

China's Challenges

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THE GLOBAL ECONOMIC CRISIS has transformed perceptions of China. Once viewed in the west as an unruly and disruptive pupil, it is now courted as potential global paymaster. Although, after sailing through the first stage of the crisis, signs of stress are appearing in its economy and financial system, it still exhibits strength and vigour compared to most of the industrialized world. Politically, in Europe - if not the US - hopes of inducing China to play by western rules have given way

to grudging acceptance that Beijing holds many of the high cards and owns the biggest pile of chips. Power, it seems, is steadily shifting to the east.

Chinese officials have been quick to seize on this abrupt reversal of fortunes, lecturing the west on the perils posed by its fiscal fecklessness and on the need to put its economic house in order. Their sub-text is even blunter. It is that the west's plight stems not just

SUMMARY

The global economic crisis has changed the perception that many Western countries shared on China. It is no longer viewed as an unruly and disruptive pupil, but rather a potential financial paymaster. Hence the aim of this paper is to identify and describe the challenges that China is facing in its new role. This paper argues that Chinese developments in all three areas are imposing increasing strains on the country's political system and institutions and demand new approaches both inside and outside the country. The future for the country is still uncertain due to many vulnerabilities in economic, domestic and foreign policy.

Economists forecast that China's GDP is to exceed that of the US within a decade or two. Although these predictions may get investors excited, it is also worth remembering that they are based on extrapolations of the past. Yet, challenges such as the obsolescence of growth model, the growing pressure of labour costs, and the lack of diversification lie ahead. These challenges need to be faced by a new government and

policy that will balance the fiscal situation and put China back on track for fast economic growth. Besides, domestic policies face the challenge of rapid escalation of social unrest among China's population. The increasing number of 'mass incidents' across China, the expanding number of people who have access to the Internet and the free exchange of information via 'micro-blogs' and tweeting networks, on which 80 million Chinese netizens (as Internet users are known) express their grievances represent a threat to the existing system. Although the Communist Party still commands big respect among older citizens the level of corruption is alarming and has started to bother younger generations. And yet, the rulers in China are still a long way from formulating a coherent response to the demands of an increasingly impatient public. As is the case for its domestic policy, China's foreign relations are rooted in one fundamental imperative: keeping its regime in power. The government is ready to do whatever is necessary to maintain rapid

growth by keeping export markets open, securing access to energy and natural resources worldwide and preventing the economy from being blown off course by external shock. Since Beijing has few military allies its international influence is exercised largely through the medium of money and the language of brute force. However, the increasing dependency on the global economy will sooner or later become too important for China to remain on the diplomatic sidelines.

There is no evidence of any broad-based popular demand for democracy, yet the pressure for change is increasing. The government's legitimacy – based on performance – is coming under strain from several directions and these challenges, which are both economic and political, need to be addressed. However, China's Communist Party has not yet formulated a clear, effective response strategy. For the rest of the world, the only realistic option is to continue trying to engage China pragmatically but without conceding on essential principles.

from economic mismanagement but from more fundamental, ultimately self-destructive, flaws in its political systems. The implication is clear: in the contest between democratic and authoritarian models of government, the former has been found severely wanting.

However, Chinese triumphalism is premature. That is not because the west's economic problems are less severe than they appear. It is because the image of solidity and might that China likes to project to the world conceals many inner frailties. In truth, China faces a growing array of vulnerabilities and challenges that make its future trajectory far from certain. Ironically, some of them bear striking, though not always exact, similarities to those confronting the west.

Chinese policy makers, for all their swagger, know this. Proud as they are of the country's impressive achievements over the past 30 years, they are acutely aware that they are fragile. They recognise that failure to successfully navigate the turbulence ahead could not only imperil past gains; it could call into question the Communist Party's jealously-guarded monopoly on power. Behind the self-confident, sometimes arrogant, exterior lurks an ever-present sense of anxiety and insecurity.

This paper examines those challenges from three separate, but related, perspectives: the economy; domestic politics; and foreign policy. It argues that developments in all three areas are imposing increasing strain on the country's political system and institutions. Though it is too early to be sure how this complex of pressures will play out, together they pose a big – possibly decisive – test of China's ability to continue its apparently inexorable ascent in the face of growing headwinds.

