

China and Britain: the potential impact of China's development

The Smith Institute

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Edited by Professor Hugo de Burgh



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China and Britain: the potential impact of China's development

Edited by Professor Hugo de Burgh

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Preface

Wilf Stevenson, Director, Smith Institute

The Smith Institute is an independent think tank, which has been set up to undertake research and education in issues that flow from the changing relationship between social values and economic imperatives. In recent years, the institute has centred its work on the policy implications arising from the interactions of equality, enterprise and equity.

The rise of China as an economic power, perhaps the mightiest economic power the world has yet seen, is a matter impinging more and more upon the consciousness of British opinion formers and decision makers. And yet we know very little about the social, institutional and environmental issues of the country. We don't study its languages. And we don't understand its approach to trading and economic issues, or engage with its geopolitical agenda.

The Smith Institute, in partnership with the University of Westminster's China Media Centre, is pleased to be publishing this collection of essays by key experts in the field. We hope that their contributions will help to develop the debate around the economic, political and cultural effects of China's rapid emergence as a global power.

The editor wishes to thank Sally Feldman, Dr Peter Goodwin and Professor Annette Hill of the School of Media, Art & Design, University of Westminster, for their support, and Professor Shi Anbin and Chang Yiru for their help. The Smith Institute gratefully acknowledges the support of HSBC, Prudential plc, the Quintin Hogg Trust, Rio Tinto plc and Rolls-Royce plc towards this publication and the associated seminar series.

Introduction

Professor Hugo de Burgh, Professor and Director of the China Media Centre at the University of Westminster

The rise of China is surely one of the most important public policy issues facing this country and many others. Our economic, foreign, environmental, education, welfare and immigration policies may all need to take into account the impact of China. This is because even if not all the predictions made for China hold good, its achievements to date and China's strengths – despite its weaknesses – cannot be denied. This introduction sketches these achievements and strengths, looks at the potential effect of China upon our education system as a case in point, and highlights the main matters raised in the following chapters.

The questions to ask

One hundred and twenty years ago, my grandfather wrote from California to his brother in Ireland: "The world will never be the same again once the abundance of this country and the energies of its people are deployed to the full." The present might of the USA, its inheritance and prosecution of what used to be referred to as "the mission of the English-speaking peoples", were only dimly foreseen in the 1890s. China today is in an analogous position but, as the essays here show, the scale of the Chinese transformation is much greater, the speed unparalleled and the implications unnerving.

"When the Engineering Employers Federation asked its members ... how they viewed China, almost 60% said they saw it as a threat," according to an article in *The Observer*. Industry leaders predict "a complete restructuring of the industrial economies of the US, France, Germany and the UK"¹. When they wake up to what is happening, electorates, James Kyng suggests, will expect something from their politicians. So, what plans do we have for when China is manufacturing all our cars, pharmaceuticals and construction supplies – oh yes, and our Irn Bru, Wensleydale cheese and souvenir sporrans? Competing with China, how do we stand up for higher taxes, better welfare provision and regulation of business?

China will soon be seeing the graduation of thousands of engineers, software designers, architects, chemists and financial advisers who not only will compete with our own graduates but may write better English too. Will our children be able to compete? Do we need to reform our education system so that they can? Should Chinese be the second

¹ Stewart, Heather "Why Mr Brown Went to China", *The Observer* (27 February 2005).

language in our schools? How will our universities cope when Chinese universities deliver in English to all comers?

Some companies, colleges and consultancies are making money from China now, but can they prosper in the future without becoming Chinese? Should we allow the Chinese to buy our companies when we cannot buy theirs? Does co-operation in research and development while desirable in its own terms, raise other issues for consideration? China is the rival of the US for influence in Asia, and is our competitor for scarce resources, yet plays by different rules. Her companies are often state-run; she is not democratic; she does not yet protect intellectual property: how equally can China be treated?

Our politicians go to the USA and come back with ideas: but do they learn from China? India? Japan, or continental Europe? Should they not be systematically studying how others do things? Isn't it time to learn languages again? To consider how we have to adapt our perspectives and our skills to ensure that we are fitted up for a world in which we cannot assume Anglophone dominance?

These are a few of the many questions to be thought through. The politician who provides the frameworks within which these challenges can be met will be a statesman.

China's achievements

In winter 1991/92 Deng Xiaoping, prohibited by the capital's media from airing his proposals for the market revolution, travelled to the south to lecture reform-minded provincial leaders on the need for free enterprise. This became known as his "Progress to the South". These provincial leaders seized their chance, fully realising the Special Economic Zones and impelling China on a course that has involved closing 3,377 state enterprises in a massive programme of marketisation,² reintroducing the stock market, joining the World Trade Organisation, privatising housing and commencing a mass of institutional reforms. As Linda Yueh shows in her essay, China has become the world's largest recipient of foreign direct investment. GDP doubled in the nine years to 2004 and grew 9.5% in 2003/04. It is generally thought that 400 million people have been lifted out of poverty.³ In 2004 China replaced the USA as the main trading partner of Japan and

2 In 1980 the state sector accounted for 76% of gross industrial output, and by 2001, 24% – Reynolds, Paul EM *The Chinese Economy – Hard Landing or Worse?* (Global Economic Policy Institute), paper delivered at the China-Latin America workshop at the University of Westminster, 3 June 2005.

3 The reforms began much earlier than 1992, but were paralysed by the 1989 Tiananmen Square massacre, one of the consequences of which was a return to power of the left. Deng's Progress to the South undermined the stasis that the leftists had forced upon China since June 1989.

South Korea. By 2020 it is expected to have surpassed Japan and will have re-established Sinocentrism in Asia.

From being a laughing stock, China now has the fastest growing economy, predicted to overtake Japan by 2015 and the USA by 2039.⁴ Three years after joining the WTO, China's influence on global trade is powerful. Chinese demand in many international markets has become the dominant price setter, or at least a big swing factor.⁵ China is the main driver of Asian growth; its need for raw materials is important to many countries from Argentina to Australia; it causes controversy by liquidating US manufacturing jobs and by using its surpluses to prop up the US economy.

China's strengths

China's impact is on account of its particular strengths: scale, sense of purpose, pragmatism and dynamism.

Scale

The idea of reaching 1.3 billion consumers has fired the imagination of world business. Chinese growth is export dependent and the internal market, the size of which has mattered so much to the USA during its rise, is only now, as Elisabeth Croll's essay makes clear, becoming a focus of policy. The massive urbanisation helps: it is planned that another 300 million peasants will move into cities by 2010.

The infrastructure development integrating China with the rest of the industrialised world is itself on a large scale. No fewer than 26 Chinese cities are currently installing underground railways; 50,000 miles of three-lane highway are under construction. This is the size of the entire US interstate network; whereas these works took 40 years in the US, China plans their completion in five.⁶ There are 30 nuclear power stations on order. Infrastructure is being built everywhere, opening up new markets, connecting with new resources.

China thinks big. Visiting new leisure complexes, university campuses or science parks you are very soon made aware of this. Entrepreneurs and officials have thrown themselves into ambitious projects that often dwarf those that were their models in the West. In Shanghai you will find the world's tallest hotel, the biggest shop, the highest TV tower, the fastest

4 Goldman Sachs, quoted by Stern, Stefan in *Financial Times* (9 June 2005), pA3.

5 Kyngé, James "The World is Dancing to a Chinese Tune", *Financial Times* (31 December 2004).

6 Somerset Webb, Merryn "Chinese Commodity Boom", *The Sunday Times* (6 July 2005).

train. The Three Gorges hydroelectric project is the most titanic such operation the world has ever seen, five times the size of the Hoover Dam in the USA, submerging tens of thousands of communities with millennia of history.

The demand for raw materials seriously profits other economies – one small, sleepy Chinese town has in five years set up 200 sawmills and 500 floorboard manufactories working with imported timber.⁷ The commodities boom that was caused by Japan's industrialisation was driven by a population of 150 million. China, India and Russia together involve a demand more like 3 billion, and of the three, the most voracious appetite is China's.⁸

The size of the domestic market is having a profound effect on the world as it enables Chinese business to gear up for huge quantities and then export surplus capacity, contributing, along with cheap labour and high skills, to the phenomenon of the 'China price', which buyers demand that competitors match – or fail.⁹ In another way, China is much bigger than China proper. There are Hong Kong and Taiwan, but also satellites and the diaspora. In every continent and most countries Chinese communities have developed wealth and advanced skills that, if not repatriated to the motherland, provide resources and point men for domestic enterprise. That is Greater China, with its cultural homogeneity and intragroup trust.

Finally, the scale of China does not faze its leaders. China has an administrative tradition that has maintained its identity, while adapting to accommodate social pressures and foreign ideas, since 221BC, when the countries composing the Chinese world were unified. Despite disruptions of war and religious movements, of which the Maoist period is quite a short example, China has been a bureaucratic and meritocratic empire for well over 2,000 years.¹⁰ This gives those who climb the greasy pole a perspective that is large-scale, long-term and ambitious.

7 "Green Guise", *The Economist* (26 March 2005).

8 How China has overtaken the more advanced economies of the Latin American and Caribbean countries and perhaps excluded them from opportunities in the emerging technology-based markets of the future is interestingly argued in Lall, Sanjaya, Weiss, John et al *China's Competitive Threat to Latin America: An Analysis for 1990-2002* (QEH Working Paper Series – QEHWP120 – WP120, January 2005), paper presented at the Asian Development Bank-Inter-American Development Bank conference, Beijing, December 2004.

9 The mechanics of this are spelled out in chapter 7 of Fishman, Ted C. (2005) *China Inc.* NY : Scribner.

10 This thesis has been further developed in *The History of China until 1978*, a paper delivered to HM Treasury in 2004 by Dr Hans van de Ven of the University of Cambridge, which he kindly supplied to me.

Sense of purpose

China differs from India in having more cultural homogeneity, which is greatly unifying. As China has shed Maoist ideology it has begun to return to its own cultural roots. Casual conversation, viewing of Chinese drama TV series and visits to restored cultural sites in the company of thousands of tourists, both domestic and from Greater China, confirm this. Visit Confucius's birthplace, where his heirs have had their imperial pensions restored. Impatient Chinese youths long despised their culture as an obstruction; less and less is this so.

Bicycling around the ancient capital of Xian, on top of its restored, largely 14th-century walls this summer, I learned that all new building in the vicinity must be of traditional Chinese design. In the capital, modern buildings have been dismantled where they obstruct views of Confucian temples.¹¹ Similar projects all over China come as welcome relief from the destructive greed of the property tycoons who have been doing their best to turn many other cities into Los Angeles with stilts. They also demonstrate increasing confidence about Chinese heritage and identity. What does this mean?

Here is an example of the practical application of Chinese culture. Hua Xi village in south China is regarded as a model community, having increased the income of its villagers twenty-fold over the past 10 years, given everyone a new, 450m² house, investments and good education and health facilities.¹² What is traditional, though, is the authoritarian way that the leading family of the village dominates decision making and imposes its narrative, in terms that would be undisputed by most Chinese: that the goal of wealth may be personal but it is also collective – to make China strong and respected in the world. Thus everybody's wealth must remain in Hua Xi.

A fundamental teaching of Confucianism is that we are immortal, in the sense that what we do in this world is an investment to be realised through our descendants, to whom we hand down the culture we received from our forebears. This belief gives a sense of purpose that sustains and motivates; is the foundation of the famous family businesses that drive the market economy; curbs the slash-and-burn instincts unleashed since the Southern Progress; helps explain the savings ratio; and can be drawn upon by policy makers.

11 Clunas, Craig "The Impact of Chinese Culture Today", address at the Agora/CMC China Impact seminars, Carlton Club, 13 April 2005.

12 Watts, Jonathon in *The Guardian* (10 May 2005).

In the public sphere, intertwined with a pride in China's superior civilisation is Maoism's claim of a unique mission for modern China as the maker of the New Man. The party has allowed only one version of modern history to be taught, and most Chinese are in thrall to a twisted and xenophobic vision of the world. Steve Tsang reminds us that the party has encouraged and personified this in ways that may have destabilising effects on the world if political reform does not mitigate it. Although Isabel Hilton suggests that the contradictions in modern Chinese identity are disabling, it may also be that modern Chinese have the best of all worlds: a set of values that underpin the economic drive and a puissant and uncomplicated sense of destiny.

Pragmatism

The pragmatic openness to the outside world championed by Deng Xiaoping throughout his tumultuous career is more typical of Chinese history than the autarky of the Maoists and the quarantine of the later Qing. As Peter Nolan tells us in his essay, present Chinese policy making ("incremental system reform") is remarkable for its experimentation and empiricism. An idea is to be judged on its merits, and ideas are seized from anywhere.

Today educated Chinese manage to combine a usually passionate patriotism with a cosmopolitan perspective. They can operate as effectively in foreign cultures – England, Germany, Brazil or the USA, say – as in their own societies. This is not globalisation, any more than the existence of a few US fast-food outlets suggests that the Chinese are abandoning their culture of food. This is the society that absorbed and sinified Buddhism, the chilli pepper and clock making, and the language of which only admits foreign names when they have been sinified (Gordon Brown becomes *ge.deng.bu.lang*).

Pragmatic principles are combined with an emphasis on personal relationships that is particularly marked. The key to all operations, from buying a suit to building a business, is assumed to be the personal relationship, the management of which involves a code understood by all. This interlocks with rational modes of decision making, and makes Chinese commerce quite different to that in the Anglophone world. In their relations with outsiders Chinese apply the same principles – modified doubtless to account for our lesser sophistication – that guide relationships at home. Foreigners proposing to work with Chinese need to crack this.

Personalism is having a very detrimental influence upon investment decision making. Another of the negative aspects of personalism is that it locks out people who are not connected. The emphasis on social questions that has been the hallmark so far of Hu

Jintao's presidency is intended to deal with the unintended consequences of rapid development, of which the phenomenon of the socially excluded, particularly in rural areas and interior provinces, is one. The "fourth generation" of Chinese leaders have adjusted their strategy from growth at any cost to "balanced and co-ordinated growth", showing their own ability to adapt to newly appreciated circumstances. Whether they can apply this in the political sphere is open to doubt, as Jude Howell shows; how a rule of law may be coming about as circumstances require it is analysed by Andrew Halper.

Chinese pragmatism was not invented by Deng Xiaoping when, famously, he refused to distinguish between black cats and white cats, declaring himself in favour only of those which could make it in mouse hunting. Suppressed under the Maoist fanatics, it has returned to be the dominant approach in personal life as in government, supplemented by another of his saws, "seek truth from facts". It is not only to foreigners that the renaming of the Communist Party's theoretical journal from *Red Flag* to *Factseeker* appears ironic. Being liberated from faith may have a downside for individuals, but it is a powerful enhancer of social dynamism.

Dynamism

Recently a British chief executive, woken in the early hours by arc lights, looked out of his hotel window in Shanghai and saw building workers working through the night, seven days a week, for \$5 a week. He felt his heart sink and asked, "How can we compete with that?"¹³ This is an economy of peasants freed from their chains. Like the Calabrians and Turks who relocated to Stuttgart and Torino after the Second World War, the rural migrants work crazily.¹⁴ With their labour China has become a leading force in many sectors from nothing, and very fast. The most obvious examples are mobile phones (local suppliers in the world's biggest mobile market are fast squeezing out the rest) and the DVD, which in less than 5 years has gone from being local eccentricity to global standard, with China producing 60% of DVD players¹⁵.

At Shanghai's elite universities a proportion of the places have to be reserved for Shanghaiers, otherwise every slot would be taken by peasant boys and girls with their high grades. The children of the party cadres and intellectuals go into business, working all

13 Johnson, Luke in *The Sunday Times* (22 May 2005).

14 China's rise is compared to that of other countries, but the most enriching comparison may be with Italy – an utterly impoverished pre-modern country in 1945, which achieved an economic miracle that had her economy briefly surpassing the UK's in the 1980s and settling down to a leading status, a very high standard of living and a strongly defended cultural heritage too.

15 Fishman, op cit, p194.

hours at the cost of their family life and health to get the wealth that brings possessions, security and face.

The lack of social security, the poverty gap yawning below, and the social divisiveness all fuel the dynamism, drive the ambition. What can throttle, or at least curtail it, as government and the think tanks are well aware, is the concentration of resources in too few hands (owing to personalism) and "corruption", or underhand allocation of resources (often public ones) among privileged networks, along with the inability of authority to control these networks. Crispin Tickell shows here that the government is getting to grips with the consequences for the environment of these social flaws.

Injustices give rise to demonstrations, petitions to the media and court actions, often responded to harshly, giving rise to yet more dislocation and also demoralisation. The dislocation is perhaps made bearable by the culture of human relationships and the joy of good food eaten in good company. Older people sing opera and play the *erhu* in the evenings, young ones in the cities go into karaoke palaces of a hundred rooms and croon the night away, but the nature of the pleasures are much the same. Of course family life and being Chinese cannot compensate the destitute, but they go a long way to mitigating alienation. Thus Chinese culture offers compensations for the negative effects of dynamic change.

Despite the dynamism, China has, it is said, produced little innovative work in any scientific field, nor does it yet have brands that command respect outside China, even though so many valued brands manufacture their wares there. Hence the desire of Chinese electronics giant Haier to buy itself a Western brand name in electronics; there will be more such bids. In the 1960s, smug Europeans said of Japan, "They copy everything, they don't initiate," and Americans of the 1970s happily blamed "overdisciplined" Korean schools for the imitative state of their industry. No longer. That discipline has worked. Having gone through the transition to modern consumerism, those countries give us an inkling of how China, with its infinitely greater resources, can be before long.

The case of education

Let's take one example and see how the scale, sense of purpose, pragmatism and dynamism of China puts her at an advantage: education.

In recent years British universities have congratulated themselves upon the large numbers of Chinese who have chosen to study in the UK. They have been welcomed for subsidising

the uneconomic fees paid by UK students and have become necessary to the survival of some departments and courses. Chinese families are famously prepared to pay fabulous sums to prepare their children for glorious futures, and many Chinese institutions have paid for others.

The reasons why they choose the UK are various, but one important reason – the lack of appropriate courses at home – is fast becoming obsolete as Chinese higher education develops. The traditional elite universities have taken stock of international examples, welcomed new staff out of foreign postgraduate training, recruited foreign lecturers, started to reform teaching and curricula and developed new courses.

The contrasts with the UK in the same period are interesting. China has identified 100 elite institutions, with whose professional management it is very concerned and into which it pours money for research; they include those that were already emulating Harvard, Yale and Oxbridge until the Party chopped them down after 1949. Today these universities are again ambitious to be world leaders and are also fired with enterprise: they are using their estate holdings as collateral in establishing money-making ventures such as science parks and business services, whose profits support further research and innovations. Moreover, like the science academies and other state institutions, the universities are often performing the role of incubating enterprise, just as in the USA.

More important even than these developments may be the new universities. Soon after UK polytechnics were rebadged as universities and began to become less practical and to produce higher degrees, China underwent a contrasting set of changes. In response to the government's call for more access to higher education, some 1,300 private universities have been established, usually with flexible, practical and very work-orientated courses and modules. Fees are high by Chinese standards but the subjects of study, the teaching and learning techniques and the emphasis on contact with employers through work placements and in curriculum design all make them a good career investment.

Far from allowing higher education institutions to cut back on science and technology courses, as has happened in the UK, the government has insisted on their primacy. The number of science and engineering PhDs doubled between 1996 and 2001,¹⁶ although higher degrees may be offered by only a minority of institutions, lest too many become too theoretical.

16 Newcomb, Amelia "China Goes to College – in a Big Way" in *Christian Science Monitor* (29 July 2005).

While the number of foreign students in China is still small, with the biggest single group being Koreans, the fact that universities are both increasing the number and quality of preparatory Chinese language programmes and introducing courses taught in English means that this will change. Elite individuals and cadets of multinationals such as IBM and Volkswagen now attend business schools in China, where they would formerly have chosen Harvard. Governments are following suit. The Singapore government, long an important customer of top UK universities, now funds as many students in China as in the UK.

Foreign corporate investors in higher education have been welcomed: the China Europe Business School is funded by, among others, Philips, Bayer, Alcatel, Colgate, AXA and LVMH. Some foreign institutions have established campuses in China, notably Nottingham University at Ningbo. New campuses, as with most of China's traditional universities, are spacious and boast fine buildings and comfortable facilities that easily rival those of the West.

China presents three challenges to UK higher education. First, the challenge of upgrading. China will not for long be a source of overseas students if its own universities overtake ours; we need to cut through the problems of our higher education system and keep ahead in the range and organisation of, and facilities for, what we offer. Second, Chinese higher education intends to offer its services in the world education market; if it wishes to compete, the UK may need thoroughly to rethink its place in that world market to take account of what China can offer.

The third challenge is of product. In China there are at present 16 million students in higher education, with plans for 20% of secondary school leavers to be in higher education by 2010 and 50% by 2050. If even a small proportion of these have first-rate education and can use English, they will compete with our graduates in virtually every field, unless, again, we can provide something very special. The quality of our product is determined by the courses we offer and the quality of those who deliver them – but it is also closely connected with the preparedness of the intake. It is an embarrassment for many UK academics that our own students, particularly when they come from state schools, perform less well in their own language than students from countries as diverse as Spain, Russia and China and have to be given remedial attention in basic knowledge (both sciences and humanities) and in use of English.

Arguably, Chinese schools provide schooling that, though now allowing of much more initiative and self-development than before, is much more disciplined and focused but also more relevant than ours. In the USA, where schools have similar problems to those in the UK, there is concern about how the comparative failure of indigenous schooling affects higher studies.

