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**CHINA IN 2020: IMPLICATIONS FOR AUSTRALIA
AND THE REGION**

Transcript of an address by

**Professor Harry Harding
Elliott School of International Affairs,
George Washington University**

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Thank you very much Brice for the very nice introduction and good afternoon everyone. Thank you so much for coming. It's a great pleasure for me to be in Australia and to be in Canberra. I do have broader interests and one in fact is the civic architecture around the world and especially planned capital cities and living in one, Washington, and having a chance to visit another, Canberra, is always a great treat.

What I'm going to do today is to talk about some of the challenges that China faces as it proceeds from where it is now, 2007, to where we are talking about, 2020 to give them some very brief sense of how these challenges might lead to different scenarios for China, ranging from quite good to quite not so good and then to conclude with some thoughts about what the challenges are for us, for the United States and for Australia, as we respond to China's evolution over the next 15 years or so.

Let me say that we have gone through in the United States a very similar kind of evolution, as Brice has described for Australia. When I began studying China way back when I was in college in the late-1960s, it was possible to read in translation everything that was published in China every day, not because our translation facilities were so great or more speed reading ability was so high, but at the height of the Cultural Revolution very little was being published.

It was in contrast impossible to live in China for an American because we didn't have diplomatic relations. China was relatively closed to foreigners because of the Cultural Revolution.

So at the time that I began studying China little was known, little was knowable - it was indeed a great mystery. Now as if to prove Brice's point, my son is living and working in Shanghai for a private equity firm, having the time of his life. And I can only envy him because the opportunities for someone at this point in China are even more exciting and even larger than the opportunities were for people like me and my generation back - well that's about 40 years ago now.

Let me suggest that China faces six major groups of challenges now and into the next decade, its response to which will determine China's future and determine much of the future of the rest of the Asia Pacific region as well.

Let me emphasise that in talking about challenges, it's important to say that I wish China well in meeting these challenges. I raise these not as suggestions that China is necessarily going to fail and certainly not in the hope that it will stumble, but to say that it faces some very daunting problems ahead.

Secondly, let me also say, that I think the Chinese leaders and Chinese intellectuals would pretty much agree with the analysis that I'm going to give you. I know of few

people who are more self-critical and more concerned about the future of China than Chinese themselves are.

So let me talk about the six challenges, in no particular order except that I've tried to structure them in a way that they'll flow one into another. These are all challenges that exist today but in some cases would become even more serious over the next decade which is why many Chinese think that the next 10 years are going to be especially critical and an especially difficult pass - mountain pass, through which China will have to pass.

The first of these is to maintain political support and legitimacy and therefore political stability for China and for the Chinese Communist Party. I think that the Tiananmen crisis of 1989 led many people to think that China was on the verge of some kind of political collapse . And I think that many in America still have the kind of mistaken assumption that that is where China remains. It is true that there are widespread grievances in China.

It's also true that many years - 20, 25 years of sustained economic growth with relatively low levels of inflation have built a substantial degree of political support for the leadership and for the Chinese Communist Party.

At the same time, however, as Chinese leaders look at the situation, they understand that first there are very important public grievances that need to be addressed and, secondly, that some kind of political restructuring is going to be necessary in order to ensure that the legitimacy of the system is not based solely on performance, which is a very fragile basis for legitimacy for any political system, but is based on processes that give people in society the sense that their wants and desires and concerns are being attended to and acted upon by government.

For the sake of time I'll just be very brief and more as a kind of an outline than a comprehensive discussion of all of these things - it would take us far more than 20 or 30 minutes to give a comprehensive discussion and I'm sure you know enough about China to be familiar with many of the grievances.

Corruption, which is widespread in the system, other abuses of power especially at local level, infringement upon property rights especially of land, increasingly serious environmental issues involving both air pollution and water pollution, the growing inequalities in Chinese society not only between the coast and the interior or cities in the countryside but within communities as well, the erosion of the social safety net particularly in rural areas and particularly involving public health and to some degree education.

The Chinese I think are well aware of these problems and in many cases they are developing laws and regulations to try to address some of these issues. The problem that China has is the gap between the definition of the law at the central level and the incomplete and imperfect implementation of those laws and regulations at the local level.

That leads to the question of political reform because one of the things that the Chinese need to do is have better mechanisms for attending to the grievances of society and also of ensuring that laws and regulations are actually enforced.

Here we know that the Chinese Communist Party is very sceptical about some of the, what we would consider to be the familiar and even necessary instruments of political reform, the creation of a multi-party system, truly democratic elections, the creation of a freer press and the development of autonomous non-governmental organisations.