WANTED: A NEW MODEL ECONOMY

ECONOMISTS' FORECASTS THAT China's Gross Domestic Product is set to exceed that of the US are so common nowadays that they pass almost unremarked. They usually differ only about when that supposedly inevitable moment will arrive. Will it be in 2030, 2025 or even sooner?

Such predictions may excite impressionable investors.

But otherwise, they are of doubtful value because they are necessarily based on extrapolations of the past. They make no allowance for discontinuities or what Harold MacMillan, the former British prime minister, termed the tyranny of "events". In reality, history moves in zig-zag patterns rather than along straight lines. In China, the margin of predictive error is particularly high.

The challenges China faces are both short and longer term, though the two can often merge into one. In the short term, the most pressing is to bring inflation under control and deflate asset bubbles without stifling economic growth. Not for the first time, the authorities are treading a fine line.

Until recently, they seemed to be succeeding, as monetary tightening steadily bore down on consumer and real estate prices, while slowing GDP growth to slightly less than 10 per cent in 2011. However, at the end of November, in the wake of a sudden weakening of domestic activity and amid fears of a further deterioration of the euro crisis, the authorities abruptly changed course, shifting the emphasis back to supporting growth.

China's economic policy makers face a double dilemma. First, the People's Bank of China, the central bank, appears unsure that enough has been done to control the inflationary forces unleashed by the huge stimulus package introduced in 2008 in response to the global crisis. Opening the credit taps wide again could simply reignite flames that the authorities have spent two years struggling to put out.

Furthermore, another monetary binge would risk adding to the bad debts already accumulated by property buyers and developers, revenue-strapped local governments, financial speculators and small private businesses that have been forced to borrow from unregulated "shadow" lenders at often extortionate rates. Reckless private lending plunged the west into crisis; China's headache stems from huge government-ordained credit expansion intended to keep the country out of this crisis.

Scarcity of hard data makes the scale and gravity of China's debt problem impossible to measure precisely. Nonetheless, if economic conditions deteriorate sharply, it is

likely to limit the scope for monetary activism, placing more emphasis on fiscal policy. At first glance, China seems well-placed to use it. Conservative management has, according to official figures, limited its budget deficit and sovereign debt, respectively, to less than 3 per cent and about 55 per cent of GDP. If these data are accurate, Beijing appears to still have considerable room for fiscal manoeuvre.

However, there are two constraints. One is that, at only about 25 per cent of GDP, China's central government budget is relatively small, while the fiscal positions of many local governments are precarious. The other is ingrained official mistrust of fiscal policy as a tool of active economic management, on the grounds that it is more cumbersome and slower to take effect than credit policy. Short-term pressure on the PBoC to crank up the printing presses again may grow, particularly from an outgoing leadership that is loath to leave office with growth faltering.

The second dilemma is more challenging still. Even if China can ride out the current cycle, it faces a bigger - structural - problem: the growth model that has powered its remarkable economic ascent for more than three decades is showing serious signs of wear, indeed of obsolescence.

It is still widely, but wrongly, believed that exports have powered China's rise. In fact, they have contributed relatively little to GDP and growth – and possibly nothing in the past three years - because they contain a high proportion of imported inputs and modest levels of local value-added. Their real importance is political, because the manufacturers involved in them employ large numbers of people, many of them concentrated in important coastal provinces.

With manufacturing wages soaring – the result of a deliberate government drive to boost household incomes – many Chinese industries now risk being squeezed by competitors elsewhere that either enjoy lower costs or boast superior skills and more advanced products. Without big leaps in productivity and innovation, the spectre of the “middle income trap” that has snared other emerging economies in the past will haunt China's future.

Labour costs face growing pressure from another quarter: demographics. China's development has benefited greatly from a seemingly infinite supply of cheap labour. But a declining birth rate, a legacy of the one-child policy, is steadily eroding that advantage. By some measures, China now has the world's fastest-aging population and net new inflows into its labour market are close to, or already past, their peak. By about 2030, its population will start to shrink. While palliatives such as prolonging working lives can mitigate those trends, they cannot reverse them. And, unlike the US, China shows little sign of being ready to fill the gap through large-scale immigration.