Thirty-eight percent of the nation's scientists and engineers with doctorates were born outside the country. And of the PhDs in science and engineering awarded to foreign students in the USA from 1985 to 2000, more than half went to students from China, India, South Korea, and Taiwan, and a third of high-tech start-ups are by people with Asian passports.¹⁷ So alarmed are US educators at the superiority of Chinese schooling – in science and mathematics certainly, and to an extent in all other subjects – that they have begun to adopt Chinese course books and teaching methods. Over 200 US secondary schools have now replaced their own curricula with Chinese ones.¹⁸

The elitism of Chinese schooling is meritocratic, as is typical of continental Europe, without a "public schools" problem. There is consensus over what matters: that everybody should achieve his or her potential and that only the teaching methods and school organisational structures that work are acceptable. In principle, when a solid schooling is available at the primary base, there are options for different kinds of ability at secondary level and therefore access to further and higher education is less dependent upon the vagaries that limit the opportunities of UK schoolchildren. As to vocational training, Germany and France are seen as models, not the UK. Educational television (the biggest such systems in the world), science parks for children, disciplined schooling with clear narrative, and parents who believe that education provides advancement through merit all combine to create a climate in which learning is valued and those who transmit learning are respected.

Since many in the UK believe that our future lies in knowledge-intensive services, it is important to learn the lessons of Chinese education, both positive and negative. Action is needed. A thorough investigation should be made of current developments. It should not merely be a survey of China as a potential market (as such initiatives are often limited to being), but a report that helps us recognise the lessons so that UK education can respond to the impact of China.

17 Segal, Adam "Is America Losing its Edge?" in *Foreign Affairs* (November/December 2004).

18 Francesco Rampini describes this process in *Il Secolo Cinese* (Mondadori, 2005) pp100-102.

Conclusion

In the case of education, rising China challenges us to rethink, and perhaps change, what we do. As Gerard Lyons argues in his essay, this is so in many spheres. If China should falter in its rise, the impacts may be very different. A crisis might originate from without, perhaps with a reduction in demand for Chinese exports. But more likely causes of crisis are internal.

A combination of environmental disasters, energy shortages and unbearable distress among the destitute might see China become ungovernable. A run on the banks could reveal the weakness of its loans and topple the whole edifice of investment. These dangers are the fault of a combination of Communist Party power, personalism and lack of implementable regulations. Because of Party power, public assets are alienated and dubious loans given to unprofitable enterprises for non-economic reasons – as much as 40% of existing loans are considered bad. As Martin Wolff puts it, "the scale of the waste is breathtaking".

Also because of Party power, unprofitable state employment is allowed to persist such that in at least the three most northerly provinces, state enterprises account for 73% of formal employment.¹⁹ Personalism means that financial discipline is hard to apply and that overinvestment is chronic.²⁰ The lack of implementable regulations means that in so-called private enterprises, share manipulation and misuse of funds are widespread.

There is widespread consensus among observers abroad as to the economic reforms China needs to undertake, and the Chinese government appears to concur. Its two main strategies are joining the World Trade Organisation, so that changes are forced upon domestic enterprises by foreign pressure and "problem bypass", or hoping to see growth sectors engulf and render irrelevant or minuscule the problem of state enterprises and their debts. It will continue to legislate and regulate to improve the institutional framework, but whether it can implement the kind of changes required is another matter. At root the dangers to China's continued growth come from its faulty institutions: lack of a rule of law, and consequent lack of clarity in commercial relations and uncertainty of property rights, as described here by Andrew Halper; administrative corruption that perverts development; lack of political accountability, transparency of decision making or separation of party and state.

¹⁹ The quotations in this final section come from Reynolds, op cit, and Wolff, Martin "India and China (part 1)" in *Financial Times* (23 February 2005), p21.

²⁰ The People's Bank of China (2004) criticised "the blind expansion of seriously low quality, duplicate projects" in steel, aluminium, and cement (Reynolds, op cit).

China is run by a tiny oligarchy. From 1949 to 1975 it made the most appalling errors, not only because of the potty ideology but because of a system of decision making that is obscure, has little debate, allows no criticism and has no need to justify itself to anybody. Errors have been uncorrected, tensions multiply, people die; once on a wrong path the oligarchy has stayed on it until disaster has engulfed it. Although she shows that some progress is taking place, Professor Howell's predictions for major change in these areas are not encouraging.

An economic crisis would cause difficulties in many countries to which trade with China is now vital. But more than that, China's ability to pursue its geopolitical objectives depends upon the economy. If it should fail, China may be even less helpful over North Korea and even more intransigent over Taiwan and its other territorial claims, with potentially awful repercussions for us. For the world, therefore, a great deal rides upon China's ability to resolve its internal contradictions.

Contemplating China's impact, Western political leaders should be afraid. But not of China's military might, at least not yet – rather, of whether they can get to grips with the issues to which China's impact gives rise; whether they can contribute to helping China resolve its contradictions; whether they can identify the right responses to the impact and then carry with them their own electorates.

Chapter 1

Geopolitics: China's place

By Dr Steve Tsang, Louis Cha Senior Research Fellow in Modern Chinese Studies, University Reader in Politics and Director of the Taiwan Studies Programme, St Antony's College, University of Oxford

It is chilling to be reminded that implicit in China's view of its place in the world are the challenging of US dominance and the reservation of the right to change its attitude towards multilateralism and international organisations. The Communist government is pursuing short-term, regional interests informed by a long-term strategy that amounts to a "manifest destiny". Domestic conditions will determine how this is realised, but neither sustained growth nor the persistence of the Party should be taken for granted. It is political reform that is probably the key to ensuring that China does not become a destabilising force.

Geopolitics: China's place

Dr Steve Tsang

Although recognised as a rising power, deemed a long-term superpower rival to the United States, China is more generally seen as the most important emerging *regional* power. China's capabilities, growth rate and the focus of its security and economic policies appear regional, yet this is also misleading.

Both in the perspective of history and since the founding of the People's Republic in 1949, China has seen its relations with the rest of the world in global rather than regional terms. Its short-term focus upon East Asia is dictated by realism and by its particular approach to dealing with the outside world, an approach intricately tied to its view of history. However, whether China can and will become a global superpower remains to be seen.

China's view of its place in the world

Even though the mainstream or Communist Party-approved view of history in China deviates significantly in key areas from a judicious reconstruction and assessment of Chinese history, it nevertheless reflects and reinforces the way that the Chinese leadership sees China and its place in the world.

In its officially endorsed history, China was the most advanced country and the centre of civilisation from at least when it became united under the First Emperor in 221BC, until this was changed by the rise of Western imperialism in the 19th century. In this view, civilisation flourished when China was a united country and dominated, in a "benign" way, the world within its reach. Those who lived beyond its civilisation were generally dismissed as barbarians.

There is therefore an unspoken understanding that the restoration of China to the pre-eminent position that it historically enjoyed, before it was successfully challenged by Queen Victoria's British Empire, will be a positive and civilising development for the world.

Imagine how the citizens of Rome might feel if the Roman Empire (a contemporary of China's first empire) had continued to exist as a united empire – albeit interrupted by periods of disunity – as the world's premier power and, technologically and administratively, the most advanced state, governing most of Europe for almost 2,000 years. It is then easier to comprehend China's Sinocentric world-view.

Seizing on the imperial activities in China of the Western powers and Japan following the first Anglo-Chinese War (1839-42), which marked the beginning of China's "century of humiliation", the Chinese Communist government has played up the theme that China was a victim of imperialism. In the officially approved view, imperialism is either Western or Japanese or even Soviet in origin, but never Chinese, regardless of the nature of Chinese rule in, say, Tibet.

Following this line of thinking, China has a right to redress this century of humiliation and to restore itself to its "rightful place" in the world. The retrocession of Hong Kong from Britain in 1997 was therefore seen as a landmark in this direction. What is now deemed the most important legacy of Western – in this case US – imperialism is the separation of Taiwan from China.

China also tends to look at the world from a global rather than a regional perspective, as the concept of Asia was an alien one in pre-modern China. The idea of China being part of Asia is a modern import.

To say that the Chinese world-view is essentially global does not imply that China does not behave like a regional power as well, particularly while waiting to have built up sufficient "comprehensive national strength" to enable it to challenge US dominance. Realism and a hard-nosed calculation of interests and capabilities apply as much to the Chinese as to most governments.

Thus the Chinese government accepts that in capability terms it is still only a major regional power, and must adhere to the late Deng Xiaoping's dictum to bide its time before seeking to resume its "rightful" place in the world.

In this interregnum, and in light of the US pre-eminence in the post-Cold War world, China puts great importance on international organisations in general, and on the United Nations Security Council – on which it holds a seat – in particular. Such organisations are useful in countering the preponderance of the USA.

Furthermore, while it is still building up its comprehensive national strength, China refrains from taking an assertive role in world affairs other than when protecting its interests. Although this is not articulated, China reserves the right to change its attitude towards multilateralism and international organisations when it is ready to assert its "rightful" place.

Another key concept that has underlain the Chinese approach to relations with the rest of the world is that of the "united front". This is not a policy but a methodology inherited from the era of Mao Zedong.

In the simplest terms, the united front requires the Chinese Communist Party to identify a principal enemy and its supporters outside the party, as well as an intermediate zone full of "wavering elements" that can be won over by either the party or its principal enemy. The party's task is to destroy the principal enemy, which requires the Chinese government to work hard to win over the intermediate zone and isolate the principal enemy.

Once this has been accomplished, the party will move on and identify from the intermediate zone a new principal enemy. This will become the target of focused attack in this new stage until it too is destroyed. The process is to be repeated until all in the intermediate zone have come under Chinese leadership.

China's international strategy

By drawing together the various forces that affect the making of China's policy towards the outside world and applying them to the present international scene, China's handling of its external relations can be put in context. Three dimensions come out strongly:

- In general terms, while China is building up its comprehensive national strength it needs a stable and peaceful international environment to ensure rapid growth under the leadership of the Communist Party.
- In national security terms, China's main focus is Taiwan, and until this "principal contradiction" has been resolved to its satisfaction, it is China's policy to reassure the rest of the world that China has no territorial or aggressive ambitions.
- In the long term and when China is ready it will assert its rightful place in the world, which may require appropriate changes to the international system.

The first dimension requires China to present itself and act as a "status quo power" in the foreseeable future, notwithstanding its own agenda to change the status quo over Taiwan. This policy is driven by a key domestic imperative and the long-term strategic thinking about biding time to enable China to rise to the top.

The domestic imperative is rooted in the existence of a de facto "social contract" between the Communist Party leadership and the people of China after the Tiananmen crackdown of 1989. This involves the party delivering social stability and steadily improving living

standards on the basis of rapid and sustained growth, in return for the general public's acquiescence in continued authoritarian party rule.

This underlines the great importance the Communist leadership puts on deepening economic reform and promoting steady growth, but all the time staying in control. It requires a benign international environment and continued inflow of foreign investments.

Since China will need at least a couple of decades before it can reform its economy to make it genuinely competitive globally and build up sufficient capabilities to assert itself in the way it would like, China needs to behave like a status quo power.

It was partly with this in mind, and partly in line with the united front, that the idea that China's rise would be peaceful was introduced. Despite a toning down in propaganda over this concept after Hu Jintao took over the leadership from Jiang Zemin, this idea will almost certainly be revived and promoted in some form.

In line with this thinking, China wants to maintain the status quo in East Asia. Hence it will not fully use its leverage over North Korea to resolve the nuclear impasse between that country and the US unless it is forced to do so.

To be sure, China would have preferred North Korea not to have developed nuclear weapons or to have brought about the present tension. However, once the US–North Korea stand-off started in 2002, China found itself caught in the middle. On the one hand it tries to avoid a showdown, and on the other hand it works to pre-empt an implosion of the North Korean regime. Either would upset stability and the basis for rapid economic growth in North East Asia, harming Chinese interests.

Provided it is not leading to an uncontrollable escalation, a continued stand-off appears the least unappealing option to China, as long as it can resist external pressure to use all the leverage it has to rein in North Korea.

Maintaining the status quo in East Asia generally – including Taiwan in the short to medium term – is China's objective, even though its main focus on security is Taiwan itself, where it wants to gain control. There is no question that China is ultimately prepared to use force against Taiwan if the latter should assert *de jure* independence, or if all other options to pre-empt such an eventuality should fail. However, this is its last resort.

In China's long-term strategic view, the best outcome is to weaken Taiwan's international standing and capacity, as well as its political will to resist, so much that Taiwan will eventually agree to negotiate for unification – under overwhelming Chinese military pressure, but without requiring Chinese forces actually to stage a full-scale invasion.

A less desirable outcome would be for China to use decisive force to subdue Taiwan before the US could respond and interfere. However, given the military balance across the Taiwan Strait and the disposition of the US to help Taiwan defend itself against an unprovoked attack, China prefers to keep the status quo, which includes pre-empting Taiwan from asserting *de jure* independence.

China's approach towards Taiwan reflects the application of the united front in a spectacular way. While Taiwan is being identified as its principal contradiction, its real obstacle to securing Taiwan is the US. The rest of the international community is in general terms seen as the intermediate zone, though Japan is deemed sufficiently close to the US over Taiwan that it is subjected to creative tension and wooing.

Given the effect of the Communist Party's own propaganda over Japan's imperial past, its expectation that Japan is its key rival in the region, the fact that Taiwan was a Japanese colony between 1895 and 1945, and the longstanding US–Japanese defence pact, the Chinese government believes it can at best neutralise Japan rather than win it over in a showdown over Taiwan.

The immediate cause of the 2005 tension between the two countries was the release of new Japanese textbooks and Prime Minister Junichiro Koizumi's insistence on visiting the controversial Yasukuni shrine, where 14 war criminals are among those enshrined to commemorate Japan's military history. The Chinese government took a very robust position towards Japan while simultaneously offering to ease tension.

As for the US, since China is not at this stage militarily prepared to take on the US over Taiwan, it sees much value in taking advantage of their temporary coincidence of interest in making sure that the Chen Shui-bian administration in Taiwan does not probe Beijing's bottom line too hard.

China's courting of the European Union, by contrast, reveals the other side of the united front at work. From the Chinese perspective, the EU can be induced not to support the US over Taiwan. Hence the assiduous Chinese efforts to enhance links with the EU, to

encourage EU leaders to think of the EU as a key player in a multipolar world, and to lobby the EU to lift its arms embargo against China. Even if the last should fail, it will create serious tension between the US and the EU.

In a similar way, the rest of East Asia has been reassured of China's good neighbourly intentions by China's playing up the value of multilateralism in the region, and stressing the uniqueness of "the Taiwan question".

Within Taiwan itself, the Chinese united front also requires its government to attempt to divide and rule. Thus China focuses its hostility upon President Chen Shui-bian, and refrains from ruling out talking to others in Chen's party while it works untiringly to court the opposition parties in Taiwan. This is meant to complement its longer-term strategy of promoting economic integration between Taiwan and China, to the point that it would become economically suicidal for Taiwan to allow hostilities to erupt between it and China.

The increasing number of Taiwanese working and living in China further gives China a critical instrument – hostages with over a million votes through family members back in democratic Taiwan – to undermine Taiwan's will to resist when China is finally ready to force Taiwan to accept unification under overwhelming military pressure.

The real long-term test of China as a member of the international community will come only after it has resolved the Taiwan issue to its satisfaction. Unless the situation within Taiwan itself should change dramatically, to the extent that it would either present an opportunity for China to seize it at little cost or force China to use force whatever the costs, China will not seek a resolution until it has built up sufficient comprehensive national strength to take on the US successfully. Such a development may take decades, if it can be reached at all.

If the nature and disposition of the Communist Party leadership and the political system remain essentially unchanged when China reaches a state of development that enables it to assert its "rightful" place in the world, such a turn of events will almost certainly not be as peaceful as Chinese propaganda today portrays. It will involve a contest of strength (and diplomacy) between the established superpower and the newly emerging one. This point will not be reached in the coming decade, as China cannot develop fast enough to turn itself into a superpower within such a timeframe.

A superpower in the making?

In making a long-term assessment of how China will approach its relations with the rest of the world, it is essential to take into account two intricately linked caveats. The first is whether China's rapid growth of the past quarter-century can be sustained in the longer term. The second is whether China's authoritarian system, based on the monopoly of power by the systemically corrupt Communist Party, can last without transforming itself.

In a key sense there is no authoritative answer to the first question. One can turn to history for guidance, particularly by looking at the postwar experience of other East Asian "miracle economies". On such grounds there is a serious question as to whether China can sustain such a high rate of growth uninterrupted for another two to three decades.

Indeed, with so much of China's growth being driven by foreign investment, it faces a grave danger that its growth momentum may collapse – if, for example, a critical mass of the largest foreign investors no longer accept that it is worthwhile to take substantial losses for years before turning a profit. Whether the Chinese economy can avert collapse should major foreign investments leave for other, more profitable destinations is a serious question that must be borne in mind.

Should the Chinese economy be hit by a recession or by a significant and sustained downturn, the capacity of the state to deal with the many problems that were created or accentuated in the last quarter-century of economic reforms will be weakened drastically. These problems include environmental degradation in the air, land and water, widening gaps between rich and poor as well as between rural and urban areas, bankruptcy of the banking sector (protected only by the lack of transparency), unemployment, the end of the social safety net, and social problems created by a huge gender imbalance. In such an eventuality the legitimacy of Communist Party rule will be challenged and the de facto social contract could collapse.

The capacity of the regime to reassert its authority and sustain itself will be sapped further should there be an intense struggle for power at the top, causing political paralysis. In other words, the Communist regime and the Chinese economic juggernaut are brittle. When all is well they look hard and strong, but they could disintegrate quickly with little warning should their key weak points be hit hard.

If the Chinese economy should turn out to be a real miracle and continue to sustain an average annual growth rate of 7–8% compound, it will result in a dramatic expansion of

the middle classes in the coming two to three decades. Despite tight government control over the media, communication and the internet, the new, expanding middle classes will witness and be part of the ever quickening changes worldwide.

Like people of other nationalities, including the Chinese of Taiwan, once they have a taste of the middle-class lifestyle, most will increasingly find the Communist authoritarian system stifling, repressive and intolerable. Will they continue to accept the de facto social contract with the party? When sufficient momentum has been gathered for political reform, the Communist regime will either have to face down such a challenge by repression or reform itself drastically.

The important point to note is that steady and sustained growth of the Chinese economy and the continuation of the existing political regime should not be taken for granted in the long term. This applies without having to underestimate the capacity and the political will of the Communist Party regime to deal harshly with any challenge. Whether repression can succeed in the long term is an open question.

The implications for China's relations with the rest of the world are that China's rise and the trajectory of its rise may turn out to be very different from what China preaches, and domestic developments in China will have a huge impact on its external relations.

While any major power would be ill advised to designate China an enemy, since this may turn into a self-fulfilling prophecy, it would be equally ill advised to take the Chinese narrative of its rise at face value. The key to making sure that China will not in the long term turn out to be a major revisionist, and therefore destabilising, force in the world is to ensure that China reforms itself politically.

If the Communist regime transforms itself into something recognisably democratic, liberal and respectful of the rule of law, it will have a greater capacity to deal with corruption and power abuses through checks and balances. It would also be able to face up to its huge socioeconomic problems by persuading its citizens that its government is doing what it can, and that their voices are being heard. Such developments should be accompanied by changed attitudes.

The Chinese perspective described at the outset is widely held on the popular level, with an intensity of bitterness against the West that has been fanned and manipulated by the government for generations. If China is to work with other powers on the basis of

equality and mutual respect, this needs to be jettisoned, as does the world-view inherited from Mao. The rest of the world should help China to accept that, as for the other great powers, its rightful place in the world is that of a responsible member of the international community.

Chapter 2

The economy: opportunities and risks

By Dr Linda Yueh, Fellow in Economics at Pembroke College, University of Oxford, and at the London School of Economics & Political Science

The pragmatic and experimental approach of China's leaders in undertaking the transition from state to market-led economy is clearly evident from this crisp survey of economic policy and investment policy. Further huge changes are presaged by the country's entry into the World Trade Organisation. For China to benefit from these changes and for foreign investors to believe that the opportunities can outweigh the risks, China will have to address itself rapidly to institutional and regulatory issues, in particular corporate governance reform and enforcement.

The economy: opportunities and risks

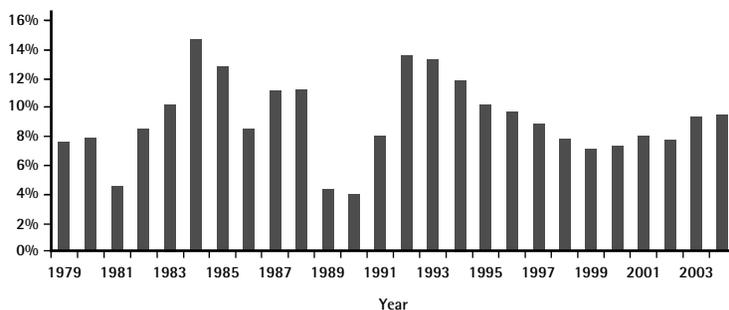
Dr Linda Yueh

China's economic growth since reforms began in 1979 has been impressive. Real annual growth of gross domestic product has averaged over 9% in the past 26 years and China's economy is four times larger today than at the start of reforms. At this rate of growth, national income will double approximately every eight years.

However, China has a GDP per capita of \$1,000, which is the level of a developing country. The low level of GDP per capita signifies the growth potential of the economy; nevertheless, there are serious issues concerning the sustainability of growth, which are related to China's status as both a transitional and a developing economy.

For the UK and other countries seeking to engage the world's fastest-growing economy, any view of the opportunities associated with this impressive emerging market – particularly following China's accession to the World Trade Organisation – must be tempered with recognition of the risks.

Figure 1: China's real annual GDP growth, 1979-2004



Source: China's National Bureau of Statistics

China's approach to economic growth

China's model of economic growth should be understood within the framework of its particular approach to reform. China has spent the past 26 years in transition from a centrally planned economy. It adopted reforms incrementally, gradually bringing market forces into an administered economy.

Economic reform in China is a partial reform strategy characterised by institutional innovations and experimentation. Reform began in the countryside, and the early successes were the township and village enterprises. The creation of these in 1979 injected industry and market orientation into the rural economy, which possessed abundant labour. Also, the household responsibility system gave residual ownership to farmers, so that they could retain some return on their effort within a framework of communal ownership of land.

These reforms reorientated national saving to households, injected incentives into an economy that did not recognise private property, and reallocated the essential factor of labour to enterprises. Output grew rapidly in the early 1980s, leading to the observation that China's growth began in the countryside.