They still believe that this is too much of a challenge to the stability of China and are concerned that rapid movement towards this kind of liberal or pluralistic political reform could lead to the same fate for China as it did for the former Soviet Union and some of the satellite states where it led to political collapse of the party and a break up of the entire political system.

So for the Chinese, at least in the current leadership, it's an open question as to whether the next generation of leaders that will begin to come into power five years from now in 2012 will think any differently.

The present generation of leaders sees much more modest political reform as part of their agenda - better recruitment of officials, more stringent evaluation of officials from the top down along a wider range of criteria, some possibility of greater democracy within the party, a greater oversight by people's congresses, the legislatures at various levels, some experiments with what the Chinese call deliberative democracy at the grassroots, consultative of mechanisms rather than pluralistic mechanisms for understanding people's concerns.

Here's the problem very simply is, will they suffice? That's the strategy, they're clearly committed to it, but will that be enough to solve these twin problems of responding to grievances and putting pressure on lower levels of government to actually address the problems in the way that Beijing wants them addressed.

This then leads to the second problem and that is the importance of economic growth in maintaining the stability of the regime. Basically the reason why support is so strong has been the good consequences of a very deliberate policy to maximise growth through a policy of economic reform and opening that followed or really was reinforced and reiterated after the Tiananmen crisis of 1989.

Deng Xiaoping made a very clear decision that the crisis required that China not move away from policies that some were describing as bourgeois or capitalist, not go back in the direction of a more egalitarian society, not roll back reform, but to continue a process of economic reform and opening, believing that the support of the Chinese population could be regained if economic reform - economic growth was sustained and rapid.

I think that to a large degree that debt paid off, much to the surprise of many at least in the United States who believed that the only possible outcome of the Tiananmen crisis would be either the collapse of the Chinese Communist Party or a democratic reform.

In fact we've seen 15 years of successful development under an authoritarian system. But if economic growth has been and will continue to be key to political stability, how sustainable is that economic growth in China? This is a very, very open question and one that Chinese leaders are very concerned about.

I've already mentioned environmental issues as a huge problem for China and anyone who has visited any of China's major cities, even Hong Kong, knows how filthy the air is. Anyone who reads the Chinese press knows about the serious shortages of usable water, the possibility of environmental catastrophe, either a large scale or a local scale.

In fact the Eurasia Group, which is a political risk firm that I've been working with for the last 18 months, identified these kinds of issues as the most serious risks that China faces over the next 10 years, not banking crisis, not war with the United States, not political collapse, but environmental and health issues as being some of the most serious for China.

In addition to that kind of environmental sustainability, however, we have in China the problems of what might be called the economic sustainability of their growth model.

To make a very long story short, the problem is that China has been a very highly investment oriented growth strategy with very high levels of investment as a ratio of GDP and relatively low levels of consumption and at the same time a very high contribution of exports and trade to the economy relative to domestic consumption in particular.

Given the inefficiency of the investment, given the opportunity costs with regard to household consumption; given the fact that the investment is extremely wasteful of energy and therefore a great contributor to various kinds of environmental problems including greenhouse gases, given the way in which China's trade surpluses have begun to pose political problems for China in the United States and in Europe and to a degree elsewhere as well, given the vulnerability of China to a downturn of a downturn in the global economy Chinese leaders themselves are saying that these ratios and proportions have to change in the direction of greater consumption and in the direction of more domestic growth.

The problem will be once again, actually implementing these decisions. As China begins to shift away from an export oriented economy the question will be can China shift its employment patterns in the same direction so that unemployment, their major source of political unrest, can be avoided.

As China shifts its balance of demand from investment to consumption, will that contribute to inflationary pressures which would be another significant factor that could erode legitimacy of the party and erode the political support that the party presently enjoys.

Third, and we were talking earlier today about some of the ways in which this third challenge may actually help China manage the second, is that China is going to have to deal - and this is already beginning to happen, but will happen even more within 10

years time - with an absolutely unprecedented combination of demographic shifts that will begin to come into full force some time around 2015 and certainly will be fully evident by 2020.

Most of these are - in fact, all of the ones that I'll mention, are very much related, not exclusively, but very much related to the one child per couple policy that China began to implement, in some ways with quite draconian measures in the early 1980s.

The first of these consequences is the ageing of Chinese society. The one child per family policy means, obviously, fewer young people. That and, in connection with greater public health for many parts of society, that means longer life expectancy so that means fewer young people, more old people. And China will become one of the first societies in the history of the world to become old before it becomes rich.