A still bigger headache is that far too much of China's prosperity relies on digging holes in the ground and pouring concrete. Construction, much of it of residential housing, generates about 14 per cent of China's GDP, while property investment is equal to almost 10 per cent, an unusually high figure for an economy at its stage of development. Although the country needs to continue building infrastructure – it still, for instance, lacks a modern national electricity grid – too much past spending has gone into white elephant projects, surplus office and high-end residential developments and other unproductive investments.

So where can China go for new sources of more stable growth? It is increasingly apparent that it will take a decisive structural transformation of its economy to unlock them. Wen Jiabao, China's prime minister has been repeating that message regularly since 2007, when he first described the country's existing development model as “unsteady, unbalanced, uncoordinated and unsustainable”.

Mr Wen's diagnosis, reflected in the current 12th Five Year Plan, is that China's growth depends far too heavily on massive fixed asset investment that encourages misallocation of capital and environmental degradation and yields steadily diminishing economic returns. In essence, the remedy would put consumption in the driving seat, by raising household incomes, expanding the provision of social welfare, lowering high savings rates and creating more vigorous services markets. At the same time, China aims to promote industrial upgrading into higher value-added activities.

This is a textbook prescription, widely endorsed and applauded outside China. Everything, however, will hinge on effective execution. That will require not only considerable technical skills and careful planning and sequencing of reforms across a wide variety of sectors but, crucially, bold leadership from the very top.

China does not lack for clever and sophisticated technocrats. The key question, though, is whether its rulers can muster the sustained political commitment and resolve to push through measures that are bound to be disruptive and unpopular, in the face of inevitable resistance from powerful vested interests, in business, in government and within the Communist Party itself.

Recent trends caution against excessive optimism. The wave of sweeping market-oriented reforms instituted by former supreme leader Deng Xiaoping and his prime minister Zhu Rongji in the 1990s slowed to a crawl in the early years of this century. Although reforms continue, cautious piecemeal incrementalism has replaced bold structural upheaval as the order of the day.

Indeed, in important respects, the clock has been turned back by the stimulus package and its reliance on China's traditional formula of massive capital spending to shore up growth. Despite Mr Wen's emphasis on the imperative of "rebalancing", and notwithstanding recent wage increases, consumption share of GDP has dwindled steadily to a mere 33 per cent, while investment share has risen to about 50 per cent – both extraordinary levels for a country at China's stage of development.

Furthermore, the command-and-control methods used to engineer the credit boom – government directives to the banks to lend, lend, lend at artificially low interest rates – is a big step backwards from the market-based capital allocation and improved risk management that China's financial system needs. Most of the stimulus money has gone to relatively inefficient state-owned industries, while the much nimbler and more productive private companies that are China's most dynamic wealth and job creators were left out in the cold. And since stimulus-related credit was made available on exceptionally easy terms, it has served further to perpetuate the vast system of subsidies that pervades China's state-owned sector.

None of this has advanced the cause of reform. Indeed, it has made the task even harder by entrenching financial distortions, enhancing the sense of entitlement among state-owned industries and further reinforcing their dependence on and influence over political decision-makers.

Some prominent figures in China have spoken out about the dangers of perpetuating close links between business and the state. Wu Jinglian, a widely respected senior economic advisor to successive leaders, has said they could inflict serious damage on the economy's health. Xu Xiaonian, a professor at the China Europe International Business School, has warned that China risks succumbing to the cronyism that characterised the Suharto regime in Indonesia and the Marcos government in the Philippines.

If reform is to be re-launched, the responsibility will fall to China's next leaders, after they take office at the start of 2013. Optimists stake their hopes on generational change, arguing that the rising class of leaders are younger, more open, more outward-looking and drawn from a wider range of backgrounds than their predecessors. That may be correct. However, as will be discussed later in this paper, it is unclear that a change of personnel at the top will, on its own, be enough to alter the direction of China's ship of state.

DOMESTIC POLITICS: A VOLATILE COCKTAIL

FIRST IMPRESSIONS CAN matter. Returning to Beijing late last year, I was struck by the number of people I spoke to there who started by saying how edgy and febrile the atmosphere in the capital had recently become. Far from exuding an air of self-assured control over the nation's affairs, its ruling classes appeared to be tense and often divided over the course ahead.

The mood is partly attributable to the ferocious jockeying for position going on behind the scenes – and occasionally in public – in the run-up to next year's appointment of China's new president, prime minister and members of the standing committee of the Politburo, the Party's most important organ. Economic uncertainties and internal differences over how to tackle them have doubtless contributed to the air of uncertainty too.