When these measures were seen to be successful, China introduced further reform into urban areas in 1984. Managers in state-owned enterprises were given increased autonomy and allowed to retain a portion of profits by use of another institutional innovation known as the contract responsibility system. And wage reform introduced a performance element into pay.

Urban reforms further bolstered the status and income of urban residents. These citizens enjoyed an "iron rice bowl" – the now abolished system of guaranteed lifetime employment – and social security provision provided by the *danwei* or work unit, which was not available to rural residents. This urban bias enabled China to undertake industrialisation and the favourable treatment of urban residents maintained stability, which is a critical element of a gradualist transition path.

The control of the government was essential in maintaining a dual-track transition. While allowing enterprises to sell part of their output at market prices, the authorities must be able to maintain control over the sale of goods to the administered part of the market, thus implementing a partial liberalisation strategy. However, at the same time, China sustained a degree of decentralisation that permitted experiments to take place, so that market-oriented reform could be introduced without affecting the economy as a whole. This approach further allowed the authorities to adapt practically to changing circumstances, rather than follow a prescribed plan of reform.

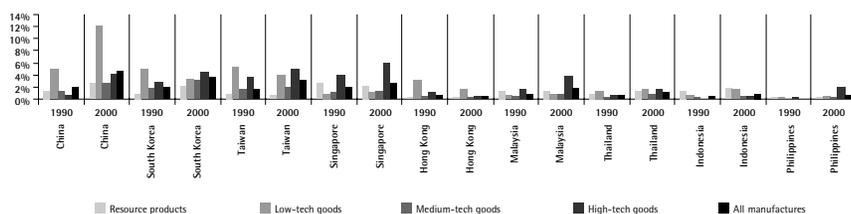
The final prong of China's growth strategy is the open door policy. China created Special Economic Zones, initially in southern provinces, which were essentially export-processing

zones that were open to foreign trade and investment. These zones allowed the government to experiment with opening trade to a limited degree. These measures began in 1979, but did not take off until 1992.

Since then, China has created further forms of Special Economic Zone, such as free trade zones and high-technology development zones, which are also geared at attracting foreign investment in technology sectors and promoting research and development.

As to openness, China's export-to-GDP ratio doubled from 15% in 1990 to 30% in 2000, which is similar to the UK's. Figure 2 gives the market shares of world trade for China and other Asian economies to provide comparison. In the span of a decade, China's market share went from the level of the new Tiger economies to rivalling the old Tigers, whose export-led growth has been notable. China's dominance in the low-technology sector is evident, but its rapid growth in higher-technology goods is even more noteworthy, and these more advanced manufactures constitute the fastest-growing sector of exports.

Figure 2: Market share of world trade for Asian economies in 1990 and 2000



Note: Resource-based manufactures ("resource products"), excluding petroleum, include agricultural/forest-based products and mineral-based products, such as prepared meats and fruits, rubber, cement, glass and cut gems. Low-technology products ("low-tech goods") are textiles and fashion goods, such as textile fabrics, clothing, footwear, leather manufactures, pottery, furniture, jewellery, toys, and plastic products, among others. Medium-technology products ("medium-tech goods") comprise automotive products and medium-technology process industries, including synthetic fibres, chemicals and paints, fertilisers, plastics, iron, engines, industrial machinery, watches and ships. Finally, high-technology products ("high-tech goods") are electronic and sophisticated electrical products, such as telecommunications equipment, televisions, transistors, pharmaceuticals and cameras. "All manufactures" comprises all four categories of goods.

Source: World Trade Organisation, author's calculations

Limits to liberalisation

The opening of China, though, has been coupled with numerous restrictions. Goods produced in Special Economic Zones were for export and not for the domestic market. Foreign direct investment was directed to Special Economic Zones and strict controls were put in place regarding capital movements and exchange of currency. Profit repatriation for foreign firms was also restricted, as was outward investment by Chinese firms, outside strategic sectors such as energy.

This is set to change, on account of China's accession to the WTO of December 2001. Membership in the WTO binds China to the principles of free multilateral trade, which includes opening domestic markets and undertaking financial as well as trade liberalisation. Foreign firms are being granted freer access to China's domestic economy and import restrictions are being lifted.

This is a significant reorientation of China's growth strategy in terms of its external sector. The Special Economic Zones were export-oriented zones, which had been successful in attracting foreign investors to take advantage of China's low labour costs. This is why approximately 50% of China's exports since 1996 have been produced by foreign-invested enterprises. Although the Special Economic Zones will remain attractive, following WTO accession, a major source of opportunities will be provided by the opening of China's domestic market.

Opportunities in China

Since China's accession to the WTO, the domestic economy and Chinese firms have become more open to conducting business with foreign firms. China has also agreed to open a large swathe of its services industry to foreign investors. Insurance, banking and financial services will be liberalised, though the issue remains one of timing and degree. Geographical restrictions will be removed and foreign banks will be permitted to engage in Chinese currency (renminbi) business by the end of 2006, for instance.

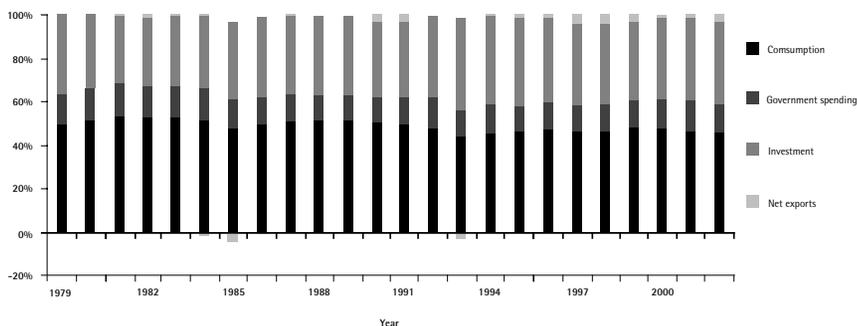
However, the limited extent of credit assessment measures in the market may limit business, as could competition from existing Chinese banks. In the insurance sector, Chinese firms also have substantial market share and have become internationally listed companies. While the financial sector has tremendous potential to develop, the lack of legal and regulatory standards as well as governmental restrictions are likely to mitigate rapid development in this sector for a time. None the less, the development of financial markets is essential for China and it is adopting numerous measures to foster this rather new industry, as the previous system was essentially state-run.

Other areas of WTO-related opportunities lie in education and service professions, such as law and accountancy. The opening of these sectors is significant and follows a trend of increase in global trade in services. For a developed country such as the UK, its trade surplus in services with China – despite an overall trade deficit – is likely to continue and grow.

In short, the opportunities in China will follow the path of market-oriented reforms. For instance, when housing provision was separated from the work unit in 1998 and effectively privatised by 2001, the market for home mortgages and home improvements grew. Opportunities will also arise from the focus of government policy.

China is attempting to reorient its economy toward consumption. Consumption is less than 50% of GDP and the government is keen to promote aggregate consumption and exports, while specific types of investment and government spending will be encouraged, particularly in rural areas. The rural-urban divide has caused the government to alter China's growth strategy from "growth at any cost" to "balanced and co-ordinated growth". The focus on rural areas and the interior provinces will be accompanied by incentives to promote investment and develop infrastructure. Opportunities are likely to follow.

Figure 3: Composition of GDP in China



Source: China's National Bureau of Statistics

The prospect of accessing a market of 1.3 billion people who are emerging from a centrally planned economy characterised by shortages has caused foreign firms and governments to rush to engage China. There are, however, numerous risks to consider.

The risks China faces

There are risks associated with continuing marketisation under a gradualist approach, the prospects of sustaining economic growth through productivity improvements, and the development of institutional and legal foundations to support a marketising economy in an era of globalisation.

If a transition strategy is not geared toward introducing rapid and complete marketisation

but is, rather, concerned with effectively implementing reform and overcoming opposition, then it has a tendency to leave the difficult issues unresolved. The core of the structural problems in China's transition path is the close relationship between the state, state-owned enterprises and state-owned banks, which is present at the national but also at the provincial level.

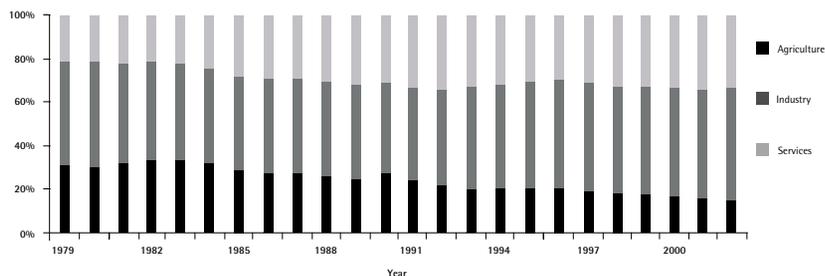
The existence of "soft budget constraints" means that firms lack discipline and will be inclined to be inefficient. The state, as it owns both the enterprises and the banks, can finance state-owned enterprises either through direct transfers or indirectly through policy loans from state-owned banks. The non-performing loans problem in China can be traced to the use of bank financing to fuel transfers to state-owned enterprises.

The state-owned enterprises, however, are not just enterprises, but providers of social security and instruments for the government policy of maintaining full employment. Despite the inefficiency of state-owned enterprises, they did not shed labour until the large-scale layoffs of the mid-1990s. China's urban unemployment rate until then did not exceed 3.5%.

Urban unemployment, more broadly defined to include laid-off workers and other forms of non-employment, is now estimated to be as high as 8-12%. Since there is no social safety net and on account of concerns about instability, the restructuring of the state-owned enterprises and banks will be a difficult challenge for China.

Other "hard" issues in China's transition path include, among many others, rural-urban migration, managing sustainable development, ownership reform and the continuing reform of factor markets – producer goods markets in which are procured the factors of production (inputs such as land, labor, capital, entrepreneurship, and other material instruments used in production of goods and services).

Figure 4 shows the degree of industrialisation in China, where industry accounts for about 50% of GDP. This figure also highlights another of China's difficult challenges. The agricultural sector is declining as a proportion of GDP, though this sector still employs over half of China's workers, and two-thirds of China's population remains rural. As comparative advantage shifts against agriculture in China, its limited stock of arable land (only 7%) becomes more evident. And the lack of competitiveness of the township and village enterprises, which were early engines of growth, contributes to the relatively slower improvement in the livelihood of the rural population.

Figure 4: Sectoral composition of GDP

Source: China's National Bureau of Statistics

Rural income is less than a third of urban income, and growing more slowly (5% versus 9% annually). Recent measures such as the elimination of grain taxes and investing in the interior have attempted to stimulate the rural economy. However, the number of migrants who are moving to urban areas – estimated at between 70 million and 200 million – is symptomatic of this divide.

They are joining the “new urban poor”, which is a class of poverty created during the lay-off programme of the mid-1990s. The cracked “iron rice bowl” and the lack of a social safety net have created substantial hardship and paved the way for unrest, mainly witnessed in areas with a concentration of heavy industry, such as the north-eastern province of Liaoning.

The limits of growth

Turning to China's growth model, the scope for sustaining economic growth through factor accumulation will be limited, owing to its aging population and already high rates of labour force participation. Therefore, one of the main challenges is to sustain growth through productivity advances. This can be achieved through factor reallocation, such as more efficient use of China's abundant labour supply.

However, although there is still much surplus labour in China's state-owned enterprises and state-owned banks, the restrictions on mobility between rural and urban holders of *hukou* (residency permits) has resulted in areas such as Guangdong reporting a shortage of a million workers. A measure of the low degree of mobility in Chinese labour markets is given by Knight and Yueh,²¹ who found in 1999 that 78% of urban residents had only ever held one job.

21 Knight, John and Yueh, Linda “Job Mobility of Residents and Migrants in Urban China”, *Journal of Comparative Economics*, vol 32 (2004), pp637-660.

Growth can also come about through reorientation of capital stock. However, given that China is already industrialised, as seen in figure 4, the creation of new capital stock is a challenge. Underdeveloped capital markets and a lack of market instruments to dictate investment into more productive assets, such as the use of interest rates – which were liberalised only in October 2004 – are substantial impediments. Although fixed asset investment continues to grow quickly, the challenge will be to generate investment in R&D and technological advancements rather than mainly in real estate construction.

Typically, developing countries can catch up by imitating the more advanced technology of developed countries. Technological spillovers from foreign direct investment are a classic vehicle. China's creation of high-technology development zones and its early focus on joint ventures, frequently accompanied by technology transfer agreements, were intended to serve this purpose. But although the amount of foreign direct investment has been impressive in China – it makes up about 10% of total annual investment – some of it is thought to be accounted for by "round-tripping", whereby Chinese capital leaves the country and returns to gain benefits as "foreign" investment.

Indeed, the need to improve domestic productivity has in the past few years led China to become the world's second-largest investor in R&D, in per capita terms. The education of scientific personnel and the development of infrastructure have accordingly been a priority. Coupled with access to foreign capital and global markets, China is attempting to increase the technological component of its growth model to sustain a rate of growth that would otherwise begin to slow, owing to limits on factor accumulation.

The need for regulatory reform

Finally, economic challenges are intertwined with needed legal reforms to provide an institutional foundation for growth. Ownership reform is complicated by the role of state-owned enterprises in providing social security as well as by the uncertain position of the state. Over 1,300 Chinese firms have been listed on one of the two Chinese stock exchanges in Shanghai and Shenzhen as well as overseas. The prevalence of non-tradable shares and the lack of control rights for equity holders have contributed to a stagnating market for Chinese equities. The need for corporate governance reform, protection of minority shareholders and regulatory supervision is evident.

China's legal and regulatory systems are adopting reforms quickly, but the laws and structures in place are not yet matched by enforcement. The advent of international economic law suggests that China's legal reforms and regulatory standards will be under

pressure to meet international requirements, particularly as its companies seek a place in global markets. The WTO, as a place for dispute resolution and the growth of arbitration, will help to mitigate some of the risks associated with dealing in China's uncertain contracting regime.

Although private property and contracting security remain focal points in the next stage of China's development, the concern that its institutions are in need of significant reform will disturb investors both within and outside China who are contemplating that market.

The threat of instability

The final element of risk associated with the above challenges is the possibility of macro-economic instability, resulting either from domestic economic cycles related to soft budget constraints and a partially liberalised economy or from external crises. The recent Asian financial crises highlighted the fragilities of an economy that has a fixed exchange rate and underdeveloped financial markets, notwithstanding an otherwise robust economy.

The fact that China was not affected by the crisis is perhaps in part owed to its lack of capital convertibility and credit controls in 1997-98, but this will change as it becomes more integrated with the global economy and liberalises credit provision. Bolstering financial markets and hedging against currency risk will be essential to help China avoid a currency crisis that could become a financial crisis.

These are but some of the risks to consider in evaluating the prospects of the Chinese economy. Others include the mandate of environmental quality to sustain development, corruption, health concerns, and many others. Despite these risks, and the remaining "hard" issues in China's path, it is an economy that has been remarkably successful in introducing marketisation and achieving an impressive rate of economic growth, which has improved standards of living for a fifth of the world's population. With membership in the world's multilateral trade body, China is also increasingly globalised, and its continued opening-up will mean numerous opportunities to engage a dynamic economy.

If China can maintain the momentum of reforms, it has the potential of becoming a notable economic power. The effect that this will have on the global economy will be diverse, and includes effects on trade and investment patterns, global demand, and the growth rate and cycle of the world economy. Engaging with China will undoubtedly be essential in the coming years.

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Chapter 3

Environmental problems: how big is the footprint?

By Sir Crispin Tickell KCVO GCMG, Chancellor of the University of Kent at Canterbury, Director of the Green College Centre for Environmental Policy & Understanding at the University of Oxford, and Chairman of the Advisory Committee on the Environment at the International Council of Scientific Unions

As China develops economically, its environment is being affected; the cumulative impacts are enormous and the wider world too is touched. Until recently China was left aside in Western thinking about geopolitics, economic change and the state of the global environment. No longer, particularly since China has some original approaches and insights now that, at last, government attention is focused upon the environment.

Environmental problems: how big is the footprint?

Sir Crispin Tickell KCVO GCMG

China accounts for around a fifth of the human species; it is the third-largest country in the world with a wide agricultural base; it has vast resources, now under rapid exploitation within an expanding economy; it has uniquely diverse plants and animals within the global ecosystem; and its contribution to civilisation in all its forms is among the earliest and most remarkable. It also has a high degree of geographical unity, which has helped to hold Chinese society together and give it its special characteristics for well over 2,000 years.

Yet China faces major and particular environmental problems. At the eastern end of Asia, it has a continental climate with extremes of rain and drought, heat and cold. Water is a perennial problem. So are the huge dust storms that sweep across the country, shifting deserts and creating new ones. With its long, low coastline, China is sensitive to even small variations in sea level, which quickly affect wetlands and river deltas. It suffers from relatively frequent earthquakes, and even occasional hits from space (the last and most serious in the 15th century).

This combination of destructive natural forces has profoundly affected Chinese history and culture. In the Chinese view, nature was there to be placated as well as, so far as possible, controlled or even mastered. Heaven and earth were closely linked, and the line between the natural and the supernatural was blurred. Dragons and spirits could sometimes be seen above the surface in thunder and lightning, and sometimes below it in earthquakes. Under whatever guise, life sustained but also punished humans. Even the behaviour of the weather was an aspect of human activity, so there was morality in meteorology.

This respect for nature did not inhibit efforts to transform it, which sometimes had disastrous consequences. As elsewhere in the world, the end of the last ice age marked major human expansion. Deforestation made way for agriculture. There was a bonanza as soils were exploited, wild animals and species were lost, and human numbers multiplied. This led to the growth of towns, cities and states, followed by increasing competition between them, often with the use of such environmental weapons as demolition of dams and crop burning. Communities rose and fell.

Everywhere in China the control of water was essential. What has been defined as "hydraulic despotism" may tell only part of the story, but it is nevertheless true that communities and even states were predicated upon the need to manage this precious and often capricious resource. The struggle to run irrigation systems, limit marine incursions, maintain banks and walls, undertake dredging, cope with floods and storms, and adapt to ever changing weather was more difficult in China than elsewhere. These have been the fundamental tasks of the officers of central government in Chinese societies since earliest times.

The importance of conservation was, traditionally, well understood. Thus in the Xia dynasty of 4,000 years ago, there were rules to prevent people from cutting trees in spring, fishing in summer, and killing young animals. In the Zhou dynasty 3,000 years ago there were strict timetables for such different activities as hunting, fishing, cutting trees and burning grass. In the Qin dynasty 2,000 years ago there were rules to prohibit collecting newly grown plants in spring, killing young animals, and poisoning fish and turtles.

Throughout Chinese history, cutting trees and bushes for firewood was controlled, and animal and human excrement were returned to the soil for fertilisation. In the countryside, where most people lived, life revolved round soil, wood, grass and water, and towns – as organisms absorbing materials and emitting wastes – depended on these elements.

The impact of industrialisation

The industrial revolution came relatively late to China, and its effects have been most marked in the past 40 years. More perhaps than elsewhere, and certainly in a shorter time span, it has profoundly affected the Chinese relationship with the natural environment. Mass development, mass production, mass consumption, mass transport and mass discharge of wastes have transformed China.

Industrialisation has winners and losers, as in 19th-century Britain, with increasing pollution of land, water and air. As in other societies undertaking economic transformation, the population has greatly increased. Between 1953 and 2001 it doubled to 1.3 billion, and the size of the urban population tripled to almost 500 million. The increase in the number of households has risen by 3.5% a year since 1990.

According to Chinese sources, in the 10 years between 1990 and 2001 consumption of petroleum increased by 100%, natural gas by 92%, steel by 143%, copper by 189%, and aluminium by 380%. The transport network of road, rail and air facilities expanded

greatly. Demand for water, energy and food rose steeply. In the words of a recent report from the World Watch Institute of Washington DC: "It is as if all of Europe, Russia and North and South America were simultaneously to undertake a century's worth of economic development in a few decades."

Not surprisingly, the impact on the environment has been dramatic, and most Chinese leaders are ready to admit, at least privately, that it is almost out of control. Even though the rate of population increase has slowed (down to 1.3% a year by 2001), the rise in population has led to accelerating migration to the cities, and the growth of cities has led to ever greater strains on urban infrastructure.

Transport is a particular difficulty, with official encouragement of car manufacture and potential use far exceeding the capacity of road systems. Chinese cities face the problems and prospects that are already favouring the use of trains and bicycles in Britain, and even rickshaws in central London.

Climatic change

Demand for fresh water may be constantly increasing, but the vagaries of the weather have not changed, and some provinces – such as Guangdong, with a population of 110 million – have recently suffered a 40% drop in annual rainfall. Water tables have been falling, particularly in northern China, through exhaustion of aquifers and new irrigation schemes, and the Yellow River now reaches the sea only a few days a year.

There is also a longer-term factor. Global warming is reducing Chinese glaciers as a source of water. They could all be gone by the end of this century. This also has the effect of diminishing the reflectivity of the Earth to solar radiation, and thus increasing warming.

So far as climate is concerned, the predictions of the Chinese National Academy of Sciences are far from encouraging. They suggest new patterns of rainfall, including less rain in certain areas of high population and more elsewhere. There should be no wonder that there are plans to build a major canal system to convey water from south to north.

The increasing demand for energy raises a host of environmental problems. China has large reserves of somewhat dirty coal, and still depends on them. But it has greatly increased its imports of other fossil fuels, and is now investing heavily in alternative energy sources. For example, it is now building the world's first major pebble-bed nuclear reactor, and has some 30 other nuclear reactors on order. It has also shown interest in

developing a variety of renewable energy sources.

Rising living standards are changing the Chinese diet. This too has environmental effects. There is a general move away from rice towards meat: not just pork, as in the past, but beef, lamb and chicken. Per capita consumption of meat, eggs and milk increased fourfold between 1978 and 2001. This means different use of land, greater dependence on pesticides and artificial fertilisers, a big increase in agricultural waste, and a demand for feedstock, which cannot now be met from domestic sources. World grain prices have already been affected, and probably will be more so in future.

A long list of problems

The cumulative effect of these changes on the Chinese environment is enormous; and it is beginning to affect the global environment in a variety of ways. There are those who want to demonise China, largely for its success in producing cheap manufactured goods and for the management of its currency, not to mention its attitude towards what it sees as its wayward province of Taiwan. A familiar complaint is about the volume of pollutants China emits into the atmosphere, in particular the major greenhouse gas carbon dioxide.