All developed societies tend to age. Japan is probably the most dramatic example of that. The United States basically has such a still pro-immigration policy that these implications for the US are more muted than elsewhere. But in Japan and Western Europe, one sees an ageing of society as birth rates decline and death rates decline as well.

But we're wealthy societies and we know how to deal with this. Actually, we don't know it that well in the United States where we have huge problems of social security and medical care that are related to ageing but China will face the additional problems of being poor.

This will, by the way, be beneficial in one regard and that will force China to begin to spend more on social services for the elderly. And that, by definition, as a statistical identity, a mere accounting identity, will mean a lower savings rate and higher consumption whether it's families paying for it or government.

So simply the ageing of society as problematic as it's going to be is going to play a role in forcing China to consume more and invest less. So that in one sense one problem helps solve the other.

More immediately we're going to see the kind of the effects of this one child per couple policy at the younger end of society. We are already beginning to see, entering adulthood, entering the labour force, a generation that is sibling-less, in other words, only children, and a generation that is disproportionately male. For the very simple reason that if a family can have only one child it will prefer to have a male. And it will develop various mechanism - as we might euphemistically say, up to and including female infanticide, to ensure that the one child that they are permitted to keep is a male.

Now, the statistics may be a bit misleading. There may be unreported females because having had a girl they will then try for a boy but not report the girl so they can do so legally. But we do have a sense that this will be a disproportionately male society and many of those males will not be able to find wives.

So we have the possibility of a variety of problems including trafficking in women across borders, the possibility of greater crime which tends to be undertaken by

younger men who are rootless and in a sense anomic outside of social structures and social institutions. So we're going to see a variety of social and economic problems some of which will have trans-border implications over the next ten or 15 years.

And what's clear about this is that demographic trends are (a) the easiest to forecast. We know who is born. Unless there is some massive plague or epidemic pandemic those numbers are not going to change. We also know, therefore, that these demographic trends are very difficult to reverse. Even if the Chinese government were to decide tomorrow to relax the one child per couple policy, the implications for the Chinese labour force would not be felt for 20 years, roughly. So this problem is something that is both known and basically unchangeable for the next protracted period of time.

The fourth challenge that China needs to confront and is already confronting is the reconsideration and redefinition of its international economic strategy. China's strategy, during the Maoist era, was basically autarchic. It minimised foreign trade and basically eliminated and prohibited incoming foreign direct investment.

That policy was changed early on by Deng Xiaoping, symbolically with the creation of the four special economic zones in the late 1970s and early 1980s. And basically China engaged in a policy, not just of internal reform, but of external opening. That was not only interested in promoting exports, as Japan say have been in the 1960s, but also wanted to promote exports by welcoming incoming foreign direct investment which could maximise China's access to markets and technology and capital and design in a very, very efficient way.

So China has been a poster child for this aspect of globalisation, a policy of bringing in foreign investment in order to create goods for export. And China has generated not only greater wealth but huge trade surpluses in part as a result of this policy.

Now, however, for a variety of reasons this policy is beginning to run out its course - run out of strength. And Chinese business and political leaders are beginning to think through the challenge of where does China go from here. And let me suggest some of the elements and dimensions of that debate.

First of all, China is now at the point where it is going to be increasingly importing energy and raw materials from abroad. And probably Australia knows this better than almost any country in the world, given the extent to which you are a supplier of natural gas and various raw materials for China. This leads, of course, to questions about China's impact on international markets, the supply demand balance going out for the next decade or so.

But it also leads to political questions because of the question of the strategy by which China will try to achieve these imports. Will China rely on what some simply call the international marketplace, the international oil companies? Can it trust those companies enough to deliver resources to China in a reliable way and at a reasonable price? Or will China increasingly try to go direct to the source and, either through direct investment or through long-term contracts, try to negotiate direct access to energy and raw material, through its national oil and resource companies, as opposed to the international marketplace?

And it's clear that China is adopting that latter strategy. China's not alone in this, by the way. India's doing very much the same thing, as is Japan, for that matter. Trying to increase the share of imports that are controlled by national companies rather than by international companies and for much the same reason - a desire to diversify sources to reduce risk.

The problem is that China's doing this and especially the countries in Africa, in which it is doing it, and the Middle East and Latin America, are being seen as quite challenging especially to the United States and are making this another aspect in which the United States and China view themselves as strategic and economic competitors rather than partners.

Second, I think the Chinese are trying to - are questioning their openness to foreign direct investment and, in fact, the second and third sub-points here are all having to deal with a kind of economic nationalism that's emerging in China.

