How will the fragility of the global financial system impact on the balance of power between China and the US over the next ten years?

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Abstract

This paper examines the extent to which the fragility of the global financial system will likely impact on the balance of power between China and the US over the next ten years. It contends that the reserve currency at the heart of the global financial system is fragile, and that while the exact cause of a catastrophic financial collapse cannot be identified, its effects on the world's two greatest powers would be significant.

The paper speculates that confronted with a global financial failure, the US would withdraw into itself, while China may aggressively expand to seize vital resources. The paper concludes that countries in the Indo-Pacific region need first to acknowledge the possibility of such an event. They would then need to build capacity in security, energy, food and currency. Only then could they turn outwards to address the potential threat of an expansionist regional power.

Introduction

The current global financial system emerged from the ashes of the Second World War. Initially based on a relationship to gold, the closing of that relationship by President Nixon in 1971 has meant the world operates on a 'fiat' currency system, that is, a currency established by government regulation or law. Noting that no fiat system in history has survived the test of time— and further noting the unhindered explosion of credit before and after the 2008 global financial crisis—it will be argued that the global financial system has become increasingly fragile.[1]

With the fragility of the financial system demonstrated, this paper will explore key macro identity and economic elements of the diplomatic/identity/military/economic framework of national power.[2] These discrete elements will be examined to assess the impact the fragile financial system may have on the balance of power between China and the US over the next ten years. The paper will argue that the fragility of the global financial system—and the possible effect this may have on the balance of power between the world's two greatest powers—has potentially precarious implications for the Indo-Pacific region.

Background

In 1944, with the tide of the Second World War turning in favour of the Allies, a conference involving all 44 allied nations (but dominated by the US and Great Britain) was held to determine the character of the post-war global financial system. The Bretton Woods system, as it became universally known, nominated the US dollar as the global reserve currency. It was pegged and made convertible to physical gold at the fixed price of US$35 an ounce. All other currencies were then pegged at different values against the US$, in a flexible process overseen by the International Monetary Fund, one of several international institutions established by Bretton Woods to manage and stabilise the new financial system.[3]

The following two decades saw the system perform well. This was aided considerably by the US possessing over 20,000 tonnes (some three-quarters) of the world's gold, largely a result of acting as debtor to much of the world over the course of two world wars.[4] However, by the mid-1960s, growing US deficit expenditure as a result of the Vietnam War and President Johnson's 'Great Society' programs, resulted in increasing outflows of physical gold from America as predominantly European nations lost confidence in the US$ and converted their reserve currency holdings into bullion.[5]

By 1971, US gold reserves had fallen to 8000 tonnes, prompting President Nixon to unilaterally discard the convertibility of the US$ into gold in order to protect his country's hegemonic financial position. This act cut the financial system's anchor and allowed it to float on the integrity of the US$—in what some would perceive as a sea of blind faith. The institution whose hands oversee control of the volume of this sea is the US Federal Reserve.[6]

The current situation

Since losing the anchor of gold in 1971, the current system's debt has exploded exponentially in the hands of its elite overseer.[7] Data from the institutions of the Bretton Woods agreement, including the US Federal Reserve, clearly show this phenomenon. World debt totalled US$5 trillion when it began this unanchored phase, representing 100 per cent of world GDP. By the time the global financial crisis hit in 2008, world debt was at a staggering US$165 trillion or 300 per cent of world GDP.[8]

Despite deleveraging and austerity rhetoric to the contrary, world debt has continued to increase, and now approaches US$220 trillion or 325 per cent of GDP.[9] While arguably frightening at face value, it is the implications that this debt-to-GDP ratio has for the health of the global financial system that are of utmost importance.

Since the 1990s, the Federal Reserve Bank has actively used monetary policy in an attempt to avoid any short-term recessionary pain in the US economy.[10] This unidirectional largesse in monetary policy has manipulated the growth of major asset classes, such as stocks and real estate. This has led to several asset bubbles and subsequent crashes. Each endogenous shock has been more significant than the last, culminating to date in the infamous global financial crisis of 2008.[11] Since then, the world's central bankers have not abandoned their application of homogenous academic theories.

