



# **Money Politics: International Credit/Debt as Credible Commitment**

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## Knowledge-Net for a Better World

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## **Money Politics: International Credit/Debt as Credible Commitment<sup>1</sup>**

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### **Abstract**

In conducting research, international relations scholars typically seek to confirm their empirical expectations (or hypotheses). This paper adopts the opposite approach, focusing on the unexpected to highlight what is likely to be more informative for theory and policy. Specifically, it discusses the seeming puzzle from the neorealist perspective that China and the U.S. have become a very large creditor and debtor (respectively) to each other. Why would these two potential adversaries want to enter this relationship if it can have significant security externalities? That is, if security concerns should always trump economic interests, why would they knowingly expose themselves to the risk of loan boycott or debt repudiation that can be used as a leverage to advance a country's political agenda and military position? I argue that this phenomenon signifies mutual reassurance to maintain cordial relationship. Heavy international loan/debt signals credible commitment because both parties can clearly anticipate the severe consequences should their political and economic ties become destabilized. In contrast to various realist formulations that focus on relative national capabilities and power shifts, this paper directs attention to how analysts may discern states' preferences and intentions by examining the extent to which they are willing to undertake costly commitments. These commitments to maintain good relations are credible to the extent that the parties arrange self-enforcing deals entailing severe ex ante costs should either side engage in opportunistic behavior.

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## Introduction

Even a casual observer of recent foreign policy analyses generally and discourse pertaining to East Asian relations in particular cannot fail to notice that a considerable amount of attention is being paid to the ongoing power shifts between China and the U.S. Much (though clearly not all) of this scholarship, at least written by Americans, has followed the standard script of whether China should be engaged or contained. Other American analysts have followed the well-worn theories of balance of power or power transition.

Because there are many more Americans or at least non-Chinese writing for Western-oriented or –dominated venues, especially scholarship published in the U.S., it is not surprising that there has been much more concern about how an extant hegemon should deal with a rising latecomer than the other way round. Thus, for example, there has been much interest about how China may be socialized or otherwise converted into becoming a “responsible stakeholder.” As well, there has been considerable interest in studying how China’s nearby neighbors and the U.S. can “enmesh” and even balance against a rising China. There has, however, been concomitantly less interest in analyzing how a rising, though still substantially weaker, power can go about managing its relations with its neighbors and especially the extant hegemon.

This asymmetric attention reflects understandably the power-transition theory’s claim that power shifts to the relative detriment of an extant hegemon augurs international instability and even the danger of systemic war. According to this theory (Organski and Kugler 1980), a rising power is apt to challenge the international order in its effort to displace the extant hegemon. Perhaps, such attention may be even understandable from the perspective of balance-of-power theorizing when applied to a regional context – based on the supposition that a rising China will be more threatening to its nearby neighbors which will therefore seek support from a more distant, albeit more powerful, U.S. for security protection.

With some notable exceptions (e.g., Glosny, n.d.; Goldstein 2005), there has not been much attention paid to the question how a rising power may or can manage its relations with other states, especially the extant hegemon. Arguably, this rising power faces an even more acute security concern than the hegemon. Until it overtakes the hegemon, it has to deal with the possibility of a preventive war launched by the latter to block its ascent (Copeland 2000; Levy 1987, 2008; Mueller et al 2006). From the rising power’s perspective, the period of power transition is the most dangerous and vulnerable time.

The rising power can resort to a variety of means to reassure other states, including the extant hegemon, about its peaceful disposition. For instance, Prussia was apparently able to avoid balancing reactions from the other European powers in the Danish-Prussian War of 1864 by signaling self-restraint, invoking common norms, and appealing to their self-identity (Goddard 2008/09). Subsequently, Bismarck pursued a series of strategic partnerships so that Prussia became a pivotal, indeed indispensable, linchpin in an interlocking set of alliances (e.g., Crawford 2003; Goldstein 2003; Joffe 1995) Diplomatic assurances, however, can be construed as “empty



talk,” and interstate alignment can be reversed (Snyder 1997). Why should the other states believe that these assurances are sincere and that commitments made today will be kept tomorrow?

In the following discussion, I present three arguments in turn. First, I argue that the problem alluded to above – the threat to international stability occasioned by power shifts – is engendered by the generic difficulty of making credible commitment. How can states be sure that their counterpart will not defect, or renege, when circumstances change in the future? Second, I argue that commitments are credible to the extent that they entail heavy self-imposed costs to the party making the pledge. Those that are insincere or unreliable would have been reluctant to incur these costs. An analogy comes to mind: the larger the amount of “earnest money” made by a prospective buyer, the more believable that this buyer is serious about closing a deal. An opportunist who is likely to renege on the deal would not have wittingly risked the forfeiture of this money. Third, I suggest that the creditor/debtor relationship between China and the U.S. exemplifies attempts to communicate credible commitment to maintain stable and cordial relations. It offers a form of “binding” -- in contrast to “balancing” – that mitigates mutual worries about opportunistic behavior. In the fourth and concluding section, I will relate the implications of this analysis to international relations in the East Asian region more generally.