Increasingly, you hear Chinese complain that foreign investors are doing too well in the Chinese marketplace. They have too much market share. They control too much of the Chinese technologies, in terms of the royalties that they collect. They have too much of an ownership stake in strategic sectors.

And so you see the Chinese at the margin beginning to be more restrictive in terms of what foreigners can do in China. Limits on the degree of ownership they can have in certain sectors, selective implementation of regulations, possibly being subjected to an anti-monopoly law and, of course, most recently, at the National People's Congress that's having their tax rates raised with the unification of the Chinese and a foreign corporate tax rate in China.

Even more interesting, to this kind of protectionism, is the second side of economic nationalism which is promoting national champions and sending Chinese firms outward. Basically, Chinese are no longer interested or satisfied in simply having that little slice in the middle of the value tank - being the low cost assembly point for goods that are then shipped over to the United States or Australia or Europe for sale to consumers.

They know that that creates some profit but it's not where the bulk of the profit lies. They want the entire package which goes from basic research and development or basic research or research and development, design, branding, marketing, distribution, finance. In other words, they want to capture more and more of the entire value chain. And Chinese firms will be increasingly trying to do that with the support of various incentives and subsidies provided by the Chinese state.

They will do this, in part, based in China. But they will do it also by moving abroad to develop the ability in third world countries to begin to internationalise their local Chinese firms and through mergers and acquisitions in developed countries including in particular the US and Europe and this will be extremely controversial. It will create a backlash in the third world, as it already is, and will begin to create great suspicions in the United States much as the outward wave of Japanese investment did in earlier decades.

And finally the fourth sub-challenge here, in terms of international economic strategy will be that China will have to decide how open it will be to financial flows in both directions. So far this huge amount of money flowing in and out of China has been in direct investment. Foreigners sending direct investment in, China is just beginning to send direct investment out to the third world and to the advanced economies.

And, of course, most financial flows in today's globalised world are indirect or portfolio investment. And the Chinese will have to decide the extent to which they're going to open their own domestic stock markets and bond markets to foreign investment and the extent to which they will allow Chinese investors with this huge pile of savings, both individual and corporate and government, to seek investment opportunities abroad.

Economic logic says that opening financial flows will be far more efficient and far more profitable than keeping them restricted but Chinese will be very nervous about the degree to which this will introduce volatility into their financial situation.

The recent example, where the Chinese Shanghai exchange dropped by nine per cent, in its value, leading to apparently - although probably not really - but the perceived echo effect around the world is going to be an early warning sign of the way in which the foreign community will want access to Chinese opportunities and Chinese funds but volatility will become an increasing factors.

Fifth challenge - and perhaps the most narrowly defined, but one that I think is very important because it could lead to direct confrontation with the United States, is the challenge of coping with Taiwanese nationalism. As all of you know, one of China's major national priorities - very high up on the list - is securing the unification of Taiwan with China and conversely preventing a unilateral declaration of independence by Taiwan.

The problem that China faces is that Taiwan is no longer led by a government or a political party that is committed to the goal of unification. Indeed, it is led by a government and a political party, many of whose members no longer see themselves as Chinese and are not committed to unification at all, but rather see Taiwan as a separate society, with a separate identity and certainly it's own sovereignty that may or may not wish to unify with the mainland ever at all.

And while Chen Shui-bian and the Democratic Progressive Party have not been able to change Taiwan's formal legal status, for reasons we can explore if you'd like, they have I think made a significant progress in changing Taiwan's self identity - making it see itself more as Taiwanese and less and less as Chinese, as reflected in a variety of public opinion polls over time.

That obviously means a challenge to China because the objective of promoting national unification now runs up against a growing sense of Taiwanese identity. That is not actually an insurmountable problem. Germans didn't have to feel a common identity - didn't have to feel themselves to be French - to join and to create the European Union, nor did British, nor did French. They had to see a common interest

in developing something bigger than all of them, a European identity that all would find benefit in joining.

So I don't think that it rules out some kind of economic or political unification or integration, over the decades. What it does rule out is the effectiveness of the Chinese strategy towards promoting it which is basically to deny a separate Taiwanese identity, to deny and independent Taiwanese sovereignty and basically to try to argue that the choice should be predetermined and preordained for Taiwan.

And it certainly makes very unattractive the formula of one country, two systems, which Beijing is trying to present as the necessary way of fostering unification. So think the challenge is whether China will respond in a creative and in some ways counter intuitive way to the issue of unification. Understanding that the only way to promote it at this point is to treat Taiwan as a more independent, equal and sovereign entity whereas conversely insisting on one outcome of a Taiwan that has no international status, is not sovereign, is going to guarantee failure.