

Transcript

Station: **CANBERRA CONFERENCE UNIT** Date: **26/05/2009**

Program: **SEMINAR** Time: **12:30 PM**

Compere: **0** Summary ID: **C00034825666**

Item: **GEORGE FRIEDMAN DELIVERS A SPEECH ENTITLED "WHAT WILL THE WORLD LOOK LIKE IN THE NEXT 100 YEARS" AS PART OF THE MENZIES RESEARCH CENTRE'S AUSTRALIAN SECURITY IN THE TWENTY-FIRST CENTURY LECTURE SERIES.**

INTERVIEWEES: GEORGE FRIEDMAN

Demographics:	Male 16+	Female 16+	All people	ABs	GBs
	N/A	N/A	N/A	N/A	N/A

GEORGE FRIEDMAN: Well, I can't say how happy I am to be in the Australian Parliament House. I regard Australia as in many ways my second country. My wife was born here and went to Sydney University. And when I come home here I really do feel like I'm coming home.

But there's another reason: My daughter was a major with the First Cavalry in Vietnam in - sorry, that's my war [laughs] - in Iraq. And, while there, she was serving with many Australians. And I thank the Australian Special Forces for taking good care of her, and not so much with supplying her with whiskey [laughs] we're dry, you're not, but she claims that she also went there for tea. So my family is intertwined with Australia, and I'm grateful to be here.



MEDIA MONITORS

I am probably the only American who remembers the Dibbs Report. And I remember the Dibbs Report because it fell to me to find out where the Cocos Islands were. When the report came out the Cocos Islands was named as the perimeter and no-one in a very smart building had the slightest idea where they were. We finally located them on the map and then the question was why? And the theories abounded: Australia is planning a Diego Garcia; well, no, they can't support a Diego Garcia. They found oil [laughs]. Every reason was given, but the reason that apparently was the case. It was as good as any, better than some, as a perimeter for Australian defence.

So I looked at your defence paper today, in the past few weeks, very carefully, and my staff did too, because we were very interested and excited by the fact that Australia is reaching the point of having a mature defence policy. Much of it made a great deal of sense, but I'll speak a little bit about the part that confused us before I go onto talk about the future of the century, and bizarre things like that. And that was the part on China which we had a little trouble understanding.

If I understand the paper correctly it basically uses China as the foundation of a national strategy that ultimately focuses in on the alignment between the United States and Australia. Much of what I read later in the study is about the development of interoperability, of strategic alignments, of



cooperation with the United States. Obviously I can't object to that.

In fact, I see an interesting thing happening in the world between the United Kingdom, the United States and Australia, almost the vision that Churchill once had, which is the emergence of a very powerful, very friendly, very united bloc now working together on a global basis to create what I think is stability. And I think that's promising.

But I have to say that since I've been here in China - in [laughs] yes - since I've been here in Australia I've heard some of the wildest enthusiasm about the future of China that I've heard anywhere in the world, and I spent this year travelling the world.

No-one doubts that China is an extraordinarily important country. No-one doubts that it matters, but your reports states that China may equal the American economy in 10 years: that in 2020 the Chinese economy may be as large as the American economy.

Well, between 1980 and 1990, the Chinese economy grew 10 times, an extraordinary achievement for a take-off economy. In 1990 to 2000 it grew four times. Between 2000 and today, it's grown by about 1.8 times. Not trivial. The forecast here is that it will grow about 4.5 times in the next decade. And that is not only unlikely, it is reversing everything we know about development.



MEDIA MONITORS

And, from that, I'd like to begin talking about the nature of contemporary geo-political power. In 1991 something extraordinarily happened. For the first time in 400 years not a single European power was a global power. With the collapse of the Soviet Union no European power had the ability to project its power globally. And most European powers were not even what I would call balanced powers; balancing economic capability and military capability. Europe had ceased to be the centre of gravity of the international system.

It was what Churchill called the changing of the guard. And there was no question who the guard changed to. Not because the United States was more virtuous, not because the Americans are more kind, and certainly not because the Americans are multilateral, but simply for some obvious reasons.

Today the American economy is larger than the next four economies combined. If you take Japan, China, the United Kingdom and Germany and you combine them, the American economy is larger.

It is extraordinarily important when we talk about power, that we focus on fundamentals. In the same way as we invest in the stock market we really do want to know what the revenues of a company is worth, usually.

When you look at the United States you see a country that, depending on how you count the



MEDIA MONITORS

dollar, constitutes between 25 and 30 per cent of the global economy. That makes the United States a vortex of economic power. Everything turns around it because you really can't avoid an economy that large.

We talk about the decline of American industrialism. At this point American industrial output is larger than the combined industrial outputs of China and Japan. That's what the industrialisation looks(*) in the United States. The United States is the world's second largest producer of natural gas, the third largest producer of oil; larger for example than Kuwait. So we think of Kuwait as a great source of energy. Don't forget the United States is a larger one. Granted, our appetites are massive.