## **Credible Commitment**

Distrust often stands in the way of states trying to reach a *modus vivendi*. They may often get themselves into a conflict even though they would have been both better off if they could have negotiated a settlement. Settling their dispute peacefully would have spared them the costs of fighting – if only they had had the foresight of knowing how a contest of arms would have turned out (Blainey 1988). Their ability to foresee the outcome of a possible armed clash, however, is hampered by uncertainties about their counterparts’ true preferences, resolve, and capabilities (e.g., Fearon 1995, 1997, 1998; Powell 1996, 1999, 2006). How can one be sure that a counterpart means what it says? And how can one be sure that its intentions will not change in the future? After all, states (or their representatives) have been known to lie, conceal, and change their mind. Thus, deliberate misrepresentation and “private information” impede efforts to reach an agreement or arrangement without war.

Another reason for war to occur despite its “inefficiency” – one that will be the focus of this analysis -- is that states are wary of trusting each other (Kydd 2005). They worry that their counterpart can turn out to be unreliable, so that it may not honor an agreement or continue an arrangement when circumstances change in the future. Concerns about their counterpart’s possible defection keep states from reaching a *modus vivendi* in the first place. Rather than taking a chance in the counterpart’s reliability, states are often supposed to resort to worst-case reasoning. The well-known metaphor of prisoners’ dilemma illustrates how a lack of trust in a counterpart’s reliability produces a sub-optimal outcome for both parties.



Lacking confidence that any agreement reached today may be enforceable tomorrow, a currently dominant but declining power may start a preventive war against a rising power in the belief that it is better to fight now when it still has an advantage than to wait until later when it will have become weaker. Conversely, from the perspective of a rising power, an inability to convince the current dominant power that it will honor its commitments – that is, it will not turn aggressive after overtaking the latter – makes it vulnerable to such a preventive strike. How can it reassure the currently dominant power that it will “play by the rules” even when it becomes stronger later on?

The above concerns are obviously central to international relations theorizing about the consequences of power shifts, including ongoing trends affecting relations between China and the U.S. They also pertain to the core analytic and policy question of how states can effectively communicate their intentions and discern their counterparts’ intentions. To borrow from a crucial distinction from the power-transition theory, how can states credibly signal that they are the “status quo” rather than the “revisionist” type? As well, how can they effectively separate these two types, recognizing the true “status quo” countries from the “revisionist” ones that just pretend to be committed to the status quo? International relations analysts have not given enough attention to this question, and often assume that rising powers (except when the U.S. overtook Britain) necessarily have revisionist intentions whereas extant hegemonies are necessarily committed to the status quo. They often confuse this assumption for analysis as a conclusion from analysis.

States, or their representatives, are surely aware of the heavy opportunity costs of mistaken identity. That is, they are cognizant of the risk of misplacing their trust in a counterpart which turns out to be unreliable – such as when one abides by an agreement to eschew certain arms but one’s counterpart cheats by surreptitiously arming itself. An inability or unwillingness to trust the other side in turn fosters a “better safe than sorry” mentality, and produces the sub-optimal outcomes mentioned earlier about prisoners’ dilemma. In the current example, both states decide to arm themselves in order to ensure themselves against their worst nightmare of being confronted with a situation whereby they have been effectively disarmed and their counterpart is armed.

Interstate distrust stems from an inability to make credible commitments. Realists emphasize that structural anarchy is the dominant feature of the interstate system (e.g., Waltz 1979). In their view, this fact in turn means that states live in a self-help system. Unlike in a domestic situation, there is not an effective supranational “sovereign” to enforce order – meaning that states cannot turn to a higher authority to compel others to “play by the rules” or to carry out their contractual obligation. Even though it is surely powerful, a hegemon cannot be relied on to perform this task. Who is to force the hegemon to carry out its agreements or to punish it for breaking the rules? Realists are generally skeptical about the effectiveness of international institutions and norms as enforcement mechanisms (Mearsheimer 1995).

