold, by well over a trillion dollars, and China's foreign reserves are now the largest in the world. (In second place is Japan, whose economy is, at official exchange rates, nearly twice as large as China's but which has only two-thirds the foreign assets; the next-largest after that are the United Arab Emirates and Russia.) China's U.S. dollar assets probably account for about 70 percent of its foreign holdings, according to the latest analyses by Brad Setser, a former Treasury Department economist now with the Council on Foreign Relations; the rest are mainly in euros, plus some yen. Most of China's U.S. investments are in conservative, low-yield instruments like Treasury notes and federal-agency bonds, rather than showier Blackstone-style bets. Because notes and bonds backed by the U.S. government are considered the safest investments in the world, they pay lower interest than corporate bonds, and for the past two years their annual interest payments of 4 to 5 percent have barely matched the 5-to-6-percent decline in the U.S. dollar's value versus the RMB.

Americans sometimes debate (though not often) whether in principle it is good to rely so heavily on money controlled by a foreign government. The debate has never been more relevant, because America has never before been so deeply in debt to one country. Meanwhile, the Chinese are having a debate of their own—about whether the deal makes sense for them. Certainly China's officials are aware that their stock purchases prop up 401(k) values, their money-market holdings keep down American interest rates, and their bond purchases do the same thing—plus allow our government to spend money without raising taxes.

"From a distance, this, to say the least, is strange," Lawrence Summers, the former treasury secretary and president of Harvard, told me last year in Shanghai. He was referring to the oddity that a country with so many of its own needs still unmet would let "this $1 trillion go to a mature, old, rich place from a young, dynamic place."

It's more than strange. Some Chinese people are rich, but China as a whole is unbelievably short on many of the things that qualify countries as fully developed. Shanghai has about the same climate as Washington, D.C.—and its public schools have no heating. (Go to a classroom when it's cold, and you'll see 40 children, all in their winter jackets, their breath forming clouds in the air.) Beijing is more like Boston. On winter nights, thousands of people mass along the curbsides of major thoroughfares, enduring long waits and fighting their way onto hopelessly overcrowded public buses that then spend hours stuck on jammed roads. And these are the showcase cities! In rural Gansu province, I have seen schools where 18 junior-high-school girls share a single dormitory room, sleeping shoulder to shoulder, sardine-style.

Better schools, more-abundant parks, better health care, cleaner air and water, better sewers in the cities—you name it, and if it isn't in some way connected to the factory-export economy, China hasn't got it, or not enough. This is true at the personal level, too. The average cash income for workers in a big factory is about $160 per month. On the farm, it's a small fraction of that. Most people in China feel they are moving up, but from a very low starting point.

So why is China shipping its money to America? An economist would describe the oddity by saying that China has by far the highest national savings in the world. This sounds admirable, but when taken to an extreme—as in China—it indicates an economy out of sync with the rest of the world, and one that is deliberately keeping its own people's living standards lower than they could be. For comparison, India's savings rate is about 25 percent, which in effect means that India's people consume 75 percent of what they collectively produce.

(Reminder from Ec 101: The savings rate is the net share of national output either exported or saved and invested for consumption in the future. Effectively, it's what your own people produce but don't use.) For Korea and Japan, the savings rate is typically from the high 20s to the mid-30s. Recently, America's has at times been below zero, which means that it consumes, via imports, more than it makes.

China's savings rate is a staggering 50 percent, which is probably unprecedented in any country in peacetime. This doesn't mean that the average family is saving half of its earnings—though the personal savings rate in China is also very high. Much of China's national income is "saved" almost invisibly and kept in the form of foreign assets. Until now, most Chinese have willingly put up with this, because the economy has been growing so fast that even a suppressed level of consumption makes most people richer year by year.