Let me add a final thing that is rarely considered but should be. Japan's population is per square kilometre 365 people. The German population is about 260 per square kilometre; the Americans 34, not counting Alaska.

That means that when we look at economic inputs - land, labour and capital - where Japan and Germany are pretty much out of land, the United States hasn't even touched Montana. And where the Germans and the Europeans have a great deal of difficulty handling immigration, the United States has an easier job, simply because you don't have to shove the immigrants up against the people who were there before.



MEDIA MONITORS

Europe has an Islamic immigration problem. There have been as many Islamic immigrants to the United States as there was to Europe, and we gave them a city called Dearborn Michigan. And I don't mean gave them, they went there. And in the same way that Italians and Irish and Jews came to the United States and stayed in their little communities until they acclimated, or their children, or grandchildren acclimated, we have that same process underway.

We're looking at an age in which population is declining; birth rate is collapsing everywhere in the world. We talk about the greying of the population, and that certainly is a problem. But we also forget that in 20 years there will be an advanced industrial world and massive labour shortage, especially with an ageing population.

In 20 years, the immigrants we're trying to keep out today, we will be competing for and paying bounties for having them come here, or to the United States. And those countries that are very, very good at integrating immigrants - the United States and Australia being chief among them - have an enormous advantage over a country like Germany or France that has a terrifically bad time integrating immigrants.

We in the United States, and you in Australia, are in an enormously advantageous position economically. Until this point, the greatest lack has always been capital. We have always assumed that there would



MEDIA MONITORS

be more workers, more consumers, more soldiers, more everything. That simply is not going to be true in the twenty-first Century, and it's already hitting countries like Germany whose population will contract by about 25 to 30 per cent over the next 30 years. That's not a strange forecast, that's arithmetic: the number of babies born, the number people die, it gets very simple.

The ability to attract, integrate and utilise labour will be one of the foundations of national power. While Japan and Germany and others struggle with the question not only of finding people to live there but integrating them into their society, those countries that do well, such as the United States, has a natural advantage.

So I begin by stating the obvious: this is the size of the American economy, which is non-controversial; that is the size. And then I point out the chief variable that will continue to drive the comparative advantage of the United States and of other countries as well, which is the ability to manage its labour force without social chaos.

And that won't be trivial.

And then we add a final characteristic to American power, which is that the US navy controls all of the oceans of the world.



MEDIA MONITORS

Never in human history has that happened. The Romans were good, but it was only the Mediterranean. The British never had absolute control. There were other navies that could challenge them. The United States has no navy that can challenge them, which means that the pattern of international trade ultimately devolves on the willingness of the United States to accommodate that trade.

The United States is always reasonable, never petulant, and never vindictive, God knows. But if it ever chose to do so, it has the perfect instrument, at the perfect place at the perfect time to carry it out.

When you combine this extraordinary fact of the complete control of the world's sea lanes by the United States, and lay next to it the enormous size of the American economy, you begin to understand the fundamentals of power.

And from this, we turn to China, which, the report says, will challenge the United States in 10 years.

Apart from the fact that it would have to grow five times and the United States not at all to catch up economically, China is a country that's in deep crisis. Let's begin with the basics. China's a country of 1.3 billion people. One point one billion of these people live at a standard of living of equatorial Africa.



MEDIA MONITORS

It is a country of vast and incredible poverty.

You will not see it when you fly into Pudong, and drive to the Shangri La, and then go to your meetings. That is not China. That is an extension of the west.

When I've gone to China, as I have several times, and I've gone to one of those wonderful Chinese dinners that you have to mortgage your home to pay for, I asked on a particular occasion the question how much does the waitress over there make.

And the answer came back that she makes \$60 to \$70 a month. She was serving a dinner worth perhaps \$1500, and she made \$60 or \$70 a month.

I asked to see where she lived, which is not what it sounds like, okay. It's all proper. She lived in a concrete building without heat in the Shanghai winter. Without water, without hot water, had cold water. And for a reason I don't understand, the privies were in the back.

And she took this job and lived in this place because it was so much better than it was at home.

China consists of two countries. One of these countries is a vast, enormous pool of poverty. The other country, the country you're familiar with, is the 200 million who live in coastal China - but



they're not part of China, because China can't buy the products they produce.

They sell to the United States. They sell to Australia. They sell to Europe.

It is far more reasonable to look at this part of China as the United States' western California, if you will, than it is to look at it as part of China. Because there is almost no connection between the coastal China and the real China.

There's no economic connection except for labour which tries to get into this region, and is kept under control by the security police who try to prevent them from coming there to get jobs for \$60.