As elsewhere, greater understanding of environmental issues has since the mid-1970s begun to mitigate excessive exploitation of resources. As China is particularly vulnerable to climate change (a point reiterated by the Academy of Sciences), the Chinese government, although not formally bound by the Kyoto Protocol of 1997, has made strenuous efforts to reduce its emissions, largely through increased industrial efficiency.

The result has been an absolute, as well as per capita, reduction in the past few years. But emissions are likely to rise again, and may eventually equal those of the principal villain in this respect, the USA.

Another global environmental hazard is the area's sandstorms, which may have their worst effects in north-eastern China, but still spread to Japan, to Hawaii, and even to the western seaboard of the USA. Soil deterioration and erosion in China inevitably affects all China's neighbours.

In addition, although the Chinese government has recently reduced its own timber cutting in response to the damage done by deforestation, Chinese demand for timber is strong and increasing, and China is a major importer of timber – some of it apparently illegal – from other parts of South East Asia. The effects of changes in biodiversity,

in particular the import or export of alien species, have been fully explored in the *Millennium Ecosystem Assessment* report,²² and all this directly involves China.

There are also the less tangible effects of Chinese technological experiments, which could easily spread to other parts of the world: for example, experiments in genetic modification of food plants, in nanotechnology and in the nuclear field. For good or ill, technology is no respecter of frontiers. The astronomer royal, Sir Martin Rees, has calculated that whether due to inadvertence, criminality or other factors, the prospects for our civilisation surviving past the end of this century are no more than 50%.

What should now be done?

Many individuals in China, as in other parts of the world, may feel a widespread sense of unease, even helplessness. Current changes seem just too much to understand, let alone cope with. The steady globalisation of world economic activity greatly adds to this effect. No one sees how to manage such a complex set of issues involving so many other people and so many other countries.

Even if the problems seem long-term, the short term is what matters for most people. Eventually a realisation may come that patching things up will not yield real results, and then people may see the need for something more radical. There have been many stops and starts and much backsliding.

Sometimes there are what might be called benign catastrophes with identifiable causes and identifiable results, which enable people to begin the painful process of thinking differently so that what looked difficult before looks easier, if not inescapable. Individuals, through the mechanisms of civil society, must obviously be involved throughout, but governments carry the major responsibility. They must display leadership, while respecting and to some extent guiding public opinion.

I have direct experience of this, having been a member of the independent China Council for International Co-operation on Environment & Development since its inception in 1992. Although an official Chinese body, the council guards its independence. Roughly half of its members are Chinese, and half come from other countries or international organisations.

22 Washington World Watch Institute (30 March 2005).

Its reports are a good illustration of how attitudes and policies have changed over the past 13 years. Each year they have become both clearer and more practical, as the work of the various working groups or task forces has become more widely known and applied in China.

In my view the essential elements in the success of this council have been: regular access to the Chinese leadership; the growth of genuine and uninhibited dialogue between Chinese and foreign participants; the production of expert groundwork by the contributing task forces; visible progress in dealing with such problems as air and water pollution in certain areas; and above all the sense that the Chinese leadership is listening to the council, and is ready, within political limitations, to take the necessary action.

Perhaps most important of all is the readiness of the Chinese government to undertake original thinking on environmental issues. Chinese leaders have understood better than most that the environment must be seen as a kind of endowment of natural capital that we have inherited and will pass on to our descendants. Few would disagree with the dictum that "the economy is a wholly owned subsidiary of the environment". In short, without a healthy environment, there can be no healthy economy.

Dealing with the failures of economics

There are those inside and outside the World Trade Organisation who like to suggest the price mechanism as a kind of magic formula. But prices are no more than indicators. As has been well remarked: "Markets are superb at setting prices, but incapable of recognising costs." Of course, telling the truth about costs is very difficult. But a pricing system should include not only the conventional costs, but also the costs involved in replacing the resource, those of the damage that the use of that resource may do, and those affecting human welfare and well-being generally.

Greater efforts have been made in China than elsewhere to establish a better methodology for measuring progress than that represented by the classic gross domestic product/gross national product mechanism. Successive Chinese governments have spoken of the need for a "socialist market economy" in which the framework is set by the public interest, with the free market functioning within it.

These thoughts were well expressed at a meeting of the Chinese government on population, resources and environment on 12 March this year. On that occasion, General Party Secretary Hu Jintao and Premier Wen Jiabao both spoke of the need to adopt a "new

development mode" or "new economic growth mode" within the overriding objective of achieving an all-round harmonious society, or *xiaokang*.

Already the idea of "green clean growth" or "green GDP" has been tested in the province of Shanxi. It means bringing in the externalities or hidden costs of change, and giving priority to human welfare and well-being rather than mere productivity. Some of these ideas are being explored elsewhere, notably in the World Bank, where a new index has been set up to distinguish between natural capital, production capital, human capital and social capital.

Future prospects

None of the environmental problems of China can be solved quickly. There is a continuing tension between those who press for economic growth in the familiar sense, and those who press for better environmental protection and the long-term sustainability of society. There is, likewise, tension between the national government and local governments and communities. There are problems over respect for and monitoring of existing environmental laws and regulations. The price structure is often perverse.

For example, some people in China and elsewhere think that access to water is a basic human right, and for that reason water should almost be free. The result is that there is little incentive to look after it properly and avoid waste. It has been calculated that a ton of Yellow River water for use in irrigation costs less than one-tenth of a small bottle of spring water, thereby removing any incentive to conserve it. Those in cities can often afford to pay more for their water, and so win an advantage over those who may need water more.

But there are many reasons for hope. Often, once a problem has been understood it becomes capable of solution. The forthcoming 2008 Olympic Games in China, coupled with membership of the WTO, have together spurred the Chinese government into confronting and dealing with problems of air and water pollution in Beijing and the protection of the city from dust and sandstorms from elsewhere.

China is also doing more to establish nature reserves, which now cover 13% of its land area, and reverting to some of the traditional agricultural methods. Likewise, a major reforestation programme is in train and experiments are under way to create green barriers to the advance of deserts, and to subsidise farmers who return cropland to forest or grassland in sensitive areas.

Just as the Chinese government tackled the population problem with the tough policy of one child/one family, so it is beginning to cope with the lurch between accelerating environmental damage on one hand and accelerating environmental protection on the other.

As a relative latecomer to the industrial world, China has the opportunity to leapfrog over the mistakes of others. It is also recovering its self-confidence after its century of troubles, and the balance of power in the world is changing as a result.

More fundamentally, its government seems already to recognise that the most effective and equitable way of protecting society and ensuring the welfare of future as well as present generations is to do a lot more to look after the only China, indeed the only Earth, there is. They may turn out to be pioneers in doing so. As in technology, the rest of the world may soon be learning as much from the Chinese as the Chinese learn from the rest of the world.

Chapter 4

Culture and cultural power: where goes China and does it matter to us?

By Dr Isabel Hilton, Editor of *openDemocracy*,
writer and broadcaster

Chinese culture is being celebrated abroad as China grows in significance, and the government has come to see cultural projection as central to its diplomatic efforts. Yet modernisation, urbanisation and changes in family form have put in question just what that culture is; and the government seeks to restrict it to a narrow, ultra-nationalistic narrative and to control the media of distribution. The projection of "softpower" – international cultural influence – has implications for Western interests in much of Asia and Africa. Furthermore, it is in the interest of all that what is shared is the broad variety of Chinese culture, rather than merely what suits the Chinese government.

Culture and cultural power: where goes China and does it matter to us?

Dr Isabel Hilton

Unlike the capacity to project lethal force, the power to project culture is not strictly related to a nation's economic power: some small nations, and, indeed, some nations that do not even enjoy statehood, achieve worldwide recognition for diverse reasons. Tibet – or, more accurately, Tibet-in-exile – is a globally recognised cultural phenomenon, despite a severe shortage of material assets and a complete absence of national power; Ireland, a small nation, enjoys a cultural profile far beyond its GDP.

Nor is it necessarily the case that a great economic or military power also becomes a global cultural force. During the Cold War, the Soviet Union was a military giant but, internationally, a relative cultural pygmy, despite a rich literary, intellectual and musical tradition. Its rival, the USA, with its universally appealing Hollywood product, its popular music, its well-marketed television programmes and, for the more sophisticated, its writers – backed up by a state-sponsored international radio network dedicated to promoting the American way – was a global cultural force that the USSR could scarcely challenge. The official cultural exports of the USSR went little beyond occasional visits from the Red Army dancing troupe and the Bolshoi Ballet.

Throughout that period, the cultural exports of the People's Republic of China were most notable by their absence. Apart from the occasional touring acrobatics show and one or two archaeological treasure exhibitions, the Chinese cultural profile abroad depended on the efforts of a scattering of "friendship associations" and a powerful radio transmitter, situated for political reasons in Albania and broadcasting Chinese propaganda to a largely inattentive Europe.

This was not simply a matter of official neglect. For the first three decades of the People's Republic of China, from its founding in 1949 to the late 1970s, Chinese culture was itself a battleground on which savage ideological wars were fought. On one side, 4,000 years of continuous cultural traditions; on the other, Mao Zedong's utopian vision of a new society served by a narrowly defined and highly controlled "culture of the proletariat". Culture was both a metaphor for politics and a means by which politics were conducted. It was little wonder that next to nothing was projected outwards.

But today China has changed. Two decades of rapid economic growth and the victory of pragmatic, market-based economics have given China both the means and the motive to project her culture. Today, there is official recognition in Beijing that cultural promotion is a necessary and integral part of China's growing international importance.

Projecting a "friendly" China

China has opened up to the world and has achieved her rising prosperity through international trade and manufacture. For the continued expansion of her economic activities, China requires friendly market conditions. Those conditions, her rulers now believe, can best be assured through the projection of an image of China that is benign, peaceful and non-threatening. Cultural projection helps to create that image. As commented in the *People's Daily* last year by the Minister of Culture, Sun Jiazheng:²³

Cultural diplomacy, along with political diplomacy and economic diplomacy, are regarded as the three pillars of Chinese diplomacy.

The minister listed 1994's achievements in cultural diplomacy: he described the first phase of "Chinese Culture Year" in France, led by his own ministry and co-sponsored by 17 other ministries and commissions, as "of paramount importance in erecting a good image of China internationally and promoting the development of strategic partnership between China and France".

The same aims were pursued in Africa, with invitations to Beijing for troupes from nine African countries and a seven-month Chinese culture tour of Africa that covered 22 countries. In Beijing, China hosted the sixth and largest Asia Arts Festival, with the participation of 17 Asian countries. Cultural diplomacy, the minister said,

... has created a good atmosphere for Chinese overall diplomacy and played an important role in promoting bilateral ties ... it promotes trust and alleviates doubts when developing relations with neighbouring countries; long-lasting and non-stop cultural diplomacy is crucial for stabilising, consolidating and developing relations with developing countries; it serves to win people's hearts and promote government exchanges with countries that have not established diplomatic relations with China.

²³ Sun Jiazheng, in an interview with *People's Daily* online, published 21 December 2004 (http://english.people.com.cn/200412/21/eng20041221_168135.html). The following quotations attributed to Sun are from the same source.

Culture is soft but powerful ... because its essence is like water. It can exert a subtle influence on people ... Under economic globalisation, cultural exchange plays an increasingly important role in international relations. Countries, especially Western powers, attach importance to demonstrating their own culture, publicising their values and enhancing influence. Therefore it is an obligation as well as a mission to promote cultural exchanges and co-operation and throw oneself into international cultural exchanges.

Culture, then, is central to the Chinese diplomatic effort in a globalised world, in which the creation of a friendly brand can tip the balance between success and failure. But it is not only an instrumental policy. China, for most of her history, was her region's major power and most important cultural force.

China has felt keenly the humiliation of the past 150 years, when foreign powers, perceived by China as culturally inferior, nevertheless succeeded in imposing their will on a weakened and decadent imperial state. The restoration of China to what many Chinese feel is her rightful cultural station in the world is as important to the sense of national well-being as a steadily growing GDP. The question is: what is Chinese culture at the beginning of the 21st century, and how will Beijing's policy of more vigorous projection affect China's rivals and partners?

Identity crisis

Chinese culture today remains a battleground, and though the contest is less acute than it was in the second half of the 20th century, it is nevertheless profound. Several causes can be advanced to explain today's tensions: the after-effects of the culture wars of the 20th century still linger in the minds of an older generation of creative artists, writers, film makers and critics. The damage to China's system of education in the 1960s and 1970s has left middle generations with an ignorance both of China's cultural history and of international culture, deriving from an official policy that defined both the external and the past as dangerous territory.

The collapse of a state ideology that had been offered as a substitute for China's historic cultural identity has left an unresolved cultural confusion, which has been a matter of concern for intellectuals since the collapse of the Qing empire. The sudden opening-up to the outside world and the virulent process of modernisation that began in the late 1970s have dealt further cultural shocks, and the acute tensions that stem from China's embrace of economic reform while failing to pursue or even seriously to contemplate a concomitant political reform are a further source of cultural conflict. As the cultural

critic Shelly Kraicer writes:²⁴

With a political system that leaves little space for open opposition, the arts are forced to bear a disproportionate, sometimes crushing, burden. Poets, novelists, musicians, film makers, artists of all types have historically – this is a continuity persisting through from pre-revolutionary China to the present day – felt compelled to respond to national dilemmas, to engage in often coded conflicts over the most profound dilemma: what is China and where is it headed?

At the beginning of the 20th century, Chinese intellectuals grappled with the challenge posed to Chinese identity by the rude arrival of Western nations whose representatives were backed by powerful, expansionist, industrialised trading nations. The imperial system, with its Confucian philosophy that for centuries had lain at the heart of Chinese identity, was in ruins, and with it the cultural assurance that had derived from it. China's intellectuals began to debate what it meant to be modern and Chinese, in a debate that embraced everything from Western scientific and technological superiority to the inadequacy of a written language that had not accommodated the vernacular.

The vernacular written language has been dealt with, but the question of identity remains. China is a multinational state and, by most definitions, an empire, one that has doubled in geographical area since 1644. The relationship between the majority Han identity and the divergent desires and cultures of the other, recently absorbed nationalities remains conflictive.

On top of these conflicts come the stresses of modernisation and a rapid industrial revolution with its accompanying urbanisation. For most of China's history, the majority of the population has been rooted in a relatively unchanging peasant and village culture, tied to family and clan structures. This is still loosely true, but it is rapidly changing as peasant labour is sucked into the expanding cities and the proliferating factories of today's China. The Chinese family, which historically generated a rich vocabulary of highly nuanced and hierarchical extended family relationships, has changed beyond recognition through a draconian one-child policy and a new mobility, as younger generations enter the wage economy.

24 Shelly Kraicer at the 14th Brisbane Film Festival, 2005 (www.biff.com.au)

The cities themselves have undergone an extraordinary transformation, beginning with the capital, Beijing. In the course of only 50 years, Beijing – one of the greatest walled cities the world has ever known, a city on whose map was written the cosmology of the Chinese state – has been destroyed. In its place is an urban dystopia, all but indistinguishable from any other metropolis, except for a few incongruously preserved relics.

Beijing could stand as a metaphor for the state of Chinese culture: museum pieces of the imperial tradition afloat in an ever shifting sea of hybridisation. Young artists colonise old factory buildings and turn out conceptual art that finds its interlocutors not in China's past, or even in contemporary Chinese society, but in similar ateliers in New York or London. The Chinese urban middle class have learned to pay high prices for Starbucks coffee and McDonald's hamburgers, to eat cheese and drink wine, to watch Hollywood movies, to play rock music, to follow football, and to read Western books – most commonly management and marketing manuals in translation.

Many more Western books are translated into Chinese than Chinese into other languages. The Chinese spend large sums of money on the cosmetic surgery that turns their features into something closer to an international aesthetic, promoted in films and other images as the most desired form of beauty. Meanwhile, on the campuses, intellectuals debate their cultural legacy, struggling to define – as their great-grandparents were doing in 1919 – what modernity implies for Chinese identity.

A state trying to find itself

A state that wishes to project its culture must first know what it is trying to project. For the present Chinese regime, the difficulty is to find an official narrative that encompasses both modernisation and the unresolved legacy of Maoism. The government has shown an interest in a revival of Confucianism and much is made of Lee Kuanyu's success in using Confucianism to deliver prosperity without democracy in Singapore.

An officially inspired rehabilitation of the recently reviled philosopher is under way: Beijing has launched a 12-month renovation of the Confucian Temple and the Imperial College at a cost of Y8 million, a renovation that includes the dismantling of any modern structures on the sites. It remains to be seen whether this Confucian revival can be adapted to fill China's present ideological emptiness.

In the meantime, in the absence of a better narrative, the government has embraced a nationalism rooted both in the injuries of the 19th and 20th centuries and in the

chauvinism that informs the modern imperial project. But a broader view of contemporary Chinese culture reveals many challenges to the official story, as artists and writers contest official histories and lay down alternative narratives. In the absence of a pluralist, liberal regime, the state is obliged to try to enforce cultural orthodoxy through surveillance and censorship, with the result that some of the most dynamic and original strands of contemporary Chinese culture are excluded from the official canon.

In recent years, this tension has led to diplomatic embarrassment: Chinese films have been garlanded at international festivals that the director has been officially prevented from attending. Chinese writers have been honoured for books that are not available in China. To the fury of Beijing, the only Chinese writer ever to have won the Nobel Prize for literature has lived in exile for decades. Most of the Chinese authors who have found success in the West are both in opposition and in exile. And as the government seeks to promote Chinese culture abroad, the very artefacts that most engage the Western imagination serve as reminders of the continuing constraints on free expression in China. Without political reform, this is unlikely to change.

Visible impact of the culture campaign

Nevertheless, despite these constraints, the Chinese cultural landscape today is infinitely richer and more diverse than it was 30 years ago, and the size of the permitted cultural space is greatly enlarged. As China grows and becomes more diplomatically adept, the positive projection of culture has already had noticeable international effects.

There are many ways to measure this: Chinese people travel abroad now in greater numbers than at any time in history. Chinese tourists now outnumber US visitors to Thailand and are rapidly catching up with Japanese numbers. In Jakarta, visitors notice billboards on which the skyline of Shanghai is juxtaposed with that of Manhattan as an equally seductive symbol.

China itself has become an attractive location for foreign students, and more foreign students go to China than ever before. Many go to study the language, but more learn the language as means of studying other subjects. For many students from developing countries, China is cheaper and more accessible than Europe. The USA has become harder to enter since 2001, and many governments in Asia calculate that, for future educated elites, connections in China may be as useful as connections in Europe and the USA have been until now. The Singapore government, for one, is now sending equal numbers of students to India and China as to the USA and the UK.

Across the world, but especially in Asia, the Chinese diaspora has grown in confidence as the motherland sheds its pariah status. Overseas Chinese have begun to reclaim their culture, setting up Chinese language schools and reasserting their cultural traditions. China is now a pole of attraction for the middle classes of Asia, to a degree almost unimaginable 15 years ago, a fact well reflected in recent opinion polls in Thailand, Singapore and South Korea.

The Chinese government is now backing a more assertive promotion of Chinese language and culture with the launch of the significantly named Confucius Institutes, conceived as partnership ventures with local hosts that will promote the teaching of Mandarin, under the patronage of China's National Office for Teaching Chinese as a Foreign Language. The first opened in Seoul last November and a further 100 are planned in other cities over the next four years. The national office estimates that there are at present some 30 million non-Chinese students of Mandarin, and aims to reach 100 million within five years.

An agreement to open the first Confucius Institute in Britain, at Manchester University, has already been signed. Chinese cultural centres have been set up in Valletta, Paris, Cairo and Seoul, and, according to the minister of culture, China plans to open cultural centres in 20 to 25 countries in the next five to 10 years.

In Africa, China has invested in educational systems, providing scholarships to African students and sending Chinese teachers to Africa – a generosity that smooths the path to other arrangements, be they access to Africa's mineral resources or political support for China's long campaign to isolate Taiwan. For certain leaders in Africa and elsewhere, partnership with China has the added attraction of engagement with a rising economic power that is unimpeded by any colonial legacy, pressure for economic liberalisation or criticism of human rights abuses. In this sense, the growth of Chinese "softpower" – international cultural influence – has important implications for Western interests.

Political positioning

China is at pains to present her rise as an opportunity rather than a threat, although this does not prevent Beijing from making increasingly belligerent noises about the right to "recover" Taiwan by force. For China's partners and interlocutors, a deeper and more stimulating cultural engagement is something to be welcomed. It seems reasonable to suppose that the more Chinese citizens travel, the less hostile they will feel towards the outside world; the more Chinese study abroad, the more they will have the opportunity to encounter democratic realities and test the pleasures of intellectual freedom; the more

Britain is associated with Shakespeare rather than the Opium Wars, the smoother relations will be.

The problems of cultural engagement, however, are embedded in China's domestic political agenda. China will host the 2008 Olympics, an event that symbolises for China a return to her rightful place on the global map. In the run-up to the games, China plans a major public relations effort to showcase the mythic historical construction that is the official narrative. Zhang Yimou's recent film *Hero* is one successful, if disturbing, example of this mythic history.

A campaign of promotion is planned in which foreign partners will be invited to co-operate. It is reported for instance, in the Chinese press, that CNN and the BBC will carry Chinese official programming on the themes of the green Olympics and the people's Olympics. The irony of both themes, in a country in which citizens enjoy few guaranteed rights and in which the deputy minister of the environment has predicted environmental catastrophe, will not be lost on sceptics. But to what extent do such cultural partnerships demand that foreign players accept the Chinese government's practices and priorities?

As discussed elsewhere in this volume, the government is determined to restrict media ownership, access and content and is prepared to devote huge resources to that end. To enter the Chinese cultural market, then, implies accepting – and therefore promoting – state censorship.²⁵

How quickly this might change will depend on China's political evolution. It is in the interests of those liberal democracies that are engaged with China, economically and culturally, that China evolve into a nation that is culturally confident without veering off into ultra-nationalism, a state that learns to celebrate heterodoxy, not suppress it. It is in China's interest, too, to encourage originality and innovation in culture as well as in technology.