But saying that China has a high savings rate describes the situation without explaining it. Why should the Communist Party of China countenance a policy that takes so much wealth from the world's poor, in their own country, and gives it to the United States? To add to the mystery, why should China be content to put so many of its holdings into dollars, knowing that the dollar is virtually guaranteed to keep losing value against the RMB? And how long can its people tolerate being denied so much of their earnings, when they and their country need so much? The Chinese government did not explicitly set out to tighten the belt on its population while offering cheap money to American homeowners. But the fact that it does results directly from explicit choices it *has* made—two in particular. Both arise from crucial controls the government maintains over an economy that in many other ways has become wide open. The situation may be easiest to explain by following a U.S. dollar on its journey from a customer's hand in America to a factory in China and back again to the T-note auction in the United States.

The voyage of a dollar

Let's say you buy an Oral-B electric toothbrush for $30 at a CVS in the United States. I choose this example because I've seen a factory in China that probably made the toothbrush. Most of that $30 stays in America, with CVS, the distributors, and Oral-B itself. Eventually $3 or so—an average percentage for small consumer goods—makes its way back to southern China.

When the factory originally placed its bid for Oral-B's business, it stated the price in dollars: X million toothbrushes for Y dollars each. But the Chinese manufacturer can't use the dollars directly. It needs RMB—to pay the workers their 1,200-RMB ($160) monthly salary, to buy supplies from other factories in China, to pay its taxes. So it takes the dollars to the local commercial bank—let's say the Shenzhen Development Bank. After showing receipts or waybills to prove that it earned the dollars in genuine trade, not as speculative inflow, the factory trades them for RMB.

This is where the first controls kick in. In other major countries, the counterparts to the Shenzhen Development Bank can decide for themselves what to do with the dollars they take in. Trade them for euros or yen on the foreign-exchange market? Invest them directly in America? Issue dollar loans? Whatever they think will bring the highest return. But under China's "surrender requirements," Chinese banks can't do those things. They must treat the dollars, in effect, as contraband, and turn most or all of them (instructions vary from time to time) over to China's equivalent of the Federal Reserve Bank, the People's Bank of China, for RMB at whatever is the official rate of exchange.

With thousands of transactions per day, the dollars pile up like crazy at the PBOC. More precisely, by more than a billion dollars per day. They pile up even faster than the trade surplus with America would indicate, because customers in many other countries settle their accounts in dollars, too.

The PBOC must do something with that money, and current Chinese doctrine allows it only one option: to give the dollars to another arm of the central government, the State Administration for Foreign Exchange. It is then SAFE's job to figure out where to park the dollars for the best return: so much in U.S. stocks, so much shifted to euros, and the great majority left in the boring safety of U.S. Treasury notes.

And thus our dollar comes back home. Spent at CVS, passed to Oral-B, paid to the factory in southern China, traded for RMB at the Shenzhen bank, "surrendered" to the PBOC, passed to SAFE for investment, and then bid at auction for Treasury notes, it is ready to be reinjected into the U.S. money supply and spent again—ideally on Chinese-made goods.

At no point did an ordinary Chinese person decide to send so much money to America. In fact, at no point was most of this money at his or her disposal at all. These are in effect enforced savings, which are the result of the two huge and fundamental choices made by the central government.

One is to dictate the RMB's value relative to other currencies, rather than allow it to be set by forces of supply and demand, as are the values of the dollar, euro, pound, etc. The obvious reason for doing this is to keep Chinese-made products cheap, so Chinese factories will stay busy. This is what Americans have in mind when they complain that the Chinese government is rigging the world currency markets. And there are numerous less obvious reasons. The very act of managing a currency's value may be a more important distorting factor than the exact rate at which it is set. As for the rate—the subject of much U.S. lecturing—given the huge difference in living standards between China and the United States, even a big rise in the RMB's value would leave China with a price advantage over manufacturers elsewhere. (If the RMB doubled against the dollar, a factory worker might go from earning $160 per month to $320—not enough to send many jobs back to America, though enough to hurt China's export economy.) Once a government decides to thwart the market-driven exchange rate of its currency, it must control countless other aspects of its financial system, through instruments like surrender requirements and the equally ominous-sounding "sterilization bonds" (a way of keeping foreign-currency swaps from creating inflation, as they otherwise could).