As already alluded, the problem of distrust – compounded by fear, anxiety, even arrogance -- tends to be most acute in the context of sharp and rapid power shifts. In his *The History of the*



Peloponnesian War, Thucydides (1954: 49) remarked “What made [the Peloponnesian] war inevitable was the growth in Athenian power and the fear this caused in Sparta.” Similarly, in his analysis of World War I and World War II, Dale Copeland (2000) showed that an acute sense of vulnerability – stemming from perceptions of the onset of an inevitable trend of relative decline – motivated Germany to start a preventive war against the Russian colossus which was rapidly closing the power gap that had previously separated these two countries. The tragedy of these conflicts has many sources. An inability to make credible commitment can be counted as one of the leading reasons. Berlin could not credibly commit to forswear the use of arms when it still had an advantage. This inability in turn energized its potential adversaries to take actions, both in terms of armament and alliance, for self-protection. At the same time, St. Petersburg could not credibly commit not to challenge Germany’s core interests (and in 1914, those of its ally, Austria-Hungary) after it had gained the upper hand. Their respective policies, and those of their allies, had had the effect of exacerbating mutual fears and distrust. What Berlin saw as justified defensive measures (such as its demand for equal recognition of its rights during the Agadir crisis or its moves to build up its fleet to respond to Britain’s naval superiority) appeared to its counterparts as offensive moves threatening them. Likewise, what its eventual adversaries did (such as the formation of the Franco-Russian alliance and Russia’s development of its railways) appeared offensive and threatening to it and its Austrian-Hungarian ally, even though these adversaries thought they were merely undertaking justified defensive action. We saw therefore the effects of “mirror images” – mutual attribution of hostility and acute sensitivity to supposed power shifts – contributing to the outbreak of these major wars.

Efforts to increase one’s armament or to secure allies – typically seen by realists as forms of “internal balancing” and “external balancing” can exacerbate tension rather than deter conflict. These policies can produce the “mirror images” just mentioned, thereby causing a chain reaction that ends in a sub-optimal, even self-defeating (by increasing the danger of a war that they were supposed to discourage) outcome. In contrast to the field’s predominant concern with the balancing of power, other ways of managing an extant or emergent hegemon have received less attention. Realists have of course discussed bandwagoning and buck-passing, but approaches such as binding, hiding, hedging, and even “transcending” have received less thorough analysis (Schroeder 1994). This study focuses on binding – a close, indeed intense, relationship that renders the parties mutually vulnerable.

## **Self-Enforcing Agreements**

How can one communicate one’s serious intention to maintain stable and cordial relations? Stated more generally, how can one make credible commitment even when the agreements or arrangements made by states are only weakly -- if at all -- enforceable by international courts and



public opinion? These questions get to the core of how states can establish their trustworthiness in the eyes of others.

Trustworthiness is more persuasively established when one behaves in a seemingly other-regarding way, when circumstances would or should have motivated more egoist operators to act otherwise. A few examples are helpful to explain this important idea. When a heavily indebted country continues to make full and prompt loan repayments during even hard economic times, this behavior should increase its creditworthiness in the eyes of bond holders. It distinguishes this country from other “fair weather” debtors that would only honor their loan obligations when their economy is performing well (Tomz 2007). As another illustration, states can preach “free trade” all they want, but whether they will really practice what they preach can only be revealed during tough economic times. It is easy to imagine a country eschewing protectionism when it is running a trade surplus. If, however, a state resists protectionist temptations during a balance-of-payment crisis, especially when it could have invoked “escape clauses,” this behavior communicates a more credible commitment to free trade. As a third example, when China’s neighbors engaged in competitive currency devaluation, as in the case of several Asian countries during the financial crisis in the late 1980s, but it refrained from similar conduct, this behavior signals important information about self-restraint. As yet another example, the U.S. routinely advocates democracy and human rights in public forums but whether it is really serious about these objectives is most effectively disclosed when its close allies, such as the Shah’s Iran, Mubarak’s Egypt, and the current governments in Pakistan and Egypt face popular uprising. In contrast, realpolitik and liberal motivations often predict the same U.S. posture when it criticizes Beijing and Moscow for their authoritarian practices. This posture is therefore “over-determined” in these latter cases which do not enable outside observers to discriminate between these alternative motivations. As a final proposition cum illustration, concessions made by a major albeit secondary state are *ceteris paribus* more meaningful than similar accommodation undertaken by either a superpower or a minor power. A superpower can afford to be accommodative without compromising its huge advantages whereas a minor power is likely to lack other choices but to succumb to foreign pressure. By a similar logic, when a hegemon plays by the rules and acts with due recognition of others states’ interests even when it could have overpowered any opposition, this self-restraint establishes a reputation for moderation and a commitment to multilateralism. As will be argued shortly, this self-restraint or self-binding makes its exercise of power more legitimate and enhances its reputation for being trustworthy (Ikenberry 2001).