The challenges China faces will require ingenuity and flexibility if they are not to prove destabilising. For China's cultural interlocutors, the challenge is to develop policies that help to expand its cultural possibilities, rather than be drawn into complicity in restricting them.

²⁵ Dr Isabel Hilton has written a section on the media which to some extent duplicates, but also expands and enriches, the exposition in Chapter 10. I have therefore added it as an endnote to the relevant section of Chapter 10 (Ed).

Chapter 5

China and the UK

By Dr Gerard Lyons, Chief Economist and Group Head of Global Research at Standard Chartered

The opening-up and growing economic strength of China will have profound implications for the world economy. It is vital that UK authorities, business and people fully understand China's potential impact. Here the key challenges and the main opportunities consequent upon China's economic emergence are identified. There is a need for global policy forums through which the UK and other countries can engage China in tackling longer-term issues. Above all, the UK needs to be competitive, to think global and to view China as opportunity rather than threat; as long as the UK remains innovative, flexible and entrepreneurial it has much to gain.

China and the UK

Dr Gerard Lyons

There are three key challenges from China: first to know more about China's economy; second to understand its global impact; and third, for the UK to be competitive.

The need for knowledge

First, an immediate challenge is the need for greater understanding of China, to recognise the risks and understand the opportunities. This, in turn, may be a sufficient trigger for UK firms to be more proactive in promoting themselves within China. It is important for UK businesses fully to understand China and, in turn, for the Chinese to become more aware of the opportunities in the UK. In China, and across Asia, there is a natural tendency for the focus to turn first to the USA. The UK – either directly or indirectly, as part of the European Union – needs to engage and promote itself more within China.

China comprises many economic regions, all of which are experiencing tremendous change. Three of the five main economic regions are growing strongly: the Pearl River Delta bordering Hong Kong, the Yangtze River Delta near Shanghai, and the Bohai Rim, near Beijing. The other two regions also have huge potential: the North East Region – the old industrial heartland of China – and the resource-rich Western and Central Region. Regional disparities are great, particularly between the booming coastal areas and inland, and between the rural and urban areas.

Although China has great potential, its immediate economic future is not without risks. A hard landing, in terms of a sharp slowdown in growth, is possible in coming years, either if policy makers make mistakes, or if investment falls sharply. Such a setback would trigger concerns about both the financial sector and regional stability. These downside risks for the economy should not be overlooked.

So far the policy makers have done well. In the past China's economy was tightly controlled from the centre. Now, with the economy changing at a rapid pace, the Chinese authorities will find it hard to run the economy the way they have previously. Already, the market is playing a bigger role in the transmission of economic policy.

For example, interest rates rose for the first time in almost a decade in autumn 2004, and during summer 2005 a shift in the exchange rate signalled China's intention to allow greater future flexibility. The economic cycle is set to become more evident and thus

I would expect China to experience greater future volatility along its upward economic path.

Global links

Second, China's emergence is already affecting the global economy directly, and in turn, having an impact on the UK. This influence will grow. An immediate issue is the increasing synchronisation of the world economy. Because of globalisation, the world's leading economies are more in tandem than before. This is good when growth is strong, as in 2004, but it could be a future problem. In the past, when the US slowed, Japan and Europe took up the slack. This no longer happens, on account either of demographics or of inappropriate policies.

The USA and China now hold the key for future global growth. Yet the same factors that could lead to a slowdown in the US are those that could dent export growth and investment in China, slowing growth there. The actions of Chinese as well as US policy makers will therefore be of increasing global significance.

This is already evident in exchange rate policy and the way in which the Chinese, along with other Asian countries, recycle their savings to fund the US trade deficit. In the future, as a sizeable middle class emerges in both China and across Asia, that region has the potential to become the alternative to the US as driver of global growth.

At present, the main driver of growth across Asia is exports. Were the driver to become domestic demand, led by higher consumption and increased investment, rather than exports, this switch would sustain future Asian growth and boost global trade through higher imports of goods and services. Within this, a strong Chinese economy would be important for Asia's future success.

Another implication of China's growth is the emergence of new trade corridors. Chinese-Asian trade has soared, helped by both increased demand from China and growing interaction among firms across the region, as the Asian supply chain becomes more interlinked. Another important emerging trade corridor is increased Asian-African trade, which is rising sharply, albeit from low levels. This, in turn, is linked to China's huge demand for commodities.

This demand for commodities is likely to be an on-going feature of China's growth. Strong Chinese demand for oil has already been a main feature and demand is rising for many

hard commodities like copper, tin and zinc. In the future, as China's population grows and as the economy urbanises – reducing available arable land – China's demand for soft commodities such as cocoa, sugar and grains could also be intense. The result will be that China will increasingly influence global markets for all types of commodities.

The longer-term trend for commodities over the past century-and-a-half is that their prices in real terms tend to fall. However, the emergence of such huge demand in China, soon to be followed by India, raises the possibility that this longer-term downward trend may be reversed.

How should the UK respond?

Third, while it is important to recognise China's growing global importance, perhaps the biggest challenge for the UK is to position itself to be able to benefit. Across the globe, companies and countries are repositioning themselves to become more competitive so as to be able to compete with China and India.

Some countries may be able to compete on cost, but the reality for most, including the UK, is that competition will have to be based on a range of factors. Specialisation is likely to increase across economies. Firms may need to spend more on research, design and development. The UK will need to remain flexible, innovative and entrepreneurial to prosper in this environment.

Chinese workers in the manufacturing sector earn a fraction of the wage of their UK counterparts. In many emerging economies, wages rise relatively quickly, reducing the cost advantage. China may be different, because of its abundant labour resources.

In recent years, China's wages have been kept low as workers have been mobile, moving from rural, inland regions to the booming coastal belt. Now, as China develops its motorway network, factories are mobile, moving inland in search of lower costs and wages. As a result costs are being contained and, despite the recent appreciation of the currency, goods produced from China are likely to remain cheap. Yet the competitive threat will not be just in manufacturing, and it will not be just from China.

China's emergence is having an impact on other countries, either forcing them to become more competitive or encouraging them to open up at a more rapid pace. India is the clearest example, being a low-cost producer of both goods and services. Although the recent focus has been on call centres, the likelihood is that India will move into

manufacturing and into higher-value-added services.

Further competitive pressures should be expected across a whole range of goods, and for some time to come. As Asian economies have become more interlinked, there is scope for firms to cut costs by getting more out of the supply chain. Say a product sells for £5 in the shops, of which £1 is production costs that are difficult to squeeze further; the remaining £4 may be costs in the supply chain. These costs can be cut further through supply chain optimisation. This may be good for UK consumers, but it will force another round of competitive pressures, driving many firms to cut costs and even jobs.

Employment in already developed economies increasingly needs to be skills-based and to offer high added value. With UK worker productivity already below the average of the seven most industrialised economies (the G7), and average educational attainment levels below those of most developed and many developing countries, the UK faces immediate challenges. One measure of competitiveness, that of the World Economic Forum, suggests that the UK has fallen from the fourth to the 11th most competitive economy between 1998 and 2004. Such a trend needs to be reversed.

Already many global firms have little allegiance to borders and increased focus on competition. Thus we should take seriously the widespread reports that businesses fear the full impact of further regulations and higher taxes in the UK. These would further weaken the UK's competitiveness and ability to generate domestic, and attract foreign, investment.

It could be argued that the UK is less at risk of losing jobs to China than are many other countries, because so much of its manufacturing base has already been hollowed out. And this, plus the very open nature of the UK economy, has already led to a high degree of specialisation in areas such as pharmaceuticals and the financial sector.

It also appears to have led to a more entrepreneurial attitude across the British economy, which could help us in the future. And the fact that many firms base their international headquarters in the UK is not just a reflection of language, but is also a testimony to the skills base that it is possible to attract here. The important thing is to build on this in an increasingly competitive global environment.

The message is clear. As HM Treasury itself has said, in its December 2004 report *Long-term Global Economic Challenges & Opportunities for the UK*, the need is to entrench

macroeconomic stability, to promote a flexible, enterprising and innovative business sector and to increase and optimise the skills mix in the labour market, while maximising flexibility. In my view, this points to the need for low taxes, light regulation and improving skills.

Opportunities in China

Let me highlight three. First, when we look at the regional context we see that it is China that is helping to deliver great opportunities in the Asian regional economy. Second, there is much that the UK can bring to China, particularly in areas such as finance and legal services. Third, future flows out of China will be huge, whether they be tourists or direct investment; the UK can position itself to benefit from these.

It is not just China but Asia that offers potential. China's growth is helping to drive the whole region. From a global perspective, consider how important China and Asia are already. A decade ago, Asian central banks held a third of all global currency reserves. Now, they hold two-thirds and will have a major say in future currency moves.

A future contributory factor to the world economy becoming more balanced is the emergence of the middle class across Asia. This group, unlike its counterpart in the West, is not burdened with debt. Whatever one's view of the global outlook, the trend rates of growth that will be seen in China and across much of Asia will outstrip those of the West for some time to come.

In China, rising income per head and a growing urban population presents an attractive market to sell into. This group will want more consumer goods and services, and they will want them from global, not just from Chinese firms. Knowing the characteristics of this huge potential market will be vital.

The fear is that China will grow old before it grows rich, on account of the ageing population; then there is the gender mismatch, with males heavily outnumbering females. Notwithstanding these demographic worries, the size of the potential domestic market is a huge opportunity for British firms to sell into.

The UK is the 14th biggest exporter to China, well behind France (12th) and Germany (fourth). Perhaps the position is not a complete surprise, given the capital goods export mix of other countries, such as Germany, but it does highlight that we need to position ourselves better in the future.

Although we fare better in terms of exports to India – where we rank fourth, on a par with Germany – there is still more potential to realise. While there is no doubt that the USA and Europe are important markets, the focus of UK firms needs to be global, seeing China and India as huge markets to sell into.

What can we sell?

The second area of opportunity is what British firms can bring to China. This could be in many areas – healthcare, insurance, energy, education, law or finance, to cite a few. Take finance. A strong economy needs a strong financial sector. In the early 1990s the Chinese economy suffered a boom-bust that left the banking sector nursing huge amounts of non-performing loans.

The opening-up of the economy has forced the closure of many former state-owned enterprises and, in turn, has led to the growth of a private sector that needs access to funds and banking services. Moreover, despite huge domestic savings, China's personal financial market is in its infancy.

The financial sector is undergoing fundamental change, moving from being state-owned and closed to being commercial, privately owned and open. The pace of change is being driven both by the development of the economy and by membership of the World Trade Organisation, which commits China to liberalisation of the financial and banking sector.

China needs a soundly capitalised, well-supervised and competitive banking sector. The 2003 creation of the China Banking Regulatory Commission was an important step in developing a sound supervisory framework. Yet China needs the input of foreign banks, which can help tremendously by accelerating the pace of change, bringing best practice and increasing competition, with benefits for consumers and firms alike.

Foreign banks are already positioning themselves, with closer working relationships with domestic banks, or even acquisitions of minority stakes in domestic banks. Such stakes have already boosted the capital base and have helped diversify the ownership structure of the local banks. Even when financial sectors in other countries have been opened up, domestic banks have dominated, especially in the retail market. The share of foreign banks is usually small but they can assume an important role.

Opportunities for the UK should be considerable, with the ability to export its proven world-class expertise and technical knowledge across a broad range of banking and financial disciplines.

Another area in which China will need strong assistance is in the development of an efficient legal system. Indeed, the need for property rights and a fully functional legal system are vital if China is to achieve economic success. Again, the UK has much to offer here.

Tapping China's future outflows

A third opportunity is the potential outflow from China as its economy grows. Initially this may mean more Chinese tourists travelling abroad; eventually it will include overseas investment by Chinese firms that are seeking to become global brands.

Across Asia, the Chinese have already become a very important tourist group, with their numbers rising sharply in recent years. One lesson is that they are price sensitive. This is something that the UK tourist industry may need to heed.

In coming years Chinese firms are likely to broaden their global reach. UK financial firms may want to position themselves to offer advice. London will want to ensure that it is seen as an attractive market for Chinese firms to list on, and the UK should ensure that it is seen as a favourable destination for future inward investment by Chinese firms. During the 1980s and 1990s the UK benefited from major Japanese foreign direct investment, which included investment into our universities and our scientific base. The same is likely to happen with Chinese investment in the future, but perhaps on a bigger scale. Beneficiaries might again be our universities and our science base, where the UK has a competitive edge, as well as more general investment into jobs across the economy.

Engaging China on global issues

Finally, there is the need for the UK to be fully engaged in how best to involve China in addressing global issues that matter to us all. Economic issues are often addressed by organisations such as the International Monetary Fund or the World Bank and by meetings of global forums such as the G7 leading industrialised countries.

In my view, there is a need for these bodies to change to ensure that the views both of the emerging new economic superpowers such as China and India and of the different regions, whether they be Asia or Africa, are fully taken into account. In the past, the industrialised countries may have had the answers to many of the global economic problems, but in the future other countries and regions need to be consulted. China's economic emergence is just one factor behind this.

International forums need to serve a purpose if they are to succeed. This not only means that each forum must be able to address key, common issues, but that it must contain the appropriate membership for resolving those issues. It is open to question whether this reform should take place by existing forums changing, or through new forums emerging.

Whether this issue is dealt with from a political or an economic perspective, successful reform has to mean empowering forums, or global institutions, so that they can find solutions to problems. As it may be difficult for countries to leave present groupings to make way for new members, existing groupings are more likely to become larger, or else new ones should emerge.

The UK's presidency of both the G7 and of the EU provided an illustration of China's growing importance in the addressing of global issues. Among other things, the UK presidency focused attention on global issues such as helping Africa and solving environmental problems. In both these matters, China's support was important because of its growing global economic and political influence. China's booming economy is already affecting Africa through demand for commodities and is having a huge impact on the environment.

While it is not possible to imagine all the challenges that the world economy will need to cope with in the future, it is likely that China, as the emerging economic superpower in Asia, will need to be consulted on them. Global forums may need to change to take into account the growing interdependence in the world economy and the profound global impact of China's emergence.

Chapter 6

Consumption and social stability

By Professor Elisabeth Croll, Professor of Chinese Anthropology
and Vice-principal of the School of Oriental & African Studies

Extensive poverty and unemployment, inadequate job creation to replace the biggest lay-offs in history, social insecurity, the declining quality of public services, the pensions crisis, the wafer-thin middle classes and the disparities in wealth are potentially destabilising for China. So too are the country's excess manufacturing capacity and its dependence upon international markets. Hence the determination of the Chinese government to give precedence in economic policy to the development of domestic demand as a main condition of future growth.

Consumption and social stability

Professor Elisabeth Croll

*Accelerating the growth of consumption is of vital importance to stimulating domestic demand so as to attain the objective of building a well-off society in an all-round way.*²⁶

In late 2003, China's government launched a new development strategy that rejected the "go for growth" policy of the previous 20 years in favour of a more comprehensive, balanced and sustainable approach and thus gave greater emphasis to the promotion of social and more equitable development. The rapid rates of economic growth, as welcome as they might be, were now recognised to have had costs – to the environment, to health and to society.

This new development policy was to be based on five principles: the promotion of harmony between city and countryside, between regions, between society and the economy, between man and the environment, and between domestic and external economies. The articulation of this new development strategy was also designed to distinguish and establish the credentials of the so-called "fourth generation" of leaders headed by Hu Jintao and Wen Jiabao.

Indeed, as the *Financial Times* noted, it could well be that "trying to achieve better harmony between the development of the economy and of society may turn out to be the hallmark of the new government".²⁷

In support of the social element of this strategy, the government has deployed two tenets: (1) "people first", aiming at the equitable promotion of human interests, and (2) "building a *xiaokang*, or moderately well-off society". These are about translating economic growth into a better quality of life and are also intended to popularise the second goal, of modernisation.

The first goal of the 1980s was to double the size of gross national product and to feed and clothe China's population; the second was to further double GNP and simultaneously offer China's population a better quality of life, defined as that equivalent to the middle classes elsewhere. The attachment of greater importance to individual well-being,

²⁶ *China's Foreign Trade* (1 February 2003).

²⁷ 30 September 2003.

equality and social development is likely to be more than just rhetoric, because the present emphasis on developing China's own market places domestic demand at the heart of China's sociopolitical agenda.

In the late 1990s a new importance was attached to developing domestic demand, or China's internal market. This was variously designated "the new source", "the new impetus" or "the main engine" of China's long-term economic growth. In 1999 Zhu Rongji, China's then premier, openly acknowledged that the greatest of China's economic problems was "lack of demand at home"²⁸ and, in 2002, the present premier elevated the expansion of domestic demand to "a long-term strategic principle".²⁹

Henceforth boosting domestic demand, long the subject of UK and foreign interest, was to be given priority in planning for consumption-led economic growth. The debate was to be as much about the quality as about the pace of economic growth.

For instance, the authoritative and influential Beijing-based weekly periodical, *Outlook (Liao Wong)*, argued that at this stage of China's development, expanding consumption was more important than increasing investment, and that enhancing the ability to consume rested not only on improving marketing facilities and credit opportunities, but also on increasing incomes, reducing inequalities and securing China's all-round development.³⁰ In short, it argued that the chief constraint inhibiting the growth of a flourishing domestic market was China's uneven development.

Uneven development

There is not a government, academic or media report in China today that does not refer to the increasing socioeconomic disparities between rural and urban China and within city and countryside. Whether China is divided between village, town and metropolis, coast and interior, or east and west, there are major divisions in resources, incomes and services, which have widened during recent years and are frequently described as "a chasm" or "yawning gap".

Changes in the Gini coefficient, an international index used to measure income inequality, show that income disparities in China increased incrementally from 0.28 in the early 1980s to 0.38 in 1995, 0.458 in the late 1990s and thereafter above 0.5 – well above the

28 *The Economist* (14 August 1999).

29 *Xinhua News* (24 April 2002).

30 *China Daily* (31 March 2003).

international warning limit of 0.386.³¹

In the first quarter of 2004, urban cash incomes were officially reported to be three times more than rural incomes, although most economists argue that the real difference is sixfold rather than threefold.³² Overall, a recent survey of incomes measured against the gross national income standards set by the World Bank calculated that only a very small percentage had high incomes (2.2%), compared with those with upper-middle incomes (22%), lower-middle incomes (26%) and very low incomes (50%).³³

Within cities there has been a growth in urban poverty, with unemployed, laid-off, low-income and elderly populations making up "the new urban poor". In 2002, a report issued by the State Council's Development Research Centre noted that, while the use of per capita income as a criterion pointed to the existence of some 14.7 million urban poor, on the basis of per capita spending, the figure rose to 37.1 million.³⁴

Although rural poverty in China has seen a major decline, the numbers of poor continue to range between 30 million and 200 million, depending on whether the poverty line is set at the government's \$0.66 or the World Bank's \$1 a day. However, many more are vulnerable and there is now a consensus that around 200 million live on less than \$1 a day – 400 million below \$2 a day.³⁵

In 2003, it was reported by the National Bureau of Statistics that of China's 807 million farmers, 22.8% lived below the poverty line set by the government; 63.2% had reached or exceeded this line; 3.7% were relatively affluent; and a mere 0.3% were wealthy.³⁶ Recently the head of the World Bank warned that China was fast becoming "the most unequal society in the world",³⁷ a sentiment also echoed by China's own Academy of Social Sciences, which has argued that this gap is so wide it is potentially destabilising.

While maintaining social stability remains at the top of the government's agenda, it is also not lost on the leadership that uneven development also begets uneven demand.

31 Sun, Liping "Re-accumulation of Resources: The Background of Social Stratification in China in the 1990s" in *Social Sciences* (Beijing) (Spring 2002), p59; *Business Weekly* (Beijing) (18-24 February 2003).

32 New China News Agency, quoted in *China Quarterly Chronicle* (20-23 March), p270.

33 *The China Business Review* (March-August 2003).

34 *People's Daily* (20 October 2002).

35 *Far Eastern Economic Review* (10 June 2004).

36 *Beijing Review* (20 February 2003).

37 *Far Eastern Economic Review* (10 June 2004).

Uneven demand

At one end of the continuum lie the mega-rich and rich of the cities, whose affluent lifestyles, homes, cars, array of durables, travel and recreational activities are much reported in the national and international media. Practically and symbolically the elite are seen to be living the good life to which all might aspire – very much in line with Deng Xiaoping's dictum of encouraging some to get rich first, to be followed by others.

Western media reports, including those in the UK, speak seductively of a new market made up of "the swelling ranks of China's affluent", "the stunning growth of a flourishing Chinese middle class" and "one of the fastest-growing middle classes in the world". However, if some have got rich first, it is not at all clear that their lifestyles and consumer habits will be emulated by rising numbers of middle-income earners.

A study of China's social classes published by the Chinese Academy of Social Sciences suggests that the middle class is still small – only 15% of the population – and that this thin wafer of a middle class, sandwiched between the few with higher incomes and the very large numbers of lower-income groups, did not warrant the journalistic hype that surrounds the size, income and expectations of China's middle classes.³⁸

It also suggested that China's social structure was best characterised as a pyramid, rather than the diamond shape more typical of Japan, Hong Kong, Korea and Taiwan, and that given the distribution and movement of income between various social strata, it was not at all clear that a middle class would emerge in the near future.

In 2004, the *People's Daily* also concluded that "most people have yet to join the middle classes".³⁹ The argument that there may be little in the way of upward mobility into the middle strata, and that middle-level income earners struggle to maintain their living standards, is supported by the slowing of retail sales, not only for houses and cars but also for durables. For all but the very rich, a study of consumption trends suggests that the spending of the first years of reform has given way to saving.

Consumption trends

One of the most conspicuous features of the early years of reform was the rise in incomes and new interest in consumption, lifestyle and the consumer – described by the foreign media as "a consumer rush", "a headlong rush into consumerism" or "a consumer fever".

38 Sun, Liping, *op cit*, pp63-65.

39 *People's Daily* (16 August 2004).

Indeed the flow of new goods, consumer choice, high material standards of living, new lifestyles, new retail outlets and the onset of consumer desire rapidly spiralled into what can only be described as a consumer revolution.

