By Peter Zeihan

The global system is undergoing profound change. Three powers — Germany, China and Iran — face challenges forcing them to refashion the way they interact with their regions and the world. We are exploring each of these three states in detail in three geopolitical weeklies, highlighting how STRATFOR's assessments of these states are evolving. First we examined Germany. We now examine China.

U.S.-Chinese relations have become tenser in recent months, with the United States threatening to impose tariffs unless China agrees to revalue its currency and, ideally, allow it to become convertible like the yen or euro. China now follows Japan and Germany as one of the three major economies after the United States. Unlike the other two, it controls its currency's value, allowing it to decrease the price of its exports and giving it an advantage not only over other exporters to the United States but also over domestic American manufacturers. The same is true in other regions that receive Chinese exports, such as Europe.

What Washington considered tolerable in a small developing economy is intolerable in one of the top five economies. The demand that Beijing raise the value of the yuan, however, poses dramatic challenges for the Chinese, as the ability to control their currency helps drive their exports. The issue is why China insists on controlling its currency, something embedded in the nature of the Chinese economy. A collision with the United States now seems inevitable. It is therefore important to understand the forces driving China, and it is time for STRATFOR to review its analysis of China.

An inherently unstable economic system

China has had an extraordinary run since 1980. But like Japan and Southeast Asia before it, dramatic growth rates cannot maintain themselves in perpetuity. Japan and non-Chinese East Asia didn't collapse and disappear, but the crises of the 1990s did change the way the region worked. The driving force behind both the 1990 Japanese Crisis and the 1997 East Asian Crisis was that the countries involved did not maintain free capital markets. Those states managed capital to keep costs artificially low, giving them tremendous advantages over countries where capital was rationally priced. Of course, one cannot maintain irrational capital prices in perpetuity (as the United States is learning after its financial crisis); doing so eventually catches up. And this is what is happening in China now.

STRATFOR thus sees the Chinese economic system as inherently unstable. The primary reason why China's growth has been so impressive is that throughout the period of economic liberalization that has led to rising incomes, the Chinese government has maintained near-total savings capture of its households and businesses. It funnels these massive deposits via state-run banks to state-linked firms at below-market rates. It's amazing the growth rate a country can achieve and the number of citizens it can employ with a vast supply of 0 percent, relatively consequence-free loans provided from the savings of nearly a billion workers.

It's also amazing how unprofitable such a country can be. The Chinese system, like the Japanese system before it, works on bulk, churn, maximum employment and market share. The U.S. system of attempting to maximize return on investment through efficiency and profit stands in contrast. The American result is sufficient economic stability to be able to suffer through recessions and emerge stronger. The Chinese result is social stability that wobbles precipitously when exposed to economic hardship. The Chinese people rebel when work is not available and conditions reach extremes. It must be remembered that of China's 1.3 billion people, more than 600 million urban citizens live on an average of about $7 a day, while 700 million rural people live on an average of $2 a day, and that is according to Beijing's own well-scrubbed statistics.

Moreover, the Chinese system breeds a flock of other unintended side effects.

There is, of course, the issue of inefficient capital use: When you have an unlimited number of no-consequence loans, you tend to invest in a lot of no-consequence projects for political reasons or just to speculate. In addition to the overall inefficiency of the Chinese system, another result is a large number of property bubbles. Yes, China is a country with a massive need for housing for its citizens, but even so, local governments and property developers collude to build luxury dwellings instead of anything more affordable in urban areas. This puts China in the odd position of having a glut and a shortage in housing, as well as an outright glut in commercial real estate, where vacancy rates are notoriously high.

There is also the issue of regional disparity. Most of this lending occurs in a handful of coastal regions, transforming them into global powerhouses, while most of the interior — and thereby most of the population — lives in abject poverty.

There is also the issue of consumption. Chinese statistics have always been dodgy, but according to Beijing's own figures, China has a tiny consumer base. This base is not much larger than that of France, a country with roughly one twentieth China's population and just over half its gross domestic product (GDP). China's economic system is obviously geared toward exports, not expanding consumer credit.

Which brings us to the issue of dependence. Since China cannot absorb its own goods, it must export them to keep afloat. The strategy only works when there is endless demand for the goods it makes. For the most part, this demand comes from the United States. But the recent global recession cut Chinese exports by nearly one fifth, and there were no buyers elsewhere to pick up the slack. Meanwhile, to boost household consumption China provided subsidies to Chinese citizens who had little need for — and in some cases little ability to use — a number of big-ticket products. The Chinese now openly fear that exports will not make a sustainable return to previous levels until 2012. And that is a lot of production — and consumption — to subsidize in the meantime. Most countries have another word for this: waste.

