

Stalemate in China-US Relations

Collapse of the G-2 Myth

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This winter has been a cold one for China-US relations. So many serious disagreements between the two countries have not surfaced simultaneously for decades: the US is exerting unprecedented pressure on China to revalue the Yuan, a cyber war erupted between Google and the Chinese administration, Washington intends to sell weapons worth \$6.4 bn to Taiwan, China dumped US bonds worth \$34.2 bn, both sides threaten to introduce punitive import tariffs, and US President B. Obama received 14th Dalai Lama Tenzin Gyatso in the White House. In the past China and the US avoided taking harsh measures against each other serially, but evidently things have changed beyond recognition over the past several months.

*Notably, the round of tensions came as a surprise – just recently US analysts used to churn out totally different predictions concerning the relations with China. US economist and the director of Peterson Institute for International Economics Fred Bergsten coined the term G-2 as the new global economy formula in his *The United States and the World Economy* (2005). In the early 2009, the concept was upheld by such US foreign politics gurus as former Secretary of State H. Kissinger and former White House National Security Adviser Z. Brzezinski. Their idea was that China should shoulder the burden of global hegemony jointly with the US, which implied that Obama's Administration would be steering a course generally benign to the country.*

Visiting Beijing in November, 2009 US President B. Obama suggested establishing the G-2, but the offer was accompanied by rather imperious recommendations that China revalue the Yuan and join the regime of sanctions imposed on Iran. China declined on the grounds that its statehood was not yet sufficiently mature and needed serious modernizations and that, in foreign politics, Beijing's creed would be to maintain independence and to stay away from whatever alliances. By the time of Obama's visit, China had enough time to get familiarized in detail with the G-2 concept, and the official rejection of the offer to become a minor partner of the US was a product of broad consensus reached beforehand.

Obama's November, 2009 visit should be regarded as the starting point of the chill between China and the US. The Iranian dimension deserves special attention in the context. China is the only remaining obstacle in the way of the crusade against Iran, and it depends on Beijing's position whether the resolution of the "Iranian problem" will follow the US blueprint. It is highly unlikely, though, that under any combination of circumstances China would refrain from vetoing in the UN Security Council the US proposal to impose sanctions

on Iran. The explanation behind the stance is that Iran is China's major commercial and strategic partner. Over 15% of China's oil import (a total of some 450,000 bpd) are supplied by Iran, with only two countries – Angola and the Saudi Arabia – supplying greater amounts. China took two important new steps to boost its cooperation with Iran in the energy sphere in the late 2009. China's state-owned Sinopec signed a contract with Tehran to develop the first phase of the Yadavaran oil field, one of Iran's largest, and to invest \$6.5 bn in the upgrade of Iran's refining capacities. Beijing reckoned it made no sense to scrap the plans in the name of taking the role of a minor partner in the duet with the US.

The revaluation of the Yuan is a recurrent theme since the beginning of the current decade. China agreed to a compromise over the issue in 2005 when it set a flexible rate for Yuan synchronized with a pool of currencies, and the Yuan actually added 21% by July, 2008. The process came to a halt on the eve of the global economic crisis. Currently the exchange rate is about 6.82 Yuan per US dollar compared to 8.2 Yuan in the early 2005. Industrialized Western countries absorbing the majority of China's exports are unhappy with the arrangement: US President B. Obama and several other Western leaders believe that the artificially underrated Yuan shields the Chinese market from Western imports while giving Chinese exporters an unfair advantage.

Western analysts maintain that China should revalue the Yuan to cap its breakneck economic growth. Though the strengthening of Yuan would cause China's export and the corresponding revenues to shrink, it would carry the beneficial effect of impeding the inflow to the country of speculative investments which drive the inflation. Last February, Goldman Sachs analysts anticipated a 5% revaluation of Yuan to follow shortly, but Beijing remained unresponsive.

Beijing found an alternative approach to curbing financial risks – according to the US Department of the Treasury, in December, 2009 China sold \$32.2 bn worth of US bonds and thus reduced its stockpile of US bonds to \$755 bn. As a result, currently – for the first time since August, 2008 – Japan, not China, is the world's largest holder of US bonds (with a total of \$769 bn).

The official version is that China dumped the US bonds in an effort to diversify its currency holdings. To avoid excessively injecting liquidity, China will not likely opt for quick cuts of investments in US bonds. They continue to play an important role in the Chinese currency reserves – the US securities account for some 70% of China's total which has topped \$2.3 trillion. Still, China's getting rid of a fraction of its dollar assets had repercussions worldwide and may be indicative of the country's long-term strategy.

A new problem in the Chinese-US relations emerged this winter as Google charged China with flooding the world with spyware. According to Google, cyber attacks against its corporate infrastructures had been launched from China. Namely, attempts were made to break the mailboxes registered on Google by Chinese dissenters. Google responded by lifting search request censorship via its engine, thus momentarily conquering a greater share of the Chinese market. Chinese citizens eagerly seized the opportunity to examine the alternative versions of the 1989 Tian'anmen Square tragedy, the situation around Tibet, Xinjiang, the Taiwan problem and other themes to which the official Beijing has a thin skin.

Chinese officials, army, and academic circles deny involvement in the cyber attack, automatically switching the suspicion to Baidu, the main domestic company posing

competition to Google. Analysis International says Baidu's market share was roughly twice that of Google in the second half of 2009 – 61.6% vs. 29.1%. While the disparity persists, the gap between the two companies is steadily growing narrower year by year.

At the moment Google's withdrawal from the Chinese market and its compromise with the Chinese administration – that is, the reinstatement of censorship – seem equally possible. Considering that China is home to some 20% of the world's Internet surfers, it is clear that the US company would hate to lose grip on such a market.

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