Significantly, the greater the opportunity costs entailed by a state’s action (or inaction), the more believable is its credibility. A minor goodwill gesture, or concession, means that the state in question is only paying a small opportunity cost. Conversely, when a state undertakes a policy that it knows will cause significant damage to its interests, it is engaging in costly signals. The costlier is the potential fallout of its policy, the more credible are its signals – because the more opportunistic, and less sincere, states would not have taken on such huge risks. While helping to establish its trustworthiness, costly signals also subject a state to exploitation by its counterpart.





That is, the goodwill gesture, or concession, made by this state confers an advantage on the other side, which may not reciprocate and which may indeed be encouraged to push even harder for additional gains. This is, after all, the danger of appeasement – when one’s counterpart considers one’s concessions or conciliatory gestures as a sign of weakness rather than niceness. It may become even more aggressive.

The above discussion raises three questions. First, how costly should one’s signals of reassurance and credible commitment be? If these signals entail only minor costs, they are not believable – because even the untrustworthy states may be willing to pay these low costs in their effort to pretend to be trustworthy in order to mislead their counterparts. That is, low-cost signals do not help to separate, or distinguish, the trustworthy states from the untrustworthy ones (Kydd 2005). Conversely and as just mentioned, costly signals are believable but can make one vulnerable to exploitation if one’s counterpart happens to be greedy, aggressive, and untrustworthy

Second and related to the remark just made, how can one protect oneself from being exploited? That is, how can one make credible signals but ones that are in some ways protected from one-sided risks? Put in yet another way, how can one construct ties that are mutually reassuring? Costly signals, by definition, entail surrendering expensive “hostages” to the other side in order to reassure the latter that one does not intend to destabilize ongoing relations. Such ties would be more reassuring, however, if there is reciprocal giving and taking of “hostages.” Both sides would then have “skin” in the ongoing relations – they would both pay a heavy price if these relations were to be upset. The Anti-Ballistic Missile Treaty signed by the U.S. and USSR deliberately left all but one of their large civilian centers unprotected and in doing so, offered their cities as expensive “hostages” to demonstrate that both sides were committed not to initiate a nuclear attack (because one’s cities have been deliberately exposed to the other side’s nuclear retaliation). Parenthetically, a missile-defense system, such as one that has the practical effect of limiting and even nullifying China’s small nuclear retaliatory force, would imply conversely an offensive intention (Lieber and Press 2006).

Third and as mentioned earlier, “structural anarchy” means that there is no “sheriff in town.” That is, if agreements or arrangements between states become unglued, they cannot appeal to a supranational authority to punish the wrongdoer. There is no “911 emergency number” for them to call in order to compel a violator to carry out its contractual obligations – or to play by the rules. The contracting parties are on their own, which is another way of saying that they will have to devise a plan, or arrangement, that is self-enforcing (Yarbrough and Yarbrough 1992). Self-enforcing agreements overcome the problem of enforcement by “making the expected future benefits of continued compliance to serve as the bond” (Yarbrough and Yarbrough 1986, 18). In other words, states are self-motivated to eschew opportunistic behavior because they realize that the momentary gains from defection or cheating are more than offset by the loss of larger benefits that could have been derived from a stable, productive, long-term relationship. The “shadow of future” inclines even egoists to cooperate in a prisoners’ dilemma game. Continued cooperation therefore depends on the parties’ own self-interest (Axelrod 1984), and not some external



enforcement. They do not act myopically to take advantage of their counterpart because they realize that they have more to lose if the other side retaliates by ending an otherwise rewarding relationship. Mutual recrimination causes them not only to forfeit the greater expected gains from future cooperation, but also to bear the added burden of diverting more resources from consumption to defending against each other (such as the opportunity costs of spending heavily on the military, e.g., Chan 1995; Russett 1970). Thus, the parties' own incentives to maximize long-term gains help to guard against their possible opportunism. Naturally, when there are onlookers to bilateral interactions, this concern for long-term gains is even greater because one's general reputation is at stake. When a country develops a general reputation for untrustworthiness, others will be more skeptical to make deals with it and they will demand costlier commitments before entering into agreements with it. These additional opportunity costs further discourage opportunistic behavior.

## **Creditor/Debtor Relationship between China and the U.S.**

As implied earlier, the more “out of character” a state's behavior – that is, the more a state behaves in a way that seemingly contradicts its immediate interest – the more noteworthy is this behavior. China's purchase of large sums of U.S. debt, and America's huge indebtedness to China are enigmatic from a realist perspective.