These and similar tools are the way China's government imposes an unbelievably high savings rate on its people. The result, while very complicated, is to keep the buying power earned through China's exports out of the hands of Chinese consumers as a whole. Individual Chinese people have certainly gotten their hands on a lot of buying power, notably the billionaire entrepreneurs who have attracted the world's attention (see "Mr. Zhang Builds His Dream Town," March 2007). But when it comes to amassing international reserves, what matters is that China as a whole spends so little of what it earns, even as some Chinese people spend a lot.

The other major decision is not to use more money to address China's needs directly—by building schools and agricultural research labs, cleaning up toxic waste, what have you. Both decisions stem from the central government's vision of what is necessary to keep China on its unprecedented path of growth. The government doesn't want to let the market set the value of the RMB, because it thinks that would disrupt the constant growth and the course it has carefully and expensively set for the factory-export economy. In the short run, it worries that the RMB's value against the dollar and the euro would soar, pricing some factories in "expensive" places such as Shanghai out of business. In the long run, it views an unstable currency as a nuisance in itself, since currency fluctuation makes everything about business with the outside world more complicated. Companies have a harder time predicting overseas revenues, negotiating contracts, luring foreign investors, or predicting the costs of fuel, component parts, and other imported goods.

And the government doesn't want to increase domestic spending dramatically, because it fears that improving average living conditions could paradoxically intensify the rich-poor tensions that are China's major social problem. The country is already covered with bulldozers, wrecking balls, and construction cranes, all to keep the manufacturing machine steaming ahead. Trying to build anything more at the moment—sewage-treatment plants, for a start, which would mean a better life for its own people, or smokestack scrubbers and related "clean" technology, which would start to address the world pollution for which China is increasingly held responsible—would likely just drive prices up, intensifying inflation and thus reducing the already minimal purchasing power of most workers. Food prices have been rising so fast that they have led to riots. In November, a large Carrefour grocery in Chongqing offered a limited-time sale of vegetable oil, at 20 percent (11 RMB, or $1.48) off the normal price per bottle. Three people were killed and 31 injured in a stampede toward the shelves.

This is the bargain China has made—rather, the one its leaders have imposed on its people. They'll keep creating new factory jobs, and thus reduce China's own social tensions and create opportunities for its rural poor. The Chinese will live better year by year, though not as well as they could. And they'll be protected from the risk of potentially catastrophic hyperinflation, which might undo what the nation's decades of growth have built. In exchange, the government will hold much of the nation's wealth in paper assets in the United States, thereby preventing a run on the dollar, shoring up relations between China and America, and sluicing enough cash back into Americans' hands to let the spending go on.

What the Chinese hope will happen

The Chinese public is beginning to be aware that its government is sitting on a lot of money—money not being spent to help China directly, money not doing so well in Blackstone-style foreign investments, money invested in the ever-falling U.S. dollar. Chinese bloggers and press commentators have begun making a connection between the billions of dollars the country is sending away and the domestic needs the country has not addressed. There is more and more pressure to show that the return on foreign investments is worth China's sacrifice—and more and more potential backlash against bets that don't pay off. (While the Chinese government need not stand for popular election, it generally tries to reduce sources of popular discontent when it can.) The public is beginning to behave like the demanding client of an investment adviser: it wants better returns, with fewer risks.

This is the challenge facing Lou Jiwei and Gao Xiqing, who will play a larger role in the U.S. economy than Americans are accustomed to from foreigners. Lou, a longtime Communist Party official in his late 50s, is the chairman of the new China Investment Corporation, which is supposed to find creative ways to increase returns on at least $200 billion of China's foreign assets. He is influential within the party but has little international experience. Thus the financial world's attention has turned to Gao Xiqing, who is the CIC's general manager.