In China it is common to talk of three separate consumer revolutions: the first in the 1980s, the second up to the mid- to late 1990s, and the third bridging the century and continuing today. Each is marked by different government policies, income trends and categories of available or desirable goods, popularly known as the "*san da jian*" or "three big items".

In the 1980s the new "three big items" were colour television sets, refrigerators and washing machines, alongside new foods and fashion. In a second consumer revolution in the early 1990s, these were augmented by three sets of electronic goods including telephones or mobile phones, air conditioners, and video recorders or hi-fi units. For the third consumer revolution, around the turn of the century, it was a computer, a car and private housing that constituted the "super three new big things", in addition to home furnishing, travel and recreational facilities.

By the late 1990s, however, it was clear that the earlier profusion of goods had not heralded a sustained consumer boom so much as a significant downturn in spending. Domestic demand for existing consumer durables and electronic goods fell, and two of the "super three new big things" – cars and houses – were so big that only a small minority were acquiring or even aspiring to their ownership.

If shopping can be taken as one measure of domestic demand, then consider that from the mid-1990s, all the signs suggested that previous trends in spending were slowing, with more interest in window-shopping than purchasing, in bargains than brands, and fewer customers for most foreign or other consumer goods. The fast-expanding retail sector was thrown into disarray, as empty shopping malls closed and as annual retail sales growth fell from an average of 25% between 1985 and 1995 to less than 11% in 1998 and around 7% in 1999.⁴⁰

The market for small household appliances and white goods was the first to be overcrowded, as retail sales of televisions, washing machines and refrigerators slowed despite overproduction and lower prices. The market for such goods was frequently described

40 Studwell, J *The China Dream* (Profile Books, 2002), p155.

as "saturated",⁴¹ in that few customers upgraded, while those who had not already made such purchases were unable or unlikely to do so.

China's overoptimistic television manufacturers had four times as much capacity as they needed,⁴² while the growth in mobile phone sales had levelled off, suggesting to business analysts that even though market penetration was still only 20%, most people who could afford a mobile phone already owned one.⁴³

Three big disappointments

The smaller luxury markets for apartments and cars told a similar story. An initial boom in the construction and sale of luxury apartments and villas in new residential estates was followed by a slowing of the market, with reports in 2003 of an inflated housing bubble, which led to a slowing of the market and a vacancy rate of 26% for residential units – despite falling prices and rents – and the abandonment of many half-completed projects.⁴⁴

Similarly, the sudden increase in demand for cars in 2002 and 2003 – making China the third-largest car market after Japan and the USA – was followed by overproduction, over-supply and declining sales. It was predicted that by the end of 2005, China would have auto production capacity for 6 million sedans but demand of only 3 million.⁴⁵ For cars too, it was admitted that "the fact is that ordinary Chinese are not getting rich enough to snap up all the consumer goods flooding the market".⁴⁶

Business analysts concluded that "to keep the China Express rolling, the emerging middle class need to get on board".⁴⁷ As the founder of the consulting firm Automotive Researches Asia concluded in June 2004:⁴⁸

We are going for overkill just as we have in other industries. China's rich are not a limitless pool. There is talk of an emerging middle class but I can't see it.

41 *Financial Times* (24 June 2004).

42 *The Economist* (19 June 2004).

43 *Ibid* (20 March 2004).

44 *Sunday Times* (2 November 2003).

45 *Far Eastern Economic Review* (1 May 2005).

46 *Sunday Times* (7 March 2004).

47 *Newsweek* (21 June 2004).

48 *The Economist* (19 June 2004).

Although there was a tendency for foreign manufacturers to blame lack of demand on bureaucratic red tape, a credit squeeze, commercial inexperience, corruption and other impediments, it is difficult not to conclude that perhaps it was that the scale of demand was not as great as anticipated. It can be argued not only that many goods, and especially those larger and more expensive, are beyond the reach of the majority of the population, but also that there is a widespread lack of consumer confidence in today's China.

It is true, demographically speaking, that even if China's customer base were to amount to around 300 million of 1.3 billion, the numbers are large – but it can also be argued that even those 300 million no longer spend so freely, due to rising costs and greater insecurity.

Failing consumer confidence

The booming interest in consumer goods was cut short by the growing spectre of unemployment, by declining and uncertain incomes, old-age insecurity and the rising costs of services and utilities. The scale of lay-offs and unemployment not only caused hardship for those directly affected but also generated widespread fears about job security among the employed.

Although the official estimate for urban unemployment at the end of 2003 was 8 million, or 4.3%, most independent analysts put the figure between 10% and 20%.⁴⁹ Even conservative estimates suggest that the urban and rural unemployed and underemployed number some 200 million, and these figures are likely to be much higher when seasonal, partial and migrant workers are included.

Despite the loss of a staggering 24 million workers – 10% of the urban labour force – between 1998 and 2002, the closures and lay-offs in the state sector have continued.⁵⁰ In autumn 2004, it was reported that some 2,500 state-owned mines and large enterprises with a total staff of more than 5 million were due to be shut within the next four years, and that substantial lay-offs were imminent at some of the country's state-owned commercial banks, which have already shed some 250,000 staff and closed 45,000 offices since the late 1990s.⁵¹

49 *The China Business Review* (May-June 2004).

50 *The Economist* (11 September 2004).

51 *Ibid.*

Although many find new jobs, the rate of re-employment very much depends on the creation of millions of new jobs, not only to make good job losses but also to accommodate new entrants to the workforce, who alone number more than 10 million each year. According to a 2004 report from Morgan Stanley, job creation has slowed, with only half as many jobs created in that year as in each of the previous five years.⁵²

It is also forecast that in the initial period of WTO accession (three to five years), a number of traditional trades and agriculture with low technical content and weak competitiveness will be relatively hard hit, so that the numbers of unemployed and laid-off are likely to rise. It is widely acknowledged that in "the current difficult situation", the creation of new posts is unlikely to meet the needs of the urban unemployed, laid-off, young entrants and the rural unemployed and underemployed.

Addressing unemployment

In 2004, Wen Jiabao accorded the highest priority to employment and re-employment, pointing out that this problem was "huge" and that resolving it would be a difficult and long-term task.⁵³

Insecurity in the event of unemployment or in retirement is exacerbated by the lack of short- and long-term safety nets in China today. Although many of the laid-off remain attached to their work units and receive benefits, and/or find alternative employment or informal sources of income, the new terms and conditions rarely match those of "the iron rice bowl" previously offered by their work units.

Outside the work unit, which in most ways acted as a shelter against the vagaries of unemployment, sickness and old age, many urban workers feel adrift and insecure. The ratio of urban jobless workers covered by unemployment insurance hovers around 50%; many of the benefits are insufficient to cover basic living costs, and growing numbers of self-employed and immigrant labourers remain outside any such insurance arrangements.⁵⁴

Although the government firmly supports a social security programme and many policies are now in place, implementing and funding insurance and income support for the unemployed has not proved to be an easy task. Similarly, the government has attempted

52 *The China Business Review* (May-June 2004).

53 *Xinhua News* (4 September 2004).

54 *People's Daily* (20 October 2002).

to allay fears for old-age support by introducing a long-term social security system funded by workers, employers and the state, to replace the previous cradle-to-grave welfare that the state sector could no longer provide.

However, the establishment of any new system is beset by several problems, chief of which here is that state-owned enterprises – many of which are debt-ridden, poorly managed and overstaffed – are unable to meet past obligations, let alone any new ones. It is estimated that more than a third of all urban workers no longer receive their rightful pensions, and that many of the present-day workers' retirement contributions have been switched to pay the pensions of current retirees, or even used for other purposes by hard-up local governments.

Significantly, it was reported in 2004 that the pension deficit already amounted to Y200 billion (\$24.2 billion) and, growing rapidly, had direct implications for social stability.⁵⁵ It is common to hear city residents, old and young, worry about old-age support and security, but it is the costs of education and health – and to a lesser extent, housing – that are the main topics of conversation and causes for anxiety, in both the streets of the cities and the lanes of the villages.

Rising costs

By 2000 it was calculated that, in absolute terms, consumers had paid nearly three times as much for healthcare – and more than double for housing and education – as they did in 1994.⁵⁶ Although the quality of urban housing has increased, reforms have privatised the housing stock and reduced subsidies. The purchase price of a city or modern apartment on the open market ranges from 10 to 20 times the average annual urban income, while for all households, the cost of renting from the state or in the private sector has risen.

For most of China's households, the costs of healthcare have also risen dramatically as government spending on health has declined, as charges for services and prescription drugs have increased and as previous subsidies, benefits and insurance schemes have been reduced or disappeared. Central government spending on health has declined by around 50% over the past 20 years.⁵⁷

55 *Transitions* (World Bank, Washington) (May-June 2002).

56 *Ibid.*

57 *The Economist* (21 August 2004); *Time* (8 December 2004).

Hospitals now receive only a small percentage of their operational funds from the state and hence have to generate revenue by levying entrance fees, charging for services and selling medicines and medical tests. It is estimated that 90% of those in the countryside and 60% of city residents have no health insurance to help with the soaring healthcare costs.⁵⁸

Indeed, it is often said that fear of illness is one of the main reasons for the high savings rates in China, and a government survey conducted three years ago found that some 60% of rural residents avoided hospitals altogether, as families had a choice of depleting their savings, going into debt or shortening treatment; this trend has led to falling life expectancy rates in poor rural areas.⁵⁹

The single most important factor behind eroding consumer confidence in recent years has been the rising costs of educating children, which weigh heavily on parents.⁶⁰ Education fees, including those for tuition, books, uniforms, food and other sundry expenses, can be very high in relation to urban and rural cash incomes, and are major topics of everyday concern and anxiety.

In rural regions, the fees for educating children in primary school – let alone secondary and higher education – have to be saved and scrimped for, and many never manage to keep their children in school long enough to acquire and maintain literacy. In the cities, schooling – in particular fees for the most competitive “key” schools – take a major proportion of family budgets, and parents frequently take evening jobs to enable their children to have the best possible education.

According to one estimate, the families of the nearly 10 million college students and 250 million middle-school students who are expected to graduate in the coming 10 years will spend around Y26 trillion to Y27 trillion on their education – a sum that does not begin to match their savings, valued at Y8 trillion.⁶¹

Given that parents perceive their greatest investment and security to lie in their children’s education, it is not surprising to find that a high premium is placed on saving. Normally there is a high rate of savings in China, of around 40%,⁶² but savings rose 19.2% to Y10.4

58 *The Economist* (21 August 2004).

59 *Ibid.*

60 *China’s Foreign Trade* (1 February 2003).

61 *The Economist* (18 January 2003).

62 *China’s Foreign Trade* (1 February 2003).

trillion (\$1.26 billion) at the end of 2003, and even those with high incomes were saving more.⁶³

As in the countryside, urban residents too increasingly look to their families for support, and to their own accumulated savings for short- and long-term security. As a recent World Bank report noted, two decades of reform have seen a massive transfer of risk from the state and work units to individual workers and their families.⁶⁴

In the face of rising uncertainty and insecurity, the government has also taken steps to encourage consumption and confidence. It has reduced the working week and extended what are called "new economic holidays" around New Year and National Day; it has reduced interest rates on savings and it has encouraged "credit consumption".

The push for higher spending

Despite the tensions involved in managing an overheated economy, the government is resolved to increase China's domestic demand. In almost every policy statement – whether it be about economic growth, the provision of social security and public services or the reduction in costs and illegal fees – the stated rationale is the increase in domestic demand. The government is determined to counter its overdependence on overseas export markets and its international vulnerability, given the vagaries of a global economy and the protective strictures of national governments.

Indeed it is hard to see, even for the most optimistic, how China's manufactured exports can keep growing at present rates, particularly if China revalues its currency, the American economy slows or if there is a glut of cheap manufactured goods on the world market.

The importance of domestic demand

In addition to external factors, the government has used consumption and consumer aspirations as internal incentives to spur economic growth and compensate for unpopular policies. Initially the whole programme of reform was introduced and sold on the platform of increased consumption, while in the 1980s it was apparent from my own fieldwork that one of the reasons the single-child family policy was implemented with less opposition than expected was the simultaneous and spiralling opportunities for consumption.

63 *The China Business Review* (May-June 2004).

64 *Transitions*, op cit (May-June 2002).

In 1990 too, it was observable that the government instantly and strategically encouraged consumption following the 1989 Tiananmen Square massacre, when a sudden flurry of retail and recreational opportunities and facilities were directed at distracting the attention of the young.

The question to be asked is: could the government similarly turn to consumption in the event of an economic downturn or widespread popular unrest? Inside China, the greatest fear remains social instability caused by the "joining up" of the many single demonstrations and protests that presently remain issue-centred and location-specific.

Outside China too, although most commentators on China's economy emphasise the on-going high growth rates, the economic boom, the modern metropolises and manufacturing, even the most optimistic prognosis for China's export-oriented economy recognises that China should look to developing its own domestic market, as a third arm alongside investment and export.

As the *Financial Times* noted with approval in late 2004, the obsession with attracting foreign direct investment and with exports is being questioned by some domestic officials and experts, as they turn to developing and emphasising domestic demand.⁶⁵ If accelerating economic growth and advancing social and equitable development to increase demand has become one of the mantras of China's present leadership, so too acceleration of domestic demand is seen to be the key to sustaining economic growth and fostering China's "all round" social development.

⁶⁵ *Financial Times* (9 December 2004).

Chapter 7

A long march to the rule of law?

By Andrew Halper, Partner and Head of the China Business Group at Eversheds

Although the rule of law does not prevail in China today, are legal institutions emerging that are beginning to offer both citizens and foreigners the mediation and justice needed in modern societies? Both the achievements and the limitations of the Chinese legal system since 1989 are identified, as are the domestic and international circumstances that are bringing about the embedding of its values and procedures.

A long march to the rule of law?

Andrew Halper

Western media coverage of the Chinese legal system is overwhelmingly negative, focusing on human rights violations and the plight of individual dissidents. We know that there are many such violations, but, even in the eyes of China's harshest critics, the Chinese legal system has come a long way in just over 20 years.⁶⁶ When the system works well, this is rarely reported: "man bites dog" is news, but "dog bites man" is not. What, then, is the correct overall picture? What is the trend line? In which direction, if any, is the People's Republic of China's legal system moving?

In appraising the situation of China in general, lately it is the arguments of optimists, rather than those of China's critics, that have been listened to more attentively and taken more seriously than before. The reasons include China's activities on the international stage, such as its 2001 accession to the World Trade Organisation and the role of Beijing in the protracted talks over North Korean nuclear objectives.

Playing by Western rules

Chinese co-operation in the international fight against terrorism is appreciated by Western policy makers and intelligence agencies. It confers on China the very welcome corollary benefit of tending to reduce US criticism of Beijing's human rights behaviour in dealing with violent and non-violent dissidents in its Muslim-populated Central Asian Autonomous Region of Xinjiang.

The unpegging of the renminbi, and the increasing Chinese presence on the international mergers and acquisitions scene – as witnessed in deals such as Nanjing Automotive/MG Rover and Lenovo/IBM, and even unsuccessful ones such as CNOOC/Unocal and Haier/Maytag – have reinforced the sense that China is joining the international economy and is now playing the same rough-and-tumble game as other players, more or less adhering to the same rules.

Notwithstanding some paranoid protectionist reactions to the international economic rise of China, in particular from France and the USA, the overall view among most informed Western observers and members of the foreign policy and financial and business communities is that, over the past decade, China has become a much more responsible international player.

⁶⁶ Randall Peerenboom, professor of Chinese law at University of California, Los Angeles.

In 2004 this view was expressed in the influential policy paper *The Beijing Consensus*, by Joshua Cooper Ramo of Goldman Sachs Asia, a laudatory appraisal of China's domestic development policies and its international political and economic strategies and positions.

China's country risk

Foreigners' views about the role of the law in China's economic development have similarly become more positive. They typically are concerned with issues of importance to foreign business trading with or investing in China, such as whether contracts are enforceable, whether legal rights of investors can be upheld, and whether intellectual property rights can receive adequate protection. These issues are in essence the legal dimensions of country risk.

By properly preparing and structuring deals to take full advantage of the protections conferred by the Chinese legal system, and by conducting rigorous verification and due diligence, it is certainly the case that legal country risk can be substantially reduced. But not even the strongest domestic or foreign supporters of Beijing's chosen developmental path would argue that the rule of law *now* prevails in China, although such proponents do often assert that China is moving steadily and surely in that direction.

Other observers contend that the Communist government, intent on pursuing "stability" at any cost, will simply not allow the rule of law to develop because social stability is promoted as a requisite of fast economic development, and considered to require the curtailing of any unrest and the ensuring of the Communist Party's monopoly of power.

The divide between these perspectives is critical. How we view the role played by legal sector change in China's economic development, and indeed in the overall governance of the Chinese polity, will heavily influence how we engage with China – whether on the level of business people making specific investment decisions, or of government deciding how to deal with China on economic and investment policy issues, and finally on how best (or whether) the UK can support legal sector development in the People's Republic of China.

Rule of law – a usable definition

In order sensibly to address the issue of whether China is moving towards the rule of law, it is necessary to define the concept. This is not as simple as it may appear.

The concept of rule of law is a Western, not a truly universal one, and it is useful to recall that in the West, the understanding of the concept has developed over a long time and

still varies – sometimes quite widely – from country to country.

A number of different conceptions of the rule of law have been formulated. These conceptions make up a spectrum. On one end of the spectrum are found formalistic and institutionally focused conceptions of the rule of law, which could arguably be accommodated within an authoritarian system. On the other are conceptions that focus heavily on the substantive presence of such values as individual liberty, democracy, human rights and minority rights, and thus can be accommodated only within a liberal-democratic system.

Genuine differences exist over the issue of the primacy of individual versus collective rights, and a rather more collectivist approach is more consonant with Chinese political and social traditions. One's view of this issue will strongly influence one's appraisal of the different rule-of-law conceptions across the spectrum described above.

Whichever account is selected, it is important to distinguish (a) a concept of rule of law in which law is in some important way *supreme*, from (b) the mere rule *by* law, in which law and regulation are essential instruments of governance and rule, but in which the law is viewed as a *tool of governance* and not supreme.

China is an ancient and, although economically still relatively poor, a highly refined civilisation that has been developing continuously for several thousand years. For at least two thousand years its governance norms have not distinguished between law and policy, or between the moral and legal sources of authority. Thus the state views itself somewhat like a benevolent ruler that is responsible for society but not accountable to it.

Moreover, the cultivation of networks of personal relationships has been and remains a high cultural value, which cuts across and undermines efforts to establish a legal system in which law is applied without reference to such relationship considerations.

China's indigenous norms and institutions shape its approach to legal system development, and it would clearly be unrealistic to expect that China's importation of international legal norms and practices, which have developed over centuries in the West, will quickly lead to a system that operates in a predictably Western fashion.

That said, the Chinese government has repeatedly asserted that it is attempting to move the country from a system of *ren zhi*, rule by people, to one of *fa zhi*, rule of or by law;

the Chinese expression is, significantly, ambiguous. When asking what it means by this, it is necessary to measure its performance against some concept of rule of law.

Such a concept should attempt to steer a middle course between the extremes of the formal/instrumental and liberal-democratic approaches outlined above, and should contain characteristics that allow one fairly to conclude that the law is, in some important way, supreme. The following indicators of the existence of the rule of law arguably constitute a reasonable list of the minimum criteria.⁶⁷

- Legal standards are reasonably distinct from other social or political norms, so that it is possible to distinguish law from political policy.
- Laws are made public and available.
- Legal standards prevail over competing social or political norms – the law is supreme.
- All persons and legal entities are subject to and equal before the law, including government, administrative agencies and officials.
- Discretionary authority is only used where there are sound policy reasons for not formulating and applying general legal standards.
- Where officials are given discretion, this is subject to restraining legal standards and the supervision of the courts.
- Mechanisms, processes and institutions are in place for the implementation and enforcement of law.
- Legal disputes are resolved by independent courts with professionally trained judges, and with the participation of a trained and independent legal profession.

Even a brief consideration of these elements leads quickly to the conclusion that the rule of law does not now exist in China. However, a mere snapshot of the present state of affairs is inadequate. We need a motion picture to get a sense of where China is headed.

A long march or a gilded cage?

Alluding to the famous Long March of the Red Army during the civil war between Communists and Nationalists, one leading scholar of Chinese law has characterised China as being embarked on a "long march towards the rule of law".⁶⁸

67 Professor Denis Galligan, director of the Foundation for Law, Justice & Society, University of Oxford, has written cogently on these indicators.

68 The phrase was coined by Peerenboom. See Peerenboom, Randall *China's Long March Toward Rule of Law* (2002). The following discussion is not intended to summarise or encapsulate his views. There is a certain irony in using the concept of a "long march" to describe the positive evolution and development of the legal system, since the actual Long March involved a tactical retreat to escape Nationalist forces.

Developments lending support to this view are abundantly in evidence. These include:

- recent revisions to the constitution of the People's Republic of China reinforcing property rights and also stipulating that "no individual or organisation" is above the law;
- the re-emergence of law faculties and the legal profession following the devastation of the Cultural Revolution (1966-76), and the ever growing popularity of legal studies and a legal career among the younger generation, fuelled in part by positive state media imagery of lawyers as dynamic, modernising and rights-enforcing professionals, as well as a genuine measure of idealism on the part of many young men and women;
- the increase in professionalism of many lawyers and also a number of judges over the past decade or so;
- the explicit and regular reiteration by leading state media and senior state officials of the importance of rule of law and the need for China to improve its legal system, thus helping to raise public expectations that development of the rule of law and impartial application of the law will accompany the country's overall developmental process;
- on-going experimentation with reform of the courts, including the use of single judges rather than panels (where the views of seniors in the judicial and party⁶⁹ hierarchy may predominate), and the issuance and publication of detailed written reasons for judgment;
- recent reforms in criminal law procedure that have strengthened the rights of accused persons;
- state media coverage of cases of abuse of detainees or violations of accused persons' rights by police;
- the promulgation of a large body of legislation (generally drafted more competently than was hitherto the case) to address China's legal obligations pursuant to its accession to the WTO, as well as to address the needs of China's transitional economy, involving issues such as intellectual property rights, property tenures and transfer, private equity, insolvency, public companies and their governance, etc;
- the steady growth in administrative law litigation, under a 1990 law that permits citizens to challenge the actions of state agencies;
- the sharp rise in intellectual property rights litigation as well as litigation over contracts, torts and real property by actors in the domestic economy, who appear increasingly to believe that they are "citizens" with "rights" and not just subjects, and are willing to invoke the Chinese legal system in support of such rights;

69 Many judges are party members, and the party hierarchical structure would thus continue to operate between judges who are party members.