Classical realists and neorealists are inclined to argue that concerns for a state's security should trump any other interest (Brooks 1997). These security concerns would/should in turn shape, indeed determine, states' economic relations with one another. Put simply, economic relations – such as trade, investment, and loan – have security externalities, meaning that the gains from economic transactions can increase or decrease states' relative military capability vis-à-vis their counterparts. Because the benefits of economic relations can help to improve another country's security position, it is natural for states to eschew or otherwise limit such relations when dealing with enemies or potential adversaries. This is after all the rationale behind the policies of economic sanction, technology embargo, and trade or investment boycott which the U.S. and its Western allies once undertook against the communist countries, including China (e.g., Mastanduno 1992). States are expected to have much more intense commercial relations with their allies than with their adversaries because they should be less concerned about the security externalities of these relations with the former than with the latter (Gowa 1994). They are expected to especially refrain from entering into dense and asymmetric economic relations with potential adversaries – a tendency that presents the converse of the typical causal logic behind the proposition that commerce promotes peace. This tendency also points to a selection effect; namely, states that do not expect to get into a fight are likely to trade with and invest in each other in the first place.



The reason for this expectation is not difficult to understand. Dense and asymmetric commercial relations undermine political autonomy. An entire school of thought – commonly labeled as the *dependencia* or dependency theories – has argued that developing countries face a new form of colonialism. This neocolonialism perpetuates the political dominance and control of the developed countries over the developing countries even though the formal apparatus of colonialism has been dismantled. As well, the connection between trade dependency and foreign influence has become widely recognized at least since the time of Albert Hirschman’s (1945) classic study on how Nazi Germany used its trade with the Balkan countries in order to gain political influence over them. Other famous examples abound, including France’s loans to Russia before World War I to secure their alliance against Germany and the U.S. strategic embargo against Japan before Pearl Harbor. More recently, the Arab members of the Organization of Petroleum-Exporting Countries have directed an oil boycott at the Netherlands and the U.S. after the Yom Kippur War in 1973, and the U.S. has applied economic sanction at various times to coerce Iraq, Iran, Libya, Cuba, and North Korea.

Economic exchanges present a double-edged sword. They confer commercial benefits which, however, can be used as a leverage to extract political concessions. The greater the asymmetry in a commercial relationship and the more costly it is to replace this relationship with some other partnership, the greater is the vulnerability on the part of the more dependent country to political exploitation. Why then would the U.S. knowingly borrow massive amounts of money from China? Conversely, why would China want to loan such large sums of money to the U.S., assisting the latter, a potential competitor, both economically and militarily? These loans help to finance U.S. fiscal policies to stimulate its economy, and are tantamount to subsidizing U.S. military spending – expenditures that can be directed against China. In mid 2010, China’s foreign currency reserves stood at \$2.45 trillion with 65% of which being held in U.S. dollars, with the rest divided among the euro (26%), the British pound (5%), and the Japanese yen (3%) according to Reuters reporting on a rarely publicized Chinese disclosure (<http://www.cnbc.com/id/38985189>, accessed on September 3, 2010). The Reuters’s article reported that China started 2010 owning \$894.8 billion of U.S. Treasury bonds, a level that declined slightly to \$843.7 billion by June of that year. In mid 2009, China was estimated to be holding about \$1.2 trillion U.S.-dollar denominated assets (Drezner 2009).

The various figures just mentioned surely make China vulnerable to the fluctuating – generally declining – value of the dollar, not to mention the risk of loan default – or repudiation – by Washington. According to Gregory Chin and Eric Helleiner (2008: 92), a 10% drop in the value of the dollar translates to about a 3% reduction in China’s gross domestic product. From the U.S. perspective, there is also a converse risk of Beijing resorting to the “nuclear option” of dumping a massive amount of U.S. debt on international financial markets, or just simply going on a creditor’s “strike” by declining to make further loans. It is not difficult to imagine that such action – or even rumors that it is being considered – will cause U.S. interest rates to jump, the value of the U.S. dollar to plummet, and world security markets to panic. Naturally, in such an event, China and other countries would also suffer because their financial markets would be



seriously destabilized, their dollar holdings would lose much value, and their currencies would appreciate and cause their exports to become more expensive and thus less competitive.