However, a still more potent and enduring concern is the rapid escalation of social unrest among China's population. Outbursts of public discontent have long been a regular feature of life in China. But they are both becoming much more numerous and are changing in their causes, form and character.

According to Sun Liping, a professor at Tsinghua University, 180,000 "mass incidents" took place across the country in 2010. Such measures can only be a crude barometer of social unrest but, interestingly, the number is more than double the 87,000 counted five years earlier. The most common grievances recorded are dissatisfaction over wages, workers' rights and government seizures of land for development.

Some observers argue that such protests, though obviously disruptive, do not seriously threaten political stability, on three main grounds: because they are principally directed at perceived misdeeds by companies and provincial and municipal authorities, not at central government; because they are localised, not organised nationwide; and because the Chinese state has a powerful apparatus devoted to crushing dissent and has become smarter at identifying and dealing pre-emptively with troublemakers.

That view, though, may be optimistic. Certainly, under President Hu Jintao, China's regime has become noticeably tougher in cracking down on persistent critics, including high-profile ones such as Nobel laureate Liu Xiaobo and Ai Weiwei, the internationally known artist who was jailed without trial last year and has been pursued since his release for alleged underpayment of taxes. Many other, less prominent, dissenters have endured similarly harsh treatment.

However, formidable as China's internal security machinery is, it is now grappling with new and more elusive targets. The most obvious is the internet. Some 500 million Chinese are estimated to be online, and their numbers are growing by the week. The past two years have seen rapid growth of "micro-blogs" or tweeting networks such as Weibo, on which some 80 million Chinese netizens daily express their grievances, criticisms and sometimes outright mockery of their rulers. The spread of smartphones enables pictures of local protests - such as the recent much-publicised uprising in the southern village of Wu-

kan - to be flashed around the country instantaneously.

The internet and mobile telephony present a new form of challenge because they allow immediate and, to a degree, anonymous communication between hundreds of millions of people thousands of miles apart. Protean and without any formal organisational hierarchy, they are, potentially, machines for realising one of Chinese rulers' grimmest nightmares: a co-ordinated wave of nationwide opposition to the regime.

Beijing has begun tightening surveillance and control over the microblogs, though its effectiveness remains unclear. But despite demands by some officials for still tougher measures, it seems reluctant to close them down completely, apparently for three reasons.

First, the internet actually serves Beijing's purposes by allowing disgruntled citizens to let off steam. More importantly, in a system in which accountability runs strictly from the top down, but in which the Party is constantly on the lookout for any threat to its power, monitoring what bloggers are writing is a form of straw poll that can give valuable insights into what is really on the public's mind.

Second, some senior officials accept that without free exchange of information, it will be much harder to promote the commercial and scientific innovation that Beijing views as central to China's economic future. For all of China's much-publicised increases in R&D expenditure, in patenting and in the output of scientific papers, some policy makers now concede that success will require it to create a more open, questioning and vibrant innovation culture based on intellectual contention and the free flow of ideas.

Third, and most important, it may be too late to impose a draconian crackdown without triggering a public backlash. To do so could risk fuelling further discontent among the public, sections of which appear not only to be growing weary of high-handed tactics on the part of the authorities but are increasingly ready to express their displeasure openly as well.

Two recent incidents are symptomatic of the popular mood. One is the individual contributions by tens of

thousands of people towards payment of the punitive tax charge imposed on Ai Weiwei. Another was the outraged reaction of onlookers after the teenage driver of an expensive car involved in a collision insisted he was above the law because his father was a general. It is hard to imagine either display of spontaneous public defiance happening even five years ago.

Though ordinary Chinese may not love the Communist party, many have long judged that it has served them and the national interest well by unifying the country, maintaining stability, raising living standards and creating economic opportunity. In rural communities such as Wukan the belief - though not always borne out by experience - persists in Beijing's benign power to right wrongs committed by lower levels of government.

However, such views are strongest among older Chinese, who have gladly exchanged the manic instability and grinding deprivation inflicted by Mao for post-Deng authoritarianism. They resonate far less with the rising generation of younger, better-educated urban middle class citizens, for whom Mao is a distant memory and whose expectations have risen in line with their greater prosperity.