China has been growing extraordinarily, but as we learned with Japan, the last power that in three years would overwhelm the United States, and they just disappear - rapid growth doesn't necessarily mean health; because China, like Japan before it, South Korea, and other countries in the region, has among the lowest rates of return on capital that you can imagine.

Some cases, negative.

And that simply means this.

When they sell products to Wal-Mart, which is their customer, Wal-Mart ruthlessly plays them off each



other, cutting their profit margins until there's nothing there.

The business that Wal-Mart is in is cutting profit margins - that's what they do.

Much of the exports that go out to the United States have no profit attached to them. For the Chinese economy - like the Japanese economy before that - that's okay, because the Chinese economy is not equity driven. It's not driven by investors who are looking for profit. It is driven by bankers, who have loaned them money who are looking for repayments.

It is a cash flow driven economy rather than an economy driven to generate profits.

As a result, there can be enormous growths in terms of the size of the economy, while at the same time hollowing out the financial system. This is what happened to Japan.

Japan surged its growth rate dramatically exporting to the west. At the very same time that it was doing that, it was destroying its financial system, because the loans that were being paid to companies could not be paid back, because no matter how fast they sold overseas, they couldn't keep up with the debt service.



MEDIA MONITORS

And as a result in 1991, after all of the media had announced that Japan was going to overwhelm the United States, the banking system of Japan collapsed; and it was about three or four years later that people noticed in the west - because I remember in 1995 reading about the Japanese miracle long after it was over.

We have seen three events of Asian economies doing this. The first was the Japanese surging their exports profitlessly, hollowing out their banking system, and then falling into a different model. The second occurred in east Asia in 1997, followed by extreme surges from south-east Asia and east Asia, winding up at financial crisis.

And we now have China doing the same thing.

Yes, China's growing enormously. But if you are in business, which China's supposed to be, the question you ask is not how fast you grow in your volume, but how profitable your business is.

And that's not a question that's asked: and when you take a look at it, one way to measure it is by non-performing loans.

How many loans were given out that couldn't be paid back?

When Japan went south, the ratio of non-performing loans to GDP was about 17 per cent.



And that's the point where they fell. In east Asia, for South Korea, it was about 23 per cent.

In China, if we are to believe Government figures, the ratio of non-performing loans to GDP is 40 per cent. Now much of that has been taken over by the Asset Management Corporation, which takes it off the books of the banks the way the Americans take it off the books, but it's still there in the system.

The assumption has always been that China has huge cash reserves to make up for this. They have \$2 trillion - but \$2 trillion isn't what it used to be, is it.

The Chinese have taken that money and \$650 billion have been devoted to a stimulus package to stimulate demand for Chinese goods to make up for the decline of western demand.

When you take \$650 billion and put it against a population of 1.1 billion, that number is really not that impressive, especially when counted out over a three to five year period - which is what they're doing.

The idea that that stimulus will in any way make up for the lost sales in the United States and elsewhere is mathematically dubious.

The second thing they're doing with that \$2 trillion is making sure that there isn't a growth in



MEDIA MONITORS

unemployment. Remember that a growth in unemployment in China does not mean a real problem with the retirement plan. When a sixty year old... \$60 a month waitress loses her job, the question here is survival.

The Chinese are very aware that throughout the twentieth century, unemployment has led to political upheaval, so they're doing two things. They're using their reserves to keep inefficient enterprises going. Not only the state-owned enterprises, which should have shut down a long time ago, but they can't because of unemployment; but also, enterprises that had been pushed to the wall by Wal-Mart - and I say that figuratively - and now have been sunk, are receiving loans through the banking system.

And you'll notice the surges in loans of the banks without new enterprises being formed to prevent bankruptcy and unemployment.

The third portion of that is being held to monetise the banks against non-performing loans. If you look at the Bank of China report for this year, there are zero non-performing loans in China. I'm impressed.

The greatest to that Chinese national security is the growing American savings rate, because one of the things that has happened in this recession is that the classes who buy at Walmart have dramatically increased their savings rate, having realised the



risks. Every dollar that saves, is a dollar not spent at Walmart. Every dollar not spent at Walmart is a solid dollar not spent in China.

China is now down below eight per cent. That is the magic number that the Chinese have cited - eight per cent growth in production - which is the magic number the Chinese and others had cited, because that is the number that maintains a stable cash-flow, so that banks can continue lending money to state owned enterprises and other entities, without hollowing out the system.

The future of China does not depend on China; it depends entirely on the propensity of the United States and Europe, but particularly the United States, to purchase products in China.

When we think of China as a surging power, it has to be understood that it's surge is an export based surge and that export based surge is based on the propensity of its largest customers to buy. And if the largest customers can't buy, it may continue to grow by cutting costs, cutting prices. But that does not mean that it can sustain that growth, because of declining rates of return on capital profit margins.