Traditional realist scholarship – emphasizing armament and/or alliances as means to balance against an extant hegemon (the U.S.) or a rising power (China) – cannot account for the intense creditor/debtor relationship between Beijing and Washington. Why would these competing states, potentially adversaries whether cast in terms of balance-of-power or power-transition theories, lend or borrow such large sums of money in full recognition of the economic ramifications and security externalities that these actions would entail? Given realists' emphasis that states care deeply about relative gains, this lending/borrowing would also appear bizarre. During the “perfect (economic) storm” that distressed the U.S. economy and those of other advanced countries during 2008-09, didn't China have an opportunity to “pile on” by refusing to extend more loans or at least to attach a political price tag to extending these loans? In line with my earlier discussion, when a state does not act in certain ways when circumstances are seemingly permissive can be informative. In this case, inaction -- not just action – can contribute to disclosing and establishing a state's trustworthiness, because it exercises self-restraint in pursuing its agenda and refrains from exploiting another's vulnerability.

A plausible, indeed reasonable, explanation for why China did not pour additional fuel on the fire of severe economic recession during 2008-09 is that Beijing was mindful of its long-term interests in a stable and growing international economy. This explanation is far from banal as it contains an important insight. As a growing economy, China acquires an increasing stake in the current system of international relations. The view that attributes a revisionist motivation to all rising powers is therefore deficient on this ground alone. A rising state's increasing ability (power) to change the rules of the system has to be considered along with its increasing incentive to preserve those rules that have enabled its upward mobility. It is the declining power that should have a greater motivation to revise the rules in order to reverse its fortune.

More pertinent to the focus of this analysis, the creditor/debtor relationship between China and the U.S. signifies reciprocal commitment to stable relations. It entails heavy opportunity costs to both sides because a rupture of this relationship would have devastating economic consequences for both sides. Precisely because these costs are well understood and because they involve reciprocal “hostage taking” and “hostage giving,” they provide credible commitment not to engage in opportunistic behavior. They also create a vested stake for each side in the well-being of the other. Political disturbances to the relationship will roil the financial markets, and cause long-term damages beyond this bilateral relationship.

The last two remarks deserve some further elaboration. A creditor obviously wants to have its loans paid fully and on schedule. A debtor is interested in continued access to the financial markets and in obtaining loans on the most favorable terms (at the lowest interest rate, with the highest loan amount, and for the longest repayment schedule). A state making loans would want to see the borrower doing well economically so that it can repay the loans. International tension, domestic disarray, economic distress, and involvement in foreign wars by the debtor state will all have the effect of reducing the borrower's ability to repay its loans. Conversely, a state that



borrowers money would be interested in the supply of available funds. A stable, prosperous world economy increases this prospect. The supply of funds is likely to be endangered when a prospective creditor state encounters economic trouble or uses its money for armament or fighting war. By the very nature of the creditor/debtor relationship, China and the U.S. therefore gain an interest in the other party's economic performance and in international peace and stability more generally. While realists are inclined to emphasize that great powers are caught in a competitive, zero-sum contest, my argument here claims the presence of a strong cooperative, positive-sum relationship. Thus, importantly, while the heavy prospective economic costs stemming from a creditor/debtor breakdown provide a credible pledge to sustain stable relationship, the very existence of this relationship becomes in itself a source for securing and deepening cooperation. The arrangement is self-enforcing in the sense described previously.

Significantly as well, this relationship is self-enforcing not just in bilateral terms – that is, due to the prospect of forfeiting joint gains from future cooperation between the two countries and paying a price for rupturing their political relationship. It is also self-enforcing in a different sense because of the effects that opportunistic behavior can have on third parties, whether they be private investors or other sovereign creditors or debtors. If China should use its loans as a lever to extract political concessions from the U.S., this behavior will be noticed by these third parties. They will be reluctant to borrow from China in the future because of this perceived political vulnerability. If, conversely, the U.S. were to repudiate its debt or deliberately engineer a dollar devaluation to repay its existing loans, this behavior will also be noticed by the financial markets. Such action will cause some prospective creditors to shun the U.S. as a borrower and others to demand higher interest rates for borrowing from them. In this sense, without recourse to international courts or the United Nations, the global financial community provides an enforcement mechanism. States care about their reputation because defection, cheating, or other forms of opportunistic behavior in one instance will be noticed by onlookers and reverberate to affect its general reputation for trustworthiness.

It was remarked earlier that states (or their representatives) often engage in misrepresentation – that is, they often posture and their public statements and behavior cannot be taken to necessarily indicate their true preferences or real intentions. Significantly, this problem of misrepresentation or posturing is greatly mitigated when financial markets react to or even anticipate political developments. All that is required is for private investors and firms to be self-regarding. These actors do not have incentives to engage in political misrepresentation or posturing; their paramount interest is to maximize their profit and preserve their capital. Accordingly, their behavior – such as their judgments about whether to extend loans and if so, how much to charge for interest – is especially informative in comparison to politicians' rhetoric (Gartzke and Li 2003a, 2003b; Gartzke et al, 2001). To the extent that financial markets are truly globalized, efficient, and influenced by private interests, they offer effective self-enforcing agreements that are hard even for governments to control and manipulate.