Rather, they have sailed further into uncharted waters with hyper-aggressive monetary policies—including forcing official interest rates into unprecedentedly low values and, at times, pumping US$85 billion per month into the system to avoid a sudden collapse—that have led to the unimpeded increase of crippling private and public debt.[12] The combination of the unprecedented accumulation of enormous debt; the increasingly obvious devaluation of currencies through massive money printing; and the maintenance of near-zero to negative official interest rates to keep the astronomical debt affordable stretches the system's capacity and undermines the legitimacy that the fiat system relies on for its existence.[13]

Noting the three pillars required to avoid a fragile entity—namely, acknowledged authority, sufficient capacity and widespread legitimacy—it seems reasonable to conclude that while the core of the global financial system may retain its formal authority, its capacity and legitimacy have been significantly undermined.[14] This leaves the financial system fragile and vulnerable to both endogenous and exogenous shocks from an increasingly unstable world.

The potential impact of fragility

To understand the risks posed by the fragility of the global financial system, it is worth examining how this fragility may affect the world's two greatest powers—the US and China. Using the diplomatic/identity/ military/economic framework, this examination will focus on several macro factors involving the identity and economic elements of national power.

These elements have been chosen as they represent the bedrock of national power, which then guide and direct the use of the diplomatic and military elements. The macro factors chosen endeavour to shed light on key internal and external dynamics of the two powers, examining their interplay if a catastrophic collapse of the financial system were to occur. With that achieved, the implications for the Indo-Pacific region will be examined.

Arguably, a conventional view of the identity element of US power is that of the pre-eminent Western liberal democracy, owner of the world's reserve currency, and the global hegemon intent on the maintenance of the current international rules and norms.[15] While it possesses robust democratic institutions, a less publicised and less favourable aspect of US identity is the significant inequality of wealth distribution, which is viewed by many commentators to be a direct result of the unanchored financial system and associated powerful financial elite.[16]

Turning to the economic element of power, it is readily apparent that the US possesses unparalleled strength—from the unmatched position of reserve currency, which allows it to accumulate endless debt (unless an intangible point is met where the world loses confidence in the fiat currency); dominant GDP of US$18 trillion; the world's largest gold reserves at 8133 tonnes; an enormous and incredibly liquid bond market (which is a pre-requisite for holding the global reserve currency); broad energy and food self-sufficiency; and renowned dynamic economic agility—and that US economic power has no equal.[17]

In comparison to the consistency of US national power, the emergent 'China story' has been little short of miraculous. Since Chairman Deng Xiaoping began opening China to the world in 1978, a careful look at the identity and economic elements of national power raises concerns incongruent with the conventional narrative.[18] The Chinese identity appears at face value to be simultaneously inscrutable and homogenous. However, deeper scrutiny reveals interesting observations and statistics.

While Chinese Communist Party rule has arguably relaxed since the 1989 Tiananmen Square massacre, recent observers note that President Xi Jinping has consolidated his rule in a manner not witnessed since the oppressive days of Chairman Mao.[19] Many of these commentators attribute this increasingly authoritarian rule to other identity and economic factors. For example, although Han Chinese are the dominant ethnic group within China, there are a number of large minority ethnicities, all of whom experience varying degrees of disadvantage and oppression at the hands of the Han. This, perhaps unsurprisingly, coincides with a jarring inequality in wealth distribution between the coastal and urban Han, and the interior and rural Han and minorities.[20]

The social discord resulting from massive and growing wealth inequality in China, combined increasingly with frustration in the domestic economic downturn and autocratic political environment, is significant. The number of protests continues to increase yearly in China, with 2015 reportedly witnessing in excess of 130,000, two-thirds of which related to wage disputes.[21] To counter this trend, President Xi's consolidation of personal power is manifesting in a crackdown on rampant corruption within the ubiquitous Chinese Communist Party, increased nationalistic rhetoric, and challenges to the extant international norms, rules and institutions—all arguably aimed at strengthening the vital pillars of authority and legitimacy of the Party in the eyes of the population it rules.[22]