One of the biggest threats to the Party's continued claims on legitimacy is growing public resentment at the widening gap between "them" and "us", between the privileges and power enjoyed by the elite and the lot of the great mass of the people. There are many reasons, both social and economic - not least a dramatic widening of income inequalities - for this disaffection. But perhaps the most important is the accelerating spread of corruption.

China is no stranger to corruption, regularly ranking around the middle of Transparency International's annual Corruption Perceptions Index. However, in Beijing and other large and richer cities, there are numerous signs that the problem is becoming worse and that a venal "get rich quick" mentality - of the kind associated in the west with rapacious investment bankers - is increasingly taking hold.

Senior figures, who once concealed illicit gains by channelling them through family members, have become much more blatant about flaunting their wealth in public. Many officials - and often their children - own flashy

foreign cars and wear elegant watches and imported suits that cannot be affordable on their modest salaries. A westerner who runs training courses in Europe for the rising generation of younger Party cadres says she is shocked by how much of their private conversation is about self-enrichment and by the extravagance of their shopping sprees at luxury goods retailers.

Graft is also increasingly rampant further down the ladder. Even middle-ranking officials are now commonly flown around in executive jets owned by rich businessmen and take holidays with their families at exclusive Caribbean resorts. Under-the-counter payments have become routine in order to procure a doctor's appointment or a place in a good school, with Apple iPads a favoured medium of exchange.

Some in the political establishment are starting to recognise that things are in danger of running out of control. Li Jinhua, China's former auditor-general and a veteran graft fighter, told the People's Daily, the Party's official mouthpiece, that the fast-growing wealth of officials' children and relatives "is what the public is most dissatisfied about". An online poll in the same newspaper found that 91 per cent of people believed wealthy families came from political backgrounds.

A report by China's central bank says corrupt officials have smuggled some Rmb 800 billion (\$124 billion) of ill-gotten gains out of the country over a 15-year period - a figure some observers consider an under-estimate - while around 17,000 Communist Party cadres, police, law officers and state industry managers fled abroad. Wu Jinglian estimates that government land seizures have left farmers \$5,400 billion worse off since 1978.

At a time when public discontent is growing on many fronts - over wages, working conditions, income inequality, pollution and house prices - and when China is heading into uncertain economic territory, there is a clear danger that it could combine with resentment at the abuse of power and privilege to create an explosive political cocktail.

That risk was spelt out in unusually blunt terms by an anonymous senior Chinese banker quoted in The Financial Times late last year. "There is a sense that we are ap-

proaching an inevitable breaking point, when the pressures in society will boil over and consume the rulers. Almost all of the elements are in place for an uprising like we saw in 1989 – corruption is worse today than it was then, people feel they can't get ahead without political connections, the wealth gap is much bigger and growing and there has been virtually no political reform at all. The only missing ingredient now is a domestic economic crisis.”

Ever since Deng Xiaoping's era, China's rulers have operated on the basis of an unspoken “contract”, at least with the urban population: they exercised untrammelled power, provided they steadily improved living conditions for the mass of the population. The greatest risk to their legitimacy was long perceived to be a failure to deliver the goods. But another is now emerging alongside it: that the élite could be thrown onto the defensive by the corrosive consequences of arrogance, greed and excess within its own ranks. In other words, the regime's control of the country could be jeopardised by losing control of itself.

It remains to be seen whether that fear will trigger serious efforts by China's new leadership to launch political reforms designed to bolster the Party's popular legitimacy by making it more accountable to the people and tolerating greater dissent. Some voices inside, as well as outside, the political establishment are urging such a move. However, it has influential opponents, who worry that loosening the levers of control would instead seriously threaten the Party's grip on power.

China's rulers appear far from formulating a coherent response to the demands of an increasingly impatient public and reluctant to open up a debate, for fear of triggering fierce and destabilising internal political battles. Yet it is uncertain for how much longer rising popular pressures will allow them to continue to sidestep the issue.

FOREIGN POLICY: RATIONALISM VERSUS NATIONALISM

UNTIL QUITE RECENTLY, China's approach to international relations was governed by Deng Xiaoping's injunction to “observe developments soberly, maintain our position, meet challenges calmly, hide our capacities, bide our

time, remain free of ambitions and never claim leadership.”