- the official dissemination throughout China of legislative texts and legal information, and the establishment of legal aid centres to represent the interests of individuals;
- the repeated efforts by Beijing to enforce legal strictures against corruption, resulting in a number of high-profile and much-publicised prosecutions of fairly senior (although not top-most) officials; and
- the gradual evolution of the National People's Congress from, in Bagehot's terms,⁷⁰ a "dignified" organ towards becoming an "efficient" one, as the National People's Congress starts to act more and more like a real legislative body, and not just a rubber stamp for party policies.

Merely listing these achievements in point form here should be sufficient to indicate that something important is going on with law in China.

What are the government's intentions?

Supporters of this "long march" view differ over whether the end-point, which some of them state to be the gradual transition to true rule of law, is actually intended by wise and far-seeing Chinese political leaders, or rather is something that they neither intend nor foresee happening, but that is likely to emerge under the impact of the mutually reinforcing forces unleashed by modernisation and economic development.

These include China's opening-up to the outside world and accession to the WTO, the developments that have already taken place in the legal system and which are having a catalytic effect, and the emergence, already in evidence, of rights consciousness among millions of Chinese citizens.

However, regardless of whether they take an "intentionalist" or a "consequentialist" view, "long march" proponents tend to concur that the end-point of this process will be the establishment of a rule of law, although probably it will be closer to the authoritarian end of the spectrum than to the liberal-democratic end.

⁷⁰ William Bagehot's 1867 work *The English Constitution* contrasted the monarchy as the "dignified part" of the constitution, meaning that it "excite[d] ... the reverence of the population", with the constitution's "efficient parts", by which government in fact worked. The distinction between dignified and efficient constitutional organs has since been applied outside the context of the British constitution and Bagehot's terms have become foundational concepts in political constitutional theory.

But is it as certain as that? Critics argue that the glass is half-empty rather than half-full, and that the law in China, as another leading scholar⁷¹ of Chinese law put it, is like “a bird in a gilded cage” – lovely to look at and singing beautifully, but kept behind bars. Such critics argue that China will continue to be dominated by a rule-by-law system for a very long time to come, certainly for as long as the party remains the dominant source of political authority.

The “gilded cage” argument

Proponents of the “gilded cage” thesis can point to a number of elements in support of their views.

- Despite China’s accession to the WTO, officials – primarily at local level but inconsistently controlled by Beijing – continue to promulgate and apply rules contrary to China’s treaty obligations of transparency and national treatment, and even contrary to Chinese national legislation.
- Despite the promulgation of comprehensive intellectual property rights legislation, in accordance with China’s treaty obligations, there are continuing rampant breaches of such rights, with only limited official action to rein in such violations.
- There is continuing politicisation of the application of criminal law, including sharply increased recourse to application of the death penalty during the frequent “strike hard” anti-crime campaigns.
- In several areas Chinese legal administration falls short of international standards, or even China’s own proclaimed standards. For example, unlawful detention, recourse to vague laws on endangering state security, and serious violations of the rights of accused persons – such as access to counsel and protection from mistreatment – are still prevalent.
- There are continuing constraints on using the 1990 administrative litigation law to challenge wrongful acts of officials, in particular the legal inability of the courts to strike down ultra vires regulations.
- There are structural limitations on the ability of lawyers to be a self-governing profession.

71 The expression was first coined by Chen Yun (d 1995), a senior party figure who argued, at the commencement of economic reforms, that market forces should be like a bird in a cage: the cage must not be too small else the bird would not thrive, but the cage must be kept locked to keep the bird from escaping. It was later adopted by Stanley Lubman, lecturer in Chinese law, University of California at Berkeley. See Lubman, Stanley *Bird in a Cage: Legal reform in China after Mao* (1999). Again, the following discussion does not summarise or encapsulate Lubman’s views.

- There is a lack of judicial independence, exemplified by the continuing existence of “political-legal committees” within the courts, which perpetuate interference in the courts’ work by the party and state on policy grounds in “sensitive” cases, and which engender violations of the rule-of-law requirements of GATT Article X(3)(b) on independent adjudication and review of trade regulation matters.
- Legislative provisions, which preserve for administrative agencies the power to interpret their own regulations and which thus prevent the courts from exercising such power, keep the courts weak.
- Personalism – *guanxi*, or personal connections – continues to be powerful as an extra-legal influence upon the outcome of legal issues, whether before the courts or where decided by administrative agencies.
- It continues to be difficult to enforce judgments.
- The central government is unable or unwilling to crack down on local officials who fail to uphold the legal property and other rights of rural Chinese, or who themselves engage in violation of those rights.

More fundamentally, proponents of this view say China’s one-party system ensures that true rule of law simply *cannot* emerge. They argue that the Communist Party’s imperative of self-preservation trumps all other considerations, and effectively forestalls the development of true judicial independence.

Rather than heading towards the rule of law, in which law is supreme and all persons and organisations are formally equal, China is determined to maintain the instrumental approach of rule *by* law in order to promote smooth development and avoid a recurrence of the chaos of the Cultural Revolution. The state will seek to conduct its operations and its governance of society by means of law, but the law itself is not supreme, and the party’s position will not be challenged.

Conclusion

These different pictures both tell a true story, in the sense that a motion picture and a snapshot each depict reality. The author tends to the view that the “long march” consequentialist (*not* intentionalist) perspective is the most accurate.

As discussed above, a number of mutually reinforcing elements are at play. Market forces and concepts have taken strong root, and are not easily capable of being regulated by diktat or administrative measure; actors in the economy need reliable dispute resolution mechanisms.

Social expectations of the Chinese government have evolved since the Tiananmen Square massacre and under the impact of improved access to information and rapid social and economic structural change, so that the government's credibility and thus durability are a matter of delivering not simply on social stability and economic growth, but also, increasingly, on being seen to promote and uphold values of clean government and good governance.

A growing middle class has a stake in more than just stability – it cares, as well, about quality of education, environmental quality, and corruption. This is creating pressure from below for greater transparency and accountability.

A large and growing body of legal professionals are starting to act and think increasingly like professionals, and this self-image will also further the development of the values of a rule of law system.

Although I have alluded to a number of institutional and attitudinal constraints on China's fulfilment of its WTO obligations, the accession has already made a noticeable difference in the quality of legislation and can be expected positively to affect the practical adherence to legal rules of transparency and fairness.

As for the tension between individualist- and collectivist-leaning conceptions of rule of law, China is likely to favour a rather more collectivist balance than exists in Western liberal democracies.

Unknown and unquantifiable contingencies also exist. Political, economic, environmental or public health crises could turn China from its present trajectory. Even if they do not, the achievement of genuine rule of law is implausible at best under the one-party system.

China's political evolution, however, has not reached its conclusion. It is not clear exactly what forms political transition will take. By fostering development of the constituent elements of rule of law, even if actual supremacy of the law is not achievable under existing political conditions, reformists within China will increase the odds that the transition will involve the kind of legal institutions and assumptions that are expected elsewhere.

Chapter 8

Governance: the challenges

By Professor Jude Howell, Professor and Director of the Centre for Civil Society at the London School of Economics & Political Science

A very large number of reforms have improved the quality of administration, but accountability remains a problem and it is difficult to see how, as long as the Chinese Communist Party wields as much power as it does, further political reform is possible. Nevertheless, as society changes, expectations will grow and new institutions be needed to fill the vacuum left by the dilution of totalitarian government, so that the boundaries of authority will increasingly be contested.

Governance: the challenges

Professor Jude Howell

The fundamental restructuring of the economy, coupled with rapid growth, has brought about significant changes in the structure of Chinese society, in the distribution of wealth, in values, attitudes, and expectations. The breakdown of rural-urban barriers to mobility, the changing nature of China's working class, the emergence of a new bourgeoisie and the rising inequalities across regions, generations and classes have all considerably complicated the processes of governance.

This paper outlines some of the key governance challenges facing the Chinese Communist Party, its efforts to address them and the constraints it encounters in doing so. It also considers their implications for the future trajectory of Chinese politics.

Governance challenges, reforms and constraints

While China's economic system has undergone fundamental change over the past quarter-century, its political institutions – the Communist Party, the state administration, the National People's Congress, the legal establishment and mass organisations, such as the All-China Federation of Trade Unions – have differed considerably in their desire for, and capacity to, adapt and change. This has affected their ability to deal with the complex governance challenges that have emerged in the process of reform.

How the state has dealt with these reveals not only some of the pathologies of the Leninist state machinery, but also some of the emerging ideas about the direction of institutional and political reform. Four closely related governance challenges are addressed here, namely legitimacy, social order, state administration and social welfare.

Legitimacy

Since 1949, Chinese political leaders have used ideology in their struggles for power, both to discredit their opponents and to justify their right to rule. Mao's radical interpretation of Marxist-Leninism led to a new version of socialist ideology, namely Maoism, that gave peasants as well as workers a leading role in the process of revolutionary transformation.

During the Cultural Revolution, contending political factions deployed the language of class struggle and Maoism in their efforts to gain control of the party and dominate society. With the downfall of the Gang of Four in 1976 and the rise of the economic reformers centred on Deng Xiaoping, the mobilising force of socialist ideology began to

wane. "Redness" gradually gave way to expertise as the respected credential.

Lack of popular enthusiasm for political campaigns, rallies, and meetings left the interpretation and making of ideology to party members and dedicated political scientists and philosophers rather than the general public. Nevertheless, the Communist Party has continued to try to rework socialist ideology to reflect its goals of modernisation, the direction of economic reforms, and the changing fabric of society.

The term "socialist market economy" is used to capture the momentous changes in the economy that have occurred and the government's vision of the future, but socialist ideology is useless as a mobilising discourse. Though in international affairs China uses its ideological armoury to position itself in relation to others, it does not help to legitimise its rule domestically. This is both because it seems irrelevant, and because of the contradiction between ideology and reality.

The party continues to maintain that the working class and peasantry are leading forces in society while the social and economic position of many workers and peasants in China declines. In his July 2001 speech Jiang Zemin introduced the notion of the "Three Represents", which acknowledged the role of private entrepreneurs in China's economy and society and paved the way for the reopening of party membership to them. Although such a move may be inspired by pragmatism and expediency, the idea of capitalists joining a communist party is an oxymoron.

Given these contradictions and the impotence of socialist ideology, the party has to rely on other means for justifying its rule and filling this ideological vacuum. In moments of perceived external threat, the Chinese government has used nationalist sentiments to rally support, as illustrated in the protests following the NATO bombing of the Chinese embassy in Yugoslavia or the recent demonstrations against Japan. Recourse to nationalism has been episodic, rather than a recurrent theme in everyday political life. However, it has considerable appeal – both domestically and among China's recent diaspora – and can readily be mobilised.

The government relies on two key capacities to justify its rule. These are: first, its capacity to create and maintain an environment in which growth and prosperity can flourish; and second, its capacity to maintain social order.

China's astounding economic performance over the past two decades is an important

source of legitimacy for the government. Thus any decline in economic performance, and/or any serious negative consequences of, say, entry to the World Trade Organisation, will affect the legitimacy of the government. How the government manages the economy in adverse conditions will therefore be crucial to the validity of its claims to rule. Related to this is the maintenance of social order, which, as we will see below, has become increasingly worrisome for top Chinese leaders.

Social order

Maintaining social stability is a key concern. The idea of chaos or disorder (*luan*) is a powerful concept used by Chinese leaders to express caution regarding, and to resist any attempts at, unwelcome change. It evokes memories and accounts of periods of disorder in China's history, most recently the Cultural Revolution.

The rapid restructuring of the economy since 1978 – in particular the decollectivisation of agriculture, the expansion of the private sector, greater global economic integration, and the relaxation of barriers to rural/urban mobility – has led to changes in the nature of society. The social composition of the working class has diversified, with rural migrants now forming the mainstay of employees in foreign companies and many domestic exporting factories.

The closure of state-owned enterprises has created a new phenomenon of laid-off workers and expanded the army of the unemployed. The growth of the domestic private sector, especially since 1992, has cultivated a new stratum of entrepreneurs. Managers, technical experts and graduates working in foreign businesses are part of a new emerging middle class.

At the same time the reform process has exacerbated certain inequalities, such as regional disparities between coastal and inland areas, and given rise to the vulnerable and deprived urban poor.

Dissatisfaction with the growing income disparities across generations and between different social groups has fuelled an ever rising number of protests across China. Pensioners who have not received their pensions, former state enterprise workers who have been laid off, migrant workers who have not been paid their wages or have been subject to abusive managerial practices, farmers who have not been adequately compensated for their land, urban-dwellers whose houses have been demolished to make way for new roads and office blocks – all have voiced their grievances through such

actions as street protests, blockades, storming of government buildings, strikes, petitions, letter writing, and court cases.

Over the past two decades, letters, complaints and petitions received by courts at all levels have risen almost 500 times. In 2004 alone, more than 3.76 million people took part in 74,000 protests; figures that are likely to be underestimates, given the restraints on reporting.

In addition to these grievances connected with the rapid processes of change, the Chinese government has also to deal with continuing ethnic unrest, particularly in the provinces of Xinjiang and Tibet. It recently signed an agreement with the Shanghai Co-operation Organisation and the Commonwealth of Independent States to work together against the "terrorist" activities of groups seeking a united Turkestan.

Also worrying for Chinese leaders are any perceived attempts to mobilise a political challenge to its rule; the 1989 Democracy Movement, Falun Gong and the short-lived rise of the Democracy Party in 1998 are recent examples. The government has responded to these manifestations of social unrest either by using its coercive and repressive powers or by deploying such measures as the courts, higher-level intervention, negotiation and resolution, detention of the leaders of protests, and so on.

These signs of unrest highlight not only growing awareness of rights and the rule of law, but also the inadequacies of existing institutional mechanisms for mediating interests. In the pre-reform period the party relied upon its mass organisations – in particular the All-China Women's Federation, the All-China Federation of Trade Unions and the Communist Youth League – as channels for the dissemination of party policy downwards to women, workers and youth respectively, and the reflection of their interests back upwards.

With the changes in society and economy in the reform period, these institutions have struggled hard to adapt to the changing needs of their constituencies and have varied in their ability to innovate, restructure and adapt. At the same time, new forms of more autonomous organisation have mushroomed in the more relaxed ideological climate of the reform period, both supplementing and implicitly challenging the authority of these Leninist institutions. They include various environmental organisations, such as Friends of Nature or Global Village, and women's groups such as Maple Leaf Women's Psychological Counselling Centre, or Women Workers' Legal Counselling Centre in Shanghai.

However, the restrictive regulatory framework governing social organisations continues to be a barrier to the flourishing of non-governmental organisation and therefore to the open, public expression of grievances and interests. The more government attempts to contain the realm of autonomous organisation and activity, the more likely it is that grievances become expressed through social protest, and issues of social order abound.

State administration

In the wake of the Cultural Revolution, one of the main goals of the reformers was to modernise the state administration, in particular to recruit "experts" rather than "reds" into its machinery. Over the course of the next decade Deng's followers gradually eased out any leftist opposition, along with poorly educated or incompetent administrators at all levels, by appointing reform-minded leaders to key positions and changing the entry and promotion requirements for state bureaucrats.

To this end it called for a younger and more educated administration, lowered the retirement age, and introduced civil service exams. However, there are stark differences in the capacity of the administration across regions, with levels of competence and technical expertise tending to decline at lower levels and in poorer regions.

In China, the state administration and the Communist Party are closely fused systems. Most leadership positions in the state bureaucracy are held by party members, and promotion is contingent upon approval from the relevant party committee. Though there have been attempts to separate the party from the government, the two systems do not function independently, not least because the party has considerable interest in retaining control over the administration.

Corruption in the administration thus also creates a problem for the party, as corrupt leaders are also likely to be party members. The party has continually sought to reduce pervasive corruption by strengthening its internal disciplinary processes, by investigating cases of corruption and by using the law courts to prosecute deviant officials.

However, the opportunities for corruption created by government involvement in business contracts, coupled with tight controls over the media and the limited scope of public monitoring, continue to thwart the party's attempts to clean up its act.

Aware of growing public mistrust and dissatisfaction with government officials, particularly at lower levels, and the endemic problem of corruption, the party has sought

to improve officials' accountability in various ways, such as through responsibility contracts and through elections to leadership positions at lower levels.

Responsibility contracts bind local government officials, in contracts with central government, to meet certain economic and social targets. If they do not fulfil them, they may be moved elsewhere or lose out on promotion. It is made clear that officials are expected to be responsible and responsive.

So, for example, in Dinggu, where thugs were hired to put down village protesters, an event that received coverage on BBC4, the local government officials all lost their jobs. Similarly, the vice-governor of Liaoning province lost his job after a coal-mining accident.

Though village leaders are not officially part of the state administration, they play a key role in disseminating and implementing party policies. For example, they are required to raise taxes and grains from farmers, to ensure the implementation of the family planning policy, and to organise contributions in the form of labour to any local infrastructural schemes.

In the early 1980s it was already apparent that there was a growing problem of order in the countryside. In some villages, committees had virtually collapsed; in others, the possibilities for pursuing alternative paths to wealth creation rendered the positions of village leadership less desirable; and in yet others, village committees were staffed by old, incompetent or corrupt leaders.

The gradual introduction of competitive village elections across China from the 1980s onwards was part of an attempt to re-establish order in the rural areas, to enhance the accountability of leaders and thereby to strengthen the base of the party. By encouraging young, popular and competent candidates to stand for election, it was hoped that villagers would vote to oust corrupt, unpopular and incompetent leaders, who brought the party into disrepute.

The village elections established mechanisms for greater transparency, such as the public display of accounts, and for greater accountability, such as reporting back to villagers at annual assemblies. Competitive committee elections in turn led to the introduction of elections for village party branch leaders in some areas, and to the experimental extension of the idea to township level.

In urban areas, competitive elections for leadership positions in communities and neighbourhood committees have also taken off in pilots in Shanghai, Shandong province and Shenyang city.

To date, competitive elections have meant elections where there is more than one candidate for one position. These candidates, in the case of village elections, are often produced through open processes of nomination by all village residents (and in the case of village Party branches, by all Party members).

Candidates compete as individuals and not as Party members. They do not have to belong to the Party, and often do not. This is part of a process of reform within the Chinese Communist Party intended to ensure that younger, more competent, more locally credible and popular leaders are voted into positions. If those elected in village elections, say, are not Party members, then the Party often approaches them afterwards to join, thereby renewing its legitimacy.

However, although the Party has promoted competitive elections at lower levels, it resists extending these up the hierarchy and the idea of Party-based elections.

Social welfare

The idea of a benevolent ruler has been a mainstay of state legitimacy in China's long history. Faced with the enormous ruptures in society over the past two decades, particularly the widening disparities across different regions and social groups, it is important for central Party leaders to pay attention to protecting the vulnerable and less advantaged.

In the past three years some senior leaders have called for a shift away from a singular focus on growth towards a more balanced approach to development. However, in attempting to address issues of inequality and vulnerability, which are increasingly a source of discontent, the government faces considerable institutional challenges.

With the diversification of ownership forms and the restructuring of state enterprises, the social and welfare functions of work units (*danwei*) have been gradually whittled away. In the pre-reform era, the work unit in urban areas often provided to varying degrees childcare facilities, housing, entertainment, access to medical care and pensions. In order to increase productivity and remain competitive, enterprises have gradually shed these responsibilities.

Similarly, in rural areas the disbanding of communes contributed also to the breakdown of childcare provision, of access to and provision of medical care (which in any case was limited), and the weakening of support systems for the elderly, disabled and vulnerable.

In the meantime the Chinese government has attempted to establish new systems of social security and social welfare, such as unemployment benefit systems, medical insurance and pension schemes, concentrating its efforts in urban areas. Aware that it is unable to offer universal systems of welfare provision, it has also increasingly looked towards communities and social organisations to play a role.

Cities such as Shanghai have experimented with the establishment of community centres that take on the functions of welfare provision. The government has encouraged the formation of charities and associations such as the China Charities Federation, the Shanghai Cancer Recovery Club or the Centre for Women's Law Studies & Legal Services, which set out to meet the needs of particular vulnerable groups.

In order to address issues of poverty in rural areas it established a Poverty Alleviation Office, channelled funds to poor counties, and encouraged international development agencies to fund projects.

However, the institutional architecture for the provision of social welfare and security remains fragmented and piecemeal. As long as adequate systems for addressing poverty and vulnerability do not exist, then any claims to be acting as a benevolent ruler sound increasingly hollow, undermining the legitimacy of the Party.

Though Party leaders encourage non-governmental organisations to take on the delivery of social welfare services, there is a reluctance to create a more conducive regulatory and financial environment for their activities, such as providing tax breaks or easing the registration requirements for social organisations.

This is not least because the Party also fears that yielding more space to non-governmental actors might rebound and undermine its power and authority. In other words, it may be prepared to tolerate an expanded and more active civil society, but only so long as this serves the purposes of social welfare and stability – a tension not peculiar to China.

China's future trajectory?

A country of China's size and complexity inevitably faces enormous governance challenges. In this paper, for reasons of space we have alluded to but some of the key governance issues; others might have included the changing role of the National People's Congress,⁷² the rule of law, elite politics, the control of international crime, the role of the military, religion and human rights. From the perspective of the UK, two key related issues are whether China will remain stable, and whether, and in what direction, it will reform politically.

It is likely that China will remain stable over the next decade. The government will not want to jeopardise the country's staggering economic growth, its ascendancy in the global economy, and its growing significance in international institutions.

Secessionist struggles on its western borders and political developments in Taiwan will be the leadership's key worries in terms of external relations. The high degree of decentralisation will continue to be a source of tension between central and local governments, but China is not on the point of breaking up.

