

CHINA AND ITS CHALLENGES

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Paul Keating's China and its Challenges provided, in 2004, a somewhat futuristic forecast as to how and in which ways China might develop. He says the 'China Project' knows no precedence in world economic history and that Deng Xiaoping and his policy of openness and engagement was never slated to materialise. Paul Keating explains that he does not see China as a strategic competitor of the United States or of other nations; rather, he sees China adding economic and social value to the region and to the world.

What is happening in China knows no precedence in world history.

Never before have 1¼ billion people dragged themselves from poverty and at such an astounding pace.

Having missed the Industrial Revolution and all its benefits, China today, after its mid-twentieth-century upheavals, is catapulting itself into the post-industrial age. Given the recentness of its shift from a predominantly agrarian economy, one could say without too much hyperbole or stretch of the imagination that in the last 25 years, China has done the equivalent of leaping from the eighteenth century to the twenty-first century in a single bound. In economic or human terms there has been nothing like it.

And the imagination of it came essentially from the creativity in one man's head: Deng Xiaoping. Of all the great people of the twentieth century—those who shaped and influenced it, like Winston Churchill and Franklin Roosevelt—no twentieth-century leader will have a greater influence on the twenty-first century than Deng. What he did in the 1970s changed the world or certainly, the way the world will work in the future.

Leaders in wartime can often enjoy huge mandates for the exercise of power. But in peacetime, these mandates are much harder to come by. Deng Xiaoping's reformation of China occurred at a time of external peace, albeit after the astringent experiences of Mao's Cultural Revolution.

But the fact is that Deng was not slated to materialise. He did not have to be there. China could very well have gone down a different pathway. We should never fail to consider or lose sight of the consequences of what that other pathway might have been. The construct of modern China cannot be taken for granted.

Underpinning Deng's great vision were two powerful yet simple notions: openness and engagement. Yet underlying these was a more powerful imperative: giving the creativity of his people a chance to express itself. Letting it run much more freely. While at the same time lining up the sinews of power to make the openness happen and to keep it happening. Coupled with this, Deng had the ability to choose real leaders among China's promising political community. And so, too, have his successors, in the party and in the government.

One would never have thought that a Communist party rooted in a huge agrarian base would bet its political future on economic growth. And growth brought about by openness. But that, in fact, is what has happened.

And much has been achieved. At the big turning in 1978, Deng said he wanted to quadruple output by the end of the century. This target has been more than accomplished.

The 1990s, the decade which saw China's growth and wealth accelerate so markedly and compound, was also its most peaceful decade in centuries. Now, the premium for China has to be on steadiness. Its challenge is to keep the growth going, to keep the country resourced, holding itself together by means of an acceptable distribution of wealth. And in the compelling context of keeping an external peace.

China's progress will, I believe, move in lockstep with its magnanimity. Great states who know what they are and what they stand for don't need to be capricious or skittish. Or even defensive.

I think China sees itself and will place itself at the epicentre of a prosperous and cooperative community of east Asian states. China will probably do more for its neighbours than its neighbours are likely to do for it. But in the doing of it, by its wisdom, underwriting the longevity of its own reformation.

We can see these influences already in the current trade outcomes. China has substantial trade deficits with Japan, South Korea, Taiwan, Australia and the Association of South East Asian Nations (ASEAN). It is generating output in these countries for the Chinese market. It is tugging them along.

Concerned about the preponderance of world foreign direct investment (FDI) going to China at the expense of its neighbours, it is itself investing in its own supply chain in these countries. Chinese foreign direct investment will be a significant factor in east Asian hemispheric growth.

The proposed regional free-trade zone between China and the ASEAN countries is another indication of China's grander view of the region and itself.

We can also see this in its foreign policy. The development of ASEAN Plus Three which, in reality, is China plus two plus ASEAN. It is China reaching out in communal terms in major economic matters and, while doing it, taking the security discussion with it into forums in which it is influential.

Strategically, China's size and steadiness add important ballast to the region. A region dominated by three powers: China, Japan and the United States. China will become a competitor of the United States through its economic integration and the growth of its output. But not, I believe, a strategic competitor—if by strategic we mean having the ability to project military power. China will try to protect its sources of raw materials and supplies but the growth in its military establishment is unlikely to be about force projection of the kind that makes the United States the sole superpower.

But having said that, nor does it seem that there will be any rush to a rapprochement between itself and Japan. For China and Japan, it is very much a case of business as usual though with concealed but growing enmities. Japan is increasingly apprehensive about the rise of Chinese power. Not that there is any inherent capacity on the part of Japan to interact or to deal more effectively with the world around it. Except to say that there is evidence that Japan sees itself taking a more serious security role.

China's participation in the six power talks on North Korea and its role in nuclear diplomacy is helping to cement its position as a regional power and reliable interlocutor.