This waste can be broken down into two main categories. First, the government roughly tripled the amount of cash it normally directs the state banks to lend to sustain economic activity during the recession. The new loans added up to roughly a third of GDP in a single year. Remember, with no-consequence loans, profitability or even selling goods is not an issue; one must merely continue employing people. Even if China boasted the best loan-quality programs in history, a dramatic increase in lending of that scale is sure to generate mountains of loans that will go bad. Second, not everyone taking out those loans even intends to invest prudently: Chinese estimates indicate that about one-fourth of this lending surge was used to play China's stock and property markets.

It is not that the Chinese are foolish; that is hardly the case. Given their history and geographical constraints, we would be hard-pressed to come up with a better plan were we to be selected as Party general secretary for a day. Beijing is well aware of all these problems and more and is attempting to mitigate the damage and repair the system. For example, it is considering legalizing portions of what it calls the shadow-lending sector. Think of this as a sort of community bank or credit union that services small businesses. In the past, China wanted total savings capture and centralization to better direct economic efforts, but Beijing is realizing that these smaller entities are more efficient lenders — and that over time they may actually employ more people without subsidization.

But the bottom line is that this sort of repair work is experimental and at the margins, and it doesn't address the core damage that the financial model continuously inflicts. The Chinese fear their economic strategy has taken them about as far as they can go. STRATFOR used to think that these sorts of internal weaknesses would eventually doom the Chinese system as it did the Japanese system (upon which it is modelled). Now, we're not so sure.

Since its economic opening in 1978, China has taken advantage of a remarkably friendly economic and political environment. In the 1980s, Washington didn't obsess overmuch about China, given its focus on the "Evil Empire." In the 1990s, it was easy for China to pass inconspicuously in global markets, as China was still a relatively small player. Moreover, with all the commodities from the former Soviet Union hitting the global market, prices for everything from oil to copper neared historic lows. No one seemed to fight against China's booming demand for commodities or rising exports. The 2000s looked like they would be more turbulent, and early in the administration of George W. Bush the EP-3 incident landed the Chinese in Washington's crosshairs, but then the Sept. 11 attacks happened and U.S. efforts were redirected toward the Islamic world.

Believe it or not, the above are coincidental developments. In fact, there is a structural factor in the global economy that has protected the Chinese system for the past 30 years that is a core tenet of U.S. foreign policy: Bretton Woods.

Rethinking Bretton Woods

Bretton Woods is one of the most misunderstood landmarks in modern history. Most think of it as the formation of the World Bank and International Monetary Fund, and the beginning of the dominance of the U.S. dollar in the international system. It is that, but it is much, much more.

In the aftermath of World War II, Germany and Japan had been crushed, and nearly all of Western Europe lay destitute. Bretton Woods at its core was an agreement between the United

States and the Western allies that the allies would be able to export at near-duty-free rates to the U.S. market in order to boost their economies. In exchange, the Americans would be granted wide latitude in determining the security and foreign policy stances of the rebuilding states. In essence, the Americans took what they saw as a minor economic hit in exchange for being able to rewrite first regional, and in time global, economic and military rules of engagement. For the Europeans, Bretton Woods provided the stability, financing and security backbone Europe used first to recover, and in time to thrive. For the Americans, it provided the ability to preserve much of the World War II alliance network into the next era in order to compete with the Soviet Union.

The strategy proved so successful with the Western allies that it was quickly extended to World War II foes Germany and Japan, and shortly thereafter to Korea, Taiwan, Singapore and others. Militarily and economically, it became the bedrock of the anti-Soviet containment strategy. The United States began with substantial trade surpluses with all of these states, simply because they had no productive capacity due to the devastation of war. After a generation of favourable trade practices, surpluses turned into deficits, but the net benefits were so favourable to the Americans that the policies were continued despite the increasing economic hits. The alliance continued to hold, and one result (of many) was the eventual economic destruction of the Soviet Union.

Applying this little history lesson to the question at hand, Bretton Woods is the ultimate reason why the Chinese have succeeded economically for the last generation. As part of Bretton Woods, the United States opens its markets, eschewing protectionist policies in general and mercantilist policies in particular. Eventually the United States extended this privilege to China to turn the tables on the Soviet Union. All China has to do is produce — it doesn't matter how — and it will have a market to sell to.

But this may be changing. Under President Barack Obama, the United States is considering fundamental changes to the Bretton Woods arrangements. Ostensibly, this is to update the global financial system and reduce the chances of future financial crises. But out of what we have seen so far, the National Export Initiative (NEI) the White House is promulgating is much more mercantilist. It espouses doubling U.S. exports in five years, specifically by targeting additional sales to large developing states, with China at the top of the list.