Nevertheless the government will have to work hard at maintaining the country's stability. Its ability to address the growing regional and income disparities, to establish effective institutions for the mediation of interests, to strengthen its own legitimacy, to develop adequate systems for protecting the poor and vulnerable, and to relax its control over the spaces for non-governmental action and for open public debate, will be crucial.

In the run-up to the 16th Party Congress in 2002 some Chinese intellectuals discussed openly the need for, and indeed inevitability of, political reform. Further economic reform would happen only if there was also political reform.

⁷² The National People's Congress has become much more a platform for discussion of issues than in the past, with sometimes quite big differences among delegates expressed in votes. Moreover, delegates can use their votes on work reports to show dissatisfaction. In some cases, some delegates to the NPC and to provincial congresses have voted against the work reports for the Procurate in order to protest against the government's poor handling of corruption. Other illustrations of changes are innovations over the past five years such as soliciting public opinion on legislative items, holding legislative hearings, and establishing investigative committees on specific questions. Provincial NPCs elect candidates nominated by the party for top civil service positions, usually unopposed. There have been occasions when the candidates supported by the party organisations have not been elected, as in the provincial people's congresses of Guizhou, Zhejiang, Hubei and Hainan. Also recently, provincial NPCs – such as in an experiment in Ya'An – are being given functions and a greater say throughout the year, not just at the one meeting each year.

What exactly is understood by political reform is quite varied and not wholly clear. It is likely that they were not thinking of multiparty democracy, but rather of defining the role of the Party in the government process, and particularly of separating out powers, professionalising its relations to society, and of finding other ways in which it might relate to a society that is increasingly differentiated.

China's new generation of leaders remain quiet and cautious for the moment about introducing political reform. The emphasis over the next decade is likely to be on enhancing the accountability of Party and government leaders at all levels, of opening up debate over public policy in a limited way, and of managing the tension between encouraging and restraining civil society so as to address social welfare issues.⁷³

The possibility of China becoming a multiparty state engaging in competitive elections is remote. However, it is likely to liberalise politically – not least because with the internet, opportunities for travel, the return of internationally trained graduates, and the increasing exposure of China to the world, the demand for a more open regime will become harder to resist. China will remain authoritarian, but the boundaries of that authoritarianism will be increasingly contested.

73 Practical, local innovations are being made, such as: obliging police to meet complainants face-to-face; government trying to become more service-oriented in such matters as relocating offices for the disabled to ground floors; encouragement of public dialogues; and greater consultation, though mainly of the intellectual and professional elites.

Chapter 9

A Third Way: China at the crossroads?

By Professor Peter Nolan, Sinyi Professor of Chinese Management at the Judge Institute and Chair of the Development Studies Committee at the University of Cambridge

China is grappling simultaneously with the challenges of globalisation, transition and development. There are several distinct opinions on how China should proceed, but increasingly the country is looking to its own past for inspiration for a "Third Way". This Third Way is coming about in circumstances much more adverse than those of Europe. The dangers of failure to the world, let alone to China, are terrible.

A Third Way: China at the crossroads?⁷⁴

Professor Peter Nolan

The choices

Since the late 1970s, China has enjoyed one of the most remarkable periods of economic growth ever seen. China appears to be on the verge of reclaiming its place as the centre of the world economically and technologically, a position that it occupied for over 1,000 years, until the European Industrial Revolution. This is a source of intense national pride.

However, the country faces deep economic, political and social challenges as it moves into the next period in its development.

These include:

- rampant corruption;
- growing domination of large swathes of the modern economy by global giant companies (China is more of a "workshop for the world" than "workshop of the world");
- stagnation over many years in the real income level of the majority of the 800 million rural dwellers;
- deep unresolved problems in the country's leading financial institutions;
- a shocking increase in inequalities of wealth, income, consumption and lifestyle;
- a surging mass of 150 million or so rootless migrant workers in the cities;
- large-scale unemployment among the former elite "industrial proletariat" in the state-owned enterprises;
- severe deterioration in the natural environment, including a crisis in water supply;
- fast-growing dependence on imported food and raw materials;
- a yawning gap in military capabilities with the USA; and
- an ideological and spiritual vacuum for the country's young people, the one-child "internet generation".

China has reached a crossroads in the evolution of its economic and business system. Is it possible for it to build a civilised, socially cohesive society over the next few decades, during what is still the early phase of China's industrialisation, and during which time there will still be a huge rural reserve army of labour?

74 The main points made in this article are from Nolan, Peter *China at the Crossroads* (Cambridge, Polity Press, 2004).

Will China be condemned to pass through a long phase of harsh political rule in order to meet the imperative of the accumulation process? If China should fail to achieve a socially cohesive path of development, will the society and political structure remain stable? Does the fact that China is trying to industrialise at the beginning of the 21st century make this task more or less difficult?

Is the task of building a socially just society made more difficult by the fact that China faces numerous other deep development challenges, including a wide-ranging threat to the natural environment? Is it made more difficult by the fact that China faces a massive international relations challenge, notably in its relationship with the USA?

Is this task more or less difficult in a huge country such as China, with a long history of economic development, possessing a highly sophisticated culture? What is the impact of the fact that China's large firms face a deep threat to their survival from the global giant firms headquartered in the high-income countries?

The Chinese leadership is trying to deal simultaneously with the challenges of globalisation, transition and development. No other country has ever faced such a set of challenges. There are no textbooks to guide China along this path. The responsibilities for the leadership are massive, because the price of failure is so huge. There is a real possibility of social and political disintegration. Every effort of policy has to be directed towards avoiding this potentially catastrophic outcome.

On-going debate

There is intense debate among Chinese policy makers, scholars and society at large about each of these issues. There is a wide sense that the country has arrived at a crossroads in its long journey away from the administratively planned economy. At a crossroads in the middle of nowhere the traveller cannot stay put. He can turn to the left, to the right, or even turn around and go home. The other option is to keep on in the same direction as the road he has come down.

Some people argue that China has no alternative but to accept that this phase of development will be characterised by a harsh political-economic order. They compare this with the phase of "primitive capitalist accumulation" in Marx's *Capital*.

Few people dispute that the main task for China's policy makers is to ensure social stability. Many people argue that the only way to achieve this in such a turbulent, challenging

environment is through the exercise of harsh social control: the process of accumulation must come first or there will be no "development". Such arguments are typically supported with historical examples from early industrialisation elsewhere.

Many people both inside and outside the country argue for a regime change. They believe that the hard tasks that lie ahead can be resolved only with Western-style democratic institutions. Many people in this camp believe that the model for China to aim at is the USA, not the "bankrupt" models of the European welfare states or "quasi-socialist" Japan. Almost invariably, those advancing such arguments claim the authority of Adam Smith who, they argue, demonstrated that the only rational way to organise the economy is through the free market.

It is frequently asserted that China's long economic history provides a powerful object lesson for today's policy makers: China's technical progress in medieval times was blocked from advancing further by a despotic state that prevented China taking the capitalist path followed in Europe. They believe that the smaller the role for the state, the faster China will progress in the period ahead.

A third group, the "new left wing", argues that the country has taken a fundamentally wrong turning by moving towards a market economy, increasingly integrated with and dependent on the global economy. They believe that the country can solve the growing tensions only by reducing China's reliance on international trade and capital inflow, and returning to the policies of the Maoist years, as pursued from the mid-1950s to the mid-1970s.

Another perspective is that China must continue along the path it has trodden for the past two decades, but adapt this approach to the fresh challenges that the country faces. For the past two decades, the Chinese leadership has been groping its way forward, away from the planned economy of the Maoist period. In the sharpest contrast to the reform path of the former USSR, China has been "groping for stones to cross the river".

Experimental approach

China's approach has been deeply influenced by the disasters it experienced since the middle of the 19th century, not least the massive famine after the Great Leap Forward, and the great suffering during the Cultural Revolution. Policy makers were determined to avoid such policy-induced disasters. The process of reform has throughout been treated as a complex process of comprehensive system transformation, in which economic, social,

political and psychological factors are considered as a seamless whole.

Unlike the former USSR, China decided to address economic reform before considering political reform, though this was not inconsistent with making great efforts to improve the capability of the bureaucratic apparatus.

In economic reform, the watchword has been consistent experimentation before widespread adoption of a particular policy. Reform began in the countryside in the late 1970s and early 1980s, with the system of contracting land to the individual household. It spread to the urban areas in the 1980s with the widespread introduction of the contract system for individual enterprises.

By the 1990s this had been replaced by a system of even wider enterprise autonomy, with taxation substituted for profit handovers to the state, corporatisation and flotation of part of company equity on domestic and international stock markets. Controls over foreign investment were lifted slowly, and were followed by a surging tide of foreign direct investment in the 1990s.

By 2002, China was the world's largest recipient of foreign direct investment, and had accumulated around \$400 billion of such investment. Rural township and village enterprises were allowed increased freedom in resource allocation, becoming a highly dynamic part of the economy in the late 1980s and early 1990s.

Market forces, including market-determined prices and entrepreneurship, gradually permeated the economy. Private business activity gradually was accepted and spread into all corners, though still not given formal protection. However, in July 2002, it was announced that private businessmen were eligible formally to join the Communist Party.

At the 16th party congress in 2002, Party General Secretary Jiang Zemin announced that citizens should be judged on their contribution to society and not penalised for their property holdings:⁷⁵

Mr Jiang's statement provides support for the speedier development of legal institutions for protecting private property and the wealth generated by the emerging middle class of entrepreneurs.

⁷⁵ *Financial Times* (10 November 2002).

Controls over foreign trade were relaxed slowly over the course of two decades, and given a final impetus by China finally joining the WTO at the end of 2001. Foreign exchange controls also were only slowly relaxed, and by 2003, the Chinese currency, the yuan (renminbi) was still not freely convertible into foreign currencies.

Swimming towards an unknown shore

China's incremental system reform produced outstanding results. By the time of the 16th party congress in November 2002, China had decisively left one bank of the river – that of the old Maoist system – but the other bank was only dimly visible. At the congress, a new generation of leaders was appointed, including a new Party General Secretary, Hu Jintao. In his first speech after being elected, he likened China's situation to that facing the leadership under Chairman Mao at the end of the Civil War.

In March 1949, at the second plenum of the seventh central committee of the Chinese Communist Party, Mao Zedong made a highly significant speech outlining the tasks ahead. The victory over the Guomindang (KMT) was basically complete. The party was entering a new phase in its development. Chairman Mao warned that it should guard against complacency, and realise that a long, arduous struggle lay ahead:⁷⁶

To win countrywide victory is only the first step in a long march of 10,000 li. Even if this step is worthy of pride, it is comparatively tiny; what will be more worthy of pride is yet to come.

The central theme of the speech was the need for the party to find a path through the enormous tasks that confronted them in the face of great challenges both at home and abroad. In the same way, China now stands at a crossroads. It must grope its way forward in the face of these immense challenges, fully aware that there is a serious danger of system disintegration. This would be disaster for the Chinese people. It would render previous achievements meaningless.

In their search for a way forward, China's leaders are looking to the lessons from the country's own past, as well as to those from other countries, in order to find a way to build a stable, cohesive and prosperous society. This effort is of vital importance, not only for China, but also for the whole world.

76 Mao Zedong, 1949.

Using the past to serve the present: a Chinese Third Way

If by "Third Way", we mean a creative, symbiotic interrelationship between state and market, then we can say that China practised its own Third Way for 2,000 years. This was the foundation of its hugely impressive long-run economic and social development.

The Chinese Third Way was not simply an abstract set of rules about intervening with the market, but rather a complete philosophy that combined comprehensive thought about concrete ways of both stimulating and controlling the market, with a deeply thought-out system of morality for rulers, bureaucrats and ordinary people.

When the system worked well, the philosophical foundation was supplemented by non-ideological state actions to try to solve practical problems that the market could not solve. It is a complete misunderstanding (not least, by Karl Marx) to view the traditional Chinese state as a stagnant Oriental despotism.

Confucianism produced a deeply developed concept of duty, which was the foundation of social prosperity and collective action. The fact that the system went through regular cycles when these principles were poorly observed, rulers and bureaucrats were corrupt, and the economy and society foundered should not blind us to the underlying coherence and lasting benefit from this integrated system.

China today is groping for its own Third Way in totally different circumstances from those pertaining in Europe in recent decades. Europe was already industrialised, militarily strong, contained a mass of powerful, globally competitive firms and was able to assert strong controls over international capital movements until the 1970s without incurring international pressure to do otherwise.

Today's China is painfully weak militarily, compared with the USA. The vast mass of the population are still poor farmers and will remain so for a long period ahead. China is still firmly locked into the Lewis phase of development (the early period of industrialisation during which there is an "unlimited" supply of labour at subsistence wages from rural-urban migrants who are underemployed in the farm sector). The middle class constitutes a tiny fraction of the population. The economy is increasingly dependent, in the classic sense used by Latin American economists in the past.

The high-value-added modern sector of the economy is increasingly dominated by international capital, with close to \$400 billion in accumulated investments forming

complete production systems within China, and accounting for over half of the country's export earnings. China faces intense pressure to liberalise its financial system comprehensively as the price for participation in the international economy.

Europe tried to pursue a Third Way in order to build a civilised society after it had already industrialised and developed. China is trying to construct a Third Way while it is still in the midst of economic development and industrialisation, with a huge rural surplus labour force, in a turbulent international environment, and with a surging flow of foreign capital into the country. This is a uniquely challenging setting for Chinese leaders' efforts to construct a civilised society.

Using the market to serve development

China cannot step outside the mainstream of world history. It cannot close itself off from the main trend in international economics and politics. It cannot turn round and go back to the Maoist period. However, system survival necessitates that it use the market as the servant of the development process, not the master, as if the market possessed an intrinsic moral value – which the US leadership and Western propagandists for the unfettered free market believe to be the case.

In this effort, China's leaders can make common cause with powerful streams in international thought that have gone against the mainstream. They have at certain periods been highly influential both in the West, including even in the USA, and in the Far East outside the Chinese mainland.

At the heart of the thinking of the most powerful advocate of the dynamic force of the market economy, Adam Smith, was a deep awareness of the damaging impact of unfettered market forces. Smith understood the contradictions at the heart of the capitalist system. We have seen that his efforts to build a moral philosophy based on controlling the market, rather than letting it dominate society, closely parallel the most fundamental issues in China's own philosophical tradition.

Central to this long tradition was a belief that commerce and finance should be nourished, but not allowed to dominate society and control the political system, either centrally or locally. However, Smith gave no answers to the deep contradictions that he identified.

Writers such as Fukuyama and Ohmae argue that the collapse of communism and the rise of the global corporation have produced an end to ideological conflict. Yergin and

Stanislav⁷⁷ have chronicled the "withdrawal of the state from the commanding heights, leaving it more and more to the realm of the free market", across a wide swathe of countries. However, they conclude their book with a prescient warning about the market:⁷⁸

[[I]f its benefits are regarded as exclusive rather than as inclusive, if it is seen to nurture the abuse of private power and the specter of raw greed, then surely there will be a backlash – a return to greater state intervention, management and control.

Can free market fundamentalism prevent a financial crisis in China? Can it solve the problem of the rapid rise in social inequality? Can it solve the problems of the Chinese farm economy? Can it enable China's large firms to compete on the level global playing field? Can it help China to deal with the massive international-relations challenge? Can it solve its environmental crisis? Can it provide China with an ethical foundation for building a socially cohesive society?

Looking beyond the free market

Anglo-Saxon free market fundamentalism, which reached its modern apogee in the 1990s, offers no hope for sustainable global development, whether of ecology, society or international relations. China's numerous deep socioeconomic challenges each require creative, non-ideological state intervention with the market, to solve the innumerable practical problems that the market alone cannot solve.

The biggest challenge of all is in the relationship between China's financial system and that of the global economy, since this has the greatest potential in the near future to trigger system disintegration.

In groping for its own system survival, China can make a powerful contribution to global system survival. In tackling these problems China can look to its own long history of nurturing market forces while simultaneously placing them under control, in the service of the whole society, in order to achieve a socially cohesive overall political economy.

It must creatively adapt these traditions to the particular challenges facing the country today, namely dealing with the challenges of globalisation in the context of a huge and still poor developing country, firmly rooted in the Lewis phase of economic development with unlimited supplies of labour.

⁷⁷ Yergin, Daniel and Stanislav, Joseph *The Commanding Heights* (1998).

⁷⁸ Yergin and Stanislav (1998), p398.

If China is able to marry the snake of the global market economy with the hedgehog of China's ancient history, as well as its recent history – especially that of the Chinese Communist Party – it will be able to offer a way forward for a stable, socially cohesive society within the country. If it fails to do so, the entire Chinese system of political economy may collapse. This would be devastating, not only for China, but for the whole global political economy.

At the very least, China may be condemned to a long period of harsh social control to contain the surging tensions of the country's high-speed growth. During the Asian financial crisis, China had to take a "choice of no choice" (*mei you xuanze de xuanze*) to survive by cutting down the trees to save the forest – in other words making Guangdong International Trust & Investment Corporation bankrupt. If it wishes the system to survive today, it must also take the choice of no choice to re-establish social cohesiveness, confidently using its own past traditions and the best traditions from outside the country.

For China to choose the path of state desertion and free market fundamentalism would lead to uncontrollable tensions and social disintegration. Full liberalisation of international financial firm competition inside China and full liberalisation of international financial flows is the most dangerous area through which this disintegration might occur. A crisis in the financial system would fan the flames amid the combustible material in all other sectors of society, into which the long tentacles of the financial system extend.

The choice to increase and make more effective the role of the state, in order to solve the intensifying socioeconomic challenges facing the country, can succeed only if the Chinese state today – with the Communist Party at its core, as in periods of greatest prosperity in the past – can radically improve its level of effectiveness, and eliminate rampant corruption. State improvement, not state desertion, is the only rational goal for Chinese system reform. This is the choice of no choice for China's system survival.

By taking this path, China's own survival can contribute to global survival and sustainable development, by offering an alternative to the US-dominated drive towards global free market fundamentalism. This is a crossroads not only for China, but for the whole world.

China and the USA

In the 1980s, the prime goal of US foreign policy was the overthrow of the "evil empire" of communism in the Soviet Union. This goal was pursued through acceleration of the arms race and numerous channels of influence upon Soviet policy makers. US policies

played a significant role in the collapse of Soviet communism and the disintegration of the USSR.

Regime change resulted in the collapse of the state, which had disastrous consequences for the Russian economy and for the welfare of most Russians. For many neo-conservatives in the US government, the time is now ripe to push China hard and bring it to its knees: "We feel we've got China on the run, and now is the time to push hard."

The USA's incentive to substitute China for the USSR as the evil empire is growing. The pressure to look for an external enemy as a unifying force is increasing, coming from growing internal class inequality; intensifying ethnic divisions due to the "reconquista" of large swathes of southern and western USA by Hispanic people, language and culture; and a growing divorce of the interests of the globalised US business elite from US national interests.⁷⁹

The USA's internal unity and national identity have been closely bound up with military struggle, from the native Americans – against whom the white settlers fought a 200-year guerrilla war – through to the invasion of Iraq. China's rise and the USA's relative decline each produce their own internal system fragilities. The potential points of conflict between the two sides' nationalist sentiments are legion.

The Soviet economy had only negligible linkages to the US economy. The USSR accounted for a tiny fraction of US exports and there was no investment in Russia by US multi-nationals. Soviet exports to the USA were trivial in scale. The collapse of the Soviet economy had a negligible impact on the US economy, other than the short-term fall in military expenditure.

After the Tiananmen Square massacre of 1989, US public opinion, led by hardline anticommunist politicians and reinforced by human rights campaigners, believed overwhelmingly that it was morally desirable for the US government to work towards the downfall of Chinese communism. In his early months in power in 2001 it appeared as if George W Bush might pursue a confrontationist policy, seeking the overthrow of the Communist Party and regime change in China.

79 See, especially, Huntington, Samuel P *Who are We?* (Free Press, 2005).

However, September 11th strongly affected US-China relations. Moreover, the damaging consequences of regime change in Afghanistan and Iraq forced a profound reassessment of US foreign policy. Recent months have seen a resurgence of US fears about China's rise and its implications for the USA.

The Chinese and US economies have become deeply intertwined. US consumers benefit from the explosive growth of low-priced Chinese exports. US companies and shareholders benefit from China's absorption of booming US investments and from access to the low-cost manufacturing supply chain in China.

US primary product producers, including food, oil and mining companies, benefit from exports to China – both directly from the USA and, increasingly, from production bases in other countries, such as Brazil and Australia. The US government benefits from Chinese government purchase of its debt, which, ultimately, helps to underpin the growth of US personal consumption.

System disintegration in China of the kind that the USA helped bring about in the USSR, Afghanistan and Iraq would of course be a disaster for China, but it would also have severe economic consequences for the USA. One can only guess at the military consequences.

Conclusion

China's high-speed growth since the 1980s has produced remarkable results. China is truly becoming the world's workshop. However, as we have seen, huge challenges exist for the leadership team of Hu Jintao (President, General Secretary of the Communist Party and Chairman of the Central Military Commission) and Wen Jiabao (Premier). This potent combination of challenges threatens the stability of the whole Chinese political economy.

To meet these challenges, the Chinese leadership has established two closely interrelated focal points for the country's development. Internationally, China is committed to a "peaceful rise". Domestically, China is seeking to build a "socially just society".

The new leadership bases its overall approach to development around a philosophy of using the past to serve the present, absorbing lessons from its own long history as well as from the development experience of other countries. In this endeavour, the party leadership is attempting to find a Chinese Third Way between the extremes of free market individualism, which seeks to maximise individual rights-based "negative freedoms"; and the Maoist approach of serving the people, which overwhelmingly

stressed the individual's duties to society, and sought to maximise "positive freedoms" for all citizens.

If China's leaders are successful in this monumental task, which is a "choice of no choice" for system survival, it will not only secure the country's long-run sustainable development, but will also contribute, both practically and philosophically, to sustainable global development.

Under these circumstances, it is in the interests of US business and the mass of US citizens, not to speak of the rest of the world, to support the efforts of China's leadership to nurture the country's peaceful rise.