Twenty years ago, after graduating from Duke Law School, Gao was the first Chinese citizen to pass the New York State Bar Exam. He returned to China in 1988, after several years as an associate at the New York law firm Mudge, Rose (Richard Nixon's old firm) to teach securities law and help develop China's newly established stock markets. By local standards, he is hip. At an economics conference in Beijing in December, other Chinese speakers wore boxy dark suits. Gao, looking fit in his mid-50s, wore a tweed jacket and black turtleneck, an Ironman-style multifunction sports watch on his wrist.

Under Lou and Gao, the CIC started with a bang with Blackstone—the wrong kind of bang. Now, many people suggest, it may be chastened enough to take a more careful approach. Indeed, that was the message it sent late last year, with news that its next round of investments would be in China's own banks, to shore up some with credit problems. And it looks to be studying aggressive but careful ways to manage huge sums. About the time the CIC was making the Blackstone deal, its leadership and staff undertook a crash course in modern financial markets. They hired the international consulting firm McKinsey to prepare confidential reports about the way they should organize themselves and the investment principles they should apply. They hired Booz Allen Hamilton to prepare similar reports, so they could compare the two. Yet another consulting firm, Towers Perrin, provided advice, especially about staffing and pay. The CIC leaders commissioned studies of other large state-run investment funds—in Norway, Singapore, the Gulf States, Alaska—to see which approaches worked and which didn't. They were fascinated by the way America's richest universities managed their endowments, and ordered multiple copies of *Pioneering Portfolio Management*, by David Swensen, who as Yale's chief investment officer has guided its endowment to sustained and rapid growth. Last summer, teams from the CIC made long study visits to Yale and Duke universities, among others.

Gao Xiqing and other CIC officials have avoided discussing their plans publicly. "If you tell people ahead of time what you're going to do—well, you just can't operate that way in a market system," he said at his Beijing appearance. "What I can say is, we'll play by the international rules, and we'll be responsible investors." Gao emphasized several times how much the CIC had to learn: "We're the new kids on the block. Because of media attention, there is huge pressure on us—we're already under water now." The words "under water" were in natural-sounding English, and clearly referred to Blackstone.

Others familiar with the CIC say that its officials are coming to appreciate the unusual problems they will face. For instance: any investment group needs to be responsible to outside supervisors, and the trick for the CIC will be to make itself accountable to Communist Party leadership without becoming a mere conduit for favored investment choices by party bosses. How can it attract the best talent? Does it want to staff up quickly, to match its quickly mounting assets, by bidding for financial managers on the world market—where many of the candidates are high-priced, not fluent in Chinese, and reluctant to move to Beijing? Or can it afford to take the time to home-grow its own staff?

While the CIC is figuring out its own future, outsiders are trying to figure out the CIC—and also SAFE, which will continue handling many of China's assets. As far as anyone can tell, the starting point for both is risk avoidance. No more Blackstones. No more CNOOC-Unocals. (In 2005, the Chinese state oil firm CNOOC attempted to buy U.S.–based Unocal. It withdrew the offer in the face of intense political opposition to the deal in America.) One person involved with the CIC said that its officials had seen recent Lou Dobbs broadcasts criticizing "Communist China" and were "shellshocked" about the political resentment their investments might encounter in the United States. For all these reasons the Chinese leadership, as another person put it, "has a strong preference to follow someone else's lead, not in an imitative way" but as an unobtrusive minority partner wherever possible. It will follow the lead of others for now, that is, while the CIC takes its first steps as a gigantic international financial investor.

The latest analyses by Brad Setser suggest that despite all the talk about abandoning the dollar, China is still putting about as large a share of its money into dollars as ever, somewhere between 65 and 70 percent of its foreign earnings. "Politically, the last thing they want is to signal a loss of faith in the dollar," Andy Rothman, of the financial firm CLSA, told me; that would lead to a surge in the RMB, which would hurt Chinese exporters, not to mention the damage it would cause to China's vast existing dollar assets.