As the ruling Chinese elite work hard to maintain the pillars underpinning the identity power element, their economic element is also not without its challenges. In simple terms, since the 2008 global financial crisis, China's GDP growth has halved while its total debt has doubled.[23] Unlike the Americans, the Chinese are unable to resort to printing currency without consuming prodigious amounts of their foreign reserves.[24] The lack of an enormous and liquid bond market, combined with opaque economic governance structures, means that claims the Chinese Yuan could replace the US$ as the global reserve currency are fallacious.[25]

Finally, unlike the US, China is dependent on energy imports and is not considered self-sufficient in food.[26] The one area of strength in this power element is China's gold holdings, which is a story in itself. While official Chinese gold holdings as of 2015 were 1658 tonnes, some experts believe China may have secretly accrued in the vicinity of 4200 tonnes of gold—which would give it strategic parity in gold reserves with the US, Russia and the Eurozone.[27]

It can be argued, therefore, that while numerous challenges face the Chinese economy, China has gained strategic parity inside the global financial system. To understand the implications of the fragile global financial system—and the impact a catastrophic collapse would have on the two great powers and the Indo-Pacific region—a sensitivity assessment needs to be undertaken.

The potential for collapse

In examining how a catastrophic collapse may occur, it readily becomes apparent that expert commentators are unanimous in declaring that they are unable to predict the exact how, when or why.[28] What is broadly agreed, and will be used as the basis of this assessment, is that there are a number of scenarios. One possibility is that the US Federal Reserve and other central bankers, attempting to inflate away the massive global debt loads, unintentionally triggers hyperinflation.[29] This would likely see societal and economic conditions analogous to those present during the terminal months of Germany's Weimar Republic in the early 1930s, where a wheelbarrow of printed currency was needed to purchase a loaf of bread.

A second possibility is that the unprecedented monetary policies described earlier produce a hyper deflationary period, where individual currency values gain greater purchasing power. This may sound positive at an individual level. However, it would quickly be followed by contagious debt defaults occurring globally due to the combination of a marked reduction in tax revenues and the unbearable weight of the increased value of global debts. Other possibilities include exogenous shocks—such as a spectacular terrorist attack, mass migration events, a stock market or localised bank collapse, or an act of aggression from a rogue state actor—triggering a catastrophic collapse of the financial system.[30]

However it commenced, each country would face significant societal disruption likely requiring martial law controls to be implemented over the short to medium term, and would be unable to rely on globalisation to provide the essentials. How would the two greatest powers fare? What could this mean for the Indo-Pacific region?

In the case of the US, there would undoubtedly be many challenges. Chief among these would be the simmering discontent caused by wealth inequality impacting negatively on the identity element of national power. That aside, the US possesses the authority vested to it by the strength of robust democratic institutions and customs; the capacity to maintain internal and external security for itself, and thus provide the essentials of food and energy to its people; and the legitimacy that comes from both the provision of essential needs to the population (the potential to strengthen legitimacy exists if the essentials are provided in a truly egalitarian way) and the gold reserves to rapidly establish for itself a new monetary currency. This would, however, likely entail the use of the majority of the US' capacity. Therefore, it is arguable that supporting the international rules and norms would not be prioritised, leaving a vacuum surrounding the global commons, with obvious implications for regions such as the Indo-Pacific.

In contrast is China. The numerous challenges discussed in the elements of Chinese national power would create a potentially vicious positive feedback loop. The Chinese Communist Party has the capacity to enforce a reasonable degree of external and, more importantly, internal security. Similarly to the US, it is likely that it has the gold reserves to back its currency sufficiently to allow it to function within China. It does not, however, possess the capacity to feed itself or provide for its energy needs. This lack of capacity would quickly undermine legitimacy, and ultimately result in authority being wrested from the Party's grip—unless it could act rapidly to gain control of food and energy sources.