It is very clear that these days, China stands for 'order' and not 'disorder', certainly of the variety it might have been seen to stand for some decades ago. This is comforting for Japan, for the countries of the region and for the United States. All of these things give China a better place in the strategic firmament.

One issue above all could change this. The situation across the Taiwan Strait. This requires the most careful handling. The consequences of miscalculation by any party would be terrible for all of us, and would spread far beyond East Asia. The worrying thing is that history abounds with examples of just such miscalculations. Europe in 1914 is a case in point. This situation requires all parties to exercise wisdom and statesmanship of a very high order.

The central principle, however, is clear. Any problems across the Strait have to be resolved within the framework of One China. That policy has been accepted by all the key countries including the United States. That principle should be expressed clearly and forthrightly to the authorities in Taipei. But China's leaders will also have to carry a heavy weight of responsibility. The situation will require China to continue exercising restraint, even in the face of provocation. It will require the kind of magnanimity I referred to earlier.

Two very bad things happened at the end of the 1990s but as it turned out these were quite good things for China. The first was the 1997 financial crisis, the other was the events of 11 September 2001.

China clearly benefited from the financial crisis in 1997. The first benefit was that the crisis brought home at a very important point in Chinese economic history that command or top-down intermediated economies were not as robust as previously thought. China's toying with the idea of a set of its own chaebol; a bit of state capitalism, as the shaper and driver of its economy, was thrown out the window

when South Korea revealed the fragility of its economic and commercial structures. As was also seen in places like Thailand. The decisions taken that year by the leadership and the government to build the economy around individuals and small to medium-sized enterprises in an open, competitive model, reinforced by WTO processes, is probably the greatest single benefit from the crisis. And the next most important economic step in China's modern history save for Deng's seminal 1970s changes.

The crisis also saw flows of foreign direct investment moving increasingly towards China, such that by 1999 China took 85 per cent of the region's total foreign direct investment, where it was 25 per cent in the early 1980s. China also involved itself in IMF packages for its neighbours and by not depreciating its currency, played a better than neighbourly role at a time of economic stress for others. China learned a lot but it also gained a lot.

The attack on the World Trade Centre on 11 September 2001 altered the international strategic settings. Before this event, China was suffering from a pariah complex with the current United States administration. And worryingly so. Within months of this cataclysm, the focus of the United States had shifted from China and issues such as national missile defence to the hills of Afghanistan. China, espousing the cause of 'order', played a constructive role in the resistance to terrorism, setting China up as a strut in the global system. The smooth step change from Jiang Zemin and Zhu Rongji to Hu Jintao and Wen Jiabao consolidated this position.

These two, large but negative events taught China a lot and encouraged China to pick up its game and make the most of the opportunity.

September 11, 2001 and the war in Iraq are events which have altered the world's strategic compass. And internecine bouts of terrorism keep things off balance. Yet, when we assess the current position of China in world terms, our assessments have to be discerned through this veil of events.

But by any objective assessment, the longitude and latitude of major strategic circumstances has rarely been better.

- Save for the Balkans, we have not seen a major European conflict for 60 years.
- The European Disease—best exemplified by the wars between Germany and France—has given way to unprecedented cooperation.
- François Mitterrand and Helmut Kohl put together a vision for a United Europe with a single market and a single currency; a monetary base larger than the US dollar; and a united Germany in NATO.
- The collapse of the Soviet Union and the end of the Cold War.
- Now the EU—expanding to 25 nations including states like Poland, Latvia, Lithuania etc.
- Pan Asian regionalism including states such as Vietnam and Cambodia joining ASEAN.
- Indonesia holding itself together to become a democratic state.
- India gradually opening its economy—dealing with large income disparities.

The world never looked as good or as solid as this at any time in the twentieth century.

Perhaps the event that adds a new and optimistic quality to this constructive world outlook is China's emergence as a major economic and political power. Its rise should be assessed in this new and more promising context.

We live, so it is said, in a unipolar world where the United States, with the major economy and superpower force projection, stamps itself out as unique. Yet, economically, the world is much more multipolar; intensely interconnected by trade and investment and integrated through communications.

In this interconnected multipolar economic world, nation states matter less and governments are less important. And there is also the overlay of the cultural divisions between the Middle East and the West. Yet for all this, all four bits or factors live in the one space:

- the unipolar United States with its geopolitical power and force projection;
- the multipolar economic world with its intense trade and investment interconnections;
- the declining influence of the nation state in this globalised homogenisation; and
- the cultural divide with the Middle East.

China can more than make its way in these new and somewhat conflicting contexts. It can be a very large piece in this economic and strategic jigsaw picture.

Let me now turn to China's economic growth and its impact on the world more broadly. And on East Asia in particular.