The problem is that these and other foreign observers must guess at China's aims, rather than knowing for sure. As Rothman put it, "The opaqueness about intentions and goals is always the issue." The mini-panics last year took hold precisely because no one could be sure that SAFE was not about to change course.

The uncertainty arises in part from the limited track record of China's new financial leadership. As one American financier pointed out to me: "The man in charge of the whole thing"—Lou Jiwei—"has never bought a share of stock, never bought a car, never bought a house." Another foreign financier said, after meeting some CIC staffers, "By Chinese terms, these are very sophisticated people." But, he went on to say, in a professional sense none of them had lived through the financial crises of the last generation: the U.S. market crash of 1987, the "Asian flu" of the late 1990s, the collapse of the Internet bubble soon afterward. The Chinese economy was affected by all these upheavals, but the likes of Gao Xiqing were not fully exposed to their lessons, sheltered as they were within Chinese institutions.

Foreign observers also suggest that, even after exposure to the Lou Dobbs clips, the Chinese financial leadership may not yet fully grasp how suspicious other countries are likely to be of China's financial intentions, for reasons both fair and unfair. The unfair reason is all-purpose nervousness about any new rising power. "They need to understand, and they don't, that everything they do will be seen as political," a financier with extensive experience in both China and America told me. "Whatever they buy, whatever they say, whatever they do will be seen as China Inc."

The fair reason for concern is, again, the transparency problem. Twice in the past year, China has in nonfinancial ways demonstrated the ripples that a nontransparent policy creates. Last January, its military intentionally shot down one of its own satellites, filling orbital paths with debris. The exercise greatly alarmed the U.S. military, because of what seemed to be an implied threat to America's crucial space sensors. For several days, the Chinese government said nothing at all about the test, and nearly a year later, foreign analysts still debate whether it was a deliberate provocation, the result of a misunderstanding, or a freelance effort by the military. In November, China denied a U.S. Navy aircraft carrier, the *Kitty Hawk*, routine permission to dock in Hong Kong for Thanksgiving, even though many Navy families had gone there for a reunion. In each case, the most ominous aspect is that outsiders could not really be sure what the Chinese leadership had in mind. Were these deliberate taunts or shows of strength? The results of factional feuding within the leadership? Simple miscalculations? In the absence of clear official explanations no one really knew, and many assumed the worst.

So it could be with finance, unless China becomes as transparent as it is rich. Chinese officials say they will move in that direction, but they're in no hurry. Last fall, Edwin Truman prepared a good-governance scorecard for dozens of "sovereign wealth" funds—government-run investment funds like SAFE and the CIC. He compared funds from Singapore, Korea, Norway, and elsewhere, ranking them on governing structure, openness, and similar qualities. China's funds ended up in the lower third of his list—better-run than Iran's, Sudan's, or Algeria's, but worse than Mexico's, Russia's, or Kuwait's. China received no points in the "governance" category and half a point out of a possible 12 for "transparency and accountability."

Foreigners (ordinary Chinese too, for that matter) can't be sure about the mixture of political and strictly economic motives behind future investment decisions the Chinese might make. When China's president, Hu Jintao, visited Seattle two years ago, he announced a large purchase of Boeing aircraft. When France's new president, Nicolas Sarkozy, visited China late last year, Hu announced an even larger purchase of Airbuses. Every Chinese order for an airplane is a political as well as commercial decision. Brad Setser says that the Chinese government probably believed that it would get "credit" for the Blackstone purchase in whatever negotiations came up next with the United States, in the same way it would get credit for choosing Boeing. This is another twist to the Kremlinology of trying to discern China's investment strategy.

Where the money goes, other kinds of power follow. Just ask Mikhail Gorbachev, as he reflects on the role bankruptcy played in bringing down the Soviet empire. While Japan's great wealth has not yet made it a major diplomatic actor, and China has so far shied from, rather than seized, opportunities to influence events outside its immediate realm, time and money could change that. China's military is too weak to challenge the U.S. directly even in the Taiwan Straits, let alone anyplace else. That, too, could change.