However, China's posture is changing, in often disconcerting ways. Though still loath to exercise decisive international leadership, the country speaks to the rest of the world, and particularly to its own neighbours, with an increasingly assertive – indeed, often aggressive – voice. It has been heard in the open snubbing of President Obama at the 2009 Copenhagen climate talks, in ever more strident (and legally dubious) claims on large parts of the South China Sea, in intransigence in border disputes with India, in recurrent diplomatic clashes with Japan and in an overtly bullying attitude to Vietnam and other smaller countries in the region.

Such ham-fisted diplomacy has not obviously served China's national interests; indeed, it has often backfired spectacularly, producing the direct opposite of its intended effect. By contradicting official Chinese rhetoric about achieving a “peaceful rise”, it has spurred other Asian countries to strengthen ties with the US, prompted Washington to reaffirm its military presence in East Asia, propelled the Philippines and Japan into a security pact and encouraged even Burma, traditionally heavily dependent on Chinese support, to distance itself from Beijing. If the CIA had infiltrated China's foreign policy machinery with a view to discrediting it, it could hardly have done a better job.

Yet, on other fronts, China has conspicuously avoided or retreated from confrontational behaviour. Tensions with Taiwan over the island's status have given way to bilateral dialogue and closer trade links. Repeated frictions with the US over trade and currency policy have - so far at least - been kept in check, while in the WTO and other multilateral organisations China has mostly opted for a low profile. Furthermore, despite constant international debate about China's supposedly growing global economic and financial power, Beijing has seemed hesitant about deploying it forcefully.

These striking inconsistencies have created profound international uncertainty about China's motives and intentions. At their heart lies a stark conflict between rationalism and nationalism; between a recognition that external stability is essential to promote domestic economic de-

velopment on the one hand, and rising internal pressures to demonstrate China's importance in the world by flexing muscles on the other. This is a volatile mix.

So far, rationalism has tended to prevail in the end. Witness the aftermath of the ugly anti-Japanese protests that broke out, seemingly with official connivance, across the mainland in 2005. Just as events appeared to be getting out of hand, realisation of the potential economic damage each side could suffer led Beijing and Tokyo to launch a fence-mending exercise – though it has not prevented the eruption of subsequent disputes that have brought its sincerity and effectiveness into question.

Equally, Beijing has reacted to the Obama administration's renewed commitment to a long-term security presence in Asia by lowering the volume of official bombast, not by ratcheting it up, while seeking to patch up frayed relations with Asian neighbours. However, while such changes of tack may have lowered the temperature temporarily, they only reinforce the sense of unpredictability in Chinese foreign policy.

Whether China will continue to step back from the brink in future is impossible to say, not least because its official decision-making processes are so opaque. However, its current level of economic development – its GDP per capita, on a PPP basis, ranked a lowly 94th worldwide in 2009 – and its deepening integration with the global trade system provide strong incentives not to rock the boat in ways that could jeopardise its own welfare.

In foreign as well as domestic affairs, Chinese policy is rooted in one fundamental imperative: keeping its regime in power. That has engendered a pragmatic readiness to do whatever is necessary to maintain rapid growth by keeping export markets open, securing access to energy and natural resources worldwide and preventing the economy from being blown off course by external shocks.

Those priorities remain central and will not be willingly jettisoned. The greatest risk is that events beyond Beijing's control could make it much harder or impossible to achieve the steadily rising prosperity that they are trying to underpin. If the country were plunged into a prolonged period of economic weakness, stagnant living standards and widening income differentials, public

discontent and social unrest would be likely to increase. There is a danger that a rattled leadership would respond by falling back on pandering to the nationalistic impulses and sense of victimhood that are never far from the surface in the public consciousness. The consequences for relations with the rest of the world, though impossible to predict precisely, are unlikely to be pleasant.

Such a scenario remains necessarily speculative. However, the potential for violent swerves in China's foreign policy has been increased by changes in its political power structure that have been brought into sharper focus by the fierce battle for position ahead of the installation of its new leadership at the start of next year.

This is the first handover of power since 1949 not to have been stage-managed by a dominant national figure commanding universal respect. It is a decade or more since China was ruled by "strong men" figures, handing down commands from high. President Hu and Prime Minister Wen have been conspicuously less able than their predecessors to impose their will and have instead had to devote much energy to trying – with varying degrees of success – to canvass consensus among influential factions within the Party. Their successors, lacking firm power bases of their own and beholden to those who elevated them to power, may struggle to break out of that pattern.