## Binding, Not Balancing

International relations theorizing, especially that which stemming from the realist school, has tended to emphasize the competitive logic of great-power relations. Balance-of-power theories and power-transition theory, despite their many other differences, share this emphasis. Because international relations scholarship has been dominated by American and British academics, it is unsurprising that it has tended to reflect the views of a hegemonic power. Analytic attention has largely gone to how this dominant power can manage its relations with a latecomer – rather than the reverse. Containment and engagement are prominently mentioned in the repertoire of policies available to the hegemon, with less attention paid to how these policies may be also available to the latecomer. Moreover, containment and engagement are usually presented as dichotomies when in fact, as I have tried to show in my earlier discussion, they can be effectively combined in the same policies and be adopted reciprocally by both parties in a relationship.

In a recent popular book, Zachary Karabell (2009) has used “superfusion” to describe the economic relationship between China and the U.S. This term may strike some as an exaggeration but it is closer to describing reality than traditional realist terminology such as balancing, bandwagoning, or buck-passing. Whereas Karabell’s analysis points to the operation of market forces, I have in this analysis given more attention to deliberate statecraft. The creditor/debtor relationship between China and the U.S. would not have taken the shape and size that it has without state awareness and indeed orchestration. It has involved an enormous amount of money in apparent contradiction to typical realist expectations about the effects of security externalities and the pursuit of relative gains. By accepting huge opportunity costs, both sides have provided compelling reassurance to the other that they are committed to maintaining stable relations. International loans therefore provide a mechanism to signal credible commitment to eschew opportunistic behavior – and to establish one’s trustworthiness.

The creditor/debtor relationship between China and the U.S. offers just one example of this reassurance and commitment diplomacy. Germany’s extension of large sums of credit to Russia as the Cold War was winding down, and Japan’s development assistance to China in the 1970s and 1980s provide other examples. The “sunshine” policies pursued by previous South Korean administrations toward Pyongyang offer still another, albeit more tentative, example. Perhaps the burgeoning commerce across the Taiwan Strait exemplifies most vividly the logic of this analysis. China is now Taiwan’s largest investment destination and export market, with over 40% of the island’s exports going to the mainland. Taiwan’s leaders are obviously aware that a heavy and asymmetric dependency on China can be a source of its political vulnerability – just as Chinese leaders are aware that attempts of economic coercion aimed at Taiwan can have reverberations beyond their bilateral relationship. From Taipei’s perspective, its trade and investment in the mainland represent a commitment not to rock the political boat. This commitment is credible precisely because Taiwan’s economic stake in maintaining the economic relationship is so great, and because it cannot evidently salvage its investment in production facilities located on the mainland or switch easily to alternative export markets should there be a political rupture.





More generally, we have seen in the recent years that commerce within East Asia has taken off. East Asian countries have become more important to each other as trade partners, investment sources or destinations, and as each other's suppliers, assemblers and consumers in extended production chains that stretch across multiple national boundaries. These widening and deepening networks of interlocking interests and shared stakes are important in stabilizing political relations in the region. They present multilateral commitment to maintain regional stability, suggesting a form of confidence building that has generally been overlooked in the current discourse. It is of course true that states that are economically interdependent have gone to war before, such as in 1914 and against in 1939. Saying so acknowledges that economic interdependence is not always sufficient to discourage conflict. At the same time, there appears to be a strong historical pattern indicating that peacefully inclined states are likely to choose each other as economic partners, and their economic partnership in turn contributes to their peaceful relationship (Russett and Oneal 2001). Thus, that some motorists get into "road rage" does not necessarily invalidate the usefulness of traffic rules for preventing automobile accidents.