Potential solutions

For China, additional food exists in the East and South China Seas, and the lands to its south hold the likely irresistible temptation of cheap and abundant rice.[31] Additional energy exists in the lands to China's north and west, and potentially under the South China Sea.[32] In morbid resonance to 1941, the Indo-Pacific could face a desperately expansionist great power. This time, however, it would do so carrying grievous individual and collective wounds from the catastrophic global financial collapse, and probably without the expected support of the world's hegemon.

Countries of the Indo-Pacific would be prudent to prepare for such an eventuality using the diplomatic/ identity/military/economic framework—focusing on the three pillars of authority, capacity and legitimacy—to assess the strength and resilience of their identity and economic elements of national power in light of a possible catastrophic failure of the global financial system. Of paramount importance would be the consideration of how to provide security, food and energy self-sufficiency, as well as stabilising their currency through strategies such as anchoring to gold.

Without resilient capacity in these areas, the legitimacy of the state would likely crumble in the aftermath of a financial catastrophe. Conversely, resilient internal elements of national power would allow each country in the Indo-Pacific to survive long enough to consider the external threat—that of a potentially desperate expansionist power in the region. Those considerations would differ depending on each country's geostrategic position in the region, and is an area worthy of further study.

Conclusion

An examination of the current global financial system, from its birth in the ashes of the Second World War, through the cutting of its gold anchor, the subsequent explosion of global debt, and unprecedented monetary policies exposes a stark finding. Despite maintaining the formal authority invested in it at Bretton Woods, the reserve currency at the heart of the global financial system is exquisitely fragile due to the self-sown seeds undermining both its capacity and legitimacy.

While the exact cause of a catastrophic financial collapse cannot be known, the effects such a catastrophe may have on the world's two greatest powers is significant. It seems quite possible that today's hegemon, the US, would necessarily withdraw into itself. It seems similarly possible that China may aggressively expand to seize vital food and energy sources to ensure the Chinese Communist Party survives.

This leaves countries in the Indo-Pacific in potentially precarious circumstances. To address this, these countries need to first acknowledge the possibility of catastrophic global financial failure. They must then build capacity in security, energy, food and currency. Only then could they turn outwards to address the potential threat of a desperate, expansionist regional power. Much work needs doing, and some would likely argue that the hour is already too late.

Notes

1 Kevin Dowd, Martin Hutchinson and Gordon Kerr, 'The coming fiat money cataclysm and the case for gold', *Cato Journal*, Vol. 32, No. 2, Spring/Summer 2012, pp. 363-5. The fragility pillars used in this paper—authority, capacity and legitimacy—were derived from the lecture (and subsequent discussion) on the topic 'Fragile states, security and state building', presented by Satish Chand to the 2017 Defence and Strategic Studies Course at the Australian Defence College, Canberra on 7 March 2017.

2 The DIME framework used is as presented by Professor Michael Evans to the 2017 Defence and Strategic Studies Course at the Australian Defence College, Canberra on 10 February 2017.

3 Barry Eichengreen, *Global imbalances and the lessons of Bretton Woods*, MIT Press: Cambridge, 2007, pp. 8-9.

4 Thomas Piketty, *Capital in the twenty-first century*, translated by Arthur Goldhammer, Belknap Press of Harvard University Press: Cambridge, 2014, p. 155.

5 David A. Stockman, *The great deformation: the corruption of capitalism in America*, Public Affairs: New York, 2013, pp. 252-9.

6 Stockman, *The great deformation*, pp. 267-9.

7 The global financial system has changed character several times over the last 100 years. For several centuries prior to 1914, the international system was anchored by a gold standard, which ensured every unit of issued currency was backed by physical gold held in reserves. Of significant relevance to today's financial environment is that the Great Depression of the early 1930s was attributed for many decades to the gold standard leading to excesses in the stock market being purged by the Wall Street crash of 1929. The consequent economic and social trauma helped fuel the rise of fascism in Europe, which precipitated the human tragedy of the Second World War.

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