Some observers have argued that diffusion of power is a positive development that builds into the system checks and balances that will prevent China from veering to extremes, as it did under the dictatorship of Mao. However, it is equally possible that the reverse will turn out to be true: that a weaker leadership will be less able to hold in check headstrong elements of a more factionalised polity, leading to greater policy instability. The recent lurches and inconsistencies in China's behaviour on the international stage, usually attributable to political in-fighting or institutional rivalry at home, may yet turn out to be a portent of just that.

This adds a further layer of complexity to a still larger question: what does China want from the world, and how does it see its own future place in it? The regime itself has provided few clues to the answer so far, beyond demanding international respect: Beijing is better at objecting to what it doesn't like than at articulating what it does.

However, the question is set to loom steadily larger, as China's economic and military importance grows and as international developments unavoidably impact increasingly on its own interests.

Beijing has few, if any, close military allies, and its intentions arouse widespread suspicion, if not outright mistrust, in many other capitals. Its international influence is exercised largely through the medium of money – as an exporter of goods and capital, as an importer of resources and as a source of finance for developing countries that produce them – and by the language, if not the actual use of, brute force.

While China's economic achievements are widely envied, its authoritarian system and the mercenary values that increasingly dominate its society inspire little yearning elsewhere to share in them. Nor do those at the top of the pile seem content: a survey last year found that half of the country's rich wanted to emigrate in search of a better life. In many ways China's prevailing cultural ethos could be described as exhibiting the worst of America's materialism with none of its – admittedly tarnished – idealism. That hardly looks like a winning proposition in the contest for soft power.

Ironically, the pressure of economic need that has driven so much of China's foreign policy may pose one of its biggest future challenges. The country's ceaseless quest for energy and natural resources to fuel its industrial development has led it to expand rapidly its investments in and dependence on other developing countries.

But this stampede is often on fragile ground. Many of China's resource investments are in highly unstable and dangerous regions, where few western companies would dare to tread. (Since most of the investments are in the production of fungible commodities, they are actually doing a big favour to the rest of the world by expanding available global supplies). In many countries, China deals happily with dictatorial and sometimes brutal regimes. In Africa, local resentment at Chinese economic expansion has given rise to frequent complaints that Beijing is recreating the western imperialism that it publicly condemns.

Beijing routinely rebuffs criticisms by insisting that it is transferring wealth to poor parts of the world without

political strings attached and by cloaking itself in the mantle of “non-intervention” in other countries' domestic affairs. Both claims are debatable. The more interesting question is whether they are sustainable.

As the US and Britain before it found, the commercial exploitation of resources in far-flung corners of the world sooner or later creates powerful pressures for political involvement, or at least the need to take sides. Where large investments and vital sources of supply are at stake, simple economic self-interest makes it much harder to stay sitting on the geopolitical fence. Cosying up to dictatorships, as Beijing often does, creates the obvious risk that if they are overthrown, their successors will not look kindly on those foreign powers that helped prop up their former oppressors.

The eruption of turmoil in the Middle East surprised China at least as much as it did the west. Tellingly, Beijing's most pressing concern has been domestic: to guard against the possibility that the Arab Spring would encourage similar unrest at home, by suppressing any hint of sympathetic protests and clamping down on news coverage of the uprisings – except when it looked as if threatened autocracies were prevailing. Its second reaction was to get out of the way, evacuating thousands of Chinese nationals in Libya and abandoning contracts there worth an estimated \$20 billion.

China's abstention from the UN Security Council vote authorizing western military intervention in Libya can hardly have endeared it to those who overthrew the Gaddafi regime, even though it has subsequently sought to improve ties with them. It is questionable whether promises of energy purchases, investment and infrastructure will be enough to erase that memory. More recently, intensified EU and US sanctions on Iran, which supplies 11 per cent of China's oil imports, have left Beijing caught between an opportunistic impulse to press Teheran for lower prices and the risk of setting up a bruising confrontation with Washington if it flouts US legislation. China has also been placed on the spot over Syria, vetoing Security Council action.