Finally, this discussion points to two pervasive analytic problems in international relations literature. The first problem relates to those studies adopting an exclusive structural perspective, emphasizing China's rising capabilities and ongoing power shifts in East Asia. Structure, however, is not destiny. Whether regional or global politics moves to a unipolar, bipolar or multipolar situation does not in itself determine the probability of war or peace, and stability or instability. Re-phrasing Karl Marx's famous aphorism, people still make choices even when they find themselves making these choices under circumstances of not their choosing. In other words, as Victoria Hui (2005) argued compellingly in her study of China's Warring States period, agential strategies matter even if these strategies are necessarily constrained and influenced by circumstances. That the Kingdom of Qin was able to overcome balance-of-power dynamics had something to do with the policies it adopted and its rivals adopted. Similarly, that war did not break out when the U.S. overtook Britain in a power transition as the world's leading state had something to do with U.S. and British statecraft, and the timing and manner of the Cold War's end were not unrelated to Mikhail Gorbachev's policies. International relations scholars who study the interstate distribution of power take on a relatively easy task because they side-step the much more difficult challenge of determining the incentives and motivations that incline states (or their representatives) to deploy or exercise the capabilities at their disposal in varying ways. National power or capabilities are often treated as a matter of tangible assets, emphasizing variables such as economic size, currency reserve, and defense spending that are mostly matters of common knowledge. Less attention has gone to the intangible aspects of national capabilities, including strategies and soft power (e.g., Nye 1990). In overlooking or giving short shrift to these latter aspects, analysts often over-emphasize physical and military size and fail to account for the successes of "trading states" relative to those that pursue territorial expansion and military conquest (e.g., Rosecrance 1986). They discount the relevance and importance of economic statecraft, especially in an era of increasing global interdependence, and are unable to explain the



rise to international preeminence by countries such as Portugal, the Netherlands, Britain, and Japan despite their relative small size.

In comparison to aggregate measures of tangible national assets such as economic size and military hardware, it is much harder to discern officials' true preferences and real intentions – an observation that in turn brings up the second common analytic problem; namely, it is problematic to rely on public media statements and even private interviews as evidence of such preferences and intentions. One needs to differentiate cheap talk (“hot air”) from sincere disclosure. This disclosure can be made credible by costly commitment. Because officials have been known to misrepresent or to lie, their avowed preferences and declared intentions have to be made credible. This credibility can be enhanced by means of “tying hands” or “sinking costs” (Fearon 1997). By repeatedly and publicly engaging a leader's or administration's reputation to a policy course, officials in a democracy can especially resort to, figuratively speaking, tying their hands so that, should they renege on their professed policy, they will suffer adverse domestic consequences (the so-called audience costs) in the hands of the political opposition, the mass media and the voters. Commitments can also be made credible by non-verbal means, such as by deliberately putting money, figuratively (and even literally as in the case of this paper), where one's mouth is. To the extent that these sunk investments are costly and even unsalvageable (large, immobile and long-term capital commitments that will only turn profitable after many years, joint military command and integrated weapons systems, stationing one's troops in the frontline as a “tripwire”), they are again (as in the case of rhetorical “tying of hands”) more credible. As just implied, the relevant costs can be political – such as when a politician agrees to and stands by arrangements with another country (e.g., U.S. military bases in Okinawa) that are domestically unpopular.

I have used the creditor/debtor relationship between China and the U.S. as an example in this paper. Other examples come to mind and they are not limited to just what states do. Sometimes, inaction (and stasis) can be highly informative. Japan's continued status as a non-nuclear country clearly indicates an unwillingness rather than an inability to acquire nuclear weapons. Like South Korea, it continues to accept U.S. military bases and personnel on its soil. As another example, despite much recent publicity about China's military modernization, Beijing has not pursued armament as much as its growing economy could have borne. Although estimates of military spending are imprecise, China's defense budget is still about one tenth or one eleventh of the U.S. defense budget – even though its economy has reached about one third of the U.S. size. As a third example, South Korea has continued its security treaty with the U.S. despite the fact that it now enjoys an overwhelming economic and military advantage over North Korea. Although phenomena such as these are often framed in terms of balance-of-power efforts, this paper's perspective argues that they may be more usefully understood as attempts to reassure others (including China), that is, as signals of credible commitment to eschew full militarization or military autonomy (as a result of being “tethered” to the U.S. militarily even though both Japan and South Korea clearly have sufficient economic wherewithal to “go it alone”). When states could have but did not act in certain expected ways, such as when they accept foreign troops on





their soil even though they do not face a direct military threat and pay a price in their national autonomy (e.g., Germany, Japan) or when they enter into a dense and asymmetric commercial relationship with an ostensible adversary (e.g., Taiwan vis-à-vis China), their conduct can be especially telling.

Those examples just mentioned tend to contradict realist expectations such as when Kenneth Waltz (1993: 66) averred, “For a country to choose not become a great power is a structural anomaly” or when some of the world’s large economies “subcontract” their national defense to another country. These phenomena suggest that states can communicate to others their trustworthiness and that they can also discern others’ trustworthiness. They do not have to just assume that power shifts or imbalanced power will inevitably cause interstate instability and conflict, or that all their counterparts are motivated by the worst instincts of greed and aggrandizement. In other words, it is within their power to mitigate the forces of structural anarchy. ■



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