China's growth and its integration with the rest of the world very much mirrors the experience of those other economies which grew rapidly in the twentieth century. Ones which successfully integrated themselves as world trade opened up; Japan, South Korea and the ASEAN countries being cases in point.

China, by contrast, is likely to have a much bigger impact on the global economy as, when market freedoms are permitted reasonable expression, population is the principal driver of GDP. China will be a supplier of lower priced labour-intensive products. Products which will benefit the developed countries in providing price competition while restraining global inflation. It will also be a market for the high value exports of the same economies.

Developing countries will find a new and growing market for their exports as the Chinese economy soaks up primary commodities and primary-stage manufactures, manufactures that are capable of being reprocessed. This, especially, will be the case in the region around China where, as a regional engine of growth, it is likely, in the not too distant future, to overtake Japan. Its role as a regional reprocessor and manufacturer of exports to the world will have an induction effect upon the exports of countries in the immediate neighbourhood. Inducing them to grow more rapidly.

China has been a major receiver of foreign direct investment. This has raised factor productivity, inducing faster labour productivity and lowering unit labour costs. And, of course, this has been backed by a large pool of unskilled people whose transition to skilling, incrementally, has maintained China's competitiveness. This should remain the case even in the event that China's currency appreciates into the future. Human capital has been growing strongly as labour has been reallocated from the low-productivity agricultural sector to the higher-productivity manufacturing sector. And so far so good.

But, even in China, the supply of marginally priced labour is not endless. Already a quarter of the agricultural workforce has migrated to urban industrial centres. And in places such as Guangzhou and Shenzhen, shortages of appropriately skilled workers is leading to a rise in the real price of labour. This is best accommodated and paid for by increasing levels of productivity, otherwise wage costs will drift into inflation, pulling back competitiveness and raising the cost of capital. Skilling and vocational education are the instruments that can best turn the flow of farm workers into higher order increments to the manufacturing and service workforce.

China is also facing the challenge of continued structural reform; reform which has been a significant factor in its productivity increases. This has been the case since the mid-1980s. We can chart the growth in productivity from the liberalisation of agriculture in the early 1980s and the introduction of more open and market-oriented changes from the early 1990s. The productivity growth induced by these changes, especially labour migration to higher productivity sectors, is the central factor in the higher output growth of China over the past twenty years.

China has clocked up a very impressive annual rate of output growth exceeding 9 per cent. But of course 9 per cent off a small base, while impressive, is more easily achieved than maintaining 9 per cent from a larger base. To keep up these rates of growth, China must sustain high rates of capital accumulation.

One of China's great assets is its high rate of national savings. The Chinese are a thrifty people, with household savings at around 45 per cent of GDP. But China's financial sector will have to become more open, flexible, commercial and adaptable in providing credit. Without it, capital accumulation at a desirable rate is going to be much harder to achieve.

An important element in financial growth is competent risk management. Something Chinese institutions are yet to come to terms with. Thriving financial systems have at their core not only the ability to create credit but lending circumstances where the loans do not impact upon the capital of the institutions involved.

It is very important for China to move away from a system where banks do most of the financial intermediation. An economy built around individual and small-to-medium enterprises must have a competent capital market, and the presence of a competent capital market will put the banks where they ought to be: providing personal and consumer credit, housing finance and finance to small business.

A situation where banks have hegemony within the financial system and are subject of a central bank with implicit guarantees off the national budget and whose

practices are influenced by the bureaucracy can never make the contribution to Chinese national growth that China so desperately needs. A capital market and a set of well-managed banks is an imperative.

In basic terms, the labour surplus coming off agriculture will not be sufficient to keep the economy gingered up. Structural changes will have to be made. And one of the laggards is the financial sector and its institutions. Financial innovation is the key to higher rates of capital formation.

As I said earlier, for the world at large, China's integration, with acceleration flowing from the WTO mandates, is likely to represent a larger change to the global economy than the integration exercises of other countries in the twentieth century. China is likely to have a bigger impact on the world economy than did the reindustrialisation of Germany or of Japan or of the newly industrialising economies. But with that shock comes an opportunity. And that opportunity represents a challenge for the rest of the world to structurally adapt to the reality of China. This will be doubly true if India continues to integrate itself with the world economy at its current trajectory.

Developed economies, particularly those with deteriorating demographics, should recognise these important changes in the international division of labour, and rather than resist them, take the benefit of them by accelerating their own trade liberalisation and integration. A tsunami of deflationary lower-priced products from China inevitably means higher real disposable incomes in developed countries, leaving developed countries to do what they do best: sophisticate further their service sectors and concentrate on the higher orders of technical innovation.

There is no doubt that China is becoming the new engine of global growth, underlining again the urgent need for a new round of multilateral trade liberalisation to keep the sinews of reciprocal trade open and growing.

The China 'project' knows no precedence in world economic history. China can continue this progress as its economic base expands. But it can only do this in an environment of stability and peace.