We've always heard of Chinese rates - margin ra... margins, profit margins being very thin. Then imagine what they have to do in the face of a recession in the world, to grow by eight per cent.



MEDIA MONITORS

And what happens to that profit margin in that circumstance?

That China has problems should not be surprising. It has grown magnificently for 30 years. But in the same way that other Asian economies have run into trouble, for the same reason, very thin profit margins designed to capture markets. And the way Japan failed, or changed its model in 1991, and the Koreans changed their model in 1998, it is not a surprising thing to find that China is going to change its model as well. That's not to say that China will collapse, or disappear, but in the same way that Japan changed its model from an urgent export model, where price was no object, to a much more conservative model in which maintaining full employment was more important than growth, so too China will change its model to something else.

What is most important to understand, is that the China that we see as so powerful, exists to the extent that the United States purchases its goods, which is why, by the way, the Chinese keep the Yuan pegged to the dollar. They can't afford to have a more expensive Yuan compared to the dollar, because there are plenty of other countries willing to sell those goods as well.

So, we now go to the question of global power. I don't know who the great Asian global power is, and it's sort of not necessary for your Defence Paper, although I would point out that the most powerful country in Asia is Japan. It is the world's



MEDIA MONITORS

second largest power. It has the navy that the Chinese are threatening to build. It has the officer core that is used to managing a fleet, which China hopes to train. It has an army, which is surprisingly big; you count it up, it's close to the British in numbers. It has an acceptable air force, and has one simple virtue, it is today the only complete power in Asia - one that combines military and economic power.

The question of whether China will be bigger than the United States is, I think, not relevant. Whether they'll ever catch up to Japan, that's an interesting question, both economically and militarily.

From my point of view, this is how I do geopolitical analysis. When I talk about power, I have to define what it is I mean by power. When I talk about economic growth, I must talk about what economic growth is. When I talk about military power, I have to define what military power is, and I have to carefully distinguish plans and realities - not Australia's, which will do everything it says - but China's. [Laughs]

When I look at powers that are strong, I see Japan. I see Turkey, the world's seventeenth largest economy, larger than Saudi Arabia with probably the strongest army in Europe, aside from Britain.

I see Russia re-asserting itself, using its window of opportunity - while the United States is bogged



MEDIA MONITORS

down in Asia; in Afghanistan and Iraq - to rectify the situation to its satisfaction in the Caucasus, to transform the politics of the Ukraine, to begin the process of placing extreme pressure on the Balkans. And using the fact that Germany is utterly dependent on its natural gas for function and the Russians cut it off for three weeks just to say hi, how are you? How you feeling? We're back.

We note that Germany is a non-functional entity against Russia and we note that if we wish to contain Russia, that containment will take place in Poland. That's just geography. And we note that the United States is obsessed about putting a ballistic missile system, it doesn't need, in Poland, rather than in other places it could put. Or the Russians are obsessed in making sure that system doesn't go there, even though they don't care.

And, therefore, we don't notice the F-16s, the Americans are putting into Poland. We don't notice many things that are happening.

The point that I'm making is that when I look at the white paper and I think of Australia creating a force that can lie with the United States and serve to protect Australia's regional interests against any Asian maritime power that might emerge, I'm attracted to it. When I see it focusing on China, then I have to put on my geo-political hat and my intelligence hat and try to put together a model that would explain the concern.



MEDIA MONITORS

I think, in Australia, I have encountered an over-estimation of Chinese capabilities and a vast under-estimation of China's problems. In the long run it won't make any difference, because the white paper will serve many purposes. But I would suggest that Australia might want to look at other countries; Japan, Turkey, Russia, all of whom are much more active, much more effective than the Chinese.

China certainly will be a great power. You will be selling much material to China, so long as the United States will turn around and buy their productive goods. But your sales to China depend on the health of the American economy, not on China's proclivity to buy, or anything like that.

So I've not gone into the future. I've not talked about the vast magnificence of Mexico in 2100 or any other of the issues. But I am grateful for this opportunity to talk to people involved in Australian defence policy, to get a poor American's view of what it is that I think we ought to be thinking together about China. Not ignore it, but let's get serious. And let me stop on that and answer questions.

[Applause]



* * **END** * *

TRANSCRIPT PRODUCED BY MEDIA MONITORS
target-monitor-analyse

CLIENT SERVICE CENTRE
1300 880 082

AGENCY REPORT For private research and not to be disseminated. Every effort made to ensure accuracy for the benefit of our clients but no legal responsibility is taken for errors or omissions. (*) - Indicates unknown spelling or phonetic spelling. Metro TV demographics are supplied by OzTAM, Radio and Non-Metro TV demographics are supplied by Nielsen Media Research.

ABs = Managers, administrators, professions. GBs = Grocery buyers.