STRATFOR finds that goal overoptimistic, and the NEI is maddeningly vague as to how it will achieve this goal. But this sort of rhetoric has not come out of the White House since pre-World War II days. Since then, international economic policy in Washington has served as a tool of political and military policy; it has not been a beast unto itself. In other words, the shift in tone in U.S. trade policy is itself enough to suggest big changes, beginning with the idea that the United States actually will compete with the rest of the world in exports.

If — and we must emphasize if — there will be force behind this policy shift, the Chinese are in serious trouble. As we noted before, the Chinese financial system is largely based on the Japanese model, and Japan is a wonderful case study for how this could go down. In the 1980s, the United States was unhappy with the level of Japanese imports. Washington found it quite easy to force the Japanese both to appreciate their currency and accept more exports.

Opening the closed Japanese system to even limited foreign competition gutted Japanese banks' international positions, starting a chain reaction that culminated in the 1990 collapse. Japan has not really recovered since, and as of 2010, total Japanese GDP is only marginally higher than it was 20 years ago.

China's Limited Options

China, which unlike Japan is not a U.S. ally, would have an even harder time resisting should Washington pressure Beijing to buy more U.S. goods. Dependence upon a certain foreign market means that market can easily force changes in the exporter's trade policies. Refusal to cooperate means losing access, shutting the exports down. To be sure, the U.S. export initiative does not explicitly call for creating more trade barriers to Chinese goods. But Washington is already brandishing this tool against China anyway, and it will certainly enter China's calculations about whether to resist the U.S. export policy. Japan's economy, in 1990 and now, only depended upon international trade for approximately 15 percent of its GDP. For China, that figure is 36 percent, and that is after suffering the hit to exports from the global recession. China's only recourse would be to stop purchasing U.S. government debt (Beijing can't simply dump the debt it already holds without taking a monumental loss, because for every seller there must be a buyer), but even this would be a hollow threat.

First, Chinese currency reserves exist because Beijing does not want to invest its income in China. Underdeveloped capital markets cannot absorb such an investment, and the reserves represent the government's piggybank. Getting a 2 percent return on a rock-solid asset is good enough in China's eyes. Second, those bond purchases largely fuel U.S. consumers' ability to purchase Chinese goods. In the event the United States targets Chinese exports, the last thing China would want is to compound the damage. Third, a cold stop in bond purchases would encourage the U.S. administration — and the American economy overall — to balance its budgets. However painful such a transition may be, it would not be much as far as retaliation measures go: "forcing" a competitor to become economically efficient and financially responsible is not a winning strategy. Granted, interest rates would rise in the United States due to the reduction in available capital — the Chinese internal estimate is by 0.75 percentage points — and that could pinch a great many sectors, but that is nothing compared to the tsunami of pain that the Chinese would be feeling.

For Beijing, few alternatives exist to American consumption should Washington limit export access; the United States has more disposable income than all of China's other markets combined. To dissuade the Americans, China could dangle the carrot of cooperation on sanctions against Iran before Washington, but the United States may already be moving beyond any use for that. Meanwhile, China would strengthen domestic security to protect against the ramifications of U.S. pressure. Beijing perceives the spat with Google and Obama's meeting with the Dalai Lama as direct attacks by the United States, and it is already bracing for a rockier relationship. While such measures do not help the Chinese economy, they may be Beijing's only options for preserving internal stability.

In China, fears of this coming storm are becoming palpable — and by no means limited to concerns over the proposed U.S. export strategy. With the Democratic Party in the United

States (historically the more protectionist of the two mainstream U.S. political parties) both in charge and worried about major electoral losses, the Chinese fear that midterm U.S. elections will be all about targeting Chinese trade issues. Specifically, they are waiting for April 15, when the U.S. Treasury Department is expected to rule whether China is a currency manipulator — a ruling Beijing fears could unleash a torrent of protectionist moves by the U.S. Congress. Beijing already is deliberating on the extent to which it should seek to defuse American anger. But the Chinese probably are missing the point. If there has already been a decision in Washington to break with Bretton Woods, no number of token changes will make any difference. Such a shift in the U.S. trade posture will see the Americans going for China's throat (no matter whether by design or unintentionally).

And the United States can do so with disturbing ease. The Americans don't need a public works program or a job-training program or an export-boosting program. They don't even have to make better — much less cheaper — goods. They just need to limit Chinese market access, something that can be done with the flick of a pen and manageable pain on the U.S. side.

STRATFOR sees a race on, but it isn't a race between the Chinese and the Americans or even China and the world. It's a race to see what will smash China first, its own internal imbalances or the U.S. decision to take a more mercantilist approach to international trade.