A Balance of Terror

Let's take these fears about a rich, strong China to their logical extreme. The U.S. and Chinese governments are always disagreeing—about trade, foreign policy, the environment. Someday the disagreement could be severe. Taiwan, Tibet, North Korea, Iran—the possibilities are many, though Taiwan always heads the list. Perhaps a crackdown within China. Perhaps another accident, like the U.S. bombing of China's embassy in Belgrade nine years ago, which everyone in China still believes was intentional and which no prudent American ever mentions here.

Whatever the provocation, China would consider its levers and weapons and find one stronger than all the rest—one no other country in the world can wield. Without China's billion dollars a day, the United States could not keep its economy stable or spare the dollar from collapse.

Would the Chinese use that weapon? The reasonable answer is no, because they would wound themselves grievously, too. Their years of national savings are held in the same dollars that would be ruined; in a panic, they'd get only a small share out before the value fell. Besides, their factories depend on customers with dollars to spend.

But that "reassuring" answer is actually frightening. Lawrence Summers calls today's arrangement "the balance of financial terror," and says that it is flawed in the same way that the "mutually assured destruction" of the Cold War era was. That doctrine held that neither the United States nor the Soviet Union would dare use its nuclear weapons against the other, since it would be destroyed in return. With allowances for hyperbole, something similar applies to the dollar standoff. China can't afford to stop feeding dollars to Americans, because China's own dollar holdings would be devastated if it did. As long as that logic holds, the system works. As soon as it doesn't, we have a big problem.

What might poke a giant hole in that logic? Not necessarily a titanic struggle over the future of Taiwan. A simple mistake, for one thing. Another speech by Cheng Siwei—perhaps in response to a provocation by Lou Dobbs. A rumor that the oil economies are moving out of dollars for good, setting their prices in euros. Leaked suggestions that the Chinese government is hoping to buy Intel, leading to angry denunciations on the Capitol floor, leading to news that the Chinese will sit out the next Treasury auction. As many world tragedies have been caused by miscalculation as by malice.

Or pent-up political tensions, on all sides. China's lopsided growth—ahead in exports, behind in schooling, the environment, and everything else—makes the country socially less stable as it grows richer. Meanwhile, its expansion disrupts industries and provokes tensions in the rest of the world. The billions of dollars China pumps into the United States each week strangely seem to make it harder rather than easier for Americans to face their own structural problems. One day, something snaps. Suppose the CIC makes another bad bet—not another Blackstone but another WorldCom, with billions of dollars of Chinese people's assets irretrievably wiped out. They will need someone to blame, and Americans, for their part, are already primed to blame China back.

So, the shock comes. Does it inevitably cause a cataclysm? No one can know until it's too late. The important question to ask about the U.S.–China relationship, the economist Eswar Prasad, of Cornell, recently wrote in a paper about financial imbalances, is whether it has "enough flexibility to withstand and recover from large shocks, either internal or external." He suggested that the contained tensions were so great that the answer could be no.

Today's American system values upheaval; it's been a while since we've seen too much of it. But Americans who lived through the Depression knew the pain real disruption can bring. Today's Chinese, looking back on their country's last century, know, too. With a lack of tragic imagination, Americans have drifted into an arrangement that is comfortable while it lasts, and could last for a while more. But not much longer.

Years ago, the Chinese might have averted today's pressures by choosing a slower and more balanced approach to growth. If they had it to do over again, I suspect they would in fact choose just the same path—they have gained so much, including the assets they can use to do what they have left undone, whenever the government chooses to spend them. The same is not true, I suspect, for the United States, which might have chosen a very different path: less reliance on China's subsidies, more reliance on paying as we go. But it's a little late for those thoughts now. What's left is to prepare for what we find at the end of the path we have taken.