The west, of course, has made its share of blunders over the years and suffered serious blows in its dealings with the Middle East and other volatile regions. It, too, has

made enemies as a result. However, it has also tried to define its policies in a broader geopolitical context designed to promote stability and has launched, with mixed results, diplomatic efforts to achieve that goal. China's approach still seems rarely to rise above a mixture of the chequebook and commercial opportunism. Evidence of any purposeful longer-term geo-strategic thinking is hard to discern.

Sooner or later, China's deepening economic links with the rest of the world will require it to make bigger policy choices. The global impact of its rise and its growing external dependence are simply becoming too important for it to continue to affect a pose of staying on the diplomatic sidelines, without putting at risk its own economic interests. How it makes those choices will have far-reaching implications, for China and for the world.

CONCLUDING REMARKS

WESTERN OBSERVERS HAVE long debated whether economic development would, in time, lead inexorably to a transformation of China's political system, in response to the demands of a richer, more sophisticated and better-informed populace. Even though there is no evidence of any broad-based popular demand for democracy, pressures for change are on the increase, with little sign that China's Communist Party has yet formulated a clear and effective strategy for responding to them.

The "performance-based legitimacy" on which China's rulers have based their hold on power for three decades is coming under strain from several quarters: from the difficulty of meeting the heightened expectations of the population, sections of which are no longer satisfied simply by annual rises in headline GDP figures; from growing popular resentment at perceived abuses of power; from serious weaknesses in China's traditional development model; and from the need to permit more open public debate in order to promote the innovation that China sees as essential to its ambitions to spur industrial upgrading and avoid the middle-income trap.

At the same time, external events are increasingly intrud-

ing on China's domestic affairs, as its global weight grows and as its economic needs steadily expand its interaction with the rest of the world across an ever broader front. The issue is not whether China will "rule the world" – a role it shows no sign of desiring or being capable of playing – but whether it can cope effectively with the international responsibilities imposed by its own development.

This is a daunting agenda. It also raises a new question about the relationship between political and economic evolution: whether it will be possible for China to proceed with the substantive economic reforms essential to its continued rise unless they are preceded by serious political reforms.

These need not involve a transition to western-style democracy, nor do they seem likely to in the foreseeable future. In China, the Party takes precedence over all other national institutions and is, in constitutional terms, answerable only to itself. Those holding power would never dream of surrendering it willingly. Yet they are also acutely aware that in autocracies, rulers who fall down on the job cannot hope for a second chance. That is a powerful incentive to adapt.

Can the circle be squared? Probably the most that can be expected in the next few years are reforms aimed at making government more decisive and efficient. That would mean restoring to the top leadership the authority needed to push through controversial restructuring and freeing the regime and the Party from the grip of creeping clientelism and cronyism that have strengthened the influence of special interests and their capacity to frustrate unwelcome, but economically beneficial, change.

The selection later this year of a new president and prime minister and, just as importantly, of members of the next standing committee of the Politburo, may offer some early clues as to whether such a transformation is possible. Much may depend on the balance in the latter body between reformers and conservatives.

But even if the reformers are in a majority, vigorous debate and differences can still be expected over the direction of policy. Though these will doubtless be only

glimpsed dimly and intermittently by outsiders, experience suggests that they could have important – and potentially destabilising – repercussions on China’s international relations. That could make it an unpredictable partner for some time to come.

How should the rest of the world, and the west in particular, respond? The first lesson should be to recognise that, while recent history has shown that China is not immune to external pressure, it cannot be coerced into acting as others would like. Indeed, attempts to do so can be counter-productive in a country whose intense preoccupation with sovereignty make it ultra-sensitive to any suggestion that it is submitting to diktats from abroad.

But neither should the west make the error of assuming that China is some unstoppable force, endowed with overwhelming might and a long-term strategy for global dominance. In truth, China’s supposed power – political, economic and military – is in practice much more limited than it may appear; either because it is sometimes genuinely modest or because, where it does exist in theory – such as in financial markets – the cost to China of exercising it would be prohibitively high. In many cases, such as the disposition of its foreign exchange reserves, China is as much a captive as a master of circumstances largely of its own making. An emerging giant, no doubt, but in important respects still a muscle-bound one.

The only realistic option for the rest of the world is to continue to try to engage China pragmatically, but without conceding on essential principles. That will require patience and a willingness to invest political capital in the expectation – but without any guarantee – of future rewards. The road ahead will be long; it is also likely to be bumpy, tortuous and strewn with surprises at every turn.

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