

Will  
CHINA  
FAIL?

**JOHN LEE**



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FAIL?

The Limits and Contradictions  
of Market Socialism

2nd edition

**JOHN LEE**

Will China Fail?  
by John Lee

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## FOREWORD

Debates about China have been overloaded by the burden of interests rather than investigation, by stiff and opinionated ideology rather than examination of the ‘engines’ of China’s economy and society. John Lee’s book breaks with these weaknesses by deftly and precisely examining the fundamental processes that shape China’s ‘economic miracle’ and the country’s modern evolution. As such, it is a landmark in China studies. It makes no claims but analyses, and as such ought to be taken with utmost seriousness by policy makers and academics.

Lee’s contention is that the PRC’s economy centers not on job creation as it occurs in true capitalist ‘creative destruction’ but on the mobilization of resources to preserve the tens of millions of jobs tied to the state-controlled sectors that provide sustenance to a large part of the ruling class and social base of the Chinese Communist Party. Many are inefficient cradle-to-grave social institutions, not enterprises.

Accumulating huge losses (except the enterprises involved in petroleum and steel), they need to be bailed out. Savings from banks are mobilized by political fiat, from local to national levels: the party-state cannot let go. Lee shows in great detail how China’s savings are being destroyed by a process of permanent bailouts. Banks are technically insolvent because their assets are tied up with these state-controlled enterprises. Consequently, the Chinese system is heavily dependent on two sources of external financial inflow—foreign direct investment and export surpluses. Under conditions of world economic decline, or even stagnation, both are declining. Mass unemployment ensues and the social contract fractures.

But in order to make the merry-go-round go on, one source of income for officials is the wanton looting of peasants’ and urban dwellers’ assets, physical and financial, by arbitrary rule. The massive devolution of power operated by Deng Xiaoping’s reforms from 1979 onward has placed enormous strength in the hands of local and provincial leaders, who have no qualms using and overusing them, producing mass social unrest.

The prospect is dire: it is in the name of party-state power that the merry-go-round continues. To introduce any real measure of rule of law, let alone ‘democracy,’ the party-state would have to relinquish what is most fundamental to governance in China: the absolute right of Party to rule by fiat. Crossing that bridge is difficult for the Party;

power may be delegated but never divided. The dances and minuets of party-state leaders in the last decades cannot conceal this basic conundrum.

The huge numbers of localized protests may or may not be a prelude to a disintegration of the political structure of power in China. Lee makes no claim to prophecy. His book outlines the main lines of possible development and what they are based on, including some of the ideology churning in the depths of China and reflections of the People's Liberation Army's possible role in future events.

Under circumstances of world recession, the People's Republic of China's fading miracle is more likely to fracture than not. It may well add fuel to the rise of malicious chauvinism. Much study is being devoted in Beijing and Shanghai to understand the causes and consequences of ongoing events; much sound advice is being proffered by high-level intellectual advisers. They crash against the real Wall of China—the unilateral claim to power of the power-holders. John Lee is to be highly commended for having demonstrated it in concrete fashion.

**Laurent Murawiec**

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May 2009

## PREFACE

Taking the long view, we simply cannot afford to leave China forever outside the family of nations, there to nurture its fantasies, cherish its hates and threaten its neighbours.<sup>1</sup>

—*Richard Nixon, Foreign Affairs, 1967*

For more than three decades, the Centre for Independent Studies has been putting forward ideas that promote the advancement of freedom and prosperity. The economic transformation that has taken place in the Asia-Pacific over the past half century has been the most rapid in human history—a testament to the power of economic freedom, good governance, and the ‘rule of law.’

The latest Asian success story is China. Emerging from the barely imaginable suffering, turmoil and chaos during the Mao Zedong years, hundreds of millions have been delivered from poverty since the beginning of reforms in 1978. China has been growing at an enormous pace for almost three decades. Once a ‘pariah state’ with a backward economy, China is emerging as a great power in the region. Building on the Centre’s recent emphasis on foreign and particularly regional affairs, the first edition of this book was our first study of China.

Why does the CIS have a special interest in China? Much of the world’s fascination is that China has managed to achieve its ‘economic miracle’ without dismantling its authoritarian structure—without reforming mechanisms to promote limited government or one that is bound by the rule of law. It has been more than three decades since reform began in 1978, and the Chinese Communist Party (the Party) seems more rather than less entrenched in power since the Tiananmen protests in 1989. Courts and other judicial bodies remain under Party supervision, as do the administrative and bureaucratic organs of the state. Significantly, the Party has identified about a dozen key ‘strategic’ industries and sectors of the economy that it will not relinquish control over—including the financial and banking sectors, hence giving the Party open access to the country’s wealth. Not surprisingly, largely inefficient state-controlled enterprises swallow up the bulk of China’s capital even as their share of output diminishes.

Despite all this, China's economy continues to grow year on year. In 2009, China and India will be the only major economies still growing. Moreover, where once China was seen as a regional menace, many experts are now willing to accept that China is becoming a confident and secure power intent on a 'peaceful rise.' China has even been called a 'successful dictatorship' on an unprecedented scale.

It has been more than three decades since Deng Xiaoping's reforms began. The post-Mao period now exceeds the pre-Mao period, which lasted 27 years. More than 30 years is time enough to offer a critical assessment of the direction of China's growth and progress of these reforms.

*Will China Fail?* warns against the 'China blindness' that is behind many of our assumptions about China's inevitable and peaceful rise. Even though China's export sector has suffered enormously, other weaknesses in Beijing's model—unrelated to current global economic problems—are not yet fully apparent. The second edition updates and reinforces these arguments and continues to examine the massive economic and social problems within China that many in the West—undoubtedly excited by the lure of a massive market—simply ignore, underestimate or discount. The book looks at the evidence and presents arguments as to why reform has stalled and is failing, why much of China's apparent success is illusory and ultimately unsustainable, why economic and social problems are worsening, how its authoritarian political system is squarely behind these problems, and why desperately needed political reform will be difficult to achieve. Furthermore, it makes the case that the future direction of Chinese foreign and security policies remains unpredictable. The logic of peaceful integration into the region—although a powerful one—is competing with a more disruptive one borne out of the regime's opportunism and desperation to remain in power.

*Will China Fail?* was written to dispel any complacency we might have regarding the difficulty of China's ongoing transition. China's system of 'market socialism' is far from a successful contradiction. Its troubles should serve as a reminder of the powerful connection between successful and sustainable free markets on the one hand, and limiting the power, role and reach of the government on the other.

**Greg Lindsay**

Executive Director

The Centre for Independent Studies



# INTRODUCTION

'Market Socialism' and China's Peaceful  
Rise—The Case for Scepticism



## Introduction

# 'Market Socialism' and China's Peaceful Rise—The Case for Scepticism

In 2004, an article appeared in the *Wall Street Journal* offering an optimistic appraisal of the state of the global economy.<sup>2</sup> The article generated unusual interest because it was a summation of interviews with a dozen Nobel-Prize winning economists. In the interviews, the economists were asked which country in the world was the closest to getting its economic policy right. Several declined to name a winner, but Norway and the United States received two votes each. Kenneth Arrow, who received the Nobel Prize in 1972, although disapproving of China's political ideology, chose China, Taiwan and South Korea on the basis of recent results. Harry Markowitz, who won the award in 1990, believed that China ran 'a close second to the US.' Vernon Smith, the winner in 2002, commended China for 'moving ever so slowly in the right direction.' Finally, Joseph Stiglitz, the winner in 2001 and the former Chief Economist at the World Bank, declined to name a winner but singled out China as the best-performing economy in the world.

As the American model of capitalism goes through a very public and painful readjustment process, there is mounting speculation that China and its 'political-economy' development model<sup>3</sup> will soon move to centre stage. Even before the current global financial crisis, the unfolding story of modern China was the fascination of our generation. It is the world's most populous nation, and has sustained a high growth trajectory for almost three decades. Its rise is seen as perhaps the most significant illustration of economic transformation in history. From being perceived more than a decade ago as a rogue power and one of the last defiant bastions of communism in the world, China is now upheld as a new and compelling example of a successfully developing state. China's 'hard' and 'asymmetric' power is clearly growing. Even though the impact of the current global financial crisis has hit the Chinese economy harder than expected, many still believe that current conditions are no more than a speed hump for the

ongoing ‘China success story.’ Indeed, it is common to hear that the crisis is accelerating the permanent transfer of economic power from West to East—with China at the centre of the future world economic order. Consequently, regional economic and security policies are overwhelmingly predicated on the ‘inevitable rise of China,’ as if there were no other possibility.

Moreover, the recent Chinese experience and success suggest that there is no inextricable link between political liberalisation on the one hand and the successful transition to a free-market system on the other. Instead, the Chinese political-economy model seems to demonstrate that there are actually advantages to having a strong, authoritarian government heavily involved in the economy, overseeing the transition process, and supervising the economy once the transition is complete.

The lack of central regulation is being blamed for the current financial crisis. Even before there was a global financial crisis—and ‘collateralised debt obligations,’ ‘credit default swaps,’ and ‘toxic assets’ became household terms—governments throughout Asia, Africa, South America, the Middle East, Russia, and the former Soviet republics were already expressing various degrees of support and admiration for Beijing’s approach. Back in 2007, the magazine *Der Spiegel* looked at ‘market socialism’ and asked: ‘Does Communism work after all?’<sup>4</sup> Deng Xiaoping’s famous dictum that ‘It doesn’t matter whether the cat is black or white as long as it catches mice’ is repeated frequently to drive home the point that economic growth matters more than political ideology. Now that high levels of state ‘regulation’ and state participation in the economy are making a comeback even in the United States, there is increased interest in Beijing’s approach. For a rising number, not only will the Chinese political-economy model pass the economic test, but the example of a presumably successful and peaceful ‘market-socialist dictatorship’ will have much to teach the West.

Any debate on China must differentiate between optimism about the future of China from optimism about the future of China’s ‘market socialism.’

This book is about the sustainability and consequences of *China’s current political-economy model*, and optimism or



pessimism regarding this approach of ‘market socialism.’ The case for optimism argues that the current approach can sustain China’s economic and ‘peaceful rise.’ For some, China has managed to merge successful economics with authoritarian politics. At the very least, authoritarian political regimes can be useful in providing a degree of transitional and institutional stability in guiding a rapidly modernising society through the uncertainty of social and economic change. For others, China’s brand of political authoritarianism is perhaps unpalatable but not a serious economic impediment to future prosperity.

On the other hand, the case for pessimism or at least scepticism (which I make) argues that a politically unreformed China cannot sustain its economic and peaceful rise; that ‘market socialism’ is neither an example of a successful dictatorship nor a system within which the transformative forces of ‘market capitalism’ can take root. Instead, the regime’s pervasiveness, interference and control over key areas of the economy, society and institutions have led to frightening economic, political and social deficits—and China’s current trajectory is precarious rather than promising.

There is no shortage of optimists ranging from the considered to the unbridled. In some cases, the reasons for, and extent of, optimism is unfounded but in many others, the optimist’s case is both well thought out and formidable. Many of the optimists are sensible and distinguished scholars who have carefully watched the story of modern China unfold. Nevertheless, I argue that even the most sensible of optimists fails to present compelling evidence that the Chinese ‘hybrid’ authoritarian model can overcome its profound and mounting contradictions, tensions and dysfunctions—weaknesses that have become more apparent in the current economic environment. On the contrary, I argue that behind the high growth rates, the current Chinese approach of ‘market socialism’ is seriously flawed, failing and unsustainable. The evidence is accumulating that the case for pessimism is the more compelling, if not yet an irresistible, conclusion. Furthermore, there are formidable obstacles preventing important political reforms and institutions from being built. These are needed for ‘rule of law’ and to limit the role of the Chinese Communist Party (the Party) and government. At the same time, the regime’s determination and desperation

to remain in power could potentially destabilise the region as domestic conditions deteriorate. Combined with worrying trends in Chinese politics and foreign policy postures, the 'peaceful rise' of China's star is far from assured.

### **Background—praise and optimism for 'market socialism'**

In 2004, former World Editor of *Time* magazine Joshua Ramo authored a paper arguing that China had become an alternative and successful model for developing countries, and this model 'offered hope to the world.' Ramo argued that the success of the 'great China experiment' had led to the rise of a so-called 'Beijing Consensus.' This consensus rejected the reform and development strategies of 'big shock' and 'rapid liberalisation' once favoured by Washington and other Western governments. Instead, the Chinese political-economy model was a 'gradual,' 'flexible,' and 'ad hoc' reform model that emphasised pragmatism over doctrine. Unlike the recent financial crises in Russia and Argentina, the Chinese political-economy model had the advantage of fostering economic development without the destabilising effects of 'big shock' therapies. Moreover, according to Ramo, Beijing's example allowed countries to choose their own path towards development without political and institutional interference from the West. For Ramo, China offered the world a 'new physics of power and development.' Its model was the driving force behind the growth of Chinese 'asymmetric' power and influence in the world.

The gradualist approach of the 'Beijing Consensus' has caught on. Since then, the optimistic case for the Beijing's pragmatic, hybrid model has been eloquently argued by scholars such as Professor Meghnad Desai, Director of the Centre for Global Governance in London, and Albert Keidel from the Carnegie Endowment for International Peace. Both make a sensible case for the sustainability of the Chinese political-economy model. For example, Professor Desai argues that China is simply following elements of the successful growth strategies employed by Asian economies such as Japan and South Korea.<sup>5</sup> Indeed, Samuel Huntington laid the intellectual groundwork 50 years ago for the development strategy of 'authoritarian transition'

whereby existing authoritarian systems could initially provide political order, rule of law, and the stability needed for successful development.<sup>6</sup> Rejecting authoritarian politics—common to the East Asian experience—is an example of Western short-sightedness. After all, the economic rise of Taiwan and South Korea were supervised by the Kuomintang and a dictatorship led by General Park Chung-Hee respectively.

Keidel argues that China is good at ‘capital’ investment strategies that feed its ‘growth,’ such as construction and infrastructure, and that the financial savings of the Chinese guarantee that this strategy can be maintained for a long time. Further, China is well on its way to becoming a well-functioning open market even though there is some way to go. It has eased restrictions on the movement and deployment of its workforce and created a flexible domestic labour market that rewards hard work, risk taking, and knowledge. In opening up its economy to global commerce, it has enhanced its economic flexibility and financed new technologies and innovations. Like other successful Asian economies, China has laid the foundations for a thriving middle class—supported by land reforms, improvements in education, and improvements in social safety nets. It is building the soft institutions needed for markets to flourish. It is strengthening the conditions for social order and economic development. The regime is showing encouraging signs that it is willing to tackle corruption within the country. It has passed laws guaranteeing property rights. For Keidel, the Party overseeing this transition is proving to be a regime ‘that is far more nimble and robust’ than many presume. Although it makes mistakes and miscalculations, the Party is generally ‘a confident leadership implementing a sophisticated and balanced policy’ when it comes to government authority, social stability, and continued reform.<sup>7</sup>

These arguments represent the case for sensible optimism fairly. They recognise China’s progress and the enormous challenges that China must still overcome. No one can credibly argue that the Chinese political-economy model is out of the woods. But as a recent joint study by four leading scholars from the Center for Strategic and International Studies and the Peterson Institute for International Economics optimistically conclude:

[I]t would be prudent for the United States to base its own strategy on the assumption that China will continue to grow rapidly and become an ever more significant factor in the global economy. China faces many domestic economic challenges ... But the strong likelihood is that China's leadership will undertake the further reforms necessary to meet its economic challenges.<sup>8</sup>

On the other hand, a handful of experts, also mainly from the United States, such as Minxin Pei from the Carnegie Endowment for International Peace and Professor Yasheng Huang from the Massachusetts Institute of Technology, have cast doubts on the 'miracle' and sustainability of China's rise in its current shape. Will Hutton in the United Kingdom has also recently proffered similar arguments. However, despite the current global economic turmoil, the overwhelming consensus in the United States, Europe and Australia is still one of general optimism.

### **Part A: 'Market socialism' and the case for scepticism**

The history of East and Southeast Asia shows that embracing open markets (and limiting the role of government in the economy as well as restraining its power) and unleashing its forces can lead to sustainable prosperity and fundamentally transform polities in the longer term. Much optimism is based on the belief that China has embraced the free market, and this will transform the country into a stable, prosperous and vibrant one. China is yet another brilliant illustration of the marching of free markets towards prosperity, say these optimists. Its political system should be of secondary concern, if it is relevant at all. Chinese politics might eventually liberalise—and perhaps it is inevitable given the global market forces that have been unleashed in its society—but it will do so in its own good time. Meanwhile, we should encourage China to continue its current course. Countries such as Taiwan stand as a compelling model of what China might become sometime in the future.

We know that economic reform was explicitly undertaken to revive the legitimacy of the Party and re-orientate and entrench its position and rule. Yet, the Chinese political-economy model

treats free markets as selective and *therapeutic* rather than *transformative*. The 'Leninist corporatist' Chinese political-economy model as it stands denies that political authoritarianism must give way eventually as markets open. On the contrary, it assumes that a regime in the sole seat of power can successfully oversee a prosperous and thriving Chinese economy, as well as retain significant control over the economic resources and wealth of the country and the most important sectors of the economy. In the words of Keidel, China's authoritarian political system can do the job of successful reform—its political system is more nimble and robust than the pessimists believe.

The first phase of reform, which lasted until the mid-1980s, was undoubtedly successful, as was the movement of labour from the country to the city. This largely involved the break-up of centralised communes in the 1980s and greater rural to urban migration towards the end of the decade. The reduction in poverty, which has been spectacular, was achieved overwhelmingly during this period. Importantly, these reforms did not threaten the existing structure of political power or interests. By the mid-1990s, however, the steam had run out of these reforms. Newer, more fundamental reforms were needed.

The second phase since the early 1990s has been much more problematic. Behind the impressive growth figures, China is beset by serious problems in its banks, the structure of its economy, and the chronic mass misallocation and waste of capital to support inefficient state-controlled industries and sectors. The efficient and effective functioning of production and resource allocation is severely inhibited by an entrenched and systematic corruption that stems from single-party dominance and influence over the bureaucracy and the judicial, administrative, and commercial organs of the state. Moreover, not only are these problems intertwined but they are the direct result of the regime's pervasive place, role and function within Chinese economy and society. Although China is frequently characterised as a free-market economy, the state retains a significant role. About 60% of China's fixed assets are owned by the state. State-owned and state-controlled corporations receive about 70% of capital even though they produce only about 30% of China's output. The problems in the Chinese economy essentially arise

from the regime's hoarding, use and misuse of the country's resources—the lack of restraint and limits on a regime that is not subject to the rule of law. China's 'market socialism' is a far different animal from what we might call 'market capitalism.'

Moreover, these problems have been deepening since the early 1990s after the first stage of post-1978 reforms lost steam and the next and current stages were implemented. The Party after the 1989 Tiananmen protests, anxious to maintain exclusive power, became a paranoid and economically 'predatory' regime overseeing an economy with frighteningly unsound fundamentals. The political imperative of retaining power prevented the building of the soft institutions needed for successful capitalism: enforceable property rights, independent courts and rule of law, and independent financial and administrative organs. These would be *transformative*—something the regime is working hard to prevent. Its *therapeutic* approach to free markets is failing. Even the President of the Chinese Supreme Court recently admitted: 'The difficulty of executing judgments had become a major chronic ailment leading to chaos in the enforcement process.'<sup>9</sup> The debate should not be what China ought to do to fix its problems—for that is obvious—but whether China (given its current political setup) is capable of implementing necessary measures in time or at all.

China has come a long way, and many believe that the regime will continue to meet its ongoing reform obligations. Unfortunately, political imperatives can endanger even the best-laid reform programs, and the transformative effects of a free market are being prevented from taking root. The evidence supports the argument of *a fundamental and deepening contradiction between China's 'command and control' authoritarian set-up and successful and sustainable free-market economics*, the latter being dependent on limiting the role and reach of government and the existence of a 'rule of law' environment. We therefore need to seriously consider the possibility, if not probability, that reform will neither be profound nor rapid enough to sustain China's spectacular growth.

There are also further complications for the regime. As a result of its politically expedient and economically predatory practices,

substantial social and political deficits have been accumulating. These deficits strike at the heart of the Party's legitimacy and capacity to govern effectively. Behind the façade of strength and unity staged by the senior leadership for the sake of international appearances, the Party is an authoritarian regime that is being increasingly seen within China as corrupt, desperate and ineffective.

If China continues to resist significant political reform—needed to limit the role and reach of the Party at all levels of the economy and society—the case for pessimism regarding the future of China is strong, and optimism about China's continued rise is misplaced. Although there are similarities, China's model is not the successful model used by Taiwan, Japan, Korea, or Singapore. Many optimistic points of view fall short because of inadequate consideration of China's political realities and the formidable political obstacles preventing further reforms that are needed during this transition. Genuine economic liberalisation—needed to propel China towards sustainable prosperity—would seriously threaten the Party's hold on, and ability to monopolise, power. The Party has maintained control of the most important levers of power in society despite three decades of reform. Although the Party is far from being a monolithic entity, it is extremely unlikely that the Party will, as a collective, easily roll over and voluntarily accept the economic logic of limiting its power, reach and influence.

China is far from an example of a 'successful dictatorship.' Other key virtues of the 'Beijing Consensus' or Chinese political-economy model—gradualism and flexibility—are largely convenient strategies for a) an economically predatory regime to gain new footholds to hang on to power; and b) initiating limited free-market reforms as a new means to that same end. Moreover, while it is true that the Party is not fully in control of the transition as new forces and centres of power are unleashed, neither is the transition a runaway and irresistible force that will necessarily force the Party to relinquish control. China has not yet reached the point of no return in which the power of free markets to transform has taken root. Indeed, recent history shows that the Party can still do much to hold off necessary reforms that would significantly erode the regime's reach and power.

Importantly, the People's Liberation Army (PLA)—still the most organised force within Chinese society and often forgotten in many analyses—remains in many respects the Party's army and the ultimate guarantor of the Party's political dominance of China.

Market capitalism is an evolutionary process, and successful instances of it do not conform to one static model. Adam Smith, Joseph Schumpeter, Peter Bauer, and Friedrich Hayek have all made this point persuasively.<sup>10</sup> Does Chinese 'market socialism' represent an example of a successfully evolving capitalist system? I argue that it is not. Not all variations are healthy. Instead, China's 'market socialism' in its modern form is a predatory, dysfunctional, and grossly inefficient system that is enormously wasteful and unsustainable but unfortunately perpetuated and deep-rooted as a result of political imperatives. I argue that 'market socialism' is not a successful example of capitalist evolution, that there is no new 'physics of development' evolving, and a strong dose of scepticism is needed as we watch China's modern development. Far from presenting an alternative conception or mounting a challenge, the dysfunction of China's 'market socialism' should be seen as doing much to affirm the enduring and connected logic of free markets, limited governments that operate under restraints and subject to the 'rule of law,' and sustainable prosperity.

## **Part B: Rethinking China's 'peaceful rise'**

China's 'peaceful rise' is grounded in the proposition that China requires a stable and peaceful environment to develop its economy and modernise. Its embrace of global trade and foreign investment, as well as the stabilisation of outstanding border issues with Russia, Mongolia and India, was a step in that direction. The argument that China needs peace in order to rise certainly seems a well-grounded and reasonable one.

But the logic of 'peaceful rise'—although a powerful one—competes with other forces within Chinese politics and society. As countries scramble to position themselves to benefit from China's self-proclaimed 'peaceful rise,' relatively little attention in foreign and security policy circles is given to the combined consequences of a Chinese economy with deep structural problems—a Chinese society suffering profound governance and



social deficits; a redoubtable army (PLA) that remains suspicious of the free market and the costs of embracing globalisation; and an increasingly desperate regime rapidly losing credibility with its own people.

How might domestic pressures influence foreign policy? Examining the frailties and flaws of the Chinese political-economy model is a vital step towards answering this question. China is undertaking a tumultuous transition as the regime desperately hangs on to power. It should not be taken for granted that the logic of 'peaceful rise' will emerge triumphant over alternative possibilities.

What are the ramifications for regional security? I argue that the widely held belief that China will remain a stabilising influence in the region should at least be reviewed, since the interlocking segments for the 'peaceful rise' argument—that China will continue its impressive rise as an economic power, and that it will integrate seamlessly and peacefully into the regional and global status quo—remain at best a matter of speculation.

There are already worrying signals in China's foreign policy posturing that should not be dismissed. Behind its 'smile diplomacy,' there are clear signs of a trend towards a 'chauvinistic nationalism' emerging within Chinese society. This trend has been both encouraged and exploited by a distressed regime in the name of national unity and dignity. The predominant driving force of an unsuccessful state or regime in transition might very well take a different and less predictable direction. In particular, the PLA remains a critical factor in the future direction of Chinese politics and society. The dynamics of transition with respect to relations between the Party, the PLA, and segments of the population are ever evolving and, in the event of an unsettled transition, possibly troubling. This increases the chances of the escalation of unresolved crises, particularly in the Taiwan Straits and possibly the Diaoyu Islands.

More broadly, calls to either 'contain' or 'engage' China fail to capture the enormity of the challenge of 'getting China right.' While it is clearly beneficial and in the national interest of Australia, the United States, and their allies to primarily 'engage' China rather than 'contain' in the classical Cold War sense of

the term, the argument that mere engagement will lure China away from authoritarianism towards forms of greater democratisation is defective. The time is long past when we could carefully ‘manage’ China’s rise, that we could lead it willingly onto a liberal path. As Robert Kagan observes, ‘The history of rising powers and their attempted ‘management’ by established powers provides little reason for confidence or comfort.’<sup>11</sup> ‘Market socialism’ is designed to preserve the power of the Party, not dilute it. China’s rulers do not intend a transition that will ultimately usher in greater political and economic freedoms, even though the current authoritarian set-up will be shown to be flawed, ineffective, and even duplicitous. It is clear that our capacity to influence domestic developments within China is severely limited. However, in ‘engaging’ China, we should not be blind to the implications of ‘market socialism,’ nor should we simply accept that the Chinese political-economy model has been and will continue to be successful.

Finally, it is one thing to ardently hope, as Ramo does, that more than a billion Chinese will achieve enduring prosperity in the coming decades. It is another to explicitly or tacitly support a failing political, economic, and moral logic. The Chinese case study is a test of whether authoritarian systems of heavy government participation and command in the economy can resist or even enhance the operation of free and open markets. Market systems evolve and do not conform to one definitive model. Is ‘market socialism’ an example of a successfully evolving capitalist system? I argue that it is not. Not all variations are healthy and sustainable. That modern day China will inevitably follow the logic of a proven path towards prosperity rather than stagnation or turmoil should be debated rather than assumed.



Part A

# CHAPTER ONE

The Rise of Chinese Power  
and 'Market Socialism'



## Chapter 1

# The Rise of Chinese Power and 'Market Socialism'

### Introduction

Shortly before his passing, Milton Friedman granted an interview to the *Wall Street Journal* in July 2006. The transcript of the interview was printed in January 2007. In the interview, Friedman was asked about whether he had any thoughts on the China versus India comparison. His reply is reproduced below:

Yes. Note the contrast. China has maintained political and human collectivism while gradually freeing the economic market. This has so far been very successful but is heading for a clash, since economic freedom and political collectivism are not compatible. India maintained political democracy while running a collectivist economy. It is now unwinding the latter, which will strengthen freedom of all kinds, so in that respect it is in a better position than China.<sup>12</sup>

When the Centre for Independent Studies released the first edition of *Will China Fail?* in 2007, not many commentators were willing to argue that Beijing's model was unsustainable. Asking whether China might 'fail' was rarely done in polite policy circles—and doing so was more likely to cause an awkward pause in conversation than trigger the beginning of lively debate. Prior to the current financial crisis, China alone was responsible for around a quarter of global growth. China actually overtook the United States in 2007 as the leading contributor to global GDP growth. According to IMF figures, from 2002–05, China was responsible for around 50% of the increase in global demand for aluminium, copper and steel; 80% increase in the demand for nickel and tin; and more than 90% of demand growth in lead and zinc—providing a boon for mineral-rich countries such as Australia.<sup>13</sup> Why rock the boat when all was proceeding so well?

Some respected analysts even spoke confidently about the ‘decoupling’ of the Chinese economy from the Western economies; its economic growth would continue even if the American and European economies stalled, and would provide a second and independent growth engine for the region.<sup>14</sup> In March 2008, Australian Reserve Bank Governor Glenn Stevens told a closed-door Department of Treasury seminar that ‘short of a catastrophic event,’ Chinese growth would continue to underpin the resources boom for many years.<sup>15</sup> Other commodity analysts suggested that China would be behind a ‘paradigm shift’ that would end the normal boom and bust cycle for commodity prices for several generations; instead, it would be all ‘boom’ for a long time. When the US economy showed signs of weakness in early 2008, there remained a widely held belief that a strong Chinese economy would keep the Australian economy out of recession even if any downturn in the United States and Europe became severe. The World Bank Country Director for China, David Dollar, cautiously lent his weight to the ‘decoupling’ thesis in February 2008, arguing that ‘confidence, profitability, liquidity and consumption’ in China was strong as ever. Dollar concluded that the World Bank’s then ‘9.6% forecast (for 2009) is also something of a nod to de-linking.’<sup>16</sup>

Although the ‘decoupling’ theory has been abandoned for the moment, most experts ultimately remain optimistic about the sustainability of China’s current political-economy model—believing it can improvise and adapt as needed. After all, in 2009, the Chinese economy will most likely be the only major economy in the world (along with the Indian economy) not in a technical recession. Moreover, recent history is on its side. Despite the projected fall in GDP growth to around 5–8% in 2009 from the high of almost 12% (according to official figures) in 2008, many remain dazzled by the modern Chinese experience, and with good reason. Hundreds of millions have been lifted out of poverty since 1979. China’s official growth rates have been hovering at, or close to, the double-digit mark each year since 1978 when reforms began. The country’s economic modernisation program is seen as one of the most spectacular illustrations of economic transformation in global history. Various long-term projections from international organisations such as the OECD

and investment banking firm Goldman Sachs continue to predict that China will overtake the US economy in terms of aggregate output (but not per capita output) sometime between 2020 and 2050. While recognising that the Chinese have a number of serious challenges to overcome in order to sustain these phenomenal growth rates, there is general optimism that these challenges can and will be met. Prior to the global financial crisis, many were prepared to declare the 'great Chinese experiment' a success. In contrast to Milton Friedman, Greg Sheridan in *The Australian* confidently declared the Chinese political-economy model an example of 'a successful dictatorship'<sup>17</sup> in 2005. The current crisis has significantly slowed China's growth. But few are brave enough to bet that the Chinese model is failing or unsustainable.

The global downturn has revealed some vulnerable elements of the Chinese economic growth model. Its heavy reliance on exports to the United States and Europe, and on foreign direct investment to drive innovation in its industry, meant that the decoupling theory was always overstated. But in many respects, the Chinese economy marches to the beat of its own drum. The social and political consequences of profound weaknesses in its economic model—in particular the systematic misallocation of domestic capital—are not yet fully apparent. The consequences of flaws and weaknesses have not yet run their course. The broader fortunes of the global economy will not necessarily dictate the particular fortunes of the Chinese political-economy model. Even as China is likely to defy global trends and remain out of recession in 2009 and 2010, potentially fatal contradictions in its political-economy model remain. Likewise, when Western economies eventually recover, it is not certain that the Chinese economy will simply rise with the tide.

Milton Friedman argued that 'political collectivism'—in this case, China's political authoritarianism and political statism—is incompatible with 'economic freedom' or the successful operation of a free market. Part A of this book argues that although the decline of China is far from inevitable, China's system of political authoritarianism and 'market socialism' is both a fundamental cause of existing problems and a significant barrier against further reforms needed to sustain China's rise.

This is not to say that authoritarian systems are always agents of economic decline. For example, Hong Kong and Singapore both boast thriving open economies. Although both are small ‘city-states,’ which makes comparison with larger countries difficult, both nevertheless achieved their economic success within an authoritarian set-up. However, countries like Hong Kong and Singapore share the commonality of limited government interference and predation in the economy, as well as sound institutions such as enforceable property rights and ‘rule of law.’ In China’s case, I argue that its deepest problems are caused by the role and reach of the regime at all levels of China’s economy, society, judiciary, and administration. The key to China’s future will, therefore, depend largely on limiting the regime’s role and restraining its power at all levels of the economy and society.

In this sense, it is a political challenge to ensure the restraint and accountability of the ruling regime. If political reform and accountability are not forthcoming, then the case for pessimism in terms of the future of China is strong. Furthermore, there are significant and entrenched obstacles to turning around the great ship that is the 46 million officials constituting the regime, or even changing its course. Albert Keidel’s depiction of the Chinese authoritarian system as nimble and robust is misplaced because China’s authoritarian regime is at the heart of its problems. Although no one can predict the country’s future, its current tensions and contradictions are profound, frightening and, ultimately, unsustainable. In other words, the Chinese political-economy model is seriously flawed and in need of significant revision and reform.

### **The ‘Beijing Consensus’ and the decline of ‘democratic capitalism’**

Joshua Ramo, the journalist who coined the term ‘Beijing Consensus,’ argues that:

China is in the process of building the greatest asymmetric superpower the world has ever seen, a nation that relies less on traditional tools of power projection than any in history and leads instead by the electric power of its example and the bluff impact of size.<sup>18</sup>



Milton Osborne already calls China the 'paramount power' in the region.<sup>19</sup> At the heart of rising Chinese prestige and soft leadership is the emergence of China's alternative political-economy model—the so-called 'Beijing Consensus'—against various Western liberal archetype models. Before looking at the 'Beijing Consensus' in greater detail, it will be useful to provide a brief setting of the historical and political landscape prior to the emergence of the conditions that led to the coining of 'Beijing Consensus.'

During the Cold War, the Soviet Union and communism provided a seemingly coherent ideological alternative to economic and political liberalism. The collapse of the Soviet Union in no small way contributed to the perceived 'triumph' and universality of Western values and institutions and, in particular, the merging of liberal politics with liberal economics. It was what Michael Novak famously called 'democratic capitalism.'<sup>20</sup> Successful economics needed complementary 'soft institutions.' A democratic system and a liberal social ethic that encouraged pluralism and individual freedoms were not just seen as desirable but adopting these principles was assumed critical to guarantee the operation of free markets; entrench genuine meritocracies; ensure the spread and adoption of knowledge and more innovative processes; and restrain the predatory nature of ruling regimes and their tendency to use resources for self-serving purposes. Democratic institutions and free societies use and allocate resources more efficiently in the long run because the predatory practices of governments are restrained. A liberal democratisation process was therefore linked with successful developmental economics.

As the prospect of political and military conflict between the great powers waned in the decade after the Cold War, the focus returned predominantly to economics. The Western, and particularly American, enthusiasm for rapid economic liberalisation as the strategy for developing countries was at its peak during this time. However, the record of developing economies that adopted rapid economic liberalisation measures since 1991 has been mixed. Chile is an example where rapid economic liberalisation seemed to work. The Argentinean financial crisis between 1999 and 2002 is a noteworthy instance of where rapid economic liberalisation was not successful. Even prior to this,

questions were already being asked about the rigid and rapid implementation of wholesale ‘neo-liberal’ reform—so-called ‘Washington Consensus’ principles—in struggling economies. For example, the ‘big shot’ therapy (to rapidly privatise, liberalise and deregulate) administered to Russia following the fall of the Soviet Union had mixed reviews, while countries such as Malaysia defied neo-liberal IMF prescriptions by restricting the free movement of their currency following the 1997 Asian financial crisis—a move that has been seen as largely successful. Rapid economic liberalisation as a ‘fix all’ for struggling economies became a blunt instrument of change. Insisting on it began to appear more doctrinaire than enlightened.

Nevertheless, ‘capitalism’ in some form or another still seemed the way forward—for example, from the more ‘liberal’ systems in Britain and the United States to the ‘stakeholder’ systems in Continental Europe. Market capitalism was evolutionary and everyone became entitled to their version of capitalism—it did not have to be a headlong rush towards implementing an American or Anglo-Saxon version of it. Though ‘capitalism’ in all its forms remained triumphant, the impetus for political liberalisation and democratisation lost steam. As Timothy Ash argued recently in *The Guardian*:

What is the elephant in all our rooms? It is the global triumph of capitalism. Democracy is fiercely disputed. Freedom is under threat even in old-established democracies such as Britain. Western supremacy is on the skids. But everyone does capitalism. Americans and Europeans do it. Indians do it. Russian oligarchs and Saudi princes do it ... Karl Marx would be turning in his grave.<sup>21</sup>

Ash makes an important point. Societies do not have to be ‘democratic’ or ‘liberal’ to ‘do capitalism.’ This was especially the case with transitional states. Almost 40 years ago, Samuel Huntington famously argued that the most effective way of dealing with the transitional stresses of rapid modernisation was to promote effective long-term political institutionalisation while maintaining strong, centralised authority. As he put it, in terms of development, the degree of government matters more

than the form of government. Huntington even suggested that authoritarian regimes could provide a degree of transitional political stability necessary to guide a rapidly modernising society. However, Huntington's caveat regarding the advantage of authoritarian approaches must also be remembered in that the comparative advantage of strong, authoritarian government was short-lived and transitive in nature. In the longer term, political power had to be institutionalised to be effective. Also, democratic institutions were superior in their capacity to adapt and respond to emergent pluralistic forces.<sup>22</sup>

In reality, any (causal) connection between economic and political liberalisation was taken for granted and rarely expounded by post Cold War leaders in any compelling or comprehensive way. Correlation is not causation. The fact that the liberal-democratic West outlasted and outgrew the Soviet Union did not in itself establish a causal connection between political and economic liberalisation. Even at the height of Reagan's Cold War revival in the 1980s, Michael Novak had warned that:

It [the relationship between economic and political/individual freedom] is too easily taken for granted because the habits of the heart are learned in childhood, supplying reasons that reason has forgotten.<sup>23</sup>

The West might have won the Cold War but there was not just one version of 'capitalism' on offer. It became unclear whether free-market economics had to be allied with political liberalism, or whether political liberalism was necessarily the end game. Any link between political culture and economics became less clear. Any connection was historical rather than analytical.

## **Rise of the Beijing model of 'market socialism'**

Crossing the river by feeling for the stones

—*Deng Xiaoping*

Critics of 'liberal' and 'neo-liberal' approaches as well as 'democratic capitalism' might have gleefully pointed to instances

where Western neo-liberal and liberal prescriptions failed to resurrect the economy, but there were few successful counter-models on offer. The European model gathered such little speed outside the continent that Martin Wolf was recently moved to ask in the *Financial Times*: 'Is the European model broken?'<sup>24</sup> The 'Asian values' and 'Asian way' debate in the 1990s, largely initiated by then Malaysian Prime Minister Mahathir bin Mohamad and Singaporean Prime Minister Lee Kuan Yew, had lost much of its momentum after the 1997 Asian financial crisis. Besides, 'hybrid' countries such as Singapore and Malaysia were not significant enough to present a fundamental challenge to the Western ideas that had earned a hard fought victory against Marxist-Leninist thought after four decades of Cold War. Economies that had successfully modernised were still mainly 'democratic capitalists' or at least headed that way. Western and American models favoured by the IMF and World Bank might have been problematic but there were few alternatives more appealing.

It is in this context that the so-called 'Beijing Consensus' emerges as an alternative model for developing countries. As mentioned before, the term 'Beijing Consensus' was first used by a former journalist Joshua Ramo<sup>25</sup> in a 2004 article sympathetic to the Chinese reform experience since Deng Xiaoping in the late 1970s. Ramo argued that China had resisted implementing textbook IMF prescriptions, and this defiance of particularly 'big-shock' 'Washington Consensus' principles had been proven successful. In reality, the 'Washington Consensus' was an easy target because the 'consensus' (if one existed at all) had been all but discredited since the Argentinean Crisis. Nevertheless, for Ramo, Beijing had introduced 'a new physics of development and power.' In rejecting the destabilising 'big shock' neo-liberal therapy, the Chinese had developed a model that was flexible and gradual rather than radical. Importantly, the model allowed the Chinese (and presumably any followers of this model) to fit into the global system 'in a way that allows them to be truly independent [and] to protect their way of life.' Certainly, the latter characterisation tapped into an underlying current of suspicion and cynicism that buying into rapid neo-liberal reform was an agenda put forward by Western powers

to shore up their influence in general and entrench American hegemony in particular. As Ramo argued:

What is happening in China at the moment is not only a model for China, but has begun to remake the whole landscape of international development, economics, society and, by extension, politics. While the U.S. is pursuing unilateral policies designed to protect U.S. interests, China is assembling the resources to eclipse the U.S. in many essential areas of international affairs and constructing an environment that will make U.S. hegemonic action more difficult.<sup>26</sup>

Although the Chinese leadership has never explicitly used the term 'Beijing Consensus,' and there is no evidence that the Party initially set out to expound a model to explicitly compete with any 'consensus' about development, there is little doubt that an ever-increasing number of experts see Beijing's model—'market socialism'—as a competing development approach against Western archetypes, of which the increasingly discredited (and difficult to pinpoint) 'Washington Consensus' was just one. Moreover, for the growing numbers of China optimists, the Beijing Consensus (otherwise known as the 'Beijing Model') is arguably the new 'exemplar' for developmental political-economy—an example of how it should be done. Kishore Mahbubani argues that China's example is a better and more palatable example for Muslim countries such as Indonesia, Pakistan and Bangladesh to replicate.<sup>27</sup> Commentators such as Ramo argue that it is generally better to do what the Chinese are doing—which evidently works—than what the West and the Americans tell you to do—which may not.

However, unlike more rigid formulations like the 'Washington Consensus,' the 'Beijing Model' does not offer a set of coherent axioms that other economies can easily follow. This is perhaps why it is attractive. The basis for much of its appeal is as a pragmatic and hybrid political-economy model. Models should be adaptable to suit the existing political, social and economic conditions within a country—not the other way round.

In this sense, the power and persuasion of a model really exist in what it rejects rather than what it puts forward.

First, by putting forward a 'gradualist' reform philosophy, the 'Beijing Consensus' rejects the 'big shock' rapid reforms once favoured by Washington (and the largely discredited 'Washington Consensus'). Reform does not have to mean large-scale economic and social instability that 'big shock' therapies would cause. Reform programs can also be 'flexible.' Since there are no pre-determined reform measures that *must* be accepted, nor are there timetables that *must* be followed, the 'Beijing Consensus' provides backing for regimes that would otherwise incur the criticism of Western commentators urging greater and more rapid changes. That in itself generates a considerable amount of prestige for China and enhances the legitimacy of the Chinese reform model.

Second, the 'Beijing Consensus' denies the existence of a necessary link or causal connection between successful economic development and political liberalisation. On the contrary, some supporters argue that authoritarianism provides order during economic transitions compared to the chaos of liberal democracy. In other words, a single-Party system provides an advantage by being able to determine the pace of, and push through, necessary reforms. This is the basis behind the 'successful dictatorship' that Greg Sheridan suggested China is becoming. In this context, one prominent commentator in Britain even went as far as to say that the alternative Chinese political-economy model is 'the biggest ideological threat the West has felt since the end of the Cold War.'<sup>28</sup> The refutation of 'democratic capitalism' is at the heart of the challenge the 'Beijing Consensus' presents to long-held liberal beliefs. As Sheridan argued in *The Australian*, 'China shows you can have [economic freedom] without [political freedom], where we used to think they were indivisible.'<sup>29</sup> Even prominent *New York Times* columnist Thomas Friedman admitted that he has 'cast an envious eye on the authoritarian Chinese political system, where leaders can, and do, just order that problems be solved.'<sup>30</sup> Where once Washington (and perhaps Brussels) was seen to be the repository of developmental wisdom, such wisdom is now seen by many to be self-serving and even dangerous; eyes are instead transfixed on Beijing.

Third, this defiance of Western economic and political prescriptions as well as Western assumptions about 'democratic capitalism' is enormously prestigious for a China with growing regional and global leadership ambitions. The old logic—that democracy would follow economic liberalisation—had been a cornerstone of Western assumptions about the benefits of engaging China and 'managing' China's rise.<sup>31</sup> China's refusal to be managed by the West and reluctance to offer judgment against the policies of other states (its so-called 'live and let live' approach) is fast becoming an example and inspiration for developing countries and governments to follow. Former Soviet Republics (such as Kazakhstan, Uzbekistan and Turkmenistan) to South America (such as Argentina, Bolivia and Brazil) to Asia (such as India, Malaysia and Vietnam) to Russia have joined 'pariah' states such as Iran, Cuba, North Korea, and Myanmar in publicly expressing a fascination and admiration for the Chinese political and economic approach. For example, Brazilian President Luiz Inácio Lula da Silva sent his advisers to Beijing to study 'Chinese economics' and declared that the Chinese and Brazilian economies 'should serve as a paradigm for South-South cooperation.'<sup>32</sup> Then former Singaporean Prime Minister Goh Chok Tong remarked that 'China's extraordinary development sets the standard for other Asian countries to follow.'<sup>33</sup> The highly respected, Oxford-educated Indian Prime Minister Manmohan Singh argued that 'Mumbai can learn from Shanghai's experience in reinventing itself; in rebuilding itself; in rediscovering itself.'<sup>34</sup> Muyingo Steuem, a senior Ugandan government adviser, told the *Financial Times* that 'In developing countries, China is regarded with a mixture of envy, admiration and awe.'<sup>35</sup> Clearly, the powerfully seductive rhetoric of a new Chinese exemplar that secures greater 'independence' of action (from the West and especially the United States) as well as stability and prosperity is compelling for its many proponents.

### **Why the rise of Beijing's model matters**

It should be obvious that assessing the 'Beijing Consensus' is clearly of enormous importance. As recession looms in the United States and Europe, and commentators fall over themselves

to criticise some ill-defined notion of the 'neo-liberal' approach, Beijing's model of 'market socialism' stands as a very visible alternative. Even prior to the current economic crisis, countries such as India and Russia were already using the rhetoric of the 'Beijing Consensus' as an excuse to drag their feet on promised reforms in the name of 'gradualism.' Developing countries in Asia, South America and Africa were looking to Beijing, and not Washington, for inspiration and guidance. Although 'big shock' liberal approaches have produced mixed results and are less suited to economies still in the early stages of development, an approach that allows no criticism of tardy or non-existent reform timetables seems a dangerous 'consensus.' Moreover, shallow reforms can easily be passed off as 'feeling for the stones' and finding one's own way when once they might have been perceived as policies designed to plaster over significant cracks.

The rise of the 'Bush Doctrine' during the previous American administration as an extreme manifestation of liberalism (and the negative international response to it) was certainly not helpful to liberalism's cause. Nevertheless, the example of Beijing is pernicious, and the potential danger and disruption to the Western backed global liberal-democratisation project is enormous. China is evidently not blind to this opportunity. China's political relations with regimes tinkering with illiberalism and authoritarianism through its 'rogue aid'<sup>36</sup> and other policies are intended to win and influence illiberal friends (and, in some cases, secure natural resources for its development). In offering political and financial support to brutal, dictatorial regimes such as those in Myanmar (Burma), North Korea, Zimbabwe, and Iran (as well as other 'problematic' regimes such as those in Laos and Cambodia) for pragmatic, strategic and other reasons, China disregards any global consensus about the value of liberal-democratic norms. China's authoritarian example and leadership—underpinned by the prestige of its political-economy model—comes only shortly after a time when winning the Cold War for many meant the democratisation of the world seemed inevitable in the same way that free-market economics had won over its rival. The Chinese political-economy model challenges the perception that it is the 'end of history,'



and great and small nations will simply roll over and accept the triumph of liberalism and democracy rather than challenge the establishment of the global liberal-democratic order, its norms, and rules of engagement.

There is also a further related aspect to China's 'stubborn illiberalism' as far as the 'China security question' is concerned. Besides economic gain, Western economic and diplomatic engagement with China has twin motivations. First, following elements of liberal 'evolutionary-institutional' logic, it is hoped that as states further embrace the free market and 'buy into' the globalised neo-liberal system, they would be forced to eventually liberalise and ultimately democratise internally. Second, by entering the global marketplace, China would be forced to accept the current security status quo in Asia (with the United States as the predominant power) because China needs a stable region in order to grow its economy. Peace would be China's overwhelming priority meaning that China would be loath to risk military confrontation with any power. This is certainly the reasoning China offers for its self-termed 'peaceful rise' or 'peaceful development,' even as the Party denies that the liberal 'evolutionary-institutional' logic *must* hold.

Former Australian Prime Minister John Howard evidently drew from the latter perspective of 'peaceful rise' in his terms of engagement with China.<sup>37</sup> For example, the last Department of Foreign Affairs and Trade (DFAT) White Paper, whilst recognising that 'China's rising economic, political and strategic weight is the most important factor shaping Asia's future ...',<sup>38</sup> spoke mainly about building a 'strategic economic relationship with China similar to those Australia has established with Japan and Korea.'<sup>39</sup> Although there might be hiccups along the way, it was hoped that China would eventually be just another successful regional Asian partner bound by the peaceful logic and pragmatism of interdependence and economic ties. Incidentally, then opposition leader and current Prime Minister Kevin Rudd, a fluent Mandarin speaker and former diplomat stationed in China, used a similar logic in putting forward his 'engagement of Asia' as one of three pillars guiding Labor Party foreign policy.<sup>40</sup>

Yet, important questions must be asked about these assumptions. Regional peace was a fundamental prerequisite for the economic development of all the successful Asian economies. But contrary to Chinese intentions, Japan and South Korea eventually moved away from authoritarian traditions to become settled democracies. Even elites in Singapore and Malaysia—successful economies with largely authoritarian systems—have been seriously wrestling with questions about walking the path towards further democratisation. Former US President Bill Clinton predicted in 2000 that ‘We will be unleashing forces no totalitarian operation rooted in last century’s industrial society can control’ in lobbying for continued trade with China.’ Former US President George W Bush repeated this logic in 2005, stating ‘I believe a whiff of freedom in the marketplace will cause there to be more demand for democracy.’<sup>41</sup> Without mentioning China or any other country by name, President Barack Obama’s inauguration speech in January 2009 proclaimed ‘those who cling to power through corruption and deceit and the silencing of dissent [were] on the wrong side of history.’<sup>42</sup> While many simply believe that the ‘evolutionary’ process of liberalisation and democratisation will sooner or later catch up with China, the fact remains that the vast majority of political elites in China are determined and desperate not to let it happen. Does this matter? ‘Market socialism’ denies that liberalism and democracy are the end game for successful economies. It even denies that limited government involvement in, and command over, the economy (as has occurred in Singapore and Hong Kong) is a prerequisite for success. Chinese political and military elites are unlikely to simply roll over and accept this ‘liberal evolutionary logic’ as inevitable. Will pressure to democratise from within or without, particularly alongside internal economic, political and social pressures, prove volatile? The (internal and external) consequences of China’s ‘stubborn authoritarianism’ as far as our security policy assumptions are concerned are critical questions. Part B will consider some of these questions.

### **Assessing the test case**

While China’s rise provides challenges and opportunities that

rightly concern and excite the world, its rise (or its decline) should not be taken as a *fait accompli*. No one knows what or where China will be in 10, 20, much less 50 years' time. This paper focuses on an assessment of the sustainability and adaptability of China's current political-economy model, and the possible ramifications of its failure.

The 'Beijing model' is China's modern journey, and China is *the* test case for the approach. China's perceived successes up to now are the driving force behind the momentum for the 'Beijing Consensus' being seen as a new and improved model of economic development and political governance. The current financial crisis has clearly added new impetus to the debate. Rightly or wrongly, there appears to be an emerging, albeit poorly examined, consensus that a lack of 'regulation' is a major cause of the crises that have their epicentre in the United States. This supports the argument that Western-style free markets cannot *always* be relied upon to *prudently* self-regulate economic behaviour. The other side of the coin is that heavily supervised economies, such as China's, have their virtues.

It therefore stands to reason that if China's political-economy model were to falter, much of the steam would be taken out of any consensus. 'Market socialism' would not be seen as a successful example of capitalism's evolution. A central question in Part A, therefore, concerns the viability of China's authoritarian model as one capable of promoting sound and sustainable growth.

There are many studies on the successes and challenges facing the modern Chinese political-economy model. The weakness of many of them is the absence of any method to assess the prospects of future success or failure—which really means the absence of argument whether China is *able* and *willing* to meet its reform obligations and challenges. Merely listing successes and challenges without any framework for assessment is inadequate. As stated above, it is important that such assessments be made because these questions have enormous implications for how we view developing economies, the relationship between economic and political reform, and the challenges that might lie ahead in security policy should present trends continue.





Part A

# CHAPTER TWO

The Politics of Market Socialism



## Chapter 2

# The Politics of Market Socialism

### Introduction

The cover of the Jan/Feb 2009 *Far Eastern Economic Review* carried the headline ‘The Coming Crack-Up of the China Model.’ This is a far cry from the headlines and sentiment less than one year earlier that widely proclaimed the continued rise of China as inevitable. Magazine covers were much more likely to ask how a powerful and successful China was changing global economics and international politics. Robert Kagan’s *The Return of History and the End of Dreams* (released in April 2008) spoke about a competition between slow growing liberal democracies and booming authoritarian capitalists as the next great defining contest of our age. The book was released at a time when optimism about Beijing’s model had probably reached its peak.

Even if the unbridled optimism that characterised recent analyses of China has died down, the vast majority of China watchers are nevertheless optimistic: The Chinese political-economy model is bracing from the fallout of an exogenous shock (a global recession), but it remains fundamentally sound. Although there is a greater recognition of outstanding challenges, many commentators still speak approvingly of the Chinese hybrid model, which is correctly seen as a pragmatic and flexible one. There is no *a priori* plan or pace to economic reform and no rigid conception about a future approach. Indeed, the fact that the Chinese political-economy model is a hybrid model is not a problem in itself. Many believe that it is in fact its strength. All economic systems are hybrids to some extent, and there are multiple paths towards prosperity. For many, the key virtue of Beijing’s model is that it can adapt.

Yet, many commentators and economists discussing the virtues of the Chinese hybrid model fail to consider and appreciate the politics behind ‘market socialism.’ This is a serious omission. The evidence in the following chapters shows that political

imperatives define, restrict and drive the development and evolution of the Chinese political-economic model. This model is not simply an economic model but a model of *political-economy*. This is a crucial distinction. The most exciting element of China's story is the country's capacity to achieve high growth rates over three decades. But statistics about growth rates tell a small part of the story. The Chinese political-economy model, even as it evolves, was largely developed as and remains a strategy for the regime's political survival. Consequently, I argue that focusing on the politics behind the model offers a fundamentally more accurate understanding of what is occurring in China than what linear extrapolations of future growth and pure economic analyses and models can offer.

### **China's growth rates—The limits of linear quantitative analyses**

China's rise has been spectacular, with official growth rates averaging around 8–10% every year, and the doubling of GDP every 10 years since 1979. Although it is likely to fall below 8% in 2009, can high growth be sustained in the longer term? Using linear analyses to make predictions for the future is common and seductive but unsound.<sup>43</sup> Numbers alone should not drive the debate about China's future prospects. Why? For one decisive reason, many of the numbers we have are a product of guesswork, obfuscation and, in some instances, downright fabrications. For example, although most sceptics agree with Thomas Rawski, a University of Pittsburgh economist, that China's pre-1998 growth figures 'were in the ballpark, although it may have been a large ballpark,'<sup>44</sup> China's post-1998 growth figures are doubtful.

The circumstantial evidence suggesting recent significant inaccuracy is strong. A few years ago, Rawski pointed out that China's spectacular economic growth numbers in the late 1990s were in contrast to the stagnating formal figures for energy consumption, freight transport, and air passenger miles. In 1998, all but one of China's provinces reported GDP growth rates above the national average—an obvious statistical impossibility. China's National Bureau of Statistics (NBS) consistently revises figures received from the provinces downward, yet refuses to



disclose its methodology for doing so. While economists like Rawski present well-documented calculations to suggest that total economic growth since 1998 has been about a third of the official figure, and generate significant media attention in doing so, NBS officials continue to vigorously defend the accuracy of their numbers without explaining how they arrive at them. Even one of China's domestic institutes, the China National Economic Research Centre, estimated that growth from 1978–98 averaged about one percentage point below official figures.

The official growth statistics since then continue to be dubious. Provinces take around two weeks to compile their growth statistics every quarter. This is three times faster than developed countries with much more efficient systems and processes for data collection. These are then sent to the NBS where statisticians—in consultation with government officials—apply an unknown methodology to trim the numbers into shape. An official growth figure is subsequently released and duly adopted by most international organisations. The conversation reported by Stephen Green, who leads the research for Standard Chartered Bank in Shanghai, is a typical:

In a recent chat with a local People's Bank of China official, I asked what the local growth rate was for first half 2008. 'The city reported 10%,' he replied before shaking his head, 'but there's no way it was really that. But they would not dare report anything less.'<sup>45</sup>

Whether sceptics such as Rawski and Green are actually correct, the point is that the numbers we are given cannot be verified, and conducting an analysis based on models that ultimately rely on linear extrapolations, as many economists do, is likely to pose more questions than answers.

Besides, even if we do accept the official numbers, it is still difficult to know how to view them. For example, Martin Wolf of the *Financial Times*, used data from economic historian Angus Maddison to show that up to 2004, China's much-admired GDP per head (at purchasing power parity) rose by 370% at 6.1% a year during 1978–2003. Yet between 1950 and 1973, Japan's GDP per head had increased 460% at 8.2% a year. From 1962–90,

South Korea's GDP per head rose by 680% at 7.6% each year, while Taiwan's rose by 600% from 1958–87 at 7.1% each year.

These figures suggest that China's official growth rates, while impressive, are not history making as such. As Wolf argues, 'What is remarkable is not how quickly China's economy has grown, but rather how slowly it has done so,'<sup>46</sup> especially when we take into account China's high fixed investment rates and low base to begin with.<sup>47</sup> They also serve once again to focus attention on China's model of development in which the politics behind the Chinese political-economy model needs to be examined. China's recent political story cannot simply be conflated with a broader East or Southeast Asian one.

## **Politics behind the Chinese political-economy model**

We have repeatedly declared that we shall adhere to Marxism and keep the socialist road. But by Marxism we mean Marxism that is integrated with Chinese conditions, and by socialism we mean a socialism that is tailored to Chinese conditions and has a specifically Chinese character.<sup>48</sup>

—*Deng Xiaoping*

The trajectory of China's history leading up to the reform period from 1978 onwards stands apart from much of Asia. For much of the twentieth century, China remained insular and suspicious of the West and Western institutions and ideology. While other, and now successful, Asian states struggled at the time to develop their hybrid economic liberalisation and modernisation models, China persisted with schemes and programs designed to 'perfect' and define the agenda for communism in China with disastrous and tragic results.

Despite the trauma and barely imaginable cost in human life of the Great Leap Forward and Cultural Revolution in particular, Chinese leaders from Deng onwards emerged with an enhanced belief in statism (i.e. significant state or ruling party intervention in social and economic matters). For example, the Cultural Revolution, which was officially

condemned in 1981, has had a profound impact. It was seen as an irrational revolution fuelled by 'popularism' and was a lesson against too much popular participation in government, not too little. The same lessons were drawn from Tiananmen in 1989; political elites believed that democracy would only lead to chaos. China has 31 provinces; 2,862 counties; 48,000 townships; and more than 700,000 villages. There are seven major dialects, and about 80 spoken languages. Only autocracy and monopoly could achieve order and keep China unified. Any political reform had to be kept in-house, that is, within the Party itself. As Deng argued:

The purpose of reforming the system ... is precisely to maintain and strengthen Party leadership and discipline, not to weaken or relax them. In a big country like ours, it is inconceivable that unity of thinking could be achieved among several hundred million people.<sup>49</sup>

The socialist command economy and grand initiatives such as the Great Leap Forward had patently failed. Previous production methods had failed to offer China sufficient 'surplus value' that any modernising country craved and needed. However, even though the decision was taken to experiment with various market reforms, the political rationale driving it remains steadfast and unchanging. Economic reform was needed to revitalise the Chinese economy. Deng came to realise that this had to be complemented by political reforms in which excessive centralisation and bureaucracy were seen as the greatest obstacles. However, as Minxin Pei from the Carnegie Endowment for International Peace argues, any political reform was restricted to administrative streamlining. Deng and his successors rejected the institutional checks and balances that would have diluted Party power.<sup>50</sup> Maintaining the continued political dominance of the Party was the ultimate objective and not negotiable. This is the starting point for understanding the politics behind 'market socialism.'

There are two important political aspects behind 'market socialism' and the need for economic reform. Both relate to entrenching and continuing the legitimacy of Party authoritarian rule.

First, when Deng introduced the beginning of the modernisation program in 1978, he was keen to emphasise the reinvigoration of socialism, not the death of it. Just as Mao Zedong distinguished Chinese and Soviet Communism by describing the former as ‘communism with Chinese characteristics,’ Deng represented economic reform as ‘socialism with Chinese characteristics.’ The reforms would be socialism’s next stage of evolution. This was a deliberate and clever continuation of the Chinese *narrative* of socialist revolution redesigned and re-branded for the contemporary audience. To be sure, Deng could have hardly represented the reforms as an abandonment of socialism. This would not have been acceptable to the Party elites, and would have undermined the basic legitimacy of the Party’s existence and right to rule. Consequently, the foundational rhetoric of the socialist creed remained intact: keep the socialist road; uphold the dictatorship of the proletariat; uphold the leadership of the Party; and uphold Marxist characteristics.<sup>51</sup>

Second, economic reform was a response to an emerging crisis of legitimacy for the Party. Democratic regimes rely heavily on the ballot box to derive their legitimacy to rule. Authoritarian rulers who reject popular elections still require popular consent and legitimacy to survive and be effective. However, factors that were once conducive to authoritarian rule no longer existed. The charismatic leadership Mao provided either as executive ruler or figurehead could not be replicated. The flames of revolutionary fervour had cooled, and (socialist) ideology mattered less and less. Put briefly, the circumstances that once propelled the Party to power and entrenched its legitimacy and rule no longer existed—a realisation devastatingly reaffirmed by Tiananmen in 1989. Given the economic need to reform in any event, Deng saw the role of the Party in driving ongoing reform as a renewal of the Party’s purpose. In other words, the legitimacy of the Party to remain in power was now increasingly tied to delivering economic prosperity and growth rather than as the repository for, and leaders of, ideological revolution. Since 1978, the succession of leaders from Deng to his appointed successor Jiang Zemin to current leader Hu Jintao have all sung from the same song sheet in terms of staking the Party’s legitimacy on China’s ability to

deliver consistent growth. Just as the Party once delivered China from imperial capitalists, this new phase of history sees them leading the nation towards economic prosperity.

### **The political and economic success of earlier reform—a brief summary**

During the period of reform in the late 1970s and 1980s, little political capital was spent or sacrificed. Chinese reform consisted mainly of the decentralisation of authority, decision-making, and resources. This was done almost completely within the context of the existing hierarchical structure. Local officials were given greater authority and responsibility to make decisions that were once made by central authorities. The basic rules and exercise of property, capital and administration of power did not change a great deal, except that local economies were opened up for limited market-orientated and entrepreneurial activity under the stewardship of local authorities.

In terms of the rural economy, the most noteworthy and successful initiative occurred when large state-owned collectives gave way to the household responsibility system (HRS). Farmland, although still owned by the state, was reallocated to individual households under fixed-length contracts.<sup>52</sup> After fulfilling procurement quota obligations, farmers were allowed to sell surplus crops to an open market—usually country fairs. The government also reformed the pricing system, and higher prices were set for state purchase of farm products. The HRS greatly improved the incentive structure of agricultural production. Farmers were given more autonomy in production decisions and allocating resources to more profitable activities such as orchards, fisheries and animal husbandry. Between 1978 and 1995, total factor productivity in agriculture almost doubled.<sup>53</sup> The success of the HRS was an early indication of the benefits of reversing decades of Mao's communism and limiting centralised control of production. In her book *How the Farmers Changed China*, Kate Zhou characterised the developments as a 'spontaneous, unorganised, leaderless, non-ideological, apolitical movement.'<sup>54</sup>

Township and Village Enterprises (TVEs) were another happy accident of spontaneous, bottom-up activity. As farmers attained

greater wealth, they experimented with non-farm enterprises and different forms of collective ownership. TVEs—the result of collusion between local officials and rural workers—generally performed more efficiently than older style state-owned-enterprises (SOEs) because the interests and actions of TVE managers and local leaders were more coordinated and mutually aligned. The property rights were still owned and controlled by Party members but these members were at the local level. Local leaders were provided incentives to help TVEs perform better and were discouraged from erecting roadblocks since the TVEs contributed directly to township budgets. TVEs proved to be spectacularly and unexpectedly successful. As Deng admitted, ‘The result was not anything I or any of the other comrades had foreseen; it just came out of the blue.’<sup>55</sup> TVEs employed about 30 million people in 1979. By 1996, TVEs employed 135 million people (but this has not increased since then). There is no doubt that rural economies would have been much worse had this not occurred. From 1978–96, the rural workforce increased by 147 million. TVEs absorbed 107 million of these, usually at better wages than they would have received from working in farms.

More generally, the challenge of the initial phase (1979–mid-1980s) was to open the economy to trade and inward direct investment, and shift labour and resources away from agriculture towards manufacturing and services. The subsequent sectoral transformation of the labour force is probably the most dramatic manifestation of the reform process. The share of the labour force employed in agriculture has declined from 70% at the beginning of the reform period in 1978 to less than 50% today. China’s shortage of arable land (about 15% of the total land area) meant that productivity in agriculture was always low. An OECD report estimated that productivity in the agricultural sector even today is about one-sixteenth the average of manufacturing and services when measured by output.<sup>56</sup> The result of this shift has been a much more efficient allocation of labour.

From the mid-1980s onwards, there was an increased focus on creating hard and soft market ‘institutions’ and ‘processes.’ In addition to intentions to reform or eliminate many of the notoriously inefficient SOEs, there was a need to foster the

creation of a new dynamic private or 'entrepreneurial' sector to promote competition and innovation on one hand and a greater reliance on market forces to inform key decisions such as commodity prices, capital allocation, and wages on the other. Prior to reform, bureaucrats in the State Planning Commission were responsible for allocating key assets such as steel and machinery. The state 'rationed' almost all conceivable consumer goods, and the State Price Commission set prices for most commodities and products, which meant there was little connection between price, profit and productivity. In the 1980s onwards, market forces began to displace planned decision-making (although not entirely as further chapters will show). In particular, market forces determined prices for most products, individuals were freer to compete for jobs in a more flexible wage market, and rural and urban migration barriers were reduced.

In many respects, the 1980s was the high water mark of China's reform efforts. The period was what respected China economist Yasheng Huang termed the 'entrepreneurial decade.' The statistic of hundreds of millions of Chinese emerging out of poverty is frequently cited as evidence of the ongoing Chinese success story. The number of people in China living in absolute poverty declined from about 400 million in 1978 to approximately 100 million in 1999. But the decline has not been continual or uniform. Widely accepted research by a number of experts shows that about 80% of the 300 million people lifted out of 'poverty' since 1978 occurred in the 1980s.<sup>57</sup> Moreover, the developments that did so much of the heavy lifting in terms of poverty reduction, such as the rise of TVEs, were spontaneous rather than planned.

The earlier phases of reform were undoubtedly successful. Importantly, since the existing political and social elites were generally protected and had their privileges preserved, there was little opposition to these earlier reforms from entrenched interests. The privileges of bureaucrats and workers in particular were largely untouched. The power of local Party officials actually increased as the system became more decentralised. Moreover, these earlier reforms led to immediate increases in output, which helped compensate the small numbers of losers during this period. In this sense, the authoritarian model was not really

problematic for reform since embedded interests remained largely untouched, and it is arguable that maintaining a decentralised, but still authoritarian, system was in fact an advantage. After all, decentralisation could be pushed through more efficiently whilst maintaining the existing political set up. Moreover, there is evidence that the success of the TVEs in particular actually increased much of the population's appetite for further reform.

Successful as these developments in the 1980s were, the consensus within and outside China by the early 1990s was that the initial reforms had run their course, and a new shot of reform activity was needed. For example, the number of people employed by TVEs reached a peak in 1996 and began to gradually decline afterwards.<sup>58</sup> Yet, rather than push ahead with further ground-up free-market reform, in many respects, the story of China from the 1990s onwards has been of the rise of state corporatism crowding out a fledging private sector from competing in key sectors. The 1989 Tiananmen protests changed Party perspectives about the nature, direction and purpose of economic reforms. As the following chapters show, the role of the regime and state in the economy makes a comeback. The Chinese approach was remodelled. Although its subsequent weaknesses play out only gradually, the Chinese political-economy model has become increasingly vulnerable since the 1990s. Economic, social and political imperatives have become increasingly contradictory rather than complementary.

### **'Gradualism' and emergence of the 'authoritarian trap'**

Most analyses of China's 'economic miracle' focus exclusively on the 1990s. This is because Western analysts began to take notice of China's re-emergence only from then onwards. After all, the many false dawns in recent Chinese history had led many in the West to doubt that reforms in China could work in the longer term. Even as reforms began in 1978, China was seen as just one out of several 'emerging' economies that perhaps had potential. Moreover, in the 1980s, trade between China and developed economies in the West was still modest. For example, in 1988, Chinese exports to the United States hovered around



US\$7.5 billion with a US trade deficit of around US\$1.5 billion. Yet, only a decade later, Chinese exports to the United States stood at US\$55 billion with a US trade deficit of US\$36 billion. By the end of 2008, exports to the United States would reach US\$337 billion with a US trade deficit of US\$266 billion.<sup>59</sup>

**Table 1:** Growth in net exports to the United States

Year	Chinese exports to the US	US trade deficit
1988	US\$7.5 billion	US\$1.5 billion
1998	US\$55 billion	US\$36 billion
2008	US\$337 billion	US\$266 billion

The almost exclusive focus on the 1990s onwards has led most to assume that the 1990s were just the continuation of reforms that began in 1978 and which continued through the 1980s. Barry Naughton, for example, terms the 1989 Tiananmen protests and the immediate aftermath ‘The Tiananmen Interlude.’<sup>60</sup> According to Naughton, once the political fallout from the protests was successfully managed, reform more or less continued unabated. But the evidence suggests that this attitude, in many respects, glosses over the significant changes in direction that took place as a result of the Tiananmen protests, which had brought the regime to its knees.

Yasheng Huang has done extensive work in examining the differences between China’s reform process before and after the 1989 Tiananmen protests.<sup>61</sup>

One significant change that occurred after the Tiananmen protests was the change in the composition and outlook of China’s leaders. For example, political reformist and Party Secretary-General Zhao Ziyang, along with his supporters, was toppled after trying to find common grounds with the students in Tiananmen. Zhao has been largely responsible for ‘getting out of the way’ and then supporting and facilitating the spontaneous reforms in rural China that allowed the entrepreneurialism of its rural poor to flourish—initially in Sichuan and Anhui provinces and then throughout China. In contrast, the leaders of the 1990s such as President Jiang Zemin and Premier Zhu Rongji were

members of what became known as the ‘Shanghai clique.’ These leaders were technocrats who rose within the urban SOE system. Importantly, these leaders placed an emphasis on state-guided capitalism in China’s urban areas as the way forward.

Huang argues that ‘In the 1980s, a version of market-driven, small-scale, and welfare-improving rural capitalism was developing vibrantly.’<sup>62</sup> Reforms were not only largely spontaneous but also ‘big shock’ ones in which developments rapidly overturned decades of Mao-era collectivist practice. There is strong evidence of a shift in emphasis from rural to urban China after the Tiananmen protests. In the 1990s, state-directed fixed investment in urban China rather than rural entrepreneurialism became the primary strategy for growth.

In the first significant change in rural finance, productive experiments funding essentially private rural enterprises were terminated. In the mid-1980s, Huang estimates that around 10 million of the 12 million TVEs were effectively privately run. Even the most successful privately run rural TVEs found it difficult to obtain formal finance from state-owned banks. In 1993, for example, state-owned banks only allocated 16.8 billion yuan for TVEs even though the Ministry of Finance believed that they collectively needed 200 billion yuan to survive.<sup>63</sup> This is despite the fact that rural TVEs had been the backbone of China’s economic re-emergence for the past decade. The second change was in Beijing’s attitude to TVEs—especially towards the most successful privately run businesses. In the mid-1980s, collective and privately run TVEs were encouraged by central officials to compete with urban firms, and many had productive relations with firms in Shanghai. In the 1990s, TVEs became boxed in as firms that could compete only in rural markets and serve primarily agricultural markets by influential figures such as Li Peng, the Chinese Premier from 1987–98. This was officially enshrined in the *1997 TVE Law* when privately run TVEs were already well in decline. The third change is evident in the changes in rural household income over time. From 1978 to 1988, rural disposable income grew over 12% per annum, falling to between 4–5% from 1992 onwards after the Tiananmen Interlude from 1989–91.<sup>64</sup> This is also clearly

reflected in trends in the income gap between rural and urban residents from the 1980s compared to the 1990s onwards. From 1978 to 1984, the income gap between urban and rural areas dropped from a ratio of 2.5 to 1 in 1978 to 1.8 to 1 in 1984. By 2001, urban incomes were 2.9 times higher. It was 3.23 times higher in 2003 and 3.33 times higher in 2007.<sup>65</sup>

The difference in emphasis in the reform process before and after the 1989 Tiananmen protests is captured by Li Changping, who began a career as a rural official in 1983 and became the Party secretary of a rural county in Hubei province. In 1999, Li wrote a letter to the then Premier Zhu Rongji expressing dismay over the plight of rural China in the 1990s compared to a decade earlier. The letter reached the Premier, who dispatched several officials to investigate Li's claims. The claims were eventually published in a popular investigative newspaper, *Southern Weekend*, where readers voted Li 'Man of the Year.' Li observes that in the 1980s, 'the standard of living of the peasants improved day by day' compared to the 1990s where the 'livelihood of peasants was difficult and tensions accelerated considerably.' In the 1990s, local officials became 'locusts' rather than partners of the peasants. Critically, Li attributes the leadership purges following Tiananmen as the reason for the change.

Li offers his thoughts on the differences that occurred after the 1989 protests:

I used two phrases to describe rural reforms in the 1980s of the last century: 'Advancing of non-governmental sector and retreat of the state.' As for the 1990s, I have two descriptions: 'Advancing of the state and retreat of the non-governmental sector.'<sup>66</sup>

The shifts that occurred after the 1989 Tiananmen protests should not be underestimated. 'Gradualism' is usually used to characterise the Chinese reform process since 1978. In reality, state-directed 'gradualism' (rather than 'big shock' approaches) is at the core of the current (post-1989) Chinese political-economy model, not the pre-Tiananmen one. The intended strategy had been to 'grow out of the plan'<sup>67</sup> meaning that the initial wave

of reforms would give way to further changes that would make the Chinese economy more competitive. But it had to be done without contributing to the regime's own eventual downfall. Besides the turmoil of the Tiananmen protests in 1989, Chinese leaders watched in horror as the Soviet Union imploded in 1991. Examination of the writings of leading Chinese social scientists and officials since then reveals a near obsession with investigating the reasons for the Soviet collapse as well as the economic turmoil that gripped Russia immediately afterwards. Many argued, with some merit, that reform had to proceed 'gradually' considering the Russian experience in which there was an immediate loss of output following the dismantling of many state-owned corporations in the rush to privatise. Moreover, it was proposed that the gradual decentralisation of decision-making would begin in the rural provinces and spread first to the cities and then to state enterprises and other public bodies. Once local authorities and individuals became more practised at making decisions for themselves, market initiative and enterprise would take hold and eventually flourish. China would then have the best of both worlds as far as the Party was concerned: The state sector would remain dominant but also dynamic enough to survive and compete.

As we shall see later in this book, 'growing out of the plan' has not been wholly successful. But there is a further political dimension and rationale behind gradually 'growing out of the plan.' 'Gradualism' also allows the authoritarian regime time and opportunity to co-opt and create new winners and elites, placate those who possibly stand to lose their privileges, and in doing so, retain authority as China changes. The strategy to co-opt was born of a lesson learnt from Tiananmen and the collapse of the Soviet Union. In the 1980s, just like in the Soviet Union, the fortunes of those getting richer in China were not tied to the fortunes of the Party. One of the few outspoken China pessimists, Minxin Pei, argues that:

[T]he process of selective withdrawal creates strong incentives for the ruling elites to defend their last strongholds of economic and political privileges [while] gradualism

allows the ruling elites to co-opt new social elites and form an exclusionary network that divides the opposition, while creating an incentive structure that rewards cooperation with the antireform elements and penalizes opposition to such elements.<sup>68</sup>

Pei makes a good point that applies to almost all authoritarian systems trying to change and undergo reform. Gradualism is widely seen as a pragmatic and innovative strategy. What is less spoken about is the relationship between the strategy of 'gradualism' and what one might call the 'reform dilemma' faced by authoritarian political elites. As argued earlier, the Party is determined to remain in power. This is a political imperative for almost all authoritarian regimes, and no less for the Party. To do so, political elites need to secure internal order and obedience. What they fear is the emergence of new elites within their own society who might challenge their political authority—a distinct possibility as fundamental reform is initiated and China's economic structure changes. This is the basis of the 'reform dilemma' for the Party.

As reforms continue, there are new and existing winners who might stand to lose a great deal. To placate potential new losers and co-opt emerging winners, economic success is essential. Why? New winners from the reform process are the emerging middle and entrepreneurial classes in China. As a group, they can be expected to remain loyal or at least indifferent to the political status quo while they prosper in the new China. In 1978, workers and peasants accounted for more than two-thirds of the Party's 37 million members. Tellingly, former President Jiang Zemin extended membership of the Party to owners of private businesses<sup>69</sup> in 2001 despite the protestations of some old-style hardline members. Much work has been done by the Party, as subsequent chapters show, to expand the economic role of the state and marry the interests of the emerging economic elites to those of the regime. In 2005, workers and peasants accounted for only 29% of the 70 million members, while 23% were professionals and 30% were college students. A study published in 2008 reported that 34% of private entrepreneurs are now members of the Party, up from 19% in 2000.

**Table 2:** Professionals in the Party

Year	Proportion of Party members who are professionals
2000	19%
2005	23%
2008	34%

The members who feel most threatened are those who benefited most from the old state-run system, in particular, bureaucrats and SOE workers. Economic success is more likely to lead the new rich to accept the legitimacy of authoritarian rule as there would seem no reason to rock the boat in an era of such prosperity. The fruits of national prosperity are, therefore, needed by the authoritarian regime to placate those who potentially stand to lose: either by preserving their employment despite rising costs and redistributing resources to soften the blow of reforms to disenfranchised groups, or by buying off opponents or at least building coalitions with some of those groups. In this sense, economic success has become a source of legitimacy especially for authoritarian regimes of and in itself.

Where do reform dilemmas and authoritarian traps come in? On the one hand, authoritarian elites have an interest in economic success and progress. But on the other, they need to ensure that their exclusive political authority survives. To this end, and because they have the power to do so, authoritarian elites tend to establish systems that favour their own interests and those of their supporters. They tend to establish or perpetuate closed markets that the state or their supporters draw succour from. They also tend to shape financial policies that distort genuine open market activity to further political ends. And finally, they tend to use the fruits of economic success to entrench their own position. In other words, even though the existence of the state is essential for order and economic growth, the state remains omnipresent and pervasive in economic activity and risks becoming a powerful agent of artificial economic decline. Authoritarian regimes that depend on economic progress for their survival at the same time perpetuate conditions that threaten sustained economic progress.

Pitting their right to a rule based on economic progress is therefore a precarious (but necessary) activity for the Party.

The emergence of the ‘household responsibility system’ in particular demonstrated the benefits of removing centralised interference and intervention. Optimists and pessimists agree that China faces enormous challenges. But the optimists argue that China can ‘outgrow’ its problems via an ever-expanding economy. However, these optimists fail to appreciate the political nature of these problems and fail to present compelling arguments why the Party can overcome this ‘authoritarian trap.’ Commentators generally see only China’s high growth rates and readily predict that China is well on its way to meeting its challenges. As I will argue, the evidence does not convincingly support the conclusion that the ‘authoritarian trap’ can be overcome. What is needed to set China on a sustainable course demands less Party control and more use of China’s wealth and resources—policies that the Party cannot accept as it attempts to remain in power. Growth rates in themselves tell only a fragment of the economic and political story, and peering behind GDP growth figures reveals a country that is much more dysfunctional and in more serious trouble than is generally admitted.

### **Critical areas needing further reform**

The challenges that China must manage are increasingly well documented. Unlike the situation just a decade ago, a lot more data are now available, and commentators have used them to offer a clearer picture as to what is happening within China’s vast territories. There is no need to go too much into depth here as these challenges are well summarised elsewhere.<sup>70</sup>

There are, however, clear development or economic ‘fault lines’ that will likely prove decisive. One cannot adequately discuss these challenges without a fundamental reference to the politics behind them. They are worryingly areas where the ‘authoritarian trap’ is most evident; where the most insidious forms of corruption reside; where the contradictions between economic, political and social imperatives are most apparent; and where the leadership has most notably and doggedly implemented

its 'gradualism' strategy. To wit, they are areas where the flaws in the Chinese political-economy model are most evident. These are listed below and will be discussed in the subsequent chapters:

- reform of SOEs and key sectors of the economy
- reform of the banking system
- reform the system of capital allocation and use.





Part A  
**CHAPTER THREE**

The Chinese 'Economic Miracle'—  
What Lies Beneath



## Chapter 3

# The Chinese ‘Economic Miracle’— What Lies Beneath

### Introduction

China’s political-economy model continues to sustain optimism all over the world. An important reason for this optimism is the compelling phenomenon of China’s record of long-term growth that has lifted hundreds of millions out of poverty. Even now, despite the present global economic turmoil, China and India are likely to be the only major economies that will avoid recession.

There are further reasons why the majority of commentators remain optimistic about China’s future. First, those waiting for a sustained Chinese slowdown have been waiting since 1979. There is a natural attrition rate for pessimism. Second, the overwhelming point of view is that reform is well underway (although how far it has come does not in itself answer how far it will keep going). Third, the Chinese leadership and the official news agencies are consistently making the right comments that especially please Western observers. The Chinese have become proficient in the art of earnest diagnosis of their problems—a point of difference with most authoritarian regimes that prefer to remain in constant denial. (Unfortunately, the solutions proposed frequently differ from the actions taken.) Finally, momentum from growing optimism can in itself fuel a measure of success. The more optimism there is, the more benefit of the doubt is given to a regime’s ability to find solutions. In effect, more time is bought, and a more generous interpretation of developments is possible.

It is worth looking at what lies beneath the ‘Chinese economic miracle.’ Some optimists underestimate the *extent* of China’s economic and structural problems. Importantly, many others fail to appreciate that politics is at the heart of China’s problems. The primary economic strategy is growth that will allow China to grow its way out of its problems. Yet, growth is not the ultimate objective—regime preservation is—and any pro-growth policy

has to be understood alongside the constraints of these political objectives. Growth enhances the Party's legitimacy, which in turn enhances its chances of survival.

However, political objectives and constraints directly hinder the capacity of the regime to meet its contemporary reform obligations. These economic and structural problems should not be treated as separate and distinct. They are not only interconnected but largely result from China's 'market socialism.' Inefficiency, waste, misallocation, and the pilfering of resources are most profound and widespread in areas where the political stakes are the highest for the regime and, consequently, in areas where the regime is most deeply involved. The regime's desperate attempt to hold on to power presents a formidable obstacle to continued economic reform needed for sustainable growth and prosperity.

It is important to appreciate the extent and nature of the expanding role of the Party in Chinese society and economy from the 1990s onwards as this goes to the heart of why systemic corruption is getting worse, and why contradictions and dysfunctions are rapidly accumulating within the political-economy model. The pervasive economic role of the regime also goes to the heart of the massive misallocation and misappropriation of the country's resources. It is this trend that is leading the current model towards failure.

## **The return of the party-state in post-Tiananmen China**

In July 2001, then President Jiang Zemin gave a widely reported speech that many believed finally offered ideological legitimacy to the private sector. President Jiang proclaimed that:

Since reforms and opening, the social structure of our country has changed substantially. There are now non-governmental high-tech entrepreneurs and technicians, managers and technicians employed by FIEs [foreign investment enterprises], individual households, private entrepreneurs ... so on and so forth. They are also contributors to the socialism with Chinese characteristics.<sup>71</sup>

The following year in November 2002, the 16<sup>th</sup> National Congress adopted a new constitution that opened Party membership to 'Any Chinese worker, farmer, member of the armed forces, intellectual or any advanced element of other social strata.'<sup>72</sup> Many saw this as a concession by the leadership that a new, capitalist China had emerged. Entrepreneurs who were once 'outcasts' were now 'honored guests.'<sup>73</sup>

The rise of the private sector has been an irresistible phenomenon in China's rise. Private sector entrepreneurs are welcomed into the Party. Indeed, this is partly a concession by leaders that China is changing. In 1978, workers and peasants accounted for more than two-thirds of the Party's 37 million members. Move ahead to 2005, and workers and peasants accounted for only 29% of the 70 million Party members; while 23% were professionals and 30% were college students.<sup>74</sup> Another extensive survey conducted in 2005 revealed that 75% of entrepreneurs surveyed (representing the economic elites of their communities) were either already members of the Party or were eager to join. More than half of those surveyed admitted that economic benefits and opportunities were the reason why they were members or wanted to join the Party.<sup>75</sup> A study published in 2008 reported that 34% of private entrepreneurs are now members of the Party, up from 19% in 2000.<sup>76</sup>

However, the interaction between the Party and rising elites such as entrepreneurs is far from one-sided and in favour of the latter. Entrepreneurs and other rising elites are eager to join the Party—and support the Party's exclusive right to rule—because membership opens up opportunities. A common mistake is to assume that while Chinese society is rapidly changing, its authoritarian political institutions have remained static. Few authoritarian leaders in history have voluntarily chosen to cede power simply because a private sector has expanded and their people have grown wealthier. Since surviving the Tiananmen protests in 1989, the leadership has been able to reassess and adapt to changes within Chinese economy and society. Most notably, since 1989, there has been a substantial expansion of the Chinese state, and its economic and bureaucratic apparatus. By strategically controlling economic resources and remaining the primary dispenser of economic opportunity and

success in Chinese society—even for many entrepreneurs—the Party is attempting to build institutions to preserve the Party’s hold on power.

The predatory role of the regime in modern China goes to the heart of ‘getting China right’—and also the basis for my pessimism that the Chinese political-economy is sustainable. Many China watchers carelessly portray modern China as a ‘capitalist,’ private-enterprise economy. They do so because they focus on the rise of selective market mechanisms that have been adopted in China but ignore the change in policy that took place after the Tiananmen protests and subsequent developments in the structure of the modern Chinese economy. In truth, the regime reasserted greater control after the protests, and the Chinese economy remains a state-dominated one in important ways.

The spontaneous explosion of private initiative in rural China throughout the 1980s certainly propelled China closer towards a free-market model. But a top-down change away from nurturing the growth of the private whilst maintaining selective free-market mechanisms is obvious when examining fixed asset investment measures before and after the so-called Tiananmen Interlude. From 1981–89, fixed asset investment by the private sector was growing at 20% per annum. During the Tiananmen Interlude, it dropped to 2.6%, and from 1993–2001 only rose 12.4% per annum. Private investment in rural China, which had been growing at above 19% prior to 1989, dropped to 1.1% during the Tiananmen Interlude and averaged only 7.5% from 1993–2001.<sup>77</sup>

**Table 3:** Private sector investment growth in China

Years	Percentage growth of fixed asset investment by the private sector (overall)	Percentage growth of fixed asset investment by the private sector (rural China only)
1981–89	20% p/a	19% p/a
1989–93	2.6% p/a	1.1% p/a
1993–2001	12.4% p/a	7.5% p/a

Domestic short-term loans to domestic private businesses tell a similarly oppressive story, comprising only 2.5% of all short-term loans extended by all financial institutions in 2005.<sup>78</sup> A World Bank survey in 2000 covering 10,000 mainly private firms across 81 countries showed that two-thirds of Chinese private firms surveyed nominated formal credit constraints as a 'major constraint' on the operation and growth of the business. Only Moldova ranked worse, according to this survey.<sup>79</sup> Indeed, the number of individuals who owned businesses fell by 15% to 26 million in 2006. Genuinely private firms contributed less than 10% of central tax revenues during 2007, and these numbers have dropped further in 2008.<sup>80</sup>

The explosion in the number of officials and bureaucrats is also indicative of the rise of the Chinese 'corporate state.' In the 1980s, China had fewer than 20 million officials on its payroll. In the early 1990s, the number grew to approximately 22 million, and by 2004 there were more than 46 million officials. This equates to around one official for every 28 people.<sup>81</sup> This number is supported in a further report that indicated the doubling of officials during the 1990s. In the 1980s, a small township had around 10 to 20 officials, and a large one 20 to 30 officials. By 2004, an average township had more than 100 officials.<sup>82</sup>

The political motivations behind these developments are clear. Authoritarian regimes become irrelevant at their peril. To preserve its relevance, the Party has made extensive efforts to maintain control of the major levers of economic power. This control is at the heart of an economic structure that entrenches, for the moment, the role and status of Party officials and members in Chinese economy and society. For example, around a dozen key segments of the economy—including banking, construction, infrastructure, media and telecommunications—are dominated by SOEs and state-controlled entities. SOEs have been the overwhelming beneficiaries of the government's industrial-policy program beginning in the 1990s—which included measures such as tax and debt relief, import licences, and greater operational freedoms such as the ability to transfer assets across provincial jurisdictions.

Another case in point is that more than 30 of the largest 35 listed companies on the Shanghai Stock Exchange are majority owned by the state and state-controlled entities. Between 1990 and 2003, fewer than 7% of the initial public offerings on the Shanghai and Shenzhen stock exchanges were from private sector companies.<sup>83</sup> The Chinese state owns about 50% of all the shares of listed companies.<sup>84</sup> When state-controlled entities are included in the calculation, the state is likely to control around 70–80% of all listed shares. In terms of assets, employment, national output, and control of the most important sectors, the state's role in the Chinese economy is still far more profound, extensive and entrenched than at any time in East Asian countries such as Japan, Taiwan and South Korea. The extent of the Party's role in China's economy will be looked at in more detail shortly.

### **Beijing's model of institutional corruption: a framework for pessimism**

I do not see a clear linkage between corruption and one-Party rule in China.<sup>85</sup>

—*Former Premier Zhu Rongji*

The one-Party system is the source of the most insidious, costly and destabilising forms of corruption in China. In many respects, focusing on corruption draws together many of the reasons why the Chinese political-economy model is failing. 'Corruption' can simply mean public officials engaging in illegal activity for private gain. But it can also be the result of a clash of contradictory structures. Legitimate behaviour within a rent-seeking authoritarian political system might very well constitute 'corruption' in a free-market economic system. 'Systemic' or structural corruption is therefore frequently a problem for countries and societies in transition.

China rates poorly on all the global corruption rankings. For example, it is currently ranked 72 by Transparency International.<sup>86</sup> Commentators frequently cite President Hu's 'speak softly but carry a big stick' adage as firm evidence of the leadership's determination to crack down on corruption. This crackdown is seen as part of Hu's aim to promote a 'harmonious society.'



Fighting corruption is an important part of the strategy. Official Chinese news agencies are more than willing to report on the very public anti-corruption drives, and in particular the spate of high-profile prosecutions and sackings (and even executions in some instances). These began in 1995 with former Politburo member Chen Xitong, and in recent times have included Vice-Admiral Wang Shouye, deputy commander of China's navy, and Liu Zhihua, Deputy Mayor of Beijing, who oversaw the city's makeover for the Olympics. The dismissal of Shanghai's Communist Party Secretary, Chen Liangyu, in September 2006 and the execution of Zheng Xiaoyu, former Director of the State Food and Drug Administration, are other high-profile examples.

Prosecuting corrupt individuals is laudable because the problem of illegal capital flight perpetrated by corruption officials is enormous. Some Chinese researchers estimate that the theft and misuse of money by officials amounts to at least 2% of GDP. The well-respected Chinese economist Fan Gang believed that illegal capital flight perpetrated by officials in 2000 was almost US\$50 billion, more than the entire amount of formal capital inflows into the country in that year, which was US\$41 billion.<sup>87</sup> Much of the money is used for gambling, purchasing of overseas personal assets, world class education for their children and relatives, etc. For example, a postal bank official in Guangdong province was sentenced to death in April 2009 for siphoning more than US\$180 million to pay her gambling debts.<sup>88</sup> But greedy individuals lining their pockets or misusing money needs to be understood in a broader context. The growing problem of corruption in China—a serious, debilitating and entrenched problem—stems from the relationship between the Party on one hand, and the bureaucratic, economic, financial, and judicial organs of the state on the other.

The problems arise from the fundamental contradiction between a political party determined to maintain an exclusive hold on power (and retaining control of significant resources within the country as well as judicial organs in order to do so), yet also attempting to introduce and benefit from a partial free-market economic system. Without an arm's-length relationship between political priorities, processes, and functions on the one hand, and economic and legal ones on the other, free-market

logic is easily obscured. The system is denied the soft institutions required for the effective operation of an efficient market. These contradictions and the entrenched corruption can be illustrated in several ways.

First, free markets need independent courts to enforce rules and regulations, and to uphold contracts and payments. The 15<sup>th</sup> Congress of the Chinese Communist Party in 1997 explicitly embraced the ‘rule of law’ as a core tenet. Two years later in 1999, the Supreme People’s Court (SPC) issued the first five-year plan encompassing 50 objectives for reforming China’s courts. The five-year plan was reissued in 2004 by the SPC.

Many of the reform initiatives consisted of plans to improve the training and competence of judges and the installation of more consistent judicial processes. But critically, the formal authority of courts at every level has been largely left untouched, and courts continue to be subject to Party oversight. Moreover, local Party officials continue to oversee judicial appointments, and court presidents continue to be chosen for primarily political reasons. Not surprisingly, the overwhelming majority of judges tend to be Party members. As one expert observer of the Chinese judicial system notes, within the Party hierarchy, the President of the Supreme Court continues to rank well below the minister of Public Security. This pattern is replicated from the top down to local levels.<sup>89</sup> Indeed, the court’s obsequiousness to the Party was explicitly reaffirmed in 2006 with the launching of an official campaign to define the ‘socialist rule of law theory.’ One of the five core elements of the campaign was that courts must ‘follow the leadership of the Party.’ There was to be an emphasis on the legal system’s ‘political colour’ and loyalty to the Party, the nation, the people, and the law (listed in that order).<sup>90</sup> If there were any further doubts that the ‘socialist rule of law’ was somewhat similar to Western conceptions of ‘rule of law,’ these were put to rest by Cao Jianming, vice-president of the SPC, in urging the rejection of the ‘negative influence of Western rule of law theory,’ which advocates judicial independence from the government.<sup>91</sup> In 2008, even more power was given to the Party-controlled Central Political and Legal Affairs Commission, which answers directly to the Politburo Standing Committee and has broad power over the police, prosecutor’s offices, and the courts.<sup>92</sup>

The issue of property rights—essential to the proper functioning of any capitalist system—also highlights the tension within China's authoritarian model in moving towards a genuine 'rule of law' system. The poor state of property law and its enforcement in China is backed by the most recent *Property Right Index* report released by the Heritage Foundation, which gave China a dismal score of 20 (out of 100.) While East Asian neighbours such as South Korea, Taiwan and Japan received a rating of 70, China's score is comparable to countries such as Bangladesh, Cambodia and Uzbekistan.<sup>93</sup>

Enforceable property rights are intrinsic to any private-enterprise free market system. But in China, granting and *enforcing* widespread property rights would strip away the power of local Party officials who essentially thrive through the extraction of collective rents and poorly compensated seizures. As You-tien Hsing observes in an examination of how land use rights are actually dispensed, 'Land serves as the main vehicle for the local state to consolidate its territorial authority in the era of fiscal and administrative decentralization.'<sup>94</sup> This is a particularly serious problem in rural China. Yu Jianrong, a leading expert on Chinese rural issues at the Chinese Academy of Social Sciences, explains that 'the state often uses a very low price to collect the land from farmers and then sell it to developers at a much higher market price, and farmers are [left out] of the negotiation process.'<sup>95</sup> An official study actually estimates that from 1990–02, almost 70 million farmers had their land seized illegally or in return for inadequate compensation.<sup>96</sup>

Constitutional laws passed in 2004 that deem property rights as 'inviolable' and reflected in the much heralded property law passed in March 2007 left alone the difficult question of rural land rights. In commenting on these laws, *The Economist* observes:

This latest law will not bring the full property-rights revolution China's development demands. Indeed, it will not meet the most crying need: to give peasants marketable ownership rights to the land they farm. If they could sell their land, tens of millions of underemployed farmers might find productive work. Those who stay on the farm could acquire bigger land holdings and use them more

efficiently. Nor will the new law let peasants use their land as security on which they could borrow and invest to boost productivity. Nor, even now, will they be free from the threat of expropriation, another disincentive to investment. Much good land has already been grabbed, and the new law will merely protect the grabbers' gains.<sup>97</sup>

In October 2008, the leadership announced rural land reforms that would allow rural residents to 'subcontract, lease, exchange or swap their land-use rights.' Even though the state still ultimately owns the land, farmers will be given control over how it is used—allowing for the prospect of land becoming a genuine asset. For example, land leases could be consolidated offering the possibility of creating larger and more efficient farms.

But the farmers still cannot mortgage their land, raising serious doubts as to whether land will become a genuine private property 'asset.' Moreover, 'collective ownership' remains unchanged. How this sits with these so-called emerging 'land rights' for Chinese farmers remain ambiguous in theory as well as in practice. In reality, the widespread custom of local officials illegally seizing or appropriating land in deals with developers will remain. In principle, any land reform—both rural and urban—has left untouched the prospect of a genuine property rights revolution. In practice, institutions that would cause the officialdom—the primary dispensers and regulators of land use—to become accountable in a rule of law system is unlikely in the one-Party setup.

Even in the case of non-agricultural or non-land assets such as a 'private enterprise,' it remains unclear who really owns what: whether it is really owned by the individual, local government, or party unit. However symbolic the property law might appear, it does not alter the primacy of state ownership. In fact, debates frequently arise as to which level of government is the primary beneficiary of particular instances of property rights, rather than whether the individual has rights against the state.

Even in urban areas, all land still belongs to the state and urbanites can buy or sell properties only under long-term leases (50 to 70 years). Moreover, any legislation, even if it were comprehensive and well crafted, cannot be relied upon while

judicial officers are appointed and sustained by Party officials. As *The Economist* further explains:

Should an underdog try to use the new law to enforce his rights, the corrupt and pliant judiciary would usually ensure he was wasting his time. Since the Cultural Revolution, when the NPC passed just one law between 1967 and 1976, the legislature has been legislating quite prolifically. But the passage of laws is not the rule of law.<sup>98</sup>

Second, the natural consequences of economic activity must be allowed to play out. Instead, political interference in economic processes is widespread. For example, in October 2001, the People's Supreme Court (China's highest judicial tribunal) ordered provincial courts to halt bankruptcy proceedings involving state enterprises. The central government had no problem with this being a legitimate decision within a 'free market with Chinese characteristics.' However, as economist Simon Pritchard commented, 'Capitalism without bankruptcy is like Christianity without Hell.'<sup>99</sup> The process of 'creative destruction' must be allowed to take place in any healthy system. More generally, 'rule of law' necessary for private economic activity cannot exist adequately in China while the Party effectively remains the final arbiter in the legal system.

Third, the successful logic of free markets also insists that capital must follow the tail of profit. The responsibility of allocating the majority of the country's investment resources cannot fall in the hands of a clique of Party members and their cohorts because no small grouping can ever have adequate knowledge of where resources are needed and how they can be most efficiently and profitably deployed in such a vast country. Neither can so much of the country's resources be allocated for political rather than economic purposes without mounting costs. Indeed, the corruption of a system allowing the political control and use of so much of China's resources is really the concise summary of reasons for problems with the banks, SOEs, the allocation of capital, and the lack of transparency of organisations. These economic 'fault lines' will be examined shortly.

More generally, as mentioned above, ‘anti-corruption drives’ are mainly focused on catching out ‘corrupt’ individuals. While the attention is firmly on the prosecution of high profile individuals for graft, there is certainly something disingenuous about campaigns to eliminate China’s ‘rampant’ corruption (in the words of President Hu Jintao) when relationships inimical to the effective operation of free markets between political and economic arms are relied upon by the one-Party regime to maintain its system of patronage and reward, which is essential to remaining in power. For example, ‘free-market’ activities such as ‘privatisation’ simply afford greater opportunities for politically connected insiders to benefit. An estimated 30% of owners of privatised SOEs are Party members. In a recent study by the regime’s own researchers at the State Council, the Academy of Social Sciences, and the Communist Party’s Central University, of 3,220 Chinese citizens with a personal wealth of 100 million yuan (US\$13 million) or more, 2,932 are children of high-level cadres. Of the senior positions in the five industrial sectors—finance, foreign trade, land development, large-scale engineering, and securities—85–90% are held by children of high-level Party officials.<sup>100</sup>

The reluctance to further open up SOEs, especially those operating in the most important sectors, to genuine competition and international standards of transparency is not politically viable. The Chinese authoritarian political-economy model relies on forms of entrenched corruption rampant in its economic system, is functionalised by proclaiming it official policy, and is needed to maintain its authority through the use of massive state resources to fulfil political objectives. The economic costs of this entrenched corruption, therefore, are much larger than various estimates that treat ‘corruption’ as a discrete problem and focus only on individual acts of greed, illegal quotas, levies between provinces, and so on. Moreover, because political, and much of economic life, begins and ends with the Party, the protection of rights is ultimately derived from political power or political connections. This entrenches corrupt activity with the Party at its core.

## The banking crisis

Let's begin with the chronic 'banking crisis'—there is really no other term for it. It is what leading Chinese economic expert Nicholas Lardy calls China's great 'Achilles heel.'<sup>101</sup> The financial assets of banks constitute about 75% of China's financial assets. Proportionately, this is approximately double the ratio (of financial assets of banks as a proportion of overall financial assets) in Asian economies such as India, Japan, Philippines, South Korea, and Singapore, and three times the ratio in the United States. Corporate bonds constitute less than 10% of overall financial assets, and equity markets constitute around 15%.<sup>102</sup> In 2005, total outstanding bank loans as a proportion of GDP was 200%.<sup>103</sup> Since then, bank loans have been rising at around 20% while GDP growth has been half that.

The banking sector is dominated by China's Big Four state-owned (SOEs by definition) and state-controlled banks, which control around 70% of total bank assets. Other 'policy banks' under direct control of the State Council control about 10% of assets, while other urban and rural cooperatives control about 18% of assets. Private domestic and foreign banks therefore constitute a tiny minority (about 2%) of the Chinese banking sector.<sup>104</sup> Ninety percent of household savings are deposited into state-owned and controlled banks.<sup>105</sup> China's banks, with loans at 130% of deposits in 2005,<sup>106</sup> provide about 80% of funding for all Chinese business investment activity and comprise around 70% of the country's total financial assets. In comparison, foreign direct investment (FDI) makes up around 18% and the stock market around 7%.<sup>107</sup> What happens to these state-controlled banking entities therefore overwhelmingly determines the financial health of the country.

### (a) Chinese banks and non-performing loans

A 2004 report in *The Economist* declared:

If money circulates around a sound economy the way blood circulates around a healthy body, then outwardly robust China has a black hole for a heart. It is in the financial system that the contradictions in Deng's 'socialist

market economy' are most apparent, with a banking sector that has built up a mountain of NPLs by lavishing cash on value-destroying state firms while starving deserving private borrowers ...<sup>108</sup>

China's main banks have been technically insolvent for more than a decade although they enjoy high levels of liquidity because of the high savings ratio of the population. The overriding problem is 'bad loans,' and in particular 'non-performing loans' (NPLs), combined with dwindling profits and accumulating losses.

Official Chinese figures consistently and significantly differ from those offered by reputable international commercial and research organisations. The former carefully conceal the methodology and data used to derive their figures. Chinese banks, according to Ernst & Young, suffer from 'a banking culture that resists openness and accountability.'<sup>109</sup> The latter openly cite the methodology and data they use. Chinese authorities are evidently feeling the pressure to downplay their problems.

As recently as 2006, international accounting firm Ernst & Young estimated NPLs of the Big Four banks to be US\$358 billion and total NPLs in the financial system at US\$911 billion.<sup>110</sup> This equals 40% of GDP. As a comparison, at the end of 2005, India's NPLs amounted to about 5% of GDP; Indonesia's was under 5%; and Japan's was under 3%. The report incensed the regime, which demanded that Ernst & Young 'apologise' to China and immediately withdraw it.<sup>111</sup> The official Chinese NPL figure for the Big Four banks was only about US\$150 billion. The Ernst & Young figure was comparable to figures produced by Fitch Ratings<sup>112</sup> and Standard & Poor,<sup>113</sup> which were around the US\$320 billion–\$330 billion range.

These discrepancies between Chinese and international estimates are not new. According to official Chinese estimates, NPLs amounted to about 9% of GDP<sup>114</sup> between 1997 and 1999, which was considerable but not disastrous. For example, Japan in the mid-1990s had similar NPL figures. However, even then, estimates by independent and commercial experts had put the figure at somewhere between 40–70% of GDP, with Standard & Poor, the most pessimistic of them, citing the 60–70% figure.<sup>115</sup> A 2004 report by Deutsche Bank put the independent consensus



estimate at about 40%, and diplomatically mentioned that the differences could be down to the 'subjectivity of the evaluators.'<sup>116</sup> In 2005, the China Banking Regulatory Commission eventually admitted to be concerned about both high NPL ratios and systematic underreporting of NPLs by banks.<sup>117</sup>

Furthermore, before 2002, the standard used to judge a 'bad' or 'non-performing' loan was much more lenient in the Chinese system compared to international standards. For example, Chinese banks frequently just 'roll over' what Western institutions would consider NPLs so that they do not appear on the balance sheets as NPLs. Even if we accepted the official Chinese figure, a report by *The Economist* estimated that if the international Western standard of NPLs were to be used, the NPL figures in China would be at least twice as high immediately.<sup>118</sup> Even after the international classification standard was adopted, official NPL figures remain the same instead of doubling as experts had expected.

The estimates only reveal a small part about the extent of the NPL problem and various attempts at a cover-up. NPLs negatively affect the liquidity and net asset ratios of banks. To meet prudent financial standards and improve the overall appearance of financial health, Chinese authorities have used two techniques to improve these liquidity ratios, both of which are shallow, tactical initiatives that only temporarily plaster over cracks.

The first tactic has been to simply use the country's substantial reserves to periodically issue massive bailouts by injecting money into the banks to grant them immediate relief. For example, in 2003, US\$45 billion was injected into two of the Big Four state-owned banks alone. In 2005, the government injected about US\$15 billion into one of the Big Four to push its capital adequacy ratio to an acceptable 8%. Between 1998 and 2005, the state injected more than US\$250 billion of capital to bail out its banks.<sup>119</sup>

The second tactic has been to transfer NPLs to the recently created 'Asset Management Companies' (AMCs), hence removing these NPLs from the banks' balance sheets. In 1999, the People's Bank of China announced that it had unloaded about US\$170 billion of NPLs to four AMCs as part of a grand recapitalisation plan. At the end of 2005,

Ernst & Young estimated that US\$330 billion of NPLs had been transferred from the Big Four banks to AMCs.<sup>120</sup> The theory was that AMCs would specialise in the recovery of debt, ensuring that the proportion of NPLs recovered would be significantly higher than if the NPLs had remained with the banks.<sup>121</sup> In return, the AMC issued promissory notes and bonds to the banks for 50% to as much as 100% of book value. Using this strategy, Chinese officials widely reported that they expected to recover at least 40–50% of the NPLs.

Ernst & Young conservatively estimates the average cash recovery rate to be about 25%. The most generous recovery rates for NPLs were estimated to be about 30% by Fitch Ratings, meaning a loss of 70%—significantly worse than the 40–50% recovery rate officials reported as the minimum. A Deutsche Bank report revealed that in 2003, the AMCs were burdened with about 19% of the state banks' NPLs and had liquidated about a quarter of these NPLs. The cash recovery rate was only about 20%.<sup>122</sup> Since promissory notes and bonds issued to banks are usually between 50–100% of the NPL book value, this strategy has simply created another class of financial organisations that have taken on the problems of the banks and will themselves be laden with junk assets.

The use of bailouts, especially using AMCs, to absorb NPLs has been substantial. McKinsey & Co analysis indicated that from 2001–05, the 60% of the reduction in NPL ratios was simply the result of transferring NPLs to asset management companies.<sup>123</sup> The 2006 Ernst & Young report believed that in addition to the US\$170 billion transferred to AMCs in 1999, from 2000–05, the banks transferred an additional US\$160 billion to AMCs and wrote off US\$157 billion of NPLs against current earnings. Of the US\$330 billion transferred to AMCs up to the end of 2005, AMCs have disposed of only about US\$100 billion—which means that US\$230 billion remain on their books. Additionally, there is about US\$323 billion worth of NPLs elsewhere in the financial system, for example in the so-called 'fifth AMC,' Huida Asset Management Company, established in 2005, as well as in other state-owned investment companies and rural credit-cooperatives.

Although official Chinese figures put the NPLs of the Big Four banks, after these transfers and write-offs, the figure of US\$133 billion at the end of 2005 is significantly at odds with independent research by international banks and accounting firms. According to a research report by UBS quoted in the Ernst & Young report, aggressive lending from 2002–04 has resulted in a new wave of unreported NPLs that could be as high as US\$225 billion. Ernst & Young estimates that over the past 15 years, the Big Four banks alone have created about US\$845 billion in bad loans (which includes this UBS estimate of US\$225 billion from 2002–04). Even after all the NPL transfers and write-offs, the Big Four banks have about US\$358 billion of NPLs on their books, which is more than double the official estimates.

The Ernst & Young bottom line, which it describes as 'conservative,' is that there is US\$358 billion worth of NPLs in the Big Four banks, US\$230 billion in AMCs, and US\$323 billion elsewhere in the Chinese financial system. This adds up to an outstanding NPL figure of US\$911 billion at the end of 2005. Bear in mind that in 2002, the corresponding Ernst & Young report had placed the entire NPL figure at US\$480 billion.

**Table 4:** NPLs in the Chinese financial system

	<b>NPLs in 2002</b>	<b>NPLs in 2005</b>
Big Four banks		US\$358 billion
AMCs		US\$230 billion
Other financial institutions		US\$323 billion
<b>Total outstanding NPLs</b>	<b>US\$480 billion</b>	<b>US\$911 billion</b>

To put in context what these numbers mean for the various banks, Fitch Ratings analysed individual bank figures, which excluded the liabilities of AMCs. Taking the estimates for 17 of China's largest commercial and policy banks, they found that estimated losses swamped reserves and made a considerable dent in capital. The entire capital of five of these 17 major banks would be wiped out.<sup>124</sup>

Furthermore, the reporting of massive bank profits by Chinese state-owned and state-controlled banks should not be interpreted

as evidence that loan quality has significantly improved, as some analysts have assumed. For example, the China Banking Regulatory Commission recently reported that profits for the Chinese banking industry were up 30.6% from 2007, representing an after-tax profit of US\$85 billion in 2008. It further reported that NPL ratios were down 3.71% compared to the beginning of 2008.<sup>125</sup>

These figures, even if accurate, are misleading if taken at face value. Since 1995, bank profits have largely been the result of the massive growth in bank loans combined with an increasing spread between the loan rate and the deposit rate. Rates on return from deposits as well as lending rates are determined by the People's Bank of China. In 1995, there was no spread (difference between the lending rate and the return on deposits). In 1996, the spread was less than 0.5%. In 1998, it increased to 2.2%, and from late 1999 onwards it was approximately 3.5%.<sup>126</sup> Given that loans have been increasing at a rate of between 20–50% each year since 2000, bank profits are largely the result of the gains from increasing spread rather than better and more prudent loan policies. In fact, net interest income accounts for 80–90% of overall bank profits.<sup>127</sup>

Moreover, the decreasing ratio of NPLs is only temporary. The improving ratio is overwhelmingly the result of either further write-offs, transferring them to asset management companies, or the issuing of a rash of new loans that have yet to be classified as non-performing. For example, after the huge bailouts and NPL transfers in 2005, the percentage of NPLs on the books almost immediately fell from nearly 18% to 7% according to official figures. Even assuming that these official figures are accurate, it was the issuing of hundreds of billions of dollars of new loans that caused official NPL ratios to fall further since then (because fresh loans are immediately classified as assets and take time to become 'non-performing'). Bear in mind that the true extent of the NPL problem will not be revealed for some time because 70% of recent loans extended were medium- and long-term loans.<sup>128</sup> The most recent large-scale write-off was performed by the Agricultural Bank of China (ABC), where approximately US\$100 billion of bad loans were written off in November 2008.<sup>129</sup> In addition, US\$20 billion of state funds in cash was injected into

the bank. The sum written-off—US\$100 billion—amounted to around one-fourth of the bank's entire loan portfolio. The NPL ratio of ABC immediately improved to a respectable 4%, not far from the internationally accepted 'safe' standard of 1–3%. But this is little more than temporary relief at enormous cost. There has been insufficient genuine and comprehensive reform of the banking system for us to believe that loan quality has dramatically improved. It is more likely that a massive spate of NPLs is yet to be revealed.

### (b) Why bailouts don't work

Back in 1997, it was estimated that the bad loan ratio was rising at about 2% each year.<sup>130</sup> The increase in NPLs would be considerable since total loans by state-owned banks doubled from 1995–2000, and doubled again from 2001–04. At the end of 1999, official figures indicated that 25% of all loans by state commercial banks were 'overdue.' Following a massive bailout in 2000 when US\$36 billion was injected directly into the banks and US\$190 billion was transferred to AMC's, the People's Bank of China was forced to admit that the percentage of NPLs in 2001 even after this bailout was about 26%. In other words, as one notable China sceptic, Gordon Chang, observes, 'the biggest bank recapitalization in China's history had no apparent effect on the health of its banks.'<sup>131</sup> Something is clearly askew with official Chinese figures. The various rescue tactics are also evidently not working.

That these tactical bailouts were unsuccessful—in that NPLs began to pile up again shortly after each instance—is not surprising. Bailouts in the form of capital injections merely restore the balance sheet to a healthier state. However, if the proportion of NPLs (to performing loans) continues to increase, and the amount of monies loaned continues to increase, it is merely like a parent paying back a child's credit card debt while the child continues to spend more than he or she earns. The credit card company might be happy for a month when the minimum repayment is back on track but future grief is certain. Therefore, statements by many observers after each of these bailouts that China's banks were 'back on track' miss the point.

Moreover, transferring the NPLs to AMC's might temporarily improve the balance sheets of the banks, but is not a long-term solution. The justification for transferring NPLs to AMC's was that AMC's would be in a better position to produce a better financial recovery rate from the NPLs.<sup>132</sup> Even so, as ratings agency Moody's stated at the time, disposing of NPLs will mean substantial book losses, and 'the most important challenge for state banks in the next few years will be to increase quality earnings sufficiently to cover potential losses from NPL reduction.'<sup>133</sup> Given the disparity between the promissory notes and bonds issued by AMC's to banks to take charge of these NPLs on the one hand, and the actual cash recovery rates, which are significantly lower than the value of the promissory notes and bonds offered to the banks on the other, the deal is a bad one for the AMC's. More generally, all that occurs is the creation of new entities (AMC's) burdened with NPLs. Loans ultimately have to be either repaid or written off. Whether a bank or an AMC does this is hardly the point—after all, the health of the financial system will not be improved because of these circumventive measures.

### (c) NPLs are growing

State-owned banks continue to *increase* loan monies even though the ratio of loans that become NPLs is actually rising. Loans increased about 40% year on year from 2001 to 2004 according to the Institute for International Economics (IIE) figures. Loan levels slowed from 2005–07 but were ramped up again when growth began to slow. In 2008, loan levels increased by around 26%. In January and February of this year, loan levels are already rising by 26.5%.<sup>134</sup> The 1.6 trillion yuan (US\$235 billion) worth of loans extended in January 2009 was a record.<sup>135</sup> A recent report by consultants McKinsey & Co estimates that Chinese banks can only prudently increase lending by 5–7% per annum.<sup>136</sup> Anything above that will worsen the NPL problem. But at these levels, GDP growth would be unacceptably low and unemployment unacceptably high for the government.

Recent CEIC data as well as other research show that China's bank loans have increased proportionately with increases in deposit growth.<sup>137</sup> Bank deposits constitute almost 200%

of GDP, the highest of any significant economy in the world. Bank loans account for around three-fourths of all financial assets in the country.<sup>138</sup> In other words, Chinese economic activity is based on the hard-earned savings of its 1.3 billion people. More than US\$5 trillion have been loaned by local banks, amounting to around 155% of GDP, rising from 145% of GDP in 2005.<sup>139</sup> Interestingly, prior to reforms in 1977, the percentage of loans as a ratio of GDP was a mere 40%.<sup>140</sup> The IIE estimated in 2005 that there was more than \$US535 billion (about 27% of GDP) in NPLs. Deutsche Bank estimates that it could be as high as US\$830 billion.<sup>141</sup> Bear in mind that these figures do not include the NPLs that had recently been written off (following the bailouts) or transferred to AMCs. Following the lending spree from 2004 onwards, some believe that the NPL figure might be closer to US\$1 trillion.<sup>142</sup>

In a normal market economy, you would limit this practice and introduce severe standards for loan approvals. In the unique Chinese 'market socialism,' banks are forced to continue to issue loans according to non-market principles. The Party had, from the very beginning of the reform period, decided to retain authority over the financial sector. State banks have the primary function of supporting government policies, and the secondary function of acting as financial intermediaries in a market economy. The *1994 Commercial Bank Law* states that after a transition period of 'unspecified duration,' all banks were to operate as independent entities. Meanwhile, they must lend according to economic, social and political needs as specified by the State Council. This includes most notably financial support of insolvent or struggling SOEs (despite these SOEs operating in generally highly protected sectors). Indeed, about 75% of NPLs are loans to state-controlled enterprises. The free flow of 'policy lending' has led to the observation that China is the only country in history to have simultaneously achieved record economic growth and record numbers of non-performing bank loans.<sup>143</sup>

### **Mass capital misallocation**

Although some optimists readily acknowledge the extent of the problems within the Chinese banking system, experts such as

Fan Gang from the National Economic Research Institute in Beijing argue that financial risks are manageable given the high growth rates of the economy. China's economic growth will not only secure the continued legitimacy of the Party but also, as Fan argues, be the panacea for its debt burdened banks.<sup>144</sup>

This reasoning depends on faulty logic. It completely bypasses why—in the desperate pursuit of growth—so many loans fail to perform in the first place. Instead, it carelessly assumes that high growth rates necessarily indicate a healthy economy, and that China can outgrow all its political and economic problems. The reality is that massive amounts of capital are being wasted on firms that have little incentive to use this capital efficiently or responsibly.

According to a 2003 IMF study, 75% of China's growth comes from capital accumulation.<sup>145</sup> It is now at around 50%. In other words, growth is largely the result of pouring money into investment projects. Fixed asset investment increased by more than 25% in 2005. In the first half of 2006, it jumped a further 30%. Investment bank Morgan Stanley estimated that fixed asset investment probably exceeded US\$1.3 trillion in 2006.<sup>146</sup> By 2008, total fixed asset investment rose 25.5% to US\$2.52 trillion.<sup>147</sup> The state (through state-owned and state-controlled banks) directed most of this, and currently owns more than 60% of fixed capital stock. This would be an acceptable strategy provided that capital is used efficiently and productively. Unfortunately, this is not the case.

The evidence for the limits of this approach is strong. World Bank findings indicated that about one-third of recent investments made were wasted.<sup>148</sup> In the 1980s and 1990s, it took \$2–\$3 of new investment to produce \$1 of additional growth. Studies from the last several years show that it now takes more than \$4 to produce \$1 of additional growth. Recent Morgan Stanley and McKinsey & Co reports suggested that it was more like \$5 invested for \$1 of additional growth, with the ratio now probably 6:1.<sup>149</sup> Using this measurement of 'incremental capital output ratio,' China's use of capital is 50% more inefficient than capital use in India, and almost 200% more inefficient as capital use in Japan and South Korea.<sup>150</sup> In other words, Chinese investment is getting less and



less bang for its buck. Why is it taking more and more money to achieve the same level of growth?

China is suffering the effects of massive and chronic 'overinvestment,' over-capacity, and declining productivity. *The Economist* estimated that while nine out of 10 manufactured goods were in oversupply in 2004, investment in fixed assets grew by 30% over the same period and contributed to 47% of GDP.<sup>151</sup> In 2006, the National Development and Reform Commission, in its report to the National People's Congress, warned that 'adverse effects of surplus production capacity in some industries have begun to emerge. Prices for the products of these industries dropped and inventories grew, corporate profits shrank, and losses mounted, and potential financial risk has increased.'<sup>152</sup> In other words, increasingly large amounts of money are being poured into the production of goods that are not consumed or needed by the economy. This is reflected in the average levels of slow-moving inventory in Chinese firms that are estimated to take around 350–360 days to sell.<sup>153</sup> These levels of slow moving or unsalable inventory are possibly the highest in the world. This is a symptom of overinvestment and produces growth figures that are bulked up by 'assets' that will never be consumed.

Where is the capital going? General estimates are that China's SOEs (and state-controlled entities) consume over 70% of capital but produce less than 30% of output.<sup>154</sup> This is despite the fact that the number of SOEs has been more than halved from two decades ago (although the number of state-controlled entities has risen). Government officials frequently pressure banks to support local expansion programs and politically expedient ventures with little regard to the venture's competitive advantage or economies of scale. As one report suggests, the relationship between banks and especially local officials (who are effectively the masters of the local branch of the bank) would be unacceptable in most market systems:

Local officials have enormous leverage over the banks, because they administratively supervise the local branches of the state banks, they negotiate with the central bank over the amount of loan quota the local banks can lend, they decide how much of the existing loans to the local

SOEs are to be repaid, and they are in a position to assist the banks in such matters as hiring, housing, and education of bank employees' children.<sup>155</sup>

The upshot is that capital allocation (in the form of credit) has frequently little to do with rational economic decision-making. Banks are effectively fulfilling the fiscal priorities of government (especially at the local level) through their 'policy lending' function.

In this situation, we should not be surprised that capital is not put to good use. Where once subsidies and grants from the central government's budget kept SOEs going during the Mao era, banks now effectively fulfil this fiscal function and are forced to lend heavily to SOEs to meet the Party's political and social stabilisation goals.<sup>156</sup> A conservatively estimated 40% of bank loans to SOEs are extended on a 'policy' rather than 'commercial' basis, while most loans to SOEs are afforded artificially low interest rates.<sup>157</sup> An estimated two-thirds of NPLs were given on a 'policy' basis. To argue that China can solve its NPL problem by growing rapidly is indeed faulty logic.

The inefficiency of these SOEs (and other collective enterprises) is predominantly behind the waste and the explosion in NPLs. For example, SOEs and state-controlled industrial entities produce one-third of the profits that other (i.e. private) industrial enterprises produce, yet receive almost three times as much capital.<sup>158</sup> Peering into the murky workings of the state-controlled sector presents a picture of enormous decay that places China's 'spectacular growth' in a darker light.

### **China's SOEs: When productivity and profits don't matter**

Recent official figures by the World Bank using official Chinese statistics report that the return on equity by SOEs have increased from 2% in 1998 to a respectable 12.7% in 2005.<sup>159</sup> However, these are certainly inflated. The massive government 'subsidies' are included in this profit figure; 'investment income' (dividend distributions) are counted twice in the profit sheets; while gross profit margins have been declining steadily since 2005, mainly because of over-capacity.

In reality, the profitability of SOEs has been in dramatic decline since 1978. For instance, their profits per unit of gross output dropped from 15.5% in 1978 to 1.6% in 1997, while profit per unit of capital dropped from 22.9% in 1978 to 0.8% in 1997.<sup>160</sup> Another study indicates that in terms of return on assets, SOEs in 2001 were five times less profitable than they were in 1978.<sup>161</sup> Predictably, many SOEs actually incur losses and the trend is worsening: 19% lost money in 1978; 40% in 1997; and 51% in 2006.<sup>162</sup> This is despite the closure or merger of about 180,000 of the roughly 300,000 SOEs since 1978, including many of the poorer performing ones. Whereas their losses totalled US\$4.2 billion in 1978, it was reportedly US\$74.4 billion in 1997, which meant total losses actually exceeded total earnings.<sup>163</sup> (Given the enormous amounts of capital injected into state banks to cover for NPLs that were loaned largely to SOEs, the US\$74.4 billion figure seems low.) A recent report released by the IMF, and authored by World Bank China Director David Dollar and IMF Assistant Director Shang-Jin Wei, was based on a survey of 12,400 firms in 120 cities in China for 2002–04. The study found that despite a quarter century of reforms, capital use by state-owned firms produced returns that were 11–54% lower than returns from capital use by domestic private and foreign owned firms.<sup>164</sup> A recent report by consultants McKinsey & Co suggested that the average Total Factor Productivity of large state-owned and state-controlled industrial firms was half that of privately owned firms.<sup>165</sup> Bear in mind that the 152 centrally managed SOEs (as well as the thousands that are subsidiaries of these large centrally managed firms) are the most efficient of the state-owned and state-controlled entities. Even then, 80% of profits of all centrally managed SOEs come from fewer than a dozen firms such as China Mobile, Sinopec, and China National Petroleum Corporation—all operating in literally monopolistic environments.<sup>166</sup> In other words, the vast majority of even the centrally managed SOEs, despite easy credit and protected environments, are poor performers. Most of the approximately 120,000 provincial state-owned or state-controlled enterprises and collectives perform even worse.

**(a) Why are state-controlled enterprises performing poorly?**

Easy credit at low interest rates (set by the government) is one reason. There is little incentive to use capital efficiently since there is little pressure to justify the borrowings on commercial grounds, to pay it back on time, or to pay it back at all. The Party simply cannot allow too many SOEs to fail. A ready supply of capital is therefore used to offer subsidies or grants, or to ramp up production irrespective of whether the commodity is in demand or can command sufficiently high prices to achieve a profit.

A second reason is weak or ineffective management. SOEs are at the centre of the Party's extensive patronage system that helps entrench the Party in power. According to extensive research done by Minxin Pei, senior associate with the Carnegie Endowment for World Peace, the Party appoints four out of every five SOE managers and chief executives, and 56% of all enterprise managers. Even in the 'restructured' large- and medium-sized SOEs that were transformed into shareholding companies, the board chairman was a Party Secretary in 50% of cases.<sup>167</sup> In the more than 6,200 large- and medium-sized SOEs classified as 'restructured' in 2001, Party committee members of the pre-restructured firms became the board of directors in 70% of the restructured firms. Finally, about 8% of the Party's 70 million card carrying members, and almost 16% of urban members of the Party, held executive positions in SOEs in 2003.<sup>168</sup> From these figures, it is clear that any reform or restructuring does not mean greater independence from the Party. Indeed, positions in 'restructured' SOEs are offered as reward for Party loyalty. In this light, SOEs backed by 'iron rice bowl' cultures and politically motivated boards and management are more concerned about patronage and keeping employees on the books than productivity and profit. The continued prevalence of 'policy borrowing' and 'political spending' of capital should be expected.

Third, because SOEs are not run like normal commercial entities in a transparent manner, many managers do not actually know, or if they do frequently lie about, how the organisation is performing. For example, in 2003 the State-Owned Assets Supervision and Administration Commission (SASAC) was established to oversee SOE management. Newly appointed

Chairman Li Rongrong announced encouraging profits for China's top 500 SOEs, reporting revenues of US\$526 billion in 2003 (up 25% from the previous year), and profits of US\$43 billion (up 33% from the previous year). According to Li, only 87 of the top 500 SOEs were making losses.<sup>169</sup> A year earlier, as Minister in charge of the State Economic and Trade Commission, Li announced to the Party's 16<sup>th</sup> National Congress that since 1989, SOE profits had soared from US\$9.5 billion to US\$31 billion from 1989 to 2002.<sup>170</sup>

If that were the case, there is no plausible explanation for why so many loans to these same SOEs were effectively written off or passed off as NPLs, and why there was any need to transfer 1.4 trillion yuan worth of bad loans to AMC's in 1999. The point is that the official Chinese version of performance during this period is at odds with most credible and independent studies backed by empirical and numerical detective work. For example, even China optimists such as Stephen Green from Chatham House acknowledge that the top 500 firms did badly in 2001, and year-by-year profits fell 37% in the first six months of 2002.<sup>171</sup> A study by Gary Jefferson et al. suggested the productivity of unstructured SOEs declined 2.9% a year from 1993 to 1996 while productivity for 'restructured' SOEs (that became shareholding firms) performed even worse—declining nearly 8% a year during the same period.<sup>172</sup> The guesswork or dishonesty of reporting officials from economic ministries and bodies indicate a dangerous culture of reporting unreality, and reported figures are very often designed to appease or flatter rather than as the precursor to rational planning.

Fourth, the fragmenting market is a serious problem. Most blame the decentralisation initiatives of Deng's reforms, which encouraged two developments. Local protectionism (e.g. administrative barriers to trade and investment under the stewardship of local Party leaders protecting their turf) flourished. Moreover, a form of 'fiscal feudalism' took root where local authorities were allowed to directly pocket taxes from the earnings of local SOEs. In 1979, local governments were responsible for 48.9% of public expenditure while the central government oversaw the other 51.1%. By 1993, the central government controlled 22% of spending while local governments assumed

78% of the fiscal role.<sup>173</sup> Beijing then decided to recentralise, ostensibly with some success. By 2004, local government's share of government revenues was pegged back to 45%.<sup>174</sup> But local governments were still responsible for around three-fourths of all government spending, pushing them to seek extra-legal sources of funding (such as illegal taxes and other unauthorised levies). Moreover, centralised spending was still largely administered by local officials. Formal and de facto decentralisation, therefore, encouraged and entrenched the establishment of de facto economic kingdoms. These are supported by local courts that are placed under pressure by local Party leaders to administer the law in a way that favours local firms (or ignores enforcing judgments made against local firms by other jurisdictions). One of the most high profile instances of this was an investigation into local authorities from the Heilongjiang province who issued specific instructions to the courts not to enforce unfavourable judgments against 67 firms that appeared to be losing their cases.<sup>175</sup>

The point about fragmentation is that its contribution to overinvestment and economic waste is significant. The result is general duplication of production and capital use, increased local protectionism and inefficient local trade wars, and the distortion of product and factor (i.e. 'factors' used in production such as labour and capital) markets. Rationalisation of production and economies of scale are simply less feasible.

From the outside, fragmentation might seem to produce positive outcomes because raw output is increased.<sup>176</sup> Since the emphasis has been on growth, and more particularly on increasing output, the incentive to 'produce' is high. SOEs would rather produce inefficiently or continue to utilise only a part of their capacity than condemn themselves to closure.<sup>177</sup> Whether individual SOEs survive or are closed down has been assessed not so much on productivity or profit but on output. Given that SOEs were the backbone of the 'iron rice bowl' for workers, there is a strong social and political incentive for local authorities to ensure that local SOEs survive and provide continued employment. They are, therefore, encouraged to do whatever needs to be done. Unfortunately, this results in the rise of local forms of protectionism, many of which are illegal.

Since the emphasis is on maximising local output, the distortion of both product and factor markets is undeniable. In product markets, to help absorb local production, local authorities erect barriers, such as quotas, regulatory hurdles, and fees, to the entry of non-local products. This 'autarchic' mindset is also much of the reason for excessive product diversification. In factor markets (i.e. where factors of production such as capital and labour are bought and sold), local authorities frequently force local firms to favour hiring local residents, while obstacles are erected for 'foreign' workers in the form of fees and permits. In capital markets, local authorities frequently interfere with the outflow of capital and restrict the investment and acquisition of local SOEs by non-local ones. Minxin Pei cites two examples of this. The first is the regulations in 18 provinces that ban the sale of alcohol produced in other provinces. The second is the use of fees to protect local manufacturers whereby those purchasing cars made in other provinces have to pay additional costs for registration and inspection. In 1998, the total of these protective levies was 160 billion yuan (while the whole automobile industry only made 4 billion yuan in profits in that whole year).<sup>178</sup>

### The difficulty of fixing contradictions

Basically all the tasks (needed to sustained economic growth) have been completed over the past four years. So I think this government has made good on its promises.<sup>179</sup>

—*Former Premier Zhu Rongji*

Optimism about the prospects of China's political-economy model is fuelled by the fact that the solutions are actually quite simple and well articulated, especially by Beijing. How do you fix the banks? Improve lending procedures and risk assessment policies, and find innovative ways of recapitalising them so that they can begin from a blank sheet with solid capital adequacy ratios. How do you improve the profitability of SOEs? Make them more responsive to the market by fostering competition and improve their corporate governance. How do you combat corruption and resource wastage at local levels? Make officials more accountable to the central government for monies spent and

allocated and continue to come down hard on corrupt individuals. Further, make sure your judicial bodies are independent from government interference.

These universally accepted solutions are continually proposed by the investment banks and organisations, such as the OECD, that offer status reports and updates about Chinese intentions to implement these measures and the small steps that have already been taken.<sup>180</sup> However, these findings about what China ‘must’ or ‘should’ do miss the point and ignore the problem. Arguing that a well-functioning free-market economy (existing within a ‘rule of law’ system) will fix the country’s major problems is an obvious prescription but ignores the problem that China is not a well-functioning free-market economy. Notwithstanding the OECD’s tendency to do so, we cannot seriously take the statement by Chinese authorities, including the Chairman of the China Securities Regulatory Commission, that they regard the OECD principles on corporate governance as the international benchmark and are determined to meet them.<sup>181</sup> The debate is not about what China ought to do to fix its problems, for that is obvious, but whether China ‘can’ or ‘will’ implement these measures in time or at all.

#### **(a) Political impracticalities: Fixing the banks and SOEs**

There are several ways to genuinely improve the banking crisis, none of which is politically feasible for the regime.

The first is to simply stop lending to loss-making SOEs. This is the crux of the problem. Even if innovative ways of recapitalising can be found—whether through AMCs, other forms of bailouts, debt market bonds, increased securitisation, etc.—the problem of insolvency will always return if bad loans continue. However, introducing better risk-assessment procedures, training and hiring more risk assessors, and the gamut of international best practice standards will not do the trick. The problem is not a technical but a political one. The government is well aware that a large slice of loans will never be repaid, but for political reasons, it is forced to continue ‘policy lending.’ Even though one estimate is that SOEs are operating at a loss of 1% of GDP each year, they employ more than one million



soldiers and officers in the Chinese reserve military forces.<sup>182</sup> Cutting off these 'policy loans' would cause too many of the SOEs to fail (many of which are balance-sheet insolvent and kept operational only because they are 'liquid') and lead to even greater unemployment and loss of support for the regime.

Optimists cite statistics that suggest a fundamental restructuring of the economy away from SOEs. The number of centrally managed SOEs was halved over the past decade while the proportion of employees working in SOEs has declined from 19% in 1978 to 9% in 2003.<sup>183</sup> However, when you consider that 75 million workers were employed by central SOEs in 1978 and 69 million workers in 2004,<sup>184</sup> the restructuring is not as wholesale as it might first appear. Furthermore, roughly half of China's 800 million-strong workforce is still employed by state-owned, state-controlled, or collective enterprises. The bottom line is that a 'declining' number of state-owned or controlled enterprises (many of which have simply been merged together) are consuming an increasing proportion and amount of the country's capital.

Second, the state-owned banks could be genuinely privatised meaning that monies raised from securitisation could be used to partially rescue the balance sheet. More importantly, management would be independent to make commercially plausible decisions on loans. Despite being cautiously optimistic about the future of the banking system, Jonathan Anderson, Chief Economist for Asia at UBS, is nevertheless forced to conclude that 'the fundamental problems (for Chinese banks) will not be fully resolved until the state gets out of the business of running banks.'<sup>185</sup> This, however, is unlikely to occur because the regime is not prepared to give up using banks as an effective fiscal stimulus to support SOEs, and to create and sustain jobs through this spending. Three-fourths of all investment spending in China is initiated by the government and offered to state-owned firms,<sup>186</sup> largely through the banks and to a lesser extent through the central budget (most of which is distributed using local channels). More than 60% of deposits are made into the four largest state-controlled banks alone, and it is not conceivable that the Party would give up its access to the bulk of resources used to prop up support for its rule. Allowing foreign corporations to own

minority stakes in these banks—capped at 25%—will not do the trick. It is likely that this restriction will remain even as China fulfils other WTO obligations. Similarly, other ‘solutions’ that would release monies to be allocated according to market principles will be resisted. These would include allowing the rapid growth of independent banks that can receive local deposits and make independent lending decisions, creating the conditions for a larger and more vibrant corporate bond debt market to flourish, and stock exchanges where stocks in listed companies are freely and fully floated rather than being manipulated by a government that remains the majority shareholder.

Third, there is a clear need to force SOEs to operate in more competitive, free-market environments where protection from private domestic and outside competition is relaxed, credit is not available at reduced rates or on ‘policy grounds,’ and poor performance is punished (by falling profits) rather than rewarded (by further bailouts).

Finally, despite adopting more and more international standards on corporate governance and transparency, the implementation of these standards cannot be effective whilst the regime controls the judiciary as well as oversight and administrative organs. For example, hundreds of articles have now been written about the potential impact of the *Company Law* (adopted in 1993, and revised in 1999, 2004 and, most recently, in October 2005<sup>187</sup>) on the progress of corporate reform and rule of law in China’s political-economy. However, there is still little doubt that Party members call the shots in SOEs even though SOEs come under the *Company Law*. For example, the Shaanxi Provincial Party Committee and the Shaanxi government issued a joint circular in 2006 requiring the Party cell in state-owned companies to participate in all major ‘enterprise’ (i.e. commercial) decisions. The circular also requested that in all provincial state-owned enterprises, the chairman of the board of directors and the Party Secretary be the same person. Moreover, at the national level, the leadership of the 50 largest central SOEs is still directly appointed by the Politburo.<sup>188</sup>

The *Company Law* revised in 2005 explicitly mentions ‘maintaining the socialist economic order’ in Chapter One,

Article 1 as one of the core purposes of the Law. In such a system, Party circulars will frequently have more efficacy than promulgated laws.

### (b) China's failing record of reform

Recent figures tell a revealing and disturbing story about the pace and adequacy of reforms.

The regime is pinning its hopes and continued legitimacy on *growth*. The theory is that growth will create more jobs; allow SOEs to grow their way out of trouble (in terms of producing more to repay loans and become dominant producers in their sectors); and decrease the number of NPLs for banks (since SOEs will be able to repay more of the loans). The targets they have set in 2010 and beyond are almost all growth targets.

How has the regime achieved growth targets up till now? It has been achieved largely with various forms of actual and de facto fiscal stimulus, namely through the budget but particularly through lending by the banks to SOEs. For example, according to official figures, fiscal stimulus alone contributed 2% GDP growth in 1999, 1.7% in 2000, and 1.8% in 2001.<sup>189</sup> Monies used for fiscal stimulus have increased from US\$89.4 billion in 2002 to US\$119 billion in 2005, an increase of more than 33% over the period.<sup>190</sup> Moreover, monies loaned by China's banks have increased by approximately 25–30% year-on-year since 2000. Lending was prolific between 2001 and 2004 when it increased at an annual rate of about US\$150 billion in 2001 to US\$240 billion in 2002 to US\$380 billion in 2003. US\$750 billion was loaned out 2008.

**Table 5:** Growth in bank lending

Year	Lending
2001	US\$150 billion
2002	US\$240 billion
2003	US\$380 billion
2008	US\$750 billion
2009 (Jan-Mar)	US\$669 billion

A study done on this model of growth suggests that investment as a proportion of GDP would have to remain at least at 50% to just *maintain* current growth<sup>191</sup>—clearly an unsustainable figure. Furthermore, an increasing proportion of funding sources in the Chinese domestic financial markets are bank loans, rising from 72.8% in 2000 to 85.2% in 2003.<sup>192</sup> In other words, other forms of finance (such as corporate bonds and security finance, which are 1% and 3.9% of domestic finance respectively) remain undeveloped; and as the regime controls the vast majority of banking assets, it controls an overwhelming and ever-increasing majority of credit in the country.

The various arms of government effectively direct more than three-fourths of investment spending in the country. What are the massive amounts of government directed money to stimulate growth being spent on? This capital is being directed mainly to SOEs (who receive about 75% of the monies) and spent largely on fixed asset investment where spending has been growing at between 20–30% year-on-year since 2000.<sup>193</sup> It grew at 23.9% in 2006 and 24.8% in 2007.<sup>194</sup> Capital investment as a share of GDP is now over 56%; up from about 35% in the 1980s, 38% in 1999, and 45% in 2004.<sup>195</sup> At least half of this is the direct result of government ‘policy.’<sup>196</sup> According to 2003 figures, the state owned 56% of China’s fixed industrial assets.<sup>197</sup> The figure is now over 60%.<sup>198</sup> China’s over-reliance on fixed investment is clearly a major factor behind the problems of overinvestment and overproduction that I have discussed. Even the People’s Bank of China has criticised the ‘blind expansion of seriously low quality, duplicate projects.’<sup>199</sup>

**Table 6:** China’s reliance on capital investment

Year	Capital Investment as a % of GDP
1985	35%
1999	38%
2003	45%
2008	56%

One would expect that having recognised the problem of over-reliance on fixed investment, the Party would try to fix it.

For example, we would expect government credit and funds to be directed away from inefficient SOEs operating in the industrial and other heavy sectors jam packed with unused and unsalable inventory, empty buildings, and underused highways. In fact, the production of industrial products (one of the worst categories in oversupply) as a component of GDP has remained almost constant since 1980 at between 44–45% of GDP.<sup>200</sup> In other words, SOEs keep receiving more money to make more products that cannot be sold or consumed. As these SOEs keep on receiving easy and cheap credit, producing wasted products, and defaulting on loans, it is no wonder the NPL ratio increases by about 2% each year. About 40% of loans issued during the bank loan bonanza period of 2001–04, when bank loans increased from US\$150 billion in 2001 to US\$380 billion in 2004, ended up being classified as non-performing. After this disastrous result, authorities only lowered lending levels to about US\$330 billion in 2004, which was raised again leading up to 2005.<sup>201</sup> As mentioned above, around US\$750 billion in loans were issued in 2008, while US\$237 billion worth of loans were issued *in the month of January 2009 alone*—up 103.6% from the same time in 2008.<sup>202</sup> February 2009 saw US\$156 billion in new loans, in addition to the US\$4.8 trillion in outstanding loans.<sup>203</sup> Recently released figures indicate that March 2009 saw loans of a further US\$276 billion.<sup>204</sup> While SOEs use about three-fourths of total investment money, they contribute about one-fourth to GDP. Given the regime's need to continually stimulate the economy for political ends, it is no wonder loans keep on increasing at an incredible pace despite economic rationale demanding that they should not.

The disturbing conclusion is that despite a decade of knowledge about these problems and talk about reform and potential, the problems are getting worse, not better. The authorities are becoming simply adept at plastering over deep cracks. For example, the leadership was proud to announce that NPLs had declined from 25% to 21% as a share of GDP between 2002 and 2003. The progress is illusory since the decline was merely a result of the massive new loans issued during that time. As mentioned above, from 2001–05, 60% of the reduction in NPL ratios was simply the result of transferring the loans to

asset management companies. The same analyses can be applied to the current low rates of NPLs according to official figures. As these new loans take time to become classified as non-performing, NPL ratios show a temporary improvement. As the proportion of loans that become non-performing increase, the NPL figure will obviously worsen. The record lending in 2008 and 2009 in the desperate attempts to increase GDP growth will undoubtedly return to haunt China's banks. Shorter-term tactical measures will not overcome the contradictions within the model.

### **China's response to the global financial crisis— relying on bad habits**

In the last few months, the World Bank, known for its bullish forecast when it comes to Chinese growth, has revised its 2009 projections down from 9.2% to 7.5% to 6.5%. In April 2009, officials in Beijing reported GDP growth of 6.1% in the January–March 2009 quarter.<sup>205</sup> Even then, a World Bank report released in late 2008 suggested that more than half of China's 2009 GDP growth will be the direct result of government influenced investment and spending.<sup>206</sup>

Some analysts are speculating that the turmoil caused by the global financial crisis presents an opportunity for the Chinese government to push ahead with fundamental economic reforms that will raise the importance of domestic consumption as a driver of economic growth. This point of view ignores political reality. The current crisis makes it more difficult for the Chinese, not less, to pursue reforms given the political need to achieve high growth at all costs. As Premier Wen reaffirmed at the post-National People's Congress press briefing in March this year, 'an eight percent GDP expansion is the government's pledge and responsibility.'<sup>207</sup>

The major response to declining growth was the announcement of a 4 trillion yuan (US\$586 billion) stimulus package in November 2008 to be spent over the next two years. Although precise details of the package have not been released and is unlikely they ever will, Premier Wen subsequently admitted that only 1.18 trillion yuan—less than one-third of the US\$586 billion package—will actually be new expenditure.<sup>208</sup> The rest had already been earmarked prior to the announcement. Made just before the

G-20 meeting in Washington, DC, in November 2008, the announcement was designed to shore up confidence that the Party was responding to the deteriorating situation as much as anything else. Nevertheless, it still amounts to about 2% of GDP in new spending. As part of the stimulus package, Premier Wen also announced additional measures such as US\$88 billion worth of tax cuts, US\$125 billion for medical facilities up to 2011, and unspecified top-ups in teacher salaries and worker pensions.<sup>209</sup>

As usual, provincial authorities will be the main entities that effectively oversee any stimulus spending. After the announcement was made, within a fortnight, provincial authorities submitted proposals worth approximately 10 trillion yuan.<sup>210</sup> For example, investment proposals worth 3 trillion yuan from Yunnan Province and worth 2.3 trillion yuan from Guangdong Province were received. Significantly, these proposals overwhelmingly consisted of big-ticket fixed-investment projects. The amount provincial authorities proposed to allocate to poverty alleviation and social welfare initiatives was small. As Cao Honghui, a senior researcher at the Chinese Academy of Social Sciences (CASS) warned in commenting on the government stimulus, 'Some projects are meant to serve the real needs of the regions [but] some are not based on realistic considerations, and others are merely efforts [by local governments] to angle money out of central authorities.'<sup>211</sup>

Beijing explained that the rationale behind the stimulus was to loosen credit and encourage state-owned banks to lend more as part of a more 'proactive fiscal policy.'<sup>212</sup> This would, according to government officials, incite consumer spending and boost the economy. Yet, the fiscal stimulus plan relies heavily on bulking up China's state-led fixed investment strategy. For example, massive infrastructure construction projects such as railways, roads and airports are being planned. Tax credits are to be given to businesses to buy machinery. Unfortunately, putting more and more money into a strategy that is becoming less and less effective will lead to more capital waste, which China can hardly afford. Even though 370 billion yuan was specifically allocated for rural China, most of it will be allocated to rural infrastructure building rather than direct social welfare.<sup>213</sup> The stimulus plan is much more about maintaining employment and growth than it is about reorientating China's economy towards a consumption based one.

The beneficiaries of any stimulus will overwhelmingly be provincial governments who extend favours to state-owned and state-controlled enterprises. Indeed, official media have estimated that around 90% of any new lending will be directed towards state-controlled entities.<sup>214</sup> Very little of the stimulus package will be used to create better conditions for private sector enterprises. The exception is tax rebates for export firms even though China remains far too dependent on exports for growth. The amount likely to go towards social welfare initiatives is also small. For example, housing for the poor was promoted as a major part of the stimulus when announced. In March 2009, Premier Wen confirmed that 7.5 million poor Chinese will be provided with housing over three years—a modest number.

To be fair, any stimulus package in the current environment is designed to alleviate any hard landing for the economy in the short term. But the package indicates that Beijing will continue to rely on dangerously high levels of fixed investment to achieve a softer landing, while it waits impatiently for the export market to recover. In just the first quarter of 2009, banks have extended a total of US\$669 billion worth of loans, which is 93% of the government's initial target for the whole of 2009. This is 600% higher than the same time last year. At the Boao Forum held April 2009 in Hainan province, China's banking regulator, Liu Mingkang, all but admitted that this target would be exceeded.<sup>215</sup> Fixed investment in the first quarter of 2009 was up 28.8% compared to the same period in 2008.<sup>216</sup> In urban regions, fixed investment was up 30.3% at the end of March 2009, compared to the same period in 2008.<sup>217</sup> Commenting on the unprecedented increase in lending, Jiang Dingzhi, former Vice Chairman of the China Banking Regulatory Commission warned that 'the biggest dangers to China's economy and financial system come from within, not from outside,' adding that 'The biggest of these dangers is the degree of bad loans in China.'<sup>218</sup>

The belief that the current environment makes it more likely that Beijing will pursue fundamental economic reforms that will transform its economic growth model to one driven by consumption is wide off the mark.



## Can China trade its way out of trouble?

The first edition of *Will China Fail?* argued that it was doubtful China could trade its way out of trouble. Exports were already playing an important role as a growth driver accounting for 12% of real GDP growth in 2004,<sup>219</sup> rising to 20–25% of growth in 2007.<sup>220</sup> Its net exports jumped from US\$100 billion in 2001 to more than US\$300 billion in 2007.<sup>221</sup> In 2008, exports represented 40% of GDP, and net exports 12% of GDP (up from 2% earlier in the decade.)<sup>222</sup>

As the World Bank's China Director David Dollar observed about China's export strategy:

These numbers [export growth] are clearly not sustainable. China would have to carve out huge new external markets every year—markets already crammed with efficient producers across Asia, Europe and the United States—to keep this up.<sup>223</sup>

The first edition of this book made the argument that there was something precarious about China's trade structure, which relied so heavily on US and EU consumption and is, hence, extremely vulnerable to any decline in consumption in those markets. For example, the United States needed to effectively borrow more than US\$600 billion each year to fund its craving for imports. It was foolhardy to believe that this could be maintained indefinitely. Thirty-five percent of Chinese exports go to the United States. China was always becoming too large to rely on export growth to pick up the slack of inefficient investment.

Recession in the United States and European Union has indeed hit China's export industry, and the broader economy, hard. China's merchandise exports in February 2009 fell 25.7% from a year earlier.<sup>224</sup> In March 2009, they fell 17.1% from a year earlier.<sup>225</sup> Already, at least 70,000 factories in the manufacturing hubs of Guangzhou, Zhejiang and Shanghai have closed down, with at least 20 million people losing their jobs. Despite some well-respected commentators arguing as recently as January 2008 that the contribution of net exports to overall Chinese growth was over-played,<sup>226</sup> overall growth in the fourth quarter of 2008 has slowed to 6.6% compared to the

13% growth in all of 2007. Even towards the latter half of 2008, at the Macquarie Group Board's Annual Strategic meeting in September 2008, chief China economist Paul Cavey argued that even if net export growth grinded to a halt, it would at most shave 2 percentage points off China's overall GDP growth.<sup>227</sup> These kinds of analyses were common but represented a failure to accurately account for the over-reliance on net exports and the positive flow-on effects of the thriving export manufacturing industry for the broader economy. For example, it is estimated that around half of all capital investment in China goes towards the production of new capital goods used to produce more goods for exports.<sup>228</sup> These analyses also fail to consider other underlying and serious weaknesses behind the current growth strategy that would be exposed by a fall in both exports and confidence. Finally, even if the United States and European Union manage to recover quickly, it is unlikely that Chinese exports to these markets will return to previous levels anytime soon. For more than half a century and until the 1990s, US household savings were between 6–10% of GDP, falling to –2% in 1997 and hovering around –1% prior to the financial crisis. In January this year, savings were at 5% of GDP as US consumers prepared for a recession. The recent tendency to save might wane slightly but the model that relied on the United States, in particular, borrowing beyond its means to consume has been discredited.

The relationship between FDI capital entering into China and the Chinese export sector is also a misunderstood phenomenon in terms of its longer-lasting benefits for China's transformation. The majority of FDI was being transferred to foreign-owned companies in China that in turn used China as an export base. Recent figures indicate that foreign-owned companies accounted for over 55% of China's exports in 2003, 70% in 2005, and 80% in 2008. This is not in itself a problem but the transfer of technologies and innovation to domestically owned businesses had been notoriously poor for various reasons.<sup>229</sup> For example, although China is able to export huge quantities of sophisticated electronics and information technology products, almost all of the high-value added parts are actually imported into China to be assembled. Hence, while China exported US\$142 billion worth high-tech products in 2003, the import of these

pre-assembled parts and components was worth US\$128 billion. In short, the net export of these high-tech products was only worth US\$14 billion<sup>230</sup> and was largely through wholly foreign-owned firms operating in China.

As a comparison, China received 10 times more FDI than India in 2005 and about six times more in 2006. China has received more than US\$60 billion a year in FDI over the past three years. In 2006, the figure was US\$63 billion,<sup>231</sup> rising to US\$92.4 billion in 2008.<sup>232</sup> Many took this as the global market's vote of confidence in the Chinese economy. But the billions of dollars in FDI entering China, and the billions of dollars in exports leaving China, although creating jobs for locals, were not driving broader transformations in the economy. This is because most of the FDI is designated for foreign-owned firms, while private domestic firms are prevented from competing in SOE dominated industries or are denied the capital needed to expand. As two highly regarded economists, Yasheng Huang and Tarun Khanna, professors at the Sloan School of Management at the MIT and the Harvard Business School, respectively, argue:

China's export-led manufacturing boom is largely a creation of foreign direct investment, which effectively serves as a substitute for domestic entrepreneurship. During the last 20 years, the Chinese economy has taken off, but few local firms have followed, leaving the country's private sector with no world-class companies to rival the big multinationals.<sup>233</sup>

## **The stubborn donkey of Chinese consumption**

China's economic growth is unsteady, unbalanced, uncoordinated, and unsustainable.<sup>234</sup>

—*Premier Wen Jiabao*

Since the 1990s, there has been a saying that the Chinese economy has been pulled by two strong horses (fixed investment and exports) and one weak donkey (domestic consumption). Poor countries tend to devote about 60% of GDP to consumption.

From 1978–89, domestic consumption as a proportion of GDP in China hovered above 50%. In the 1990s, it was at around 45% but has been declining since 2000.<sup>235</sup> It is now at around 32%, by far the lowest of any major economy in the world. Even domestic consumption in India as a proportion of GDP is around 56%.<sup>236</sup>

**Table 7:** Decline in China’s domestic consumption as a proportion of GDP

Years	Domestic consumption as a proportion of GDP
1978–89	50%
1990–99	45%
2000–present	32%

The trauma caused by the global financial crisis and the subsequent steep fall in GDP growth has brought renewed attention to the urgency of raising Chinese domestic demand. Indeed, the need to do so was a pressing one even before the onset of the present crisis. The chief economic editor of the *Financial Times*, Martin Wolf, had presciently argued in a book released in 2008 just after the onset of the crisis that imbalances in the Chinese economy (too much money poured into wasteful fixed investment and too little into policies to improve the lives of ordinary people, hence leading to low consumption levels) was creating profound global imbalances. To wit, the build-up of Chinese foreign currency reserves worth almost US\$2 trillion—of which around half was spent buying American debt instruments—kept the yuan artificially low but also made debt artificially cheap for Americans. Another consequence was that developed markets were flooded with liquidity. For some time, as Michael Pettis observed, ‘excess US demand and excess Chinese supply was in a stable but temporary balance.’<sup>237</sup> The imbalance allowed Americans and the US government (as well as their European counterparts) to spend beyond their means, thereby creating conditions that contributed to the near collapse of the financial system that we are now witnessing.<sup>238</sup>

Some commentators might take issue with Wolf's analysis in directing blame in the direction of Chinese imbalances rather than the spendthrift habits of Americans and Europeans as the cause of the current crisis. But there is an overwhelming consensus among China's leaders and leading economists that China needs to increase domestic consumption in order to move towards a more balanced and sustainable economy.<sup>239</sup> In particular, many are hoping that domestic consumption can take up the slack following the decline in exports. As mentioned before, the GDP proportion share for domestic consumption is worryingly low with a downward trend. For example, it is estimated that even if just 10% of China's shoe exports were transferred to the domestic market, the whole shoe market in China would be saturated.<sup>240</sup> More generally, one economist has calculated that if US savings rise and consumption decreases by a sum equal to 5% of US GDP, consumption in China would have to rise by a sum equal to 17% of Chinese GDP.<sup>241</sup> Chinese leaders have been promising the creation of a demand driven economy for a decade but with limited success so far. Nevertheless, more optimistic commentators put forward a number of reasons why the prospects for domestic consumption in China are good.

The first is the so-called 'tiger in the cage' scenario: the world-beating saving habits of the Chinese. The national savings rate has reached almost 50% of total annual output. The idea is that the 'tiger' (savings in banks) once released will lead to a tide of consumer spending that will take up any slack from the reduction in fiscal stimulus and also increase demand to reduce over-supply problems.

The problems with this position are threefold. First, savings are at such high levels largely because there are very few and poor provisions for social welfare, health, and old age. Only about one-seventh of the population, for example, is covered by basic health insurance, so many households save to cover medical expenses. Families save for retirement because the basic pension scheme covers only about 16% of the economically active population—and in any case provides a pension equal to just 20% of average wages. Households also save for education. Primary school fees are a large financial burden, particularly for poorer rural households. It is unlikely that rises in domestic consumption will provide a way out.

Second, the average disposable income of urban dwellers is about US\$1,350 annually, growing at between 10–20% each year. In rural areas, it is about a third of that figure. It will be a long while before it is possible to reach the US\$5,000 figure, the point at which discretionary spending is said to take off.

Third, the regime needs these savings in the bank because the banks need them to maintain liquidity ratios. As mentioned earlier, most of China's banks are only solvent because of the high savings rates. The government simply cannot afford massive withdrawals from the banks to fund a consumption-led growth.

Others believe that Chinese SOEs can become increasingly innovative and learn to make better use of capital. This, it is argued, would ensure a much more efficient and prosperous economy, the effects of which will eventually flow on to create the conditions for increased domestic consumption. But since moving towards a state-led development model from the 1990s onwards, total factor productivity (TFP) is diminishing in China. Various research studies, depending on sample and methodology, offer different results. But all clearly show a declining trend in TFP. For example, one report estimates that TFP grew annually by 3.26% from 1978–95, but slowed to 0.32% from 1995–2001.<sup>242</sup> Another report shows that TFP grew annually by 3.83% from 1988–94 but declined to 0.52% from 1995 onwards.<sup>243</sup> Back in 1994, in looking at other East and Southeast Asian economies, Paul Krugman warned that growth achieved simply through ever increasing 'inputs' (i.e. directing enormous amounts of capital towards fixed capital investment) would yield diminishing returns.<sup>244</sup>

Evidence shows that dramatic improvements in the use of capital are more indicative of hope than reality. As long as SOEs—which receive the lion's share of capital—are coddled and protected, they have no incentive to innovate. Moreover, too much capital is being denied to the private sector, which is much more likely to invest in innovation or invest innovatively. Even the most successful private sector firms tend to flat-line at around 30 employees because of capital restraints. In other words, capital that should be reserved for innovators in the private sector is instead increasingly wasted on inefficient state-owned businesses

whose productivity is about half that of private industry both by aggregate and sector.<sup>245</sup> Whereas in 1985–90, the private sector accounted for 20.7% of all fixed asset investment, in 1996–2000 it was only 13.9%.<sup>246</sup>

Private firms with poor political connections need to rely on the informal lending market. A report by consultants McKinsey estimated that this was around US\$100 billion in 2006.<sup>247</sup> In 2009, the People's Bank of China estimated that it could be around US\$300 billion.<sup>248</sup> Even so, this is a relatively small proportion compared to loans by banks, and the most profitable private businesses continue to pay higher rates of interest on capital than inefficient state-owned businesses.

Clearly, the SOEs consuming a rising proportion of the country's available capital are crowding out the private sector. During the past decade, there has been little evidence of SOEs changing their mindsets and taking the innovation route. Even the three or four of China's most profitable SOEs are far short of world class standards in terms of sustained innovation, performance and financials. Moreover, the capital denied to the private sector, which really is the cradle of innovation, is not measurable but surely significant. As highly regarded MIT economist Yasheng Huang argues:

It is amazing how little attention the most important matters receive in the media, such as domestic entrepreneurship ... The main problem is that it does not have a fair, level, playing field for domestic private firms while the big state-owned enterprises maintain their lock on influence and access to capital ... I am not an economic nationalist at all [but] it is really paramount that the country maximises the use of domestic entrepreneurial resources and talents. The key difference between China's reforms and those elsewhere since the Soviet Union collapsed is that the goal in the other transitional economies has been to institute capitalism, whereas in China the goal has been to preserve socialism.<sup>249</sup>

In general terms, the Chinese political-economy is preventing the robust growth of domestic consumption even as GDP growth

surges. As mentioned earlier, when the state supported the private sector in the 1980s, household incomes were rising across the board largely as one and with the tide. Once Beijing moved towards its current state-led model, the private sector bottom-up economy that offered the best hope for hundreds of millions to prosper suffered, only a relatively small number of ‘insiders’ thrived, and development as well as income growth became much more unequal. This is substantiated by the fact that between 1992 and 2003, China’s household disposable income as a share of GDP fell 5%; and fell another 4% in 2004.<sup>250</sup>

John Stuart Mill famously described the study of ‘political economy’ as ‘the sources and conditions of wealth and material prosperity for aggregate bodies of human beings.’ As Huang pointed out, the use of the term ‘aggregate’ is crucial because it gets to the heart of why economic growth matters. It does so because it offers lifestyle improvements to the *majority* of the population. As the evidence shows, this is something better achieved through a bottom-up entrepreneurial model than a top-down statist one. The fact that domestic consumption has been dragging its feet for more than a decade is one manifestation of the limitations of the China’s political-economy model.

## **Differences between the Chinese and East Asian models of development**

We should resist viewing China’s rise as simply the next exciting instalment of an economic miracle in Asia, albeit one on a historical scale. This simplistic comparison is frequently made and fuels significant optimism in discussions of China’s rise. To be sure, China has looked to Asia (especially Singapore) rather than the United States or Europe to guide its political-economy growth model. Some argue that China is simply following the Asian model of growth,<sup>251</sup> and that commentators sceptical about China’s rise would do well to look at the other economic success stories in Asia.

Indeed there are some parallels between Chinese growth and the Asian successes after World War II. Between 1950 and 1980, Japan grew at an average real rate of nearly 8%. From 1960–95, Hong Kong grew at an annualised real pace of 7.7%;



South Korea grew at 8.1%; Singapore at 8.4%; and Taiwan at a stunning 8.6%. In Southeast Asia, 'quasi-tigers' such as Thailand and Malaysia were not far behind. China's growth rates, accepting official figures, are similar to Asia's best performers.

Moreover, China currently shares another similarity with Asian high-performers, namely growth based on extremely high rates of capital investment, significant protection of domestic firms, and access to cheap and plentiful labour. This 'perspiration, not inspiration' strategy, as Paul Krugman famously put it,<sup>252</sup> largely created growth as a result of capital inputs drawn from high domestic savings. Productivity was never a large part of the Asian success equation in the earlier years.<sup>253</sup>

Yet, the extent of China's reliance on state-led fixed investment to generate growth differentiates its strategy from other East Asian economies. Taiwan, for example, which had an unparalleled growth rate of 8% every year for more than 50 years, never had capital investment spending of more than 30% of GDP.<sup>254</sup> Taiwan's annual capital investment averaged at about 26%. In terms of directing capital to the private sector, Taiwan's story is the reverse of China in that the private sector received 77% of all capital during the 1970s—the primary Taiwanese growth period.<sup>255</sup> Japan had a capital investment rate of around 33% of GDP in the 1970s. South Korea had a one-off spike in the capital investment rate of 40% of GDP in 1990, but averaged around 30% during its growth periods in the 1970s and 1980s. The private sector received around 70% of all investment in the 1970s and over 80% in the 1980s. China's figure of both capital investment (as a proportion of GDP) and investment by SOEs is extremely high by any standard, and its strategy is significantly different to the general East Asian growth one.

Yasheng Huang's insight that China's goal has been to preserve socialism rather than institute capitalism per se is important. Other Asian economies adopted the free market as a *transformative* strategy; China adopted it merely as a *therapeutic* strategy to preserve the regime's hold on power. While these other Asian economies encourage and support private enterprise and innovation, China directs the majority of its capital to prop up SOEs and other state-controlled entities. The commercial and

operational rights of foreign firms are given more protection than private domestic ones. Indeed, protection in more than two dozen key industries that the SOEs operate in (such as telecommunications, infrastructure, banking, construction) is primarily directed at private domestic firms to prevent them from challenging SOEs. Combined with the lack of access to capital afforded to these domestic private firms, it is no wonder that China cannot produce any world-class private domestic firms in key sectors of its economy. Even the state-sanctioned Academy of Social Sciences was forced to admit in one report that:

Because of long-standing prejudices and mistaken beliefs, private and individual enterprises have a lower political status and are discriminated against in numerous policies and regulations.<sup>256</sup>

Moreover, these other Asian models understood the importance of property rights; 'rule of law' and independent courts; independent bureaucracies and administrative organs; and the like. The regime in China, determined to maintain its power, control and relevance, is indisposed to allow these institutions to take root. Stock markets in China are generally used to raise capital (to keep the SOEs afloat) and increase share price for those firms with state backing (in which only about one-third of shares are floated and the state retains majority ownership). It does not serve as an effective capital raising medium for enterprising private firms for which listing is restricted. Only 40 of the more than 1,500 listed firms are genuinely private firms.<sup>257</sup> State bureaucrats are given powers to control the allocation of stock parcels (many of which go to Party members) rather than allowing the market to decide. Ultimately, Japan and South Korea were prepared to embrace a free-market economy; accept a limited government philosophy in all major aspects of economy and society; embrace 'rule of law' systems to restrain governments and its agents; and, more generally, allow the transformative effects of these markets to take root. The Chinese regime is not. Despite the fact that China has looked to other Asian countries for inspiration, one should be careful about drawing too close a comparison.

## Hazards for the regime

There have been few examples of comprehensive economic reform of the Chinese economy over the past decade. In fact, as Derek Scissors observes, since the present leadership took power, market-orientated liberalisation has been 'wound down and supplanted by renewed state intervention, price controls, the reversal of privatisation, the rollback of measures encouraging competition, and new barriers to [private] investment.'<sup>258</sup> According to Scissors, this has occurred because of 'politics run amok.' Genuine liberalisation is no longer perceived to be in the interests of the Party.

Even the most flawed and inefficient systems can survive for years beyond all expectations. Although no one can predict with certainty an imminent economic crisis or its timing, there are several trigger variables to watch out for.<sup>259</sup> The key to the Party maintaining power is co-opting new elites and appeasing newly created losers. To do so, the Party has to prolong its control of and access to resources, which means continued access to the enormous pool of savings. Tax revenues are a less efficient and feasible option to access funds, given the fragmented (i.e. decentralised) and non-transparent nature of China's economy. Access to bank savings is much more valuable.

There are still not many options outside depositing savings in state-owned banks and buying government bonds. The regime has been successful so far in stifling financial diversification. This is despite the WTO agreement to open up the banking sector to genuine competition at the beginning of 2007. This agreement allows foreign banks to compete with domestic banks on a level playing field, accept local currency deposits, and engage in the full range of corporate transactions.

Moreover, in addition to the lack of choice, life savings are deposited into state-owned banks largely because the general population is not aware of the precarious financial position of these banks. If the bubble of misplaced confidence in these institutions (or the government) were pricked, and there were genuinely widespread and practical options to deposit savings into non-state-owned institutions (such as foreign banks or a well-functioning securities market), it's likely that a withdrawal

of monies from state-owned banks would occur on a massive scale, and bank liquidity would certainly be threatened. The regime's reluctance to promote genuine financial broadening—increasing the number of non-state-owned banks and other forms of financial intermediaries such as stock markets and corporate bonds—is largely grounded in this fear of loss liquidity for the state-owned banks. Even as China fulfils its WTO obligations by allowing foreign-owned and independent banks to receive deposits in local currency from individuals, foreign banks and analysts are in general agreement that the top priority of China's banking regulators is to protect the domestic market from foreign competition. This is being done by insisting on exorbitant capital requirements, slow licence approvals, and other obstructive tactics.<sup>260</sup> Were there to remain no alternative to state-owned banks, it is debatable whether savings would be withdrawn on the same massive scale simply because there would be nowhere else to deposit the money. But were there to be a massive 'bank run,' which always occurs with immense speed, it is likely that crisis would hit before the central government could do much about it.

If the regime can manage to maintain its dominance of the financial deposits sector and debt markets, then any unfolding loss of control is likely to be much slower. With almost US\$2 trillion in foreign reserves alone, there is a large pot of money to potentially conduct a few more cleanup operations and prop up the rickety system for a while longer. Official figures also state savings in mainland banks to be US\$3.7 trillion at the end of 2005, which means almost US\$1.2 trillion left over if we believe the official figure for outstanding loans.<sup>261</sup> If these numbers are close to accurate, a collapse of the banking system may still be some time away. The regime could possibly continue the bailing-out and recapitalisation dance with the banks, but their capacity to do so would decline over time as would the stimulus effect on growth.

It is also important to note that the decentralisation of political authority in China exacerbates problems. In a study of the collapse of the Soviet Union, Steven Solnick demonstrated that decentralised authority tends to exacerbate the instances of the regime's misuse and theft of state assets.<sup>262</sup> This has certainly

occurred in China. As decentralisation occurs in a one-party system, unaccountable 'agents' of the state multiply. Where once there was a relatively small group of bureaucrats at the top controlling vast resources, there are now many more local bureaucrats controlling these same resources. As central authorities lose effective control and oversight over local officials, the opportunities for theft of public resources increase. These local authorities are also given greater power over the country's finances, and the use of resources for non-productive 'political' purposes multiply. Moreover, the renegotiation of rights and responsibilities between central and local Party officials is mostly to the advantage of the latter. As local Party members control and redistribute more resources, they are in a better position to use these resources to garner support for the regime; improve their local networks and connections; and, in turn, continue to demand support from the central leadership, whose legitimacy relies more and more on the work and policies of local Party officials. It is, therefore, difficult for the central leadership to both keep in touch with local issues and complaints and retake power and responsibility from local officials in any re-centralisation movement.

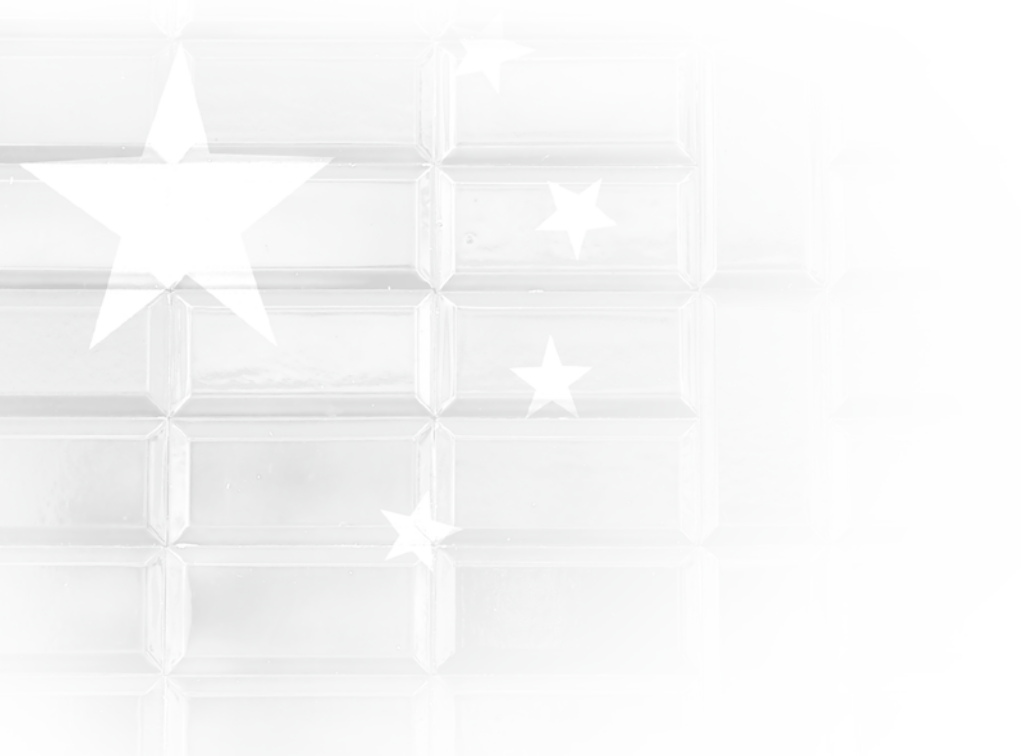
## Conclusion

The World Bank's chief Asia economist, Vikram Nehru, observed with both praise and envy that 'China is unusual in that it has this incredible capacity to mobilise all its institutions—central government, local governments and the entire banking system—to boost government influenced investments.'<sup>263</sup> The Soviet experience revealed that the ability to mobilise resources does not mean that resources will be used wisely or efficiently. In this respect, the Chinese experience is telling a similar story. For authoritarian regimes controlling the vast bulk of a country's savings, the temptation to use resources for political ends is perhaps irresistible. Paul Krugman observed more than a decade ago that 'current projections of Asian supremacy extrapolated from recent trends may well look almost as silly as 1960s-vintage forecasts of Soviet industrial supremacy did from the perspective of the Brezhnev years.'<sup>264</sup> As he further argues, even if economists lost sight of the impending

Soviet economic demise, the Soviet decline could have been 'predicted on the basis of growth accounting.'<sup>265</sup>

Chinese leaders adopted the free market as a therapeutic device to accelerate growth and remain in power. The regime never intended the free market to be transformative. There is only lip service paid to the principles of 'limited government,' and efforts to build robust systems of 'property rights,' 'rule of law,' etc. have been weak. Instead, the desire of the Party to stay in power is the driving force behind the Chinese political-economy model. Supervising a partial free-market economy from the seat of unchallenged power was Deng's grand plan. As Premier Wen declared recently, democracy would only develop once a 'mature socialist system' evolved, and this could take 100 years.<sup>266</sup>

Economists and many others have been awestruck by Chinese growth rates. But we need to look beyond the impressively high Chinese headline growth figures. The evidence suggests that commissioning the free market to expand the rule of an authoritarian regime is riddled with arguably fatal contradictions. We need to bear in mind the advice of Chinese theoretician Zhang Bijian who cautions us about the 'multiplication and division' principle in Chinese development: all problems that arise in China are multiplied by 1.3 billion people, and all successes are divided by the same amount. We should resist assuming that GDP growth is sufficient evidence of sound and sustainable development. The global financial crisis has revealed some weaknesses in the Chinese approach, but manifestations of its more comprehensive vulnerabilities are yet to fully appear. The Chinese political-economy model is failing its people and cannot be sustained in its present form.



Part A

# CHAPTER FOUR

Assessing 'Market Socialism'—  
The Case for Scepticism





## Chapter 4

# Assessing 'Market Socialism'— The Case for Scepticism

### Introduction

There was a brand of bicycle produced by China—the brand name is 'Forever.' It is a very heavy, very sturdy, but very ugly and very clumsy looking. It does not have much stylish decorations [sic] and looks very rusty ... The Chinese Communist Party is just like that brand of bicycle. First, it is very 'unstylish' and 'old fashioned.' It has vicious nicknames like 'commies' and 'chicoms.' Its gear and axis all look very ugly and are not even shiny under the sunlight, so you would not like to take your girlfriend out on such an embarrassing looking bicycle. But even though the Chinese Communist Party does not have such gadgets like elections, TV debates, free protests, political ads, etc, etc., it knows how to get things done ... It built China's first nuclear bomb, first automobile, first fighter jet, first nuclear submarine, first personal computer, etc. The Chinese Communist party is really a 'treasure-trove' in the hearts of the average Chinese family ... In conclusion, I want to praise the Chinese Communist Party some more. I think the Chinese people need not listen to those democracy lovers, and should totally ignore the flashy elections of America. The Chinese people have chosen the Chinese Communist Party, and we will continue to use that bicycle because we like it and there's nothing you can do about it. Maybe we'll renovate that bicycle once every few years, like putting on some new paint, or change an axel. But the bicycle is still the same old rusty bicycle. There's not a best [sic] bicycle in the world, there's only the most useful and practical bicycle.<sup>267</sup>

—*Math*, The Peking Duck blog

The blog entry reproduced above represents the kind of defiant support that is growing for the Chinese political-economy model. Experts can debate the merits and flaws of models, but the most compelling rhetorical argument for the 'Beijing Consensus' is the perception that it is working.

Yet, evidence presented in the previous chapter shows that Beijing's approach is not working as well as official growth figures suggest. The Chinese regime has become skilful at partial imitation, selective adaptation, and self-promotion. Glowing surveys of the Chinese economy by investment banks that are making millions from underwriting privatisation reforms and procuring capital for clients in an easy credit environment belie the difficulties of the grassroots situation and the meagreness of profits by most foreign and local firms.

At the expense of economic logic and efficiency, massive amounts of resources are being used to further social and political ends. But this is only part of the story with respect to the regime's problems. China stands a real risk of being headed towards political and social turmoil. The regime's strategy of entrenching its legitimacy and rule through a *therapeutic* free market is failing and the social ramifications are profound. Indeed, it is arguable that the mounting political and social deficits present a greater threat to the regime than its economic problems. Growth has not been the harbinger of social and political harmony that the leadership assumed. Certainly, the regime takes the reality of its declining legitimacy and the possibility of its own collapse much more seriously than many international observers appear to realise.

### **Holding onto power: a paranoid regime**

Authoritarian regimes tend to be suspicious of elements within their populations at the best of times, but the Party government is a fearful and paranoid regime. The gap between those benefiting from reform and those who are left behind is widening at a frightening pace. New elites are less interested in communist and revolutionary ideology and more interested in material wealth. That these new elites might demand greater freedom is a persistent concern for the regime. The citizens left behind may eventually

feel abandoned by the Party. In this sense, the regime is fearful that support for it will slide from all sides.

Furthermore, recent history has not been kind to communist regimes. The leadership is fighting hard to avoid being the latest and most notable communist assignee to the 'scrapheap of history' as former US President Ronald Reagan once boldly predicted about the Soviet Union a decade before its fall. The Party is struggling to persuasively redefine the next stage of Chinese socialism to an audience that is increasingly disinterested or disillusioned.

The signs suggesting a 'crisis of legitimacy' for the Party are profound and widespread. This crisis springs from two sources. The first is an internal or domestic one; the second an external one.

#### (a) The crisis from within

'Revolution' was the cry that stirred the blood of the Party's most ardent supporters—note Mao with his ideas of entrenching 'permanent revolution,' then 'continuous revolution,' then his 'Great Leap Forward,' and, finally, the disastrous 'Cultural Revolution.' Deng called his reforms 'China's Second Revolution.' The point is that establishing continuity from Mao onwards is mandatory rhetoric. 'Revolution' and forms of renewal have always been core to modern Chinese political storytelling.

The problem for the Party in modern times is that the rhetoric of revolution is no longer engaging. China has become less of a totalitarian state (where the state was deeply involved in every aspect of life) and more of an authoritarian one. As in all communities in which the fires of revolution have died, economic and material concerns assume greater importance. Opening up the economy has decreased the relevance of the Party for millions of Chinese and increased the resentment of many others; in particular, rural areas where reforms have been the most dramatic. Where once the Party was central to one's life from cradle to death, the Party is now no longer the provider of material and economic security for many Chinese. Importantly, the Party is failing to meet the challenge of political and social deficits that are growing at pace.

*(i) Rural discontentment*

Roughly half of the population still lives in rural areas where discontent is most evident. The leadership recognises the problem of rural discontentment, but attributes the causes to the inevitable growing income gap as a result of growth and the reform process. Indeed, that is how many commentators see it and, ironically, rural income disparity is almost treated as comforting evidence for some that China is indeed reforming and modernising.

As noted earlier, research indicates that 80% of the Chinese people who emerged out of poverty since 1978 did so in the first decade of reform. Since 1996, per capita income growth from agricultural activities has been generally declining, and there was actually negative growth from 1998–2000.<sup>268</sup> Much of this was due to falling agricultural commodity prices and higher production costs, which farmers do not always associate with the regime.

There is, however, growing evidence of deep resentment against taxes and fees known as ‘peasant burdens’ levied on farmers. Officially, such burdens cannot exceed 5% of net income. In reality, central laws do not stop local authorities from issuing their own levies, none of which is recorded in official statistics. Conservative estimates of local taxes and fees imposed range from 10–20% of net income,<sup>269</sup> and 30–40% of net income in some estimates.<sup>270</sup> Moreover, these burdens tend to be regressive because such taxes are levied on a per capita basis. Hence, while poorer peasants (earning 400–500 yuan a year) paid about 17% in these taxes, those in the more wealthy coastal rural areas paid about 2.8% of their net income. When you consider that the average costs of production of the three main crops (rice, wheat and corn) are about 43% of the *sale* price, local and federal taxes in addition to other costs borne by farmers become oppressive. A study done in 1999 in Hubei found that 80% of farms in one jurisdiction were unprofitable.<sup>271</sup> This is a common finding.

Besides the pure financial burden, another problem is that such taxes do not translate to government services such as infrastructure, public health, and education—free services that were largely changed to user-pay ones during the reforms. Local taxes are, therefore, largely seen as illegitimate and self-serving

for local Party members to preserve their relevance and position. This is brought out by various official and unofficial surveys that are cited in Minxin Pei's research. For example, in a survey of 2,000 rural residents in Xinjiang in 2001, 'excessive tax burdens' were cited by 65% of respondents as the principal cause of social instability. 'Tax resistance' was prevalent in 40% of peasants surveyed. On the other side, local authorities say collecting taxes and fees consumed 60–70% of their time. In one report issued by the National Bureau of Statistics in 2001, 70% of village Party officials thought collecting these taxes was their 'most difficult task.'<sup>272</sup> In an increasing number of cases, relations between local Party officials and villages were so dysfunctional that officials relied on organised crime syndicates to aid in tax and fee collection through intimidation and violence.

Loyalty to the Party, and cooperation between it and rural China, is breaking down. As almost all instances of unrest in rural areas involve dissatisfaction with decisions or actions taken by local official bodies perceived to be corrupt or unfair, the Party is explicitly implicated. Questionable land confiscations involving collusion between developers and local Party officials are common, while 40 million peasants (and growing at about 2 million a year)<sup>273</sup> have been forced off their land to make way for development without being given adequate compensation. In China's fragmented system, the 'rent seeking' predation of local Party officials is politically, administratively and judicially unaccountable. Local officials extract 'rents' through their control of land, business regulations, and other resources when the need arises.

All central attempts to solve this problem have been tactical rather than genuine. For example, the recent *feigaishui* reform to replace local fees with taxes (in order to reduce the arbitrariness of fee collection) was not accompanied by any moves to reduce the bloated size of rural government, or by any calls to account for their discretionary spending. Although Premier Wen vowed to spend at least 340 billion yuan a year on rural infrastructure, education and health, such seemingly large amounts must be put in context with fleets of cars for local officials that alone cost 300 billion yuan each year. Overseas trips, banquets, and other entertainment costs incurred by these local officials cost about

500 billion yuan each year.<sup>274</sup> It is, therefore, not surprising that Premier Wen's 2003 plan to abolish the administrative apparatus at the town and rural township levels (some 40,000 units) was abandoned because of immense opposition from vested interests within the Party. The situation remains largely unchanged.

*(ii) Unemployment*

Although official Chinese figures tell us that unemployment and underemployment in urban areas are around the 5% mark and around 5–10% in rural areas, increasing numbers of independent studies (backed by anecdotal accounts) place unemployment and gross underemployment levels in urban and rural areas at about 10–20% and 25–40% respectively.<sup>275</sup> Even researchers at Beijing University's China Center for Economic Research estimated that the true rate of unemployment was between 10% and 15%.<sup>276</sup> One scholar at the Central Party School in Beijing, which is closely linked to the Party, believed that the real rate of unemployment in urban China was already about 12% and would be around 14% in 2009.<sup>277</sup> Translated in human terms, this is between 125 million–200 million workers in rural areas, and 30 million–60 million workers in urban areas, struggling to find proper employment. The argument that the millions of unhappy rural unemployed can be appeased simply by encouraging them to move to urban areas ignores this fact.

Moreover, even during a sustained era of reported growth, a recent study found that for every 100 people in large- and medium-sized cities looking for jobs, there were only 65 on offer.<sup>278</sup> A 2006 study indicated that three out of every five university graduates were likely to be jobless, and a 2007 survey indicated that the number of young people looking for jobs would rise by 22% even as positions available were declining by 20%.<sup>279</sup> A more recent CASS report estimated that of the 6.1 million college graduates entering the market in 2009, 30–40% would be unable to find jobs.<sup>280</sup> More recently, reports indicate that there are 7 million recent graduates looking for work.<sup>281</sup>

Researchers frequently refer to the magical 8% growth rate as the level at which the unemployment rate remains stable. My research indicates that for every 1% below 8% growth,

10 million–15 million additional people become unemployed. The growth rate for China has recently been revised down to 6.5%.<sup>282</sup> This will compound the unemployment problem that was already in existence prior to the global and subsequent Chinese slowdown.

In a system with limited welfare protection, the Party fears rising unemployment and the resulting unrest. Given the one-child policy and a widespread preference for having sons over daughters, some believe that the growing population of single unemployed men is a recipe for instability.<sup>283</sup> The desire to restrict unemployment is behind much of the logic to continually direct resources towards inefficient areas. However, the forced growth economy is not doing its job as far as employment is concerned. While the economy has been officially growing at close to 10% since 1980, employment growth fell from 4.2% in the 1980s to 1.1% in the 1990s.<sup>284</sup> Employment growth in the labour-absorbing non-agricultural sector declined from 6.8% in the 1980s to 3.4% in the 1990s.<sup>285</sup> By contrast, the working age population is growing at about 15%.

Although greater unemployment is the inevitable result of a planned economy in transition, the regime has only itself to blame for the severity of the problem. The regime is torn between laying off workers to promote greater efficiency and instructing banks to offer more money to these organisations to keep them artificially alive. Any decision is taken on a case-by-case basis and is tactical rather than far-reaching.

First, 'growing out of the plan' in terms of developing a world-class, non-state sector alongside the public sector has not been given the necessary support by the Party. As mentioned before, state-owned and state-controlled enterprises, which account for less than a third of output, receive over 70% of state capital. By contrast, profitable domestic private enterprises, which are best able to absorb workers in productive and sustainable ways (and raise their incomes at the same time), have been relatively starved of state capital. Indeed, the percentage of private firms receiving bank loans in the 1990s was actually lower than the 1980s and, by the early 1990s, informal finance substantially overtook bank finance for private firms.<sup>286</sup> Although the number of private

firms has grown consistently, this poor access to the pool of China's capital has limited the growth of many of these profitable private firms beyond a certain size. The median size of private firms in the 1990s actually remained the same at the 1980s level at about 30 employees.<sup>287</sup> The absence of giant, world-class Chinese private firms is telling. Despite the 'economic miracle,' there is not one Chinese equivalent of a world-class corporate brand like Toyota, LG or Samsung. As one Chinese commentator notes, 'Though governments at all levels have attached great importance to the development of private firms in their statements, such firms still felt the inequality in government treatment when compared with state-owned and foreign-invested enterprises.'<sup>288</sup> What this means is that the domestic private sector has been unable to absorb the mass of rural economic migrants searching for jobs in urban areas. Growth of employment in the non-state sector fell from 6.8% in the 1980s to 3.4% in the 1990s.<sup>289</sup> For every 65 that find a job, 35 do not. With an estimated 200 million excess rural workers throughout China, and about 140 million 'floating' workers on the move and looking for jobs, the solution to move them into the cities is not a viable one.

Second, research shows that the same volume of capital hires less labour in China than in other developing countries.<sup>290</sup> This flows from the mass capital allocation to SOEs that is designed to preserve jobs, not create them. Moreover, with the failure rate of Chinese investment projects remaining at about 50% from 1991–2001,<sup>291</sup> and with a failure rate for medium- and large-scale projects at 42% from 1991–95, such waste of capital is hardly conducive to employment creation.

Third, in the quest for growth at all costs, little attention or resources are reserved for alleviating the effects of unemployment. Laid-off workers experience an immediate and drastic decline in living standards. According to one survey, for men who were laid-off, unemployment payments and social welfare constituted only 7.9% of post-employment support, with savings and income of another family member contributing to the lion's share at 57%.<sup>292</sup> These findings are similar to a number of other surveys.<sup>293</sup>



As evidence of mass unemployment mounts, few workers see the government or the Party as the saviour. The Party is irrelevant at best, and has betrayed them at worst. Various surveys reflect this sentiment. For example, in Tianjin, only 2.3% of laid-off workers indicated they would rely on government support. In Changchun, only 5% would count on the government to solve their economic problems. Not surprisingly, in a 1999 survey, 70% of laid-off workers said they were dissatisfied with their lives, and 75% of them sympathised with workers staging collective demonstrations.<sup>294</sup>

*(iii) Neglecting social goods and safety nets*

For a 'socialist' regime system in transition towards a 'market socialist' system, the lack of resources saved for social or public goods is a ticking time bomb for the regime.

For example, while life expectancy rose dramatically to 71 years in 2003—largely the result of disease prevention measures—the country's medical insurance system covered less than 50% of urban residents and about 10% of rural residents.<sup>295</sup> About 90% of rural residents were covered in the 1970s. Since the government only spends about 15% of the health budget on rural areas, public health in these areas is deteriorating quickly. Rural residents rely largely on 'village clinics,' in which 40% of practitioners in one survey were found to be not registered, two-thirds of practitioners did not keep medical records, and only half of injection tubes and needles were sterilised.<sup>296</sup> The proportion of rural household expenditure spent on health care has risen from 4% in 1982, to 12% in 1992, and to 15% in 2002.<sup>297</sup> Rural residents receive about one-third of the health care offered to urban residents in per capita terms.<sup>298</sup> Even in urban areas, 44% of residents who were sick declined to go to hospital in 2003 because of rising health care costs.<sup>299</sup> In 1993, around one-fourth of urban residents were uninsured. It is now around two-thirds.<sup>300</sup> Probably most damning is a World Health Organization study that concluded China was one of the most inequitable countries in the world in terms of distribution of and access to health care. China was ranked 188, ahead only of Brazil, Myanmar and Sierra Leone.<sup>301</sup>

At the National People's Congress in 2007, Premier Wen announced that spending on education, health, and other social services in rural China would increase by 15%. Bear in mind that this was only 3% above the rate of GDP growth for 2007.

Moreover, unlike Japan, China will get old before it gets rich. Its ageing population as a result of the one-child policy introduced in 1979 is common knowledge. After 2015, the working age population will decline. Yet one report suggests that only 55% of urban workers and 11% of rural workers are covered by the pension systems.<sup>302</sup> Another suggests that only 14% of the workforce overall is covered.<sup>303</sup> These pension obligations appear to be another 'black hole' in China's mismanaged financial system. In 2002, consultants McKinsey & Co released a report stating that China's 'pay as you go' pension pools 'were on the verge of bankruptcy',<sup>304</sup> not surprising as the system is based on employers making enough profit to meet these obligations. Although Chinese suggest that the pension black hole is a US\$100 billion–\$200 billion problem (using official employment figures), researchers in other organisations such as the World Bank and former investment bank Lehman Brothers put it at about US\$1 trillion in 2002.<sup>305</sup> Since then it has got worse. Mass forced retirement might make the unemployment figures look good but puts further stress on an already broken down pension system. By 2030, about 25% of the population will be over 60 compared to 10% currently. That will be almost 350 million people, compared to only around 60 million in 1980 who were over 60 years old. Renowned demographer Nicholas Eberstadt argues that in a big picture sense, 'The real wealth of the modern world is human resources.' In China, it is said that there is a '1-2-4' problem: one Chinese child supporting two parents, supporting four grandparents. In 2006, the ratio of the dependent elderly to those in employment was '1:5.2.' In 2030, it will be '1:2.2.' The worker to retiree ratio will fall from 3:1 in 2006 to 2:1 in 2030.<sup>306</sup> Given that the huge increases in national wealth since 1978 have been misused and allocated unwisely, and the fact that a large number of ageing Chinese will not have a child with the resources to provide for their parents, Eberstadt concludes that there is a 'slow-motion humanitarian tragedy coming down the track for China.'<sup>307</sup>

One could list dozens of areas that have deteriorated despite the impressive growth figures—from fair access to judicial and administrative resolution, to environmental and water degradation, to sewage, to rural roads, to working traffic lights, and so on. The important point is that there have been very poor attempts to replace the 'cradle to grave' benefits of the 'iron rice bowl,' and resentment is festering as Chinese residents repeatedly hear about China's world-beating growth rates.

Much of the problem lies in China's dysfunctional fiscal system. As the capacity of provincial and local authorities to collect taxes and fees increases, social spending is increasingly neglected and more unaccountable. Why? In 1978, the government's tax receipts were about 30% of GDP while in 1999 figures, it was about 14% of GDP. This figure, however, is augmented by about 20% of off-budget and unrecorded revenues mainly collected by provincial and local governments in the form of taxes and fees. In other words, the proportion of government revenues has remained constant at about 30%, but most of it is now controlled by local and provincial governments. These governments have little interest in spending to receive 'social returns,' cannot be called into account for these 'unrecorded' revenues and, hence, have complete discretion. They are more likely to spend the money on big 'growth' projects that have higher political returns and can offer tangible 'economic' growth results than on social goods that are harder to measure and extract praise for.

The collapse of the 'tofu' school buildings during the Sichuan earthquakes in June 2008 is a tragic case in point. Schools and dormitories that almost immediately collapsed killed between 10,000–15,000 students and teachers, while properly built government buildings next to these schools were largely unaffected. Shoddy workmanship combined with unreinforced materials (in direct contravention of building regulations) was responsible, with corrupt officials skimping on standards in order to save money.<sup>308</sup>

#### *(iv) Inequality*

Eva Bellin observes that state-led development—a direction China has taken since the 1990s—breeds inequality and dependence

on the state in capital and labour.<sup>309</sup> There are now between 50 million and 200 million middle-class people (depending on your definition) in China, but more than 1 billion people are increasingly missing out on the benefits of development.

The previous chapter looked at the decline in the growth of average household incomes since the 1990s, as well as downward trends in net disposable incomes, despite two decades of double-digit GDP growth. Broader measurements of inequality support these observations.

Most notably, within one generation, China has gone from being the most equal (albeit from a low base) to the least equal society in Asia. Its Gini coefficient (a measurement of income inequality) in 2007 was 49.6,<sup>310</sup> rising from the low 20s in the 1980s to the mid-30s in the 1990s.<sup>311</sup> (This backs up the observation that mean household incomes were rising with the tide during the 'entrepreneurial decade' of the 1980s.) In comparison, the United States had a Gini coefficient (where 0 represents perfect income equality and 100 represents perfect income inequality) of 40.8.<sup>312</sup> India's in 2004 was 36.8; Indonesia's was 34.3; South Korea's was 31.6; and Japan's was 24.9.<sup>313</sup>

To offer a historical comparison, the Gini coefficients of South Korea and Taiwan from the 1960s to the 1990s hovered at around 34 and 29 respectively even as the economies of these countries were growing rapidly.<sup>314</sup> China's deteriorating performance in this area is more comparable to what has occurred in South American countries such as Brazil or Peru than in its East Asian neighbours.

### *(v) The crisis of legitimacy*

As institutional corruption deepens and the system fails to distribute the fruits of prosperity fairly or wisely, it is not surprising that a crisis of legitimacy is already looming. Using international standards of poverty measurement, the World Bank in 2001 estimated the poverty level was more than double the official one at 12–15% or around 106 million people in poverty.<sup>315</sup> The World Bank figure was more recently revised to 130 million in poverty, which is still less than the 2006 CASS estimate of 200 million people.<sup>316</sup> Another World Bank study in 2007 used a more realistic measurement of what was

needed to purchase 2,000 calories of food per day (which researchers generally define as the 'poverty' line) and suggested that the number of people who were desperately poor was closer to 300 million.<sup>317</sup> If we redefine 'poverty' as those living under US\$2 a day, which many believe is a more accurate figure of what is needed for basic survival, around 45% of Chinese, or 585 million people, are in poverty.<sup>318</sup> The vast majority of these people would be in rural China. Remember that this is on the back of an economy that has been growing at approximately 10% for 30 years.

The upshot has been a drastic decline of the Party's legitimacy in these areas. An internal report in the mid-1990s found that up to 75% of rural Party organisations were in a 'state of collapse.'<sup>319</sup> A report by the Shanxi Party branch in 2000 admitted that 700 villages had not recruited a single member in the previous three years. This is far from atypical. Between 1994 and 2000, the Party was forced to 'fix' 356,000 rural Party cells—the most important grassroots political entities—that were adjudged to be 'weak' or 'paralysed.' This represented half of the Party's village cells. This is consistent with reports from the Shanxi, Zhejiang and Sichuan PODs (Provincial Organization Departments) that more than half the village cells in these regions were in serious trouble. A survey of Party members in Sichuan showed that one in four did not support or trust the Party and wanted to end his or her membership.<sup>320</sup>

Although the rural situation is of the gravest concern, the urban situation is also serious. There has been a direct correlation between closures and bankruptcies of SOEs and the effective dismantling or crippling of Party infrastructure in urban areas. This is not surprising as SOEs were at the heart of local Party activities. For example, in Liaoning, which was one of the provinces hardest hit by the closure of SOEs in the 1990s, of the 680,000 workers employed in those factories, 80,000 were Party members. Of the 80,000, only 8% subsequently re-applied for Party activity passes, and the rest effectively voluntarily surrendered contact with the Party.<sup>321</sup> Similarly, an internal report prepared by the Shanxi Party POD concluded that 'in non-operating SOEs, the Party apparatus is almost in a state of collapse. It does not conduct organisational activities or recruit new members. It cannot even collect party dues.'<sup>322</sup>

As these insights have been taken from official provincial Party research, we can be certain the leadership is aware of them. These figures are serious enough to fuel paranoia in any authoritarian regime. There is, however, more evidence of widespread disenchantment with the Party. In a survey of more than 800 migrant rural workers in Beijing in 1997–98, only 5% thought that local cadres ‘worked for the interests of the villages and do not use their power for private gains.’ Some 60% said that local cadres ‘*only* use their power for private gains and *do not* work for the interests of the villages.’ Eighty-five percent said that village heads (who are Party members) and Party secretaries were corrupt.<sup>323</sup>

Consider now the instances of unrest and protest in China.<sup>324</sup> These have grown from a few thousand in the early 1990s to 58,000 in 2003 to 87,000 in 2005<sup>325</sup> involving an estimated 4.5 million to 15 million people in that year. As these are official figures, it is almost certain that the actual number is greater than that reported by the Party. For example, a Hong Kong based labour rights group estimated that the figure was closer to 300,000 protests in 2003.<sup>326</sup> Moreover, as one report to US Congress affirms, ‘Although political observers have described social unrest among farmers and workers since the early 1990s, recent protest activities have been broader in scope, larger in average size, greater in frequency, and more brash than those a decade ago.’<sup>327</sup>

The vast majority of these protests are directed towards Party officials and policies: laid-off SOE workers, urban development displacing homes without adequate compensation, arbitrary and corrupt rulings by local Party officials, repressive tactics by local officials to implement decisions and policies, etc.

Although these rising instances of protests are not generally politically motivated and are not organised or unified, they clearly represent growing dissatisfaction with the Party. In other words, they bring to light the ‘crisis of legitimacy’ that is plaguing the Party. Although the Party has given extensive thought to dealing with these protests in a way that mitigates escalation of unrest—which essentially involves either brutally targeting the organisers but exercising restraint in using force against the majority of protesters, or paying off organisers or aggrieved protesters to

defuse the situation—the point is that having a monopoly on the organs of force and enforcement has never been enough. The Party is failing to provide for the people in current times what they once provided, and the result is that the Party is becoming irrelevant at best, and resented at worst.

The Party is fearful, but it is probably justified in being paranoid as well. These are seriously troubling developments for any authoritarian regime, and certainly for one that rules over 1.3 billion people. The further problem is that the regime does not know which pocket of dissatisfaction or resistance could spring into something big and, therefore, seeks to suppress all forms of alternative thought and activity as much as possible. The regime's repression of the Falun Gong movement is a perfect example. Many in the West fail to understand why the regime would care about a movement that is not political in nature and preaches 'truthfulness,' 'benevolence,' and 'forbearance.' In its current paranoid mindset, any movement with millions of followers that is separate from the regime presents a danger, especially one led by a charismatic leader in the form of Li Hongzhi. Officially accused of 'engaging in illegal activities, advocating superstition and spreading fallacies, hoodwinking people, inciting and creating disturbances, and jeopardizing social stability,'<sup>328</sup> religion and organised belief systems prick hard at the Party's paranoia. There are believed to be approximately 100 million Falun Gong practitioners in China. The Falun Gong demonstrated its organisational skills by arranging more than 300 protests between April and August in 1999 involving between 10,000–30,000 people in total, as well as more than 30 protests in Beijing involving 7,500 people in 2000 despite the regime's attempts to monitor the activities of members. There are also believed to be up to 100 million 'house Christian church' practitioners—citizens who worship in the privacy of their own homes and beyond the scrutiny of the state—in the country. Crackdowns and arrest of Christian activists are common. The role of Pope John Paul II in helping to inspire the drive to end communism in Eastern Europe provides a chilling historical lesson for the Chinese regime, and it is no coincidence that the only 'Catholic' worship allowed in China is under the auspices of the Chinese Patriotic Catholic Association (CPCA), a division of Beijing's Religious Affairs Bureau.

**(b) The crisis from without**

The second source for a crisis of legitimacy springs from an external one. Chinese politicians speak frequently and enthusiastically about how excited they are by opportunities arising from 'globalisation.' The mantra is particularly well received by Western business leaders. However, it is clear that the Party is ambivalent about China entering the globalised world, which they consider a 'double edged sword.'<sup>329</sup> On the one hand, the economic pay-off is unmistakable. On the other, outside influences are likely to fuel greater questioning of Party authority and policies—especially by the rising middle classes who are prospering from the modern reforms. In particular, greater access to information through the Internet and television carries the inevitability that the population will learn more and more about international and Western norms, as well as gain a deeper appreciation of China's problems such as income disparity, corruption, and fundamental economic difficulties.

A more affluent and educated population with greater access to information is also a serious threat to the regime's control and manipulation of its official histories. Controlling the telling of history is important in establishing the entitlement of the Party to rule. For example, state-sanctioned historians tell the story of how China's ruling Party has brought dignity, unity and order to China after its 150 years of humiliation. Chinese textbooks teach students that the defeat of the Japanese in World War II was the result of the Mao-led communist resistance and not due to the Americans dropping the bomb on Hiroshima and Nagasaki. Many young Chinese do not know about the Party's role in the chaos and organised violence of the Cultural Revolution, which, in the name of strengthening China, killed millions of Chinese, destroyed the education system, and paralysed the economy.<sup>330</sup> What they are told instead is that 'Mao called for political participation and got a national riot'<sup>331</sup>—a clear edict against democratisation. The attempts to censor international television and news programs and the 'Golden Shield' initiative with its more than 30,000 state employees<sup>332</sup> working to block and censor websites from well over 100 million Chinese Internet users—known by outsiders as the 'Great Firewall of China'—must be understood in this light.



## In trouble with its own people

In a survey of workers in Beijing in 1998, two-thirds of respondents thought the authority of local cadres were 'low' or 'very low,' 60% believed their authority was declining, and 85% believed their village heads and Party secretaries were corrupt.<sup>333</sup>

Behind China's official world beating growth rates, the government's place in society is tenuous, and the tensions between regime and the population are increasing. The leadership had named 'domestic stability' achieved by a 'well-off society' (*xiaokang shehui*) as its single biggest challenge. The Party has hedged its bets unwisely, and China's growth, unsustainable anyhow, has come at a huge political cost. The regime's appeal is fading, its rationale to exist and rule exclusively is weakening, its capacity to garner and mobilise support is declining, and its organisation is fragmenting. The Party is no longer able to build broad-based coalitions and, instead, has to rely on increasingly desperate and burgeoning tactical redistribution policies to remain in power. In a story typical of authoritarian regimes long after the fires of revolution have died, it is seen as corrupt, self-serving, and perhaps worse of all for an authoritarian regime, increasingly ineffectual and irrelevant. For a regime that tries to combine the role of 'defender of the socialist faith' as well as 'free market reformer,' the contradictions mean that it has succeeded in neither.

With its traditional rural support base in tatters, resentment of urban populations growing, and new elites agreeing to be co-opted only while there is more money to be made, the leadership is fretfully delaying the consequences of its wasteful resource allocation policies. Meanwhile, the economic, social and political deficits are accumulating. The government is not meeting the terms of its 'social contract' or fulfilling the necessary functions that legitimate governments must fulfil to remain in power. For a one-Party authoritarian regime, this obligation is even more critical and the standards more onerous.

Some might predict an incremental slowdown in growth rates given China's flawed model, but few are brave enough to predict the actual or effective breakdown of the regime. However, even a modest slowdown would have significant social and political effects, and the ingredients are all there for a potential social or political meltdown.

## The drying of the reservoir

In an eloquent piece on the rise of China viewed from the Chinese perspective, editor of *Time* magazine, Michael Elliott, observes:

Most casual observers outside China don't understand that even as the nation gains respect, its people are haunted by a deep sense of past slights. China's long journey toward modernity began not because the dragon gently flexed its scaly muscles but because others prodded it with a sharp stick. When China began to open up to the world 150 years ago, it did so because gun-ships of the British Royal Navy, working in the service of opium smugglers, forced the imperial government to accept foreign trade. As China sees its history, the country was subjected to foreign humiliation for the next century, its territory invaded and dismembered, its people raped and massacred. Along with the foreign interventions came homegrown catastrophes: rebellions, revolutions, civil wars, famine and unspeakable cruelty. *Luan*, the Chinese word for chaos, is perhaps the single most important concept that the outside world needs to grasp about the new China, for the memory of the long years of chaos continues to have a profound impact on Chinese thinking today.<sup>334</sup>

The reservoir is deep, and the Party draws heavily from this collective yearning for dignity to be returned to the Chinese people. The Party is the custodian of this sacred assignment. It tells its people that it will bring stability and prosperity, and return China to greatness. Yet, a sense of mission and a sense of entitlement are not the same thing. The mission of the Party was to lead China back from chaos to greatness. But this mission has been taken over by the Party's sense of entitlement to rule. Hanging onto power at any cost has become the Party's overwhelming concern. A failing political-economy model accompanied by mounting economic, social and political deficits is the result. Co-opting new elites and appeasing older ones is done through material means. Even relatively small decreases in economic growth could have dramatic results. Without refilling, even the deepest reservoirs will eventually dry out.

## Conclusion

In the past 20 years and more since China embarked on the road of reform and opening up, we have moved steadfastly to promote political restructuring and vigorously build democratic politics under socialism.

—*President Hu*, Speech to Australian Parliament,  
24 October 2003

On 23 October 2003, when US President Bush was visiting Australia, protestors mocked America's human rights failings in Iraq. A day later on 24 October, Chinese President Hu was given the honour of a standing ovation by both Houses of Parliament after his speech. Perhaps Australians were too reluctant to offend Chinese sensibilities even though President Hu's vigorous building of 'democratic politics under socialism' sits squarely with La Rochefoucauld's adage that hypocrisy is vice paying homage to virtue. The Party retains organised power for itself through repression and at the expense of any other political party or grouping. Democratic politics under socialism is more about the voting processes within the Party than elections that are genuinely contested. Experimental elections in almost one million villages somehow contrive to have unpopular Party officials voted back into office—through intimidation or fraud. All elections are 'supervised' by Party officials. Even where village election processes are held fairly, independent candidates are prohibited from forming parties. Therefore, the election of a popular independent candidate in one village will not create political momentum for non-Party members in another village. Moreover, the successful candidate at the village level must make decisions jointly with the local village Party chief.<sup>335</sup>

Bear in mind that the village level is not even a formal administrative level of government. Decisions made consist of everyday affairs such as where to lay pipes, or build fences, or where to allow cars to park. As flawed as village level elections are, there is no intention to allow elections at any level of government. Using the term 'democratic' is an empty gesture on the part of the regime. As Deng openly admitted in dismissing democracy:

The purpose of reforming the system of the Party and state leadership is precisely to maintain and further strengthen Party leadership and discipline, and not to weaken or relax them. In a big country like ours, it is inconceivable that unity of thinking could be achieved among several hundred million people ... Without such a party, our country would split up and accomplish nothing.<sup>336</sup>

In more recent times, President Hu leaves us in no doubt that he seeks to continue this tradition:

The Communist Party of China takes a dominant role and coordinates all sectors ... The leading position of the Party is a result of a long-term practice and is clearly stipulated by the Constitution ... The role of the Party organizations and Party members in government departments should be brought into full play so as to realize the Party's leadership over state affairs.<sup>337</sup>

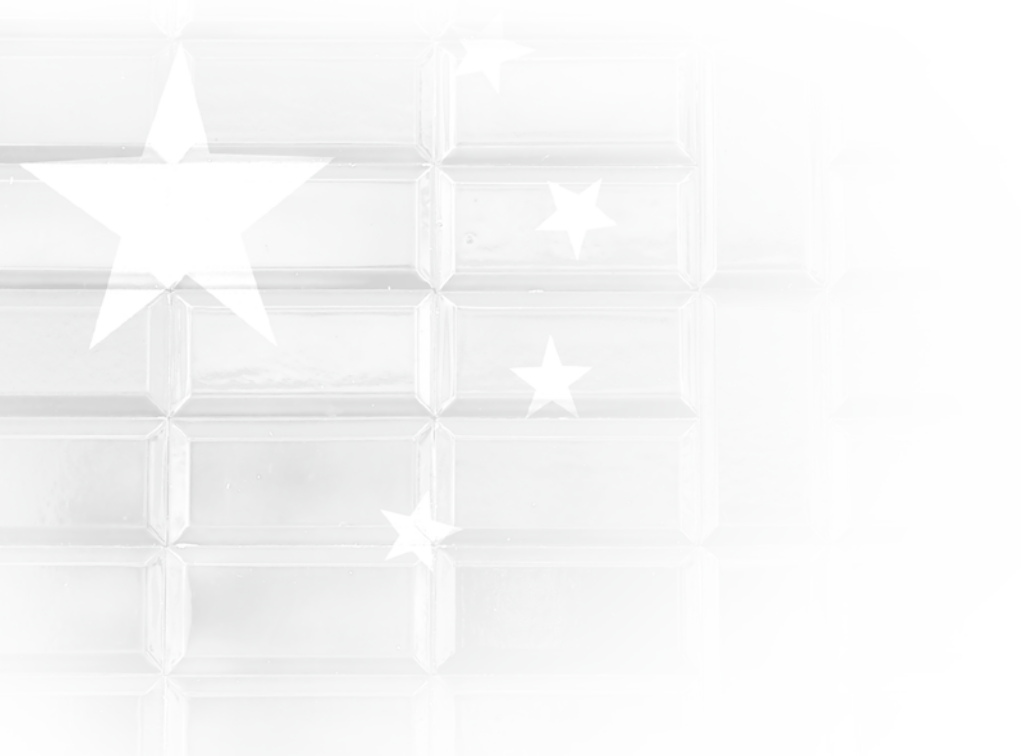
Chinese leaders consistently proclaim that China is becoming a 'democracy under socialist conditions.'<sup>338</sup> This means nothing more than a Party tactically adapting in order to remain in power. The tragedy is that this determination to remain in power and remain dominant in all affairs is at the heart of China's most serious problems.

The originator of the 'Beijing Consensus,' Ramo, argued that Beijing had introduced 'a new physics of development and power.' Instead, Beijing is trying to live in a parallel universe where the form of free markets is accepted but much of the substance and logic of it (which call for curbs on the role, power and excesses of government) is not. Ramo also argued that the flexible model allowed the Chinese to fit into the global system 'in a way that allows them to be truly independent [and] to protect their way of life' and to pursue an 'equitable model of development.' Instead, behind the 'Beijing Consensus' is a regime desperate to hold on to its authoritarian rule by using the fruits of the partial free-market system to entrench its power. Finally, although Ramo cites Chinese promotion of 'gradualism' and 'flexibility' as virtues, in reality these strategies have often been adopted by authoritarian

regimes to buy time in order to build new footings for the future and remain in power.

The Chinese political-economy model is far less 'nimble' and 'robust' than optimists such as Albert Keidel suggest. Most analysts offer advice on security and foreign policy based on China's rise. It is worthwhile asking what challenges we might face vis-à-vis a China that is stagnating, declining or, in the worst case, imploding. The decline of China is not inevitable. But I argue that its current model of political-economy is untenable and unsustainable. The model needs significant overhaul, and the most important reforms (and the most serious obstacles to them) are largely political rather than economic. If left unchanged, the case for pessimism is strong. The mounting economic, political and social deficits have placed enormous pressure on the regime. Part B will look at possible developments within Chinese politics and resulting challenges the world faces in dealing with a stagnating, declining and imploding China rather than an increasingly prosperous and rising one.





Part B

# CHAPTER ONE

The Internal and External Consequences  
of Declining Legitimacy





## PART B

### Chapter 1

# The Internal and External Consequences of Declining Legitimacy

## Introduction

Failing states and failing regimes present many different challenges compared to accommodating the rise of successful states and confident regimes; *a fortiori* when talking about a great power. China evidently needs peace and stability to continue its development. But its ‘peaceful rise’ follows the logic of a successful state in transition. Yet, the predominant driving force of an unsuccessful state or regime in transition might very well take a different and less predictable form. In particular, the People’s Liberation Army (PLA) remains a critical factor in the future direction of Chinese politics and society. The dynamics of transition with respect to relations between the CCP-PLA and other segments of the population are ever-evolving and, in the event of an unsettled and failing transition, likely to be difficult.

What factors are driving us to consider the growing *possibility* of a failing Chinese state, or more precisely, a failing Chinese regime? I have pointed to four interrelated factors in the preceding chapters. The first is the deepening crisis of legitimacy faced by the Party. The second is the vertical fragmentation of the Party’s power and its declining ability to implement and execute top-down macro policy because of the shift in power and economic control and resources towards local authorities. The third is unsound economics. The fourth is a regime increasingly failing to meet the social needs and expectations of huge numbers of its people—a serious failing in an authoritarian state such as China.

Crucially, despite the best efforts of the Party, the government is failing to meet these challenges—the same challenges that established liberal democracies have generally been able to address more effectively given their greater levels of social and

political accountability, and the greater structural alignment of interests between polities and governments. The timeless stuff of politics—‘obligation’ and ‘coercion’ according to Isaiah Berlin—and economics—the creation, use and distribution of wealth and resources—are not functioning well in authoritarian China. The Party tries to keep these on-the-ground realities hidden from the rest of the world while sanguine commentators enthusiastically proclaim the miracle of China’s stellar rise.

Despite these problems, no one really knows where or what China will be in 10 or 20 years. Consequently, no one can be certain about the most appropriate strategy for the ‘China question.’ At best, recent history provides only limited lessons on how we should deal with China. The country is neither Nazi Germany nor the Soviet Union. There is no certainty that it is a modern version of Bismarck’s Germany. ‘Containment’ appears too extreme and unnecessarily provocative; given China’s role in the global economy, few countries would be prepared to support a containment policy. Simple ‘engagement’ seems too optimistic. China provides an emerging hard and soft power challenge to the United States and the West. Beijing’s focus on ‘comprehensive national power’ includes a combination of international prestige, economic and military power, cultural influence, and regional leadership. An ‘engagement’ policy that ignores these challenges would be irresponsible. Further, an engagement policy that blissfully assumes China can be managed or pressured to democratise, or that democratisation is inevitable, is similarly misguided. Finally, forceful intervention is out of the question. It would be, by some margin, the most reckless and ill-advised approach that could be taken.

Even though a comprehensive strategy to deal with China is in doubt because of China’s unclear future, many analyses are premised on China’s *inevitable* rise. The more optimistic points of view, such as those put forward by Zheng Bijian<sup>339</sup> and Kishore Mahbubani,<sup>340</sup> are premised on China’s continued ‘peaceful rise’ or ‘peaceful development.’ The term ‘peaceful rise’ was first used by Chinese leaders in 2003 to counter international fears about Beijing’s growing power. The argument was that China needed a peaceful environment and good relations with other powers to focus on its economic development. Its rise would therefore

be peaceful rather than disruptive. As Premier Wen declared in 2004:

China's rise will not come at the cost of any other country, will not stand in the way of any other country, nor pose a threat to any other country.<sup>341</sup>

The 'peaceful rise' thesis is essentially based on two arguments. First, China's transition from a backward to a prosperous nation will be a successful one; second, the benefits of peace will outweigh the gains from conflict during this transition.

Part A argued that China's political-economy model is flawed and failing. Although the future is far from certain, without further political reform, China's continued rise is very much open to question. Therefore, assuming that China will continue to reform successfully is as much a matter of guesswork as predicting a China that will fail to adequately reform. This part (Part B) looks at possible consequences of a struggling and increasingly desperate regime both domestically and with respect to key aspects of China's foreign relations. An important question is how the regime might respond to mounting economic, political and social pressures in the quest to hold on to power—and whether the benefits of peace will always outweigh the benefits of conflict.

## **Condition precedents**

Speculation about a declining or even failing China must be based on a series of 'condition precedents' that might or might not occur. Even if China does not undertake significant political reform, lessons from the Ottoman and Hapsburg empires to the Soviet Union teach that even systems with deep and inherent flaws (that we now know about) can exist for a surprisingly long time and need to be pushed by exceptional (or sometimes just the seemingly innocuous) historical incidents before falling over. Some regimes can also delay the onset of significant decline through partial adaptation and reinvention. However, I argue that while political reform remains stunted, these 'condition precedents' for failure are firming up; it is time to give serious thought to what a failing Chinese regime might look like and how such a regime might respond to its own decline. Although such speculation will

always invite criticism and counter-scenarios, we cannot ignore the troubling trends emerging in China.

Individual personalities have historically been important in understanding Chinese politics and decision-making at the top. The larger-than-life figures of Mao and Deng exercised more power and discretion than their official positions and titles suggested. Since then, leadership has been weakly institutionalised, and while the current leader of the ‘Fourth Generation,’ Hu Jintao, lacks the stature of Mao or Deng, his position as ‘paramount leader’ is entrenched as President, Party leader and, more recently, Chairman of the Central Military Commission (CMC). Nevertheless, to remain in power, President Hu needs the support of dominant factions within the Party and the loyalty of the PLA.

Part A looked at the economic challenges facing the Chinese. But President Hu’s authority and position within the Party, as well as the larger question of the regime’s future, will also largely depend on how well President Hu and his successors meet the political and social challenges facing the regime. As I will outline below, these challenges are much more serious than many commentators in the West realise. The two recent trends that need to be discussed are the emergence of the ‘New Left’ in Chinese politics under President Hu’s leadership and the dynamics of CCP-PLA relations in the context of these profound political and social challenges for the regime. Domestic pressures influence foreign policy. The following chapter will look at how these domestic concerns, and the regime’s responses to them, are loosening the foundations of a foreign policy that could very well be different to the one behind China’s ‘peaceful rise.’

### **Between order and chaos—political and social challenges for the regime**

As one of the writers who best understood the phenomenon of totalitarianism in the twentieth century, Robert Conquest in reflection argues that any totalitarian attempt to control all aspects of life is untenable in the long run, while allowing a far greater leeway on some matters—‘tactical disagreements’—is much more viable.<sup>342</sup>

China is no longer a totalitarian state. The regime no longer seeks to control every aspect of life or way of thinking. Although the Party remains determined to hold on to power, there is no 'utopian' end-goal that totalitarian regimes can ruthlessly strive towards. Indeed, as I have argued, the Party is becoming less relevant to many Chinese, and different forms of behaviour are largely tolerated as long as they are not deemed to be threatening to Party authority or social stability. In the words of one expert who has worked and lived in China for more than 25 years, 'life in China has softened a great deal.'<sup>343</sup>

This might augur well for the regime if it were not suffering an immense 'crisis of legitimacy.' Many former totalitarian regimes like the one in the Soviet Union became most vulnerable when they were in transition. This makes sense since regimes are 'totalitarian' in nature only when they can be. Single-party systems reach their height when their vision of the future is universally received, and there is sufficient 'buy-in' from the population for the regime to employ totalitarian tactics, of which state-backed force is only one part of the coercive apparatus. When regimes move towards softer authoritarian models, it is often a sign that their grip on society is slipping and they have no choice but to relax aspects of authority.

For the Party, the current transitional period of mounting political and social challenges is correctly seen as a period of immense significance in terms of the future of its authoritarian rule in China.

#### (a) **The credibility problem for the regime**

There is growing evidence that the authority and capacity of the regime to govern (in addition to its legitimacy) are declining. This is occurring for two main reasons.

First, although it is now clear that increasingly allowing the operation of free markets was seen as *therapeutic* rather than 'transformative in terms of Chinese politics and society,' the authority of the Party is now based on an insecure strategy of using resources inefficiently to fuel a bubble economy. Moreover, the solution—to grant the private sector greater and greater access to this wealth and control of critical sectors of the economy—would

accelerate the irrelevance of the Party and weaken its ability to remain exclusively in power. As the regime continues to oversee an economy based on unsound fundamentals and becomes increasingly less able to provide social and public goods, more and more cracks are appearing on the façade of Party credibility. The survey results cited in the previous chapter bring this out emphatically.

Second, public decision-making and administration are becoming more sporadic and unpredictable as the disconnect between the central leadership and the majority of its population becomes more pronounced. This is occurring for several reasons. First, senior Party members are increasingly becoming part of the new wealthy elite as a result of their privileged position within a China that is growing richer. Moreover, as part of the tactic to co-opt the new and emerging urban elites, the senior leadership has neglected the poor and especially rural populations to its detriment. It is easy to forget that there are still about 800 million rural inhabitants in China (and only 50 million–150 million in the middle and upper classes). The capacity (and intent) of the leadership to understand their problems and deal with their complaints is greatly diminished. Second, as the regime decentralised, there was a resulting loss of fiscal (tax collection and spending), administrative, and legislative power for the central government, which was increasingly transferred to local ones. This means that the execution of political, social, legal, or economic macro policy from the top becomes much more difficult and unpredictable. In other words, there is a loss of centralised control and a greater reliance on local governments that are neither very accountable nor transparent. The worst local government practices tend to be in the poorer rural areas that are ruled by the ‘law of local leaders.’

The lack of predictability might be less important in a purely agrarian society of uneducated peasants shut off from the world and each other, but is much more critical as a society becomes more complex and the people more educated. China has a literacy rate of about 80%, which includes most of the poor peasants. In looking at the Soviet experience, Alfred Evans argued that the inability to set up impartial mechanisms for adjudication, enforcement and regulation, and effective rules for resolving

disputes, went a long way towards explaining the resulting loss of legitimacy for the regime and the subsequent implosion of the system.<sup>344</sup> If simple grievances—such as why one is prohibited from bidding for a legitimate contract in a neighbouring province, or why one's home can be bulldozed without warning or adequate compensation despite national laws stating otherwise—are not resolved in an appropriate and predictable way, daily life is invariably compromised and the regime is invariably blamed. The rise in the number of petitions from aggrieved Chinese citizens is an indication of dissatisfaction. Between 1979 and 1982, approximately 20,000 such petitions were filed each year. In 2005, according to Li Shuguang, a vice dean at a university closely associated with the ministry of Public Security, close to 30 million petitions were filed in 2005.<sup>345</sup> One study reported that out of the millions of petitions registered in 2003 with the Petitions Office, which was established to hear and resolve public grievances and disputes, just two out of every thousand were resolved.<sup>346</sup> If the party in power retains the right to 'intervene' regardless of agreed rules, and does so either because of a fragmented and disjointed decision-making process or because of politically motivated or corrupt Party officials, the tactic of central leadership deflecting blame towards local officials starts to wear thin. If the Party maintains that 'it knows best,' and the rule of law can be bypassed by incompetent or corrupt Party officials as well as courts and tribunals ultimately under the Party's instruction, then the loss of credibility remains directed towards the Party as a whole.

The fact that the reported instances of unrest are rising exponentially suggests a rising tide of discontent. However, most analyses stop at this point because little information is revealed by the government about the nature of these instances and what they concern. What we mostly hear from the Chinese government is talk of 'procedures' established to mitigate the seriousness of these incidents. Piecing together a picture of what is happening has mostly been left to intrepid insiders and determined reporters. These piecemeal reports, which are becoming more lucid and comprehensive, point to scenarios that have variously been described as a 'tipping point,' 'time bomb,' and a 'precipice' for the regime. Indeed, official media channels can no longer hide

(and perhaps no longer want to hide) the rising instances of social unrest. These instances are the most tangible signs of a more and more disgruntled population.

**(b) Social unrest in China**

Officially reported instances of social unrest (involving 15 or more people) have risen from 8,700 in 1993 to 87,000 in 2005 (which are the latest available figures). That is about 240 instances each day. A flood of reports and articles have been released by Chinese researchers lamenting the rapidly deteriorating state of governance since the 1990s.<sup>347</sup>

The first important point about the rising instances of social unrest is that it indicates a citizenry increasingly defiant or unafraid of the authoritarian coercive apparatus. This means either that the level of discontent is so profound that the protesters no longer care about the consequences of unrest, or that the regime's ability to enforce compliance and order has been seriously compromised. As the truth is undoubtedly a combination of both, this is worrying news for any authoritarian government.

Second, as earlier passages point out, only a small proportion of Chinese citizens have been benefiting from economic growth since the 1990s. This is exacerbated by the fact that social and financial safety nets (e.g. health, education and welfare) have been greatly reduced during the reform period. For example, a recent UN study estimated that out-of-pocket spending on health care in China has almost doubled as a percentage of total health expenditure in the period from 36% in 1980 to 68% in 2002. Meanwhile, government spending in the same period has been reduced from 39% to 15%.<sup>348</sup> Much economic progress has been made from 1979 to the mid-1980s. But since then, of the approximately 800 million peasants, about 400 million have seen their incomes stagnate or decline during the past decade.<sup>349</sup> Another study by the World Bank suggests that the income of the poorest 10% was declining by 2.4% each year at the beginning of this century.<sup>350</sup> This structural inequality, which is largely the result of policy shifts from the 1990s onwards, suggests that broad growth in itself will not remove discontentment. In fact, as inequality becomes even more obvious, it is likely to worsen.



Third, the political danger is not just the growing divide between China's minority 'privileged classes' and the rest (most of whom are desperately poor)—although this is in itself a genuinely tragic humanitarian crisis<sup>351</sup>—but the fact that most of the cases, and the worst cases, of unrest are directed towards local authorities and officials. In other words, the problem is seen to emanate from the government, and a connection is being made between the regime and the hardships the poor face.

This is not surprising since most cases of protest are a way to vent frustrations against corrupt local officials: arbitrary and repressive taxes and land grabs from officials; unpaid benefits or loss of rights against official bodies; non-enforcement of laws by authorities and courts; lay-offs of workers by the state; use of thugs by local officials to demand compliance; and the like. Even though they control about two-thirds of government revenue collection (with the central government receiving about a third), local officials do not deliver services that are relied upon by the masses because of insufficient budgeting, corruption and incompetence. When local officials want more money, they simply collect more taxes or fees, or literally seize more land. Local officials make decisions and assume rights over the factors of production: land, assets and labour. Central officials constitute only around 2–5% of China's 46 million officials. The other 95–98% are local officials (county level and below).<sup>352</sup> These largely unaccountable officials administer the centrally devised projects such as infrastructure building, poverty reduction, and any land reforms.

According to one study covering 2,000 households across 17 provinces, blatantly illegal land-grabs by local officials increased 15-fold over the past decade.<sup>353</sup> In another 2003 study, it was conservatively estimated that 40 million households had their land illegally seized by local officials.<sup>354</sup> In rural areas, because all village land is ostensibly owned collectively, the lack of clear and definable property rights allows greedy local officials to effectively make decisions as to how the land is used, distributed, sold, developed, etc. The regime is intrinsically culpable. The frustrations cannot be dismissed as unruly citizens fighting amongst themselves or as a result of racial or intra-provincial tensions as the central leadership attempts to do.

Fourth, the size of instances of unrest is growing and can be frightening. For example, in cases recently documented for 2003, a mob of 50,000 torched police cars in Chongqing to protest the beating of a migrant worker; 100,000 stormed a government building and forced the postponement of a dam project in Sichuan because of inadequate compensation; 20,000 miners and their families rioted against layoffs and the loss of their pensions.<sup>355</sup> Other recent instances of unrest include 80,000 retired workers protesting in China's northeast over unpaid pensions in 2002; 30,000 rioting over exorbitant bridge tolls issued by local authorities in 2004; 7,000 textile workers protesting after being forbidden to form their own union in the Shaanxi Province in 2004.<sup>356</sup> Of the 74,000 instances recorded in 2004, 17 involved 10,000 or more people; 46 involved 5,000 or more people; 120 involved 1,000 or more people; and 2,180 instances involved 500 or more people.<sup>357</sup> The fact that order could be restored only after martial law was implemented in many of these cases highlights the seriousness of the problem. Even for the smaller incidents, the numerous anecdotal accounts of protesters violently targeting or resisting authorities speak volumes about the crumbling regard for the *people's* party.

Fifth, there is evidence that unrests and protests are not just confined to backward rural regions in China as many analysts assume. National data for 2000 indicates that 34% of participants in protests were urban residents.<sup>358</sup> The makeup of protesters is also broad—encompassing workers, businesspeople, intellectuals, former PLA soldiers, and also civil servants.<sup>359</sup>

Finally, protests appear to be getting more disruptive and violent. These are generally categorised into three types: 1. Blocking and destroying public transport facilities; 2. Encircling and attacking government buildings or officials; 3. Fasting or committing suicides in public. According to a survey of official reports, incidents of 'encircling and attacking' government buildings increased from 2,700 in 2000 to 3,700 in 2003. There were more than 3,100 blockages of public roads and railways in 2003.<sup>360</sup> A recent example was a protest in June 2008 when more than 30,000 people gathered in front of government buildings and police stations in Weng'an County (Guizhou Province) to protest the cover-up of a rape and murder of a local girl.

Protesters set fire to more than 20 cars and torched two police stations as well as the Party headquarters.<sup>361</sup>

The government strategy of linking its legitimacy to macro-economic growth might temporarily placate the privileged classes but has no apparent bearing on reducing social unrest. As the Chinese economy boomed from 2001–05, the number and scale of protests continued to rise<sup>362</sup>—further evidence, as if more were needed, that the fruits of any growth are restricted to the privileged few. Clearly, impressive macro figures inflated by fixed investment spending cannot solve problems festering in the micro-environment.

### (c) The possibility of coordinated social unrest

When speculating about the future, there is no way to know to what extent something is ‘possible’ or ‘probable.’ This would require perfect knowledge of who, what, where, how, and why. This is the inherent incomprehensibility of (knowing) causation in any human activity, particularly so when dealing with the world’s most populous nation. We can, however, point to certain *condition precedents* that, should they occur, would make social unrest more likely or more unlikely.

We do know that China is a country in a profound mess. Its economics and wealth creation are inefficient and flawed, its financial structure is unsound, and the misallocation of resources is massive, chronic and deep-rooted. Its growth is artificially fuelled and unsustainable, and the wealth created is systematically wasted and directed towards less and less productive areas. Government and social deficits are mounting while the regime—which is itself largely the cause of these deficits—cannot offer any viable solutions without precipitating its own demise. It therefore maintains a holding strategy while these problems worsen. Meanwhile, the lot of the majority of the population is either stagnant or in decline, while economic elites (who are the regime’s newest support base) continue to thrive, but only as a result of the tenuous and ultimately unsustainable growth strategy. Most significant decisions made by the regime are therefore tactical ones—‘putting out spot fires’—driven by the logic of pure political survival rather than the logic of fundamental and

sustainable transformation. Meanwhile, the fragmented regime hangs on the best it can and eliminates or impedes any threats to its political dominance.

Most commentators outside China agree that the possibility of coordinated and widespread social unrest is low and does not pose any foreseeable threat to the regime. Although the social unrest is usually directed towards local officials, and by implication the regime as a whole, these are not coordinated. They do not generally call for the overthrow of the Party, let alone constitute any kind of pro-democratic movement, and they do not amount to, in the eyes of most experts, a Tiananmen-style protest aimed at the central leadership. They are probably better understood as unprompted pressure valves to vent and release frustrations within a system that does not provide formal mechanisms for such a release. They tend to be reactive rather than political in nature, and many experts believe that a social movement arising from these protests appears unlikely.

However, the confidence many Western commentators have that these protests do not contain seeds of coordinated mutiny is of little comfort to the Chinese leadership who take this possibility much more seriously. It is true that there is no readymade and credible political alternative to the Party in the present scenario. The regime has seen to that by being well versed in the art of remaining in power by eliminating alternatives and controlling the apparatus of coercion rather than enhancing legitimacy and service delivery. Yet, non-political organisations can lend their support to political causes. Organised groups within China such as the Falun Gong, Roman Catholics (as opposed to Chinese Catholics), and independent trade unions are paid close attention and are subject to significant persecution and control. The Chinese are well aware that the same confidence was expressed about the viability of communist regimes prior to the recent revolutions in the Soviet Union, Czechoslovakia and Romania. For good reason, authoritarian regimes tend to take the possibility of revolution much more seriously.

Moreover, the regime is aware that the popular dissatisfaction of hundreds of millions with their lives, official corruption, and the inability to procure redress for injustices and frustrations

have led to rising unrest and disenchantment with the Party. As more economic, administrative, and also coercive powers move into the hands of local rather than central officials, effective 'governance' by the vanguard of the regime becomes less feasible. The inability (and political unwillingness) to genuinely target the corruption problem is a prime illustration. The structural flaws and economic difficulties that lie ahead will exacerbate these conditions. How the regime responds is critically important.

**(d) It only takes one spark ...**

A spark from heaven can light up an entire plain.

—*Deng Xiaoping*

Winston Churchill once observed that great events in history rarely have great causes but are instead set off by the most minor of incidents (e.g. the assassination of an archduke in Serbia as the trigger for a world war). Those waiting for great causes to emerge generally miss the boat, and there is more practical wisdom in seeking the conditions for great upheavals rather than specific grand causes.

Deng was certainly correct: when conditions pile up like bonfires waiting to be lit, it only takes one spark. There are a whole host of trigger events that cause unrest (having grown 10-fold since 1993 according to conservative official figures). Any of these hundreds of incidents each day—whose average size is continually growing—is a potential 'spark.' If the beating of one migrant worker can cause 50,000 people in Chongqing to riot, and this is not atypical, then there are clearly deep veins of discontent that such protests can tap into.

The regime's great fear is that rather than instances of social unrest being selectively isolated and reactive events, protesters will unite under common causes, and unrest will become organised and coordinated across different townships and even provinces. A few thousand peasants protesting about polluted drinking water in a small Western township is a very different proposition to the uniting of intellectuals, students, and urban workers marching

towards Tiananmen Square demanding greater political reform and protesting against Party corruption (while eliciting widespread sympathy from the population for doing so). Tiananmen remains the model of discontent that the regime is desperate to avoid.

Yet, communication has always been the enemy of authoritarian regimes—especially those suffering profound credibility problems. Party officials are well aware that there are almost 450 million mobile phone users and well over 100 million Internet users in China. Sharing stories, incidents and ideas amongst themselves is an inherently threatening activity for the Party. Although there is nothing inevitable linking the growing communication network and the rise of democracy or popular participation in China (despite what optimistic democratisation enthusiasts might argue), it is a new and profound challenge for the regime. Where once it was easy to control the media and the spread of information and content, it is impossible now. Populations that knew little about what was happening in the next town (let alone the next province) are now much better informed. The spread of facts and opinions, and also of completely unfounded rumours, increases every day. Though watching CNN on Chinese satellite television is still a disjointed experience as snippets are regularly excluded or cut short, Internet savvy users can relatively easily evade officially censored sites and find out what they have missed from other sources. In one widely reported incident in October 2004, word of a simple traffic dispute spread so quickly that thousands of Hui from other parts of China learned of the clashes by telephone and rushed to the region before riot police could respond. A week later, a simple altercation between a deliveryman and a fruit market worker in western Chongqing attracted a crowd of thousands within hours via phones and text messages because the worker passed himself off as a government official and attempted to resolve the dispute in his favour. The protesters were making a point against someone they thought was a Party official. Censorship in any form is simply much less effective in the age of modern communications. There was also another ominous development for the regime when, in September 2007, more than 2,000 demobilised soldiers rioted simultaneously in two cities more than 1,000 kilometres apart, suggesting a high degree of coordination.<sup>363</sup>

Worryingly for the regime, the population is gaining knowledge about country-wide trends and statistics. A recent United Nations Development Program (UNDP) survey within China reported that 80% of Chinese believe that China's current income distribution is either 'not so equitable' or 'very inequitable'.<sup>364</sup> Most of those surveyed would have been educated urbanites who are far removed from the poorest in China. Moreover, where once books like the one written in 2004 by the husband-and-wife team of Chen Guidi and Wu Chuntao—*The Chinese Peasant Study*—would have been confined to foreign readership a world away, the banning of it has not prevented the estimated distribution of up to 10 million copies through the underground press, making it a bestseller. Millions of Chinese are reading passages such as these from *The Chinese Peasant Study*:

We observed unimaginable poverty and unthinkable evil, we saw unimaginable suffering and unthinkable helplessness, unimagined resistance with incomprehensible silence, and have been moved beyond imagination by unbelievable tragedy ...

Farmers worked all year long to earn an average annual income of 700 yuan [average annual urban income is 6000 yuan] ... There were 620 households in the whole village, of which 514, or 83 percent, were below the poverty line. Even though the village was very poor, the leaders were prone to boasting and exaggeration about their performance, and as a result the government struck it off the list of impoverished villages. So the villagers were burdened with exorbitant taxes and levies.

Nor have the authorities been successful in stopping excerpts of the book from being widely distributed through the Internet. The fact that the 460-page book can be easily bought under the counter for a couple of dollars in bookshops throughout China means there are large segments of the population that are hungrily consuming information about the plight of their country folk. The fact that Chen is a member of the respected, state-sanctioned Association of Chinese Writers and far from a 'radical splittist'

suggests that it's not just outsiders who are dismayed by what is occurring in China. Indeed, the plight of the majority of Chinese and their causes are occasionally subjects of comment by factions within state-sanctioned media, as well as state-backed academics and intellectuals. While they rarely flirt with the great ideological and treasonous sin of 'splittism' (denouncing the Party as the legitimate rulers), criticism of the government shows opening and festering wounds within the Party itself and concern about the plight of the people they lead.

What about urban elites? According to a recent Pew report, 75% of the dominant elite urban respondents are generally optimistic about China's future.<sup>365</sup> This is not surprising as the elites share a disproportionate amount of the country's wealth and tend to be optimistic. However, what this report reaffirms is that China's elites have high expectations not just about China's economic growth but also expectations about continuing to benefit from this growth. While most instances of unrest have been in the countryside, urban movements tend to focus on loss of employment and non-provision of promised or accumulated social benefits such as pensions, health care, affordable housing, and education.<sup>366</sup> (The primary triggers for the latter tend to involve officials embezzling or incompetently managing funds.) We have already seen that unemployment is increasing in both urban and rural areas as a result of the accumulated flaws within the political-economy model. Pension funds, in particular, have been squandered, and out-of-pocket expenses for health care have been increasing for a decade. It is doubtful whether such optimism even in urban regions is well placed.

Finally, the 'dark horse' of discontent is the *mingong*, the more than 200 million migrant peasant workers roaming mainly in urban China looking for work. These itinerant workers do not mix well with the elites, as one report describes:

You can spot a *mingong* from miles away. Their work clothes, blue or brown, are shabby and covered in dust; they are thinner than most Chinese; and they are also shorter ... Their armies can be seen in countless construction sites in Shanghai and Beijing, living in shelters more crowded than prisons cells ... In this Beijing winter, late at night, they can



be seen working in the streets under freezing temperatures and merciless winds from the Gobi Desert. Sometimes during a lighting-quick break one can spot their shadows gazing longingly at out-of-reach sneakers and mobile phones behind glittering department-store windows.<sup>367</sup>

The *mingong* constitute significant pockets of discontent in urban areas. About 25% never get paid or have their pay delayed by employers; 97% have no medical benefits whatsoever; and standards for work conditions are non-existent. To appreciate the scale of this kind of displacement, there are more *mingong* in China's biggest cities than there are registered urban workers.

No one can be sure where all this is leading. What I am arguing is that a China successfully in transition is far from the reality. The evidence reveals a regime trapped by its own contradictions. On the one hand, the extent of misallocated resources and dysfunctional macro-economic setup means that China's 'growth' economy cannot fulfil the regime's economic and social needs. Employment creation is falling dramatically short, and social funds such as promised and accumulated pensions will not be available for the millions when they need it. This is particularly worrying given China's well-reported ageing problem. Moreover, although the bursting of the bubble economy and its consequences are unpredictable, it will certainly lead to massive social disruption. The first edition of this book (late 2007) argued that 'Even a slight tremor in the US economy would be devastating for China's growth economy so dependent on exports to America.' Now that the US economy is facing a prolonged recession, it is estimated that at least 20 million migrant workers in China have already lost their jobs in the export manufacturing sector alone.<sup>368</sup> Prior to this, surplus rural workers (the group from which migrant workers arise) were estimated at anywhere between 200 million and 300 million as TVEs were declining and had already absorbed all the employees they could handle. Even prior to the global financial crisis, around half of the rural migrants to the cities had difficulty finding jobs. Bear in mind that the whole Chinese private sector only employs 200 million–250 million people. The unemployment problem is immense and will get worse.

On the other hand, reforming the economy is necessary, including allowing private enterprises (who are best able to create and provide sustainable employment and consumption-led growth) access to key sectors and the majority share of capital. As the previous chapter argues, the regime is unlikely to allow this as it would result in an unacceptable diminishing of its control over the most important levers of the economy. Moreover, such structural reform would cause the unemployment and displacement of millions of state workers and employees in state-supported sectors. We would only have to look at the period from 1997–2000 when instances of civil unrest increased by 235%. A high proportion of these instances were in urban areas experiencing accelerated layoffs of SOE workers at a time when the leadership was looking to reduce the number of SOEs. The leadership is especially fearful of urban unrest as it would occur in the vicinity and in full view of China's elites and intellectuals, as well as world media.

Grassroots level problems and discontentment highlighted earlier—frequently flaring up unpredictably—are really just individual illustrations of the broader conditions in China that are made worse by interaction with corrupt officials. The possibility of regime collapse as a result of accumulated social deficits and declining legitimacy is dismissed by many in the West but not by the senior leadership. President Hu repeatedly warns that disconnect with the masses is the Party's greatest problem. In a Central Committee report in September 2004, officials were urged to improve governance amidst the warning that 'the life and death of the party is at stake.' In a follow-up article the following month printed on the front page of the *People's Daily*, Vice President Zeng Qinghong wrote:

The Soviet union used to be the world's number one socialist country, but overnight the country broke up and political power collapsed ... One important reason was that in their long time in power, their system of governing became rigid, their ability to govern declined, people were dissatisfied with what the officials accomplished, and the officials became seriously isolated from the masses.<sup>369</sup>

Zeng might have been talking about the Soviet Union but he has portentously listed the condition precedents for regime implosion that exist in China now. Chinese leaders have consistently urged officials and the People's Armed Police (PAP) to contribute towards building better conditions for social stability, but also to 'always obey the commands of the Communist Party of China.'<sup>370</sup> But there is little evidence the leadership has a plan to turn the tide, instead relying only on tactical initiatives to put out 'spot fires,' placate protesters, or intimidate them.

#### (e) The dangers of managing disorder

Managing rising disorder is a dangerous activity. The important and pertinent question is how the Party will respond as economic and structural problems deepen, causing growth to slow, and government and social deficits keep mounting. In other words, how will the regime respond as instances of unrest multiply, and the size and organisation behind them become more alarming?

As its mandate based on 'economic and social order competence' fails, Murray Tanner, an expert studying Chinese unrest, observes that the basic strategy of the regime to retain effective power depends on 'driving a wedge of prosperity and coercion between the enormous mainstream of average citizens and the minority who might try to organize opposition [or] promote systemic political change.'<sup>371</sup> Most importantly, this means convincing the urban elites that the Party can provide them with continued economic growth, effective governance, national unity, and even national dignity (more of the latter shortly). I have already argued that the impetus of this strategy is stalling. Moreover, the evidence of a more assertive mass political culture of protest is compelling. The capacity of the regime to deliver is highly questionable while there is a growing consciousness about China's rural plight. This growing consciousness might very well evolve into collective concern and anger should the situation of the economic elites deteriorate.

Second, the regime has two *tactical* ploys in attempting to manage unrest and discontent. The first is to deflect blame onto local officials rather than the central government. The leadership encourages protesters to believe that the injustices they suffer

as a result of actions taken by local officials are not typical of other regions or of the system as a whole, and that the central leadership would solve them if they knew of the injustices. Unfortunately for the regime, this tactic is wearing thin as conditions worsen, grievances and petitions through formal channels are ignored, and information and stories spread via modern communication media.

Furthermore, the regime depends on the tactical use of permissiveness and repression, and compromise and coercion, on a case-by-case basis. Manuals are produced for local enforcement stipulating principles and procedures with the aim of preventing unrest from escalating into major events. The problem with relying on this tactic is that it assumes a much greater level of professionalism and discipline from local enforcement authorities (who are usually the first onto the scene) than actually exists. The professionalism of these authorities, unsurprisingly, varies greatly from township to township. Moreover, as Scot Tanner observes, local police forces are often forced to serve two masters because the priorities and procedures of the central leadership often differ from those of local Party leaders.<sup>372</sup> Besides, when the corruption of local authorities is often the very issue driving the discontentment, it is implausible to always expect these same officials to respond calmly according to textbook procedures.

The issue of central versus local coercion and management of instances of unrest is a serious one for the Party. Since the Tiananmen protests in 1989, the job of quelling domestic unrest has shifted from the PLA to the People's Armed Police (PAP) under Article 22 of the *National Defence Law*. The PAP was drawn from dismantled ranks of the PLA and currently numbers around 800,000.

Officially, the PAP comes under the joint command of the Central Military Commission and the State Council. Operationally, the PAP is under the leadership of the Ministry of Public Security. There are three administrative levels to the PAP leadership structure: general headquarters (central), contingent (provincial levels), and detachment (county levels). In terms of overall operations and capacity building, the general headquarters is under the leadership of the Ministry of Public Security.

There is a PAP command office in every province and territory. At the provincial level, a garrison command office is established, which includes the leaders of local public security officials as well as leaders of local PAP units. These garrisons are obligated to follow the ‘directions’ of the local PLA Garrison Command Headquarters. However, the implementation of these ‘directions’ are left to the discretion of local PAP and local public security leaders.

If this ‘joint leadership’ system sounds confusing, it is—reflecting the intricacies of the modern Chinese apparatus of state. Although there is very little official material on how these operational structures are meant to work, in practice, piecemeal and anecdotal local sources indicate that Party officials continue to exercise a great deal of influence when it comes to the de facto command and control of PAP units—even in instances when martial law is used.<sup>373</sup>

This first came to light very publicly when PAP forces, at the behest of local officials, opened fire at protesters in Shanwei, Guangdong Province, in December 2005.<sup>374</sup> Local officials initially ordered forces to fire tear gas into a crowd of protesters. One of these officials then unilaterally gave the order to fire live rounds as the protests continued. Witnesses reported at least 20 people dead and up to 50 people missing.<sup>375</sup> Although the official who gave the order to fire live rounds was later reprimanded by higher authorities because of intense public pressure, there was little change to procedure. Local officials still retain the right to issue the same orders to local PAP units. Indeed, the delegation of authority to local officials to selectively deploy force in the face of unrest was subsequently outlined in internal security strategy manuals in 2006.

Predictably, there have been constant complaints by Chinese citizens that local officials use PAP troops for extra-legal purposes such as tax and debt recovery, and land seizures. For example, the PAP was used to break up a large protest against illegal land grabs in Sanjiao, Guangdong Province, in January 2006.<sup>376</sup> In May 2007, more than 1,500 PAP troops were used to break up a 20,000-strong protest against corrupt officials in Hunan Province.

This temptation to use the PAP as a coercive instrument to entrench one's rule within a de facto kingdom is immense. Local Party leaders have a huge informational advantage over the central leadership, who have few formal sources of information other than what local authorities reveal. It is difficult for central authorities to prove that local officials abused their power or over-reacted when ordering any coercive action. In reality, China's provincial and local leaders have long had enormous discretion given the size and population of the country combined with the relative lack of institutions to guide public decision-making and enforce top-down accountability. As an old Chinese proverb states: 'Heaven is high and the emperor is far away.'

Outside major urban centres, where most instances of unrest occur, central officials have no choice but to authorise local officials to instruct PAP troops and other law enforcement agencies to respond quickly to quell any unrest.<sup>377</sup> According to one expert, 'Some localities have degenerated into private fiefdoms run by local party officials.'<sup>378</sup> What frequently occurs is a decentralised and even feudal-like system of enforcing social order.

Moreover, increasingly frequent calls by President Hu and other Politburo Standing Committee leaders to work towards a 'harmonious society' and target social disorder as the top priorities serve to hand more power and leeway to local officials with regard to the use of PAP troops. Local officials simply justify their deployment of armed police as a decisive response, as nipping potentially dangerous instances of unrest in the bud. Removing the right for local officials to immediately deploy PAP troops at their discretion would risk the inflammation of any one of the tens of thousands of incidents of unrest into a major event.

Over time, these local officials build up powerful connections with influential members and organisations within their communities, and become well entrenched. The now emerging story of Zhang Zhiguo, the local Party boss who ran Xifeng County in Liaoning Province like his own kingdom for five years with impunity, is 'very typical of China,' according to one of its local lawyers Su Chunyu. Key to Zhang's power was collusion with heads of the local Public Security Bureau and other law enforcement authorities. This is 'typical of the way politics works,'

says Su. Zhang was finally sacked but only after he sparked widespread outrage when it was revealed he sent local authorities 960 kilometres to arrest a journalist in Beijing who had written an article criticising his rule.

Despite some attempts at reversing the decentralisation of many state functions over the past decade, China's central leaders have little choice but to continue to support local officials in order to prolong the survival of the Party as rulers. Beijing relies on local Party officials to represent its authority and preserve its interests. Authorities in Beijing have a much clearer appreciation of the dangers of managing disorder because the stability of the state is always at stake. In contrast, local officials lack the same awareness and discipline. They are also frequently under enormous pressure because it is the actions of local officials that cause most of the protests. Consequently, the prospects of over-reaction by local security forces and escalation become much more likely.

**(f) Are there 'Tiananmens' looming on the horizon?**

Assessing the prospects of future Tiananmen type incidents is not a preoccupation of China pessimists in Washington waiting for the country to stumble, but it is an obsession of the Party's senior leadership. The conditions for such widespread social unrest occurring again are clearly there. Should protesters unite and descend upon Beijing or Shanghai again, the important question is what will the leadership do—and what did they learn (or did not learn) from Tiananmen in 1989.

There have been internal Party calls to revise the official interpretation of Tiananmen as a treasonous 'counter-revolutionary rebellion' that was dealt with appropriate force by the authorities, but these calls have been ignored by senior leadership. Such revisions of official history are not just academic because they are expressions of official Party policy and serve as a guide for future responses.

Bear in mind that the protests in Tiananmen were not calls for regime change but merely greater, albeit far-reaching, reforms. However, from the point of view of Deng, the authority of the Party was being challenged in full view of world media. That in itself was sufficient for a 'tipping point' (although only

after anxiously wrestling with the decision). The first insight of Tiananmen is that the regime finds it difficult to take a sober view of large-scale protests and offer a proportionate response when its authority (and not just that of local officials) is directly challenged. The second is that the massacre took place amidst Party indecision and chaos at the highest levels.<sup>379</sup> When push comes to shove and the leadership is placed under severe pressure, habits formed over five decades of authoritarian rule suggest that Party factions favouring coercion over compromise will endure. The Party remains the unbending oak tree, not the reed. Challenges are viewed as a test of its 'resolve' or 'authority' that must be overcome as a 'matter of principle.' Unlike human rights advocates who primarily emphasise the dignity of the individual, hardliners in the Party core take the perhaps sincerely held view that preserving the authority and 'face' of the regime is the same as upholding China's collective dignity. Denigrating the Party through 'counter revolutionary' actions would fracture the history and principles of the 1949 revolution when China as a nation under one strong rule finally 'stood up.'

Tiananmen showed that brutal suppression can force protesters to abandon their demands for some time. It also showed that protest movements are capable of drawing support across many cities and provinces, even if the goals of different centres of protest were different. Since then, levels of disaffection have become more profound and widespread than in 1989. There is increasing evidence that coercive tactics are backfiring, and the use of force has actually increased calls by protest organisers to widen the scale of unrest against authorities. A further worrying sign for the regime is the rising numbers of prolonged protests that have lasted several months—another sign of declining authority and rising fearlessness (or desperation) of the people.

### **The regime's response: the emergence of the 'New Left' in Chinese politics**

The preceding section provides the domestic setting that confronts President Hu. It is a China that Westerners rarely hear about or see. Yet it is becoming the dominant issue in Chinese politics. Managing social deficits and turmoil rather than the need for further reform is increasingly influencing the regime's



political agenda. But it is as yet unclear how this will play out in terms of Chinese foreign and security policy.

On the one hand, China is well aware of its own economic and technological weaknesses. It has benefited from joining a global liberal economic order that it had no part in initially shaping. In particular, China needs stable and peaceful relations with the United States even though significant distrust remains between the two countries. In terms of broad strategy, Chinese thinkers make frequent references to the ancient lessons of the Warring States Period (from the fifth century BC to the first Qin Dynasty in 221 BC); in particular, that a state which rises too fast suffers ‘attack, dismemberment, and even complete extinction.’<sup>380</sup> China experts have warned that this is what happened to Germany and Japan in the 1940s, and to the Soviet Union in the latter’s attempt to take on the Americans in a strategic battle and arms race it could not sustain. This explains China’s self-proclaimed ‘peaceful development’ as the guiding principle behind its foreign policy. The promotion of China’s ‘peaceful development’ and of itself as a status quo power as it gradually moves from a planned to free-market economy is designed to appease fears of a re-emerging socialist power that could eventually challenge Western power and norms. But a patient and non-confrontational foreign policy is also designed to bide time while China increases what it calls its ‘comprehensive national power.’

On the other hand, Western policy makers need to accept that even though China’s current tactic is to remain a largely patient and cooperative power, there are powerful elements within Chinese politics and society that are pushing Beijing away from pursuing a prudent, patient and measured foreign policy. In addition to the promise of prosperity, the Party has promised the people that it will return China to its former greatness. The point is that significant and prolonged economic turmoil—accompanied by increased economic disengagement from the global economy—would cause Beijing and many Chinese to question the benefit of continuing with a prudent and patient foreign policy. There is already evidence that the Party is appealing to and encouraging a ‘virulent’ rather than a ‘confident’ and ‘secure’ nationalism to shore up its own support domestically. This will become increasingly tempting if social deficits and resulting turmoil worsen.

(a) **The two faces of President Hu Jintao and the Party**

As the paramount leader within the Party, President Hu and the Party have two very different personas—each one drawn from one of the two broad standpoints above. The first is specifically designed for international audiences; the second is what successive leaders since Deng have promoted outside China: the pragmatic ‘reformer’ behind China’s ‘peaceful rise’ or ‘peaceful development’ approach.<sup>381</sup> This is the message Hu relentlessly pushed prior to his 2006 US visit and that captivated Australia in 2003. As he told the National People’s Congress shortly before the US visit, his administration would ‘uphold [China’s] reformist orientation without hesitation,’ while official media ran stories about how government departments were set to ‘storm the fortress’ of reform. This was echoed by Premier Wen who announced that during the 11<sup>th</sup> Five Year Plan (2006–10), reform would enter the ‘deep water zone,’ and ‘peaceful development’ would continue to characterise Chinese policy.<sup>382</sup>

The second persona is driven by domestic politics and rarely translated for a Western audience. In a 2005 editorial in the *People’s Daily*, Hu argued that ‘hostile foreign forces have not abandoned their conspiracy and tactics to Westernise China and to divide the country.’<sup>383</sup> Chinese language publications are replete with statements expressing similar sentiments by various members of the leadership. A glimpse of these sentiments was again apparent following the recent confrontation between PLA naval vessels and a US Navy survey ship off the Chinese island province of Hainan in March this year. Days after Chinese naval vessels encircled the US survey ship, Hu allowed the state-run *People’s Daily* to publish some strident comments defending ‘Chinese sovereignty.’ In the published speech to PLA officers, Hu urged the military to ‘staunchly defend national sovereignty, security and territorial integrity and provide a powerful support and assurance for protecting national development interests and broad social stability.’<sup>384</sup> He ended by warning the Chinese military of ‘perils’ ahead.

What is behind the so-called ‘New Left’? For senior Chinese leaders, the Soviet Union imploded not because the empire was in economic decline over the two decades under

Leonid Brezhnev but because Mikhail Gorbachev was too radical and rapid in his reform attempts. Like most authoritarian regimes, the Party prefers to be like oak trees that stand strong against the winds of change and resistance rather than reeds that sway and bend. Survival is seen as a matter of tightening one's grip, not relaxing it; retaining control of different levers of power; and silencing or isolating and only occasionally appeasing dissention rather than primarily accommodating it. In other words, survival is seen to depend on strengthening the power and reach of the Party and, by their reckoning, the Chinese state. Within a month of becoming the undisputed paramount leader (when he replaced Jiang Zemin as Chairman of the CMC), the Central Committee passed resolutions that declared the foremost task of China's leaders was to secure the 'long reign and perennial stability of Party rule' by 'strengthening the construction of the Party's governance ability.' For example, the Party needed to 'strengthen leadership over legislation work' and play a greater part in people's congresses, as well as strengthen its presence at all levels of administration and consultative conferences. Despite talk about 'multi-party cooperation' and 'consultation sessions' with China's eight so-called democratic parties, these parties are at a serious disadvantage. They are controlled by the Party's United Front Department and depend on state financial support for survival. The solution to society's problems and complaints was, therefore, to be met by more extensive Party power, not less.

It is important to understand that the Party, like other political parties, is replete with factions: conservatives, leftists, liberals, reformists, nationalists, the Shanghai clique, Maoists, provincial interest groups, etc. As a recent work by Mark Leonard reveals, these factions have different points of view about the causes of China's problems and how they are to be fixed.<sup>385</sup> Different factions blame each other for the social deficits building up in the country and the Party's unpopularity. Although Hu is the paramount leader, he needs to constantly consolidate his support within the Party. The previous chapters looked at the Party maintaining its hold on important economic levers and sectors as well as its concerted attempts to co-opt new elites. In addition to this, there are strong signals indicating the emergence of a

'New Left' led by Hu, with the intention of reinvigorating and strengthening the Party (and Hu's position) from within.

Former President Jiang attempted to sum up his vision with a rather obtuse 'Theory of the Three Represents' (that the Party represents the most advanced production forces, the foremost culture, and the overall interests of the masses). In light of growing dissatisfaction, Hu considers this too elitist and too slanted towards the empowerment of the new 'red capitalists.' He put forward his own 'Theory of the Three Harmonies' consisting of seeking peace in the world, 'reconciliation' with Taiwan, and harmony in Chinese society. While the Three Harmonies appear ambiguous, they do give us clues about Hu's orientation.

To reinvent purpose and reclaim unity, the classic authoritarian strategy is to emphasise the foreign demons poised and ready to enter the kingdom. It is clear that Hu is falling for the temptation to use external influences as an internally binding force for the sake of his 'harmonious' China. The path away from political reform was made easier by the ailing health and eventual death of former Party Chief Zhao Ziyang, who died in early 2005. Zhao had been under house arrest since 1989. The image of Zhao tearfully begging the protesters at Tiananmen Square to stand down or be crushed by the impending arrival of army tanks remains a powerful image for many pro-reform Chinese. Prior to this, Hu, who was actually once seen as more liberal than his predecessor, was already speaking about assassins in the shadows. The senior leadership from 2005 onwards had begun to decry collusion between 'hostile foreign forces' and 'bourgeois-liberal intellectuals.' Party campaigns pushing for more social and economic reform were blamed on 'right-wing' intellectuals and exponents of a traitorous 'new liberalism.'<sup>386</sup> Even the Tibetan protests in March 2008 were blamed on a conspiracy between the 'Dalai Lama clique' and 'Western agents' to weaken China.<sup>387</sup> There have, therefore, been moves in the last two years to weed out recalcitrant 'liberalists' or 'Western sympathisers,' and the return of a 'New Left' promoting 'Marxist rectitude' and 'ideological purity' among Party members. Campaigns have been officially launched to re-educate the 70 million or so Party members in Maoist, Marxist and Leninist thought to resist Western ideas about social and political reform. As one professor in the Central Party School

pointed out, without sarcasm, the campaign is aimed at building 'an ideological Great Wall' to safeguard the purity of cadres and Party members. The aim was to develop the correct 'worldview, personal philosophy and value system' of Party members.<sup>388</sup>

**(b) Why the 'New Left' turn?**

What is the psychology and strategy behind this leftward turn? Most commentators would put it down to Hu and his faction trying to consolidate their power. This is certainly true. Chinese politics, from senior leaders to local cadres, tends to split vertically down factional lines. By seizing the ideological agenda and appealing to the traditions of Mao and the ideologies of Marx and Lenin, Hu distinguished himself from predecessor Jiang (who had a strong urban, elitist bias) and reaffirmed himself as the champion of socialism within the Party—a creed the Party has never given up. By alienating the liberals, Hu is protecting the authoritarian regime from internal factions that seek more power sharing. Moreover, by returning to ideological purity, he is better able to deflect criticisms about slow or non-existent economic and political reforms.

Second, the 'New Left' is an attempt at recapturing the hearts of the hundreds of millions of Chinese who have not benefited from China's new wealth. It is a reaffirmation that the Party is the party of the masses. Hu realises that selling China's 'economic miracle' to those hundreds of millions of Chinese who have been left behind by the new middle class is an impossible task. Reconnecting with the masses, an objective wisely elevated by Hu as an urgent priority for the regime, means in practice an appeal to the concept of a continuing Socialist revolution in order to re-establish the primacy and irrefutability of the Party's 'mandate from heaven.'

Third, this 'New Left' turn also bulks up Hu's PLA support base. Unlike previous leaders such as Deng, Hu has had no military experience and has only very recently emerged out of the shadow of Jiang, who had been the CMC chief for almost 15 years before finally handing over the chairmanship to Hu. It was important for Hu to establish his credibility as the commander-in-chief; his left turn—a move towards traditional revolutionary and

ideological fervour away from liberal and capitalist philosophy—is generally welcomed by the PLA. Remember that the PLA is still the most powerful embodiment of revolutionary nationalism in China. Hu's elevation of the sons of First and Second Generation revolutionaries to senior PLA posts is a sign of the President indicating to the PLA that the revolution is ongoing.<sup>389</sup>

Finally, the 'New Left' is not just about an internal grab and consolidation of power. I mentioned the Party is a paranoid regime fearful of both internal and external threats. With respect to external threats, despite consistent efforts to court the West, Hu sees interaction with the West, and the United States in particular, as fraught with danger. For example, the Party Leading Group on Foreign Affairs (LGFA), which is headed by Hu, closely watched the re-run of the presidential polls in Ukraine between the pro-West Viktor Yushchenko and pro-Russia Prime Minister Viktor Yanukovich. Despite differences between Hu and Russian President Vladimir Putin, Hu agreed with Moscow's assessment that Yushchenko's victory was because of heavy support from 'Western interests' led by the United States. In internal sessions devoted to the Ukraine elections, Hu's aides in the LGFA alerted the President to the belief that 'the West, led by the United States, has been successful in infiltrating former Communist countries, thus resulting in their tilt toward America.'<sup>390</sup> The LGFA subsequently raised the issue of a 'domino effect' in which Western-backed interests could emerge in former Soviet-bloc countries, including member countries of the 'Shanghai Cooperation Organisation,' such as Uzbekistan, Tajikistan and Kyrgyzstan, whom Beijing had made such strong efforts to court. Indeed, as mentioned above, Hu explicitly stated this in an editorial in the *People's Daily* in January 2005 claiming that 'hostile foreign forces have not abandoned their conspiracy and tactics to Westernise China and to divide up the country.'<sup>391</sup> The wealthy and increasingly urbane elites in China would be a prime target for these 'bourgeois' ideals. New elites need to retain the faith. Pertinent to this has been Hu's criticism of former Soviet leader Gorbachev for introducing radical, Western-style reforms to the 'detriment' of the Soviet Empire. Hu has also praised the regimes in Cuba and North Korea for successfully shielding their people from the subversion and infiltration of the West.

There is no doubt that Chinese leaders remain paranoid about 'colour revolutions' (e.g. Ukraine's Orange Revolution and Georgia's Velvet Revolution) and 'democratic viruses' infecting potential breakaway provinces (such as Xinjiang and Tibet) and eventually the whole of China. Hu's intensification of the crackdown on liberal intellectuals and continued oppression of organised groups, such as the Falun Gong (with approximately 100 million practitioners in China), that might facilitate large democratic movements must be understood in this light. Although there are no plans to return to any Mao-like isolationism from the (Western) world, China's deepening paranoia about having to resist democratisation pressures hatched by a conspiracy between external and internal enemies is very much behind the championing of the political aspects of the 'Beijing Consensus.' Externally, it is clear that China's 'live and let live' ethics in international relations is very much a defence against Western calls for greater democracy. China's promotion of a 'harmonious world,' for example, must be squarely read in this light. The foreword of the white paper *China's National Defense in 2004* states that challenges to peace and stability will not be overcome unless 'diverse civilizations, social systems and development models live together harmoniously, trust each other and engage in cooperation.'<sup>392</sup> 'Harmonious world' was mentioned again in the 2005 white paper *China's Peaceful Development Road*.<sup>393</sup> Although the term 'harmonious world' sounds like a utopian term for the transformation of international affairs, it is actually something much more intellectually conservative and self-serving. For the Chinese, 'harmonious world' really means a return to the commitment to strict principles of absolute sovereignty and non-interference in another state's 'domestic' affairs. It is disingenuous in that the Chinese themselves would, of course, always reserve the right to intervene in the affairs of another state if their national interests were at stake. But it is upheld as an alternative to both the perceived liberalising agenda of US foreign policy and the advancing liberal order, which merely tolerates the existence of autocratic states.

Internally, in some kind of conceptual retreat into revolutionary nationalism, any dissention or dissatisfaction with Party rule is seen as a betrayal of national purpose at the highest level. The state

and regime are one in the eyes of the senior leadership, and any resistance against the regime is still the most serious act of treason.

## **The power of the gun: CCP-PLA (and PAP) relations**

Every Communist must grasp the truth, 'Political power grows out of the barrel of a gun.'<sup>394</sup>

—*Mao Zedong*

The evolution of the Party's relationship with the PLA and the recently created People's Armed Police (PAP) is probably the most important factor in understanding the future direction of the regime's domestic and foreign policy. President Hu ultimately depends on the PLA's support, and more broadly, the regime ultimately depends on the PLA's loyalty. China's foreign policy must receive the PLA's backing. Almost 70 years after Mao's observation, political power in China still grows out of the barrel of a gun. Hu reaffirmed this in late 2004 in a speech to the Central Military Commission, stating that 'ensuring military support for continued Party rule in Beijing' remains one of the PLA's core missions.<sup>395</sup> In the speech, Hu stated that 'So long as our Party firmly controls the military, there will be no large disturbances in China, and we will be able to face with confidence any dangers that might arise.' More recently, in explaining a 14.9% boost in military funding in 2009, National People's Congress spokesman Li Zhaoxing stated that the increase in the military's budget would help 'maintain stability and other non-warfare military operations.'<sup>396</sup>

The relationship between the CCP and PLA is a complex one. Although nowhere in the Chinese Constitution does it say that the PLA should devote itself to preserving the Party's supremacy, the PLA has been the 'steel Great Wall' of the Communist Party and the Chinese people (but not the state) since the beginning of the Revolution. The triumphant founding ceremony at Tiananmen in October 1949 and the rule of the Party came to stand for the renewed *dignity* of China. The PLA remained the army and protector of the Party and, by implication, the protector of the Chinese people and the guarantor of China's



newfound strength, unity and national dignity. The PLA was at the centre of China's re-emergence as a nation in the world. It was never just a professional standing army that emerged after the formation of modern China. Even though there were moves to institutionalise the role of the PLA as a professional state army during Deng's reign (*guojiahua*), the PLA and PAP remain the Party's army as well as the ultimate guarantors of domestic order and obedience. Almost all observers agree that the PLA is not yet a 'state army' in the full sense of the term.

To understand the extent to which the PLA is still effectively the Party's private army, we should first consider that the debate is an artificial one in an institutional sense. The Party *is* the civilian government. Although legislation tends to stipulate that the PLA exists to serve the 'state,' there is no doubt that the PLA remains committed to the unique responsibility of protecting the regime (rather than the state per se) and keeping it in power. This was emphatically reaffirmed by President Hu shortly after becoming Chairman of the CMC in September 2004 when he issued instructions to China's top military commanders that the foremost function of the PLA was to 'provide forceful guarantee to enable the party to consolidate its ruling-party status.'<sup>397</sup>

However, the PLA is far from a passive servant of the regime. Loyalty, especially of those controlling the gun, usually has a price. The PLA undoubtedly has an interest in maintaining the power and authority of the Party. However, many modern analyses get it wrong by treating the PLA as an apolitical and passive entity awaiting a winner to arise out of internal Party power struggles. Mao might have expressed the desire to ensure that 'the Party commands the gun and the gun must never command the Party,' but the CCP-PLA relationship is certainly much more complex than this.

First, civilian or Party control of the PLA is very weakly institutionalised at best.<sup>398</sup> Even though the CMC is in principle answerable to the Central Committee, in practice it is the key military decision-making body and has been so historically. President Hu is the Chairman of the CMC, but the other seven members are all serving PLA generals. Moreover, titles tend to reflect personal allegiances rather than the other way round.

That is the nature of authoritarian politics in which power is rarely institutionalised independent of the individual. If it were, such systems would be more constitutional than authoritarian.

Second, though the PLA remains the Party's army, it still identifies strongly with being the 'People's Army.' As long as the regime remains successful at conflating the Party, regime, state, and society, there will be no conflict. However, with the Party's declining legitimacy in the eyes of hundreds of millions, cracks have significantly widened between serving the Party and the people. This was brought out most tragically at Tiananmen in 1989 when the reluctant generals eventually agreed to fire at their own people. Although the PLA ultimately sided with the regime, the army was strongly shaken by the resulting loss of support of large sections of the population and has worked hard since then (e.g. assisting during natural crises) to win back the respect of the people. As the common Chinese saying goes, 'soldiers are the fish and people are the water; without water the fish will die.' It is unclear what the PLA would do in the event of another Tiananmen if the credibility of the Party as the people's party continues to suffer. A corrupt Party with questionable modern 'socialist' credentials will find it more difficult to demand the support of the PLA during a crisis if the Party's intention is to simply hang on to power.

Furthermore, many aspects of China's transition and modernisation, and its new found capitalist wealth, do not sit well with the PLA, particularly, the worsening income and regional disparities.<sup>399</sup> In a sense, the army is actually more in touch with China's poor than the Party leadership. Hundreds of thousands of conscripts return to their villages each year and are exposed to the despair of common people. The beliefs and lifestyle of soldiers are much closer to the principles of the Communist Revolution than of the increasingly out-of-touch Party officials. The army is often called upon to aid people during crises and work and live alongside them, unlike many Party officials. The point is that while the PLA remains the 'Party's army,' the relationship is potentially strained whenever the Party is seen to move away from the people. The PLA is an inherently 'conservative' institution; the military establishment is suspicious of any move away from traditional Chinese Socialist principles and tend to be deeply distrustful of

modernising ‘Western influences.’ Small cliques of ‘liberal’ PLA thinkers have been generally sidelined from the mainstream. In 1993, two distinguished army veterans famously voiced fears about China’s and the PLA’s continued exposure to bourgeois and capitalist elements in Chinese society that would result in soldiers being seduced by ‘luxury and pleasure’ and corrupted by ‘money worship, hedonism, and extreme individualism.’<sup>400</sup> Since then, exhortations to remain true to traditional principles are frequently issued by senior PLA members who seek to limit the rank and file’s exposure to the upwardly mobile ‘capitalist’ classes. It is becoming more difficult to ‘command the gun’ when the Party is merely clinging on to power and is no longer seen as the committed guardian of socialist political ideology and values.

Third, although the Party in principle largely controls funding and the power of appointment within the PLA, the bargaining process between the two bodies is less one-sided than the institutional structure might suggest. As the PLA modernises and acquires characteristics that Samuel Huntington puts forward as defining professional armies—expertise, corporateness and responsibility—the PLA is also becoming more aware of itself as a distinct entity from the regime and its interests and worth to the Party. This is a worrying development for the regime because this is essentially a trend away from the PLA being a Party-army (but not necessarily a shift towards the PLA being a state-army). We can see this in the preparedness of PLA leaders to publicly comment about developments in Chinese politics, give their opinions on military budgets, and even express approval or disapproval of political appointees.<sup>401</sup> The successful anti-satellite test missile fired by the PLA in January 2007—a provocative gesture by the military—was done without consultation with the Chinese Foreign Ministry.<sup>402</sup> The broader implication is worrying. While the Party struggles with its declining legitimacy, the PLA—an entity that is actually better organised than the Party—becomes perhaps the most formidable interest group that the Party must manage, placate and co-opt. The PLA was relatively neglected during the first 20 years of reform because of the focus on economic development. But on- and off-record military budgets in recent times have been growing at between 15–20% year on year. Military spending is officially at about

US\$50 billion, but military and intelligence sources within the United States estimate that it is actually between US\$70 billion–120 billion. The increases in military spending that have been approved by the Party are likely to be as much a consequence of a co-opting tactic as well as a strategy of external power projection. Officials recently announced that the PLA budget will increase by 14.9% in 2009,<sup>403</sup> the 19<sup>th</sup> double-digit increase over the past 20 years. Importantly, as the regime loses further domestic credibility, the PLA's influence is likely to increase given that the regime needs its support to remain in control.

Finally, the need to retain the support of the PLA is a further reason why further liberalisation and reform of the system might be slow. Hundreds of thousands of soldiers are employed by SOEs. The PLA will not look kindly upon a slowing of credit for inefficient SOEs as many of these firms will eventually fall, immediately exacerbating the unemployment situation and leading to social unrest. Beijing's plans to slash subsidies and reduce tariffs in key areas to fulfil WTO obligations will allow 'foreign devils' to enrich themselves by giving them carte blanche access to the economy. But this plan will not sit well with the PLA whose rank and file are largely still recruited from the poor. Genuine market reforms in the most important sectors will be difficult because the Party cannot suddenly reverse decades of pro-Communist and anti-Western rhetoric without undermining its credibility with the PLA. Instead, the inefficient strategy of fiscal stimulus through 'policy lending' by banks seems set to continue.

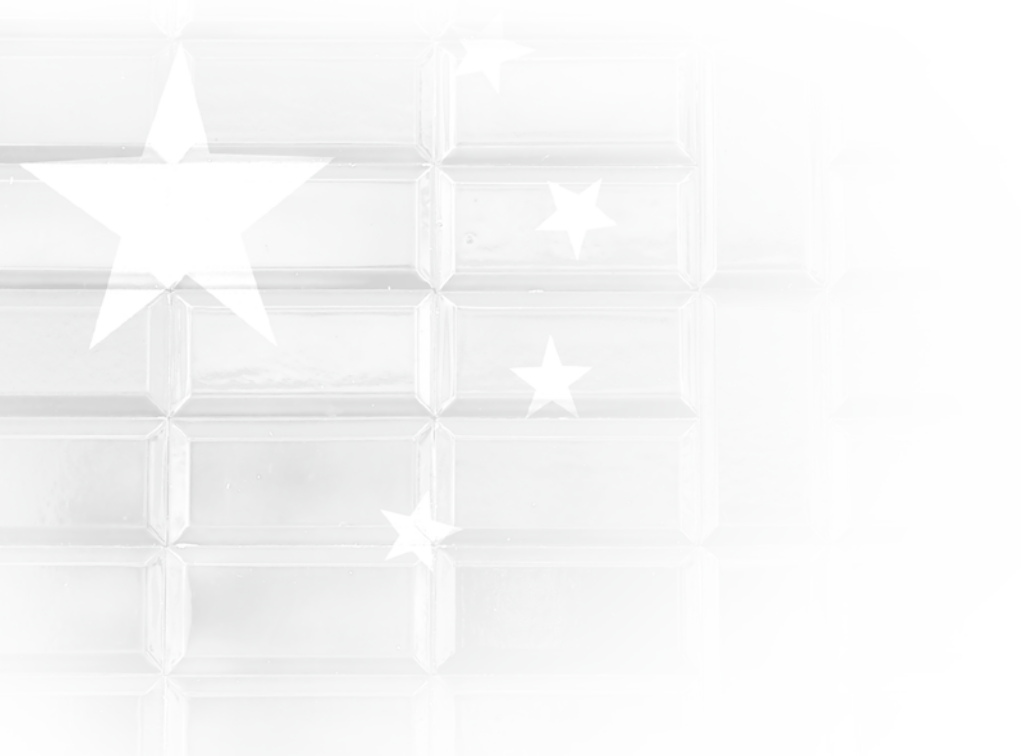
## Conclusion

Mere growth cannot solve China's domestic and social problems, just as it cannot solve the structural problems with its economy. These social and political problems are not simply the transient problems of a country in transition but are symptoms of an authoritarian regime desperately trying to defend its power and privileges. China's social and political deficits are serious.

Deng Xiaoping's 'keep a low profile,' strategy, which focuses on economic development rather than military strength and confrontation, underpins China's 'peaceful rise' thesis. But more recently, domestic politics and concerns have meant that national

security and power projection have become higher priorities on the agenda. As early as 2003, President Hu declared that Beijing must pay greater attention to foreign affairs and ‘make good preparations before the rainstorm ... and be in a position to seize the initiative.’<sup>404</sup> Premier Wen pointed out in a meeting of the State Council that ‘We must boost our consciousness about disasters and downturns ... and think about dangers in the midst of apparent safety.’<sup>405</sup> The following chapter looks at possible consequences of unsettling manifestations of nationalism that are being encouraged by the regime to rebuild legitimacy and social cohesion.





Part B

## CHAPTER TWO

Uniting Against 'Foreign Devils'—Will The  
Nationalism Card be played?





## Chapter 2

# Uniting Against 'Foreign Devils'— Will the 'Nationalism Card' be Played?

### Introduction

Speculation that China will engage in bouts of military adventurism to distract the world from its domestic problems arises periodically. Such speculation, sometimes phrased in terms of China playing the 'nationalism card,' is usually presented glibly and supported by little hard evidence.

However, the issue of China playing the 'nationalism card' with destabilising consequences should not be discounted as it is an important and serious one. Chinese nationalism is proud and enduring, and the country is undergoing a difficult and painful transition. To the outside world, China's rise seems spectacular. But within Chinese society, there is turbulence. Domestic politics and pressures are increasingly wielding an influence on foreign policy. Will the 'nationalism card' be played? In fact, it is already being played by the regime. There is convincing evidence that appealing to the more virulent forms of nationalism is increasingly being used to rebuild support for its leadership, to deflect blame from itself for many of China's problems, and to increase the Party's appeal to the PLA. Indeed, strong trends already exist of the increasing likelihood of the regime playing the 'nationalism card' in the form of a more assertive if not aggressive foreign policy. These trends will most likely strengthen if domestic conditions continue to deteriorate. China's 'peaceful rise,' although not yet discounted, should be revisited.

### China's modern mission and emerging chauvinism

*'Chinese Grievances' or 'What do you really want from us?'*

When we were the Sick Man of Asia, We were called The Yellow Peril.

When we are billed to be the next Superpower, we are called The Threat.

When we closed our doors, you smuggled drugs to open markets.

When we embrace Free Trade, You blame us for taking away your jobs.

When we were falling apart, You marched in your troops and wanted your fair share.

When we tried to put the broken pieces back together again, Free Tibet, you screamed, It Was an Invasion!

When we tried Communism, you hated us for being Communist.

When we embrace Capitalism, you hate us for being Capitalist ...

What do you really want from us? Think hard first, then answer ...

Because you only get so many chances.

Enough is Enough, Enough Hypocrisy for This One World.

We want One World, One Dream, and Peace on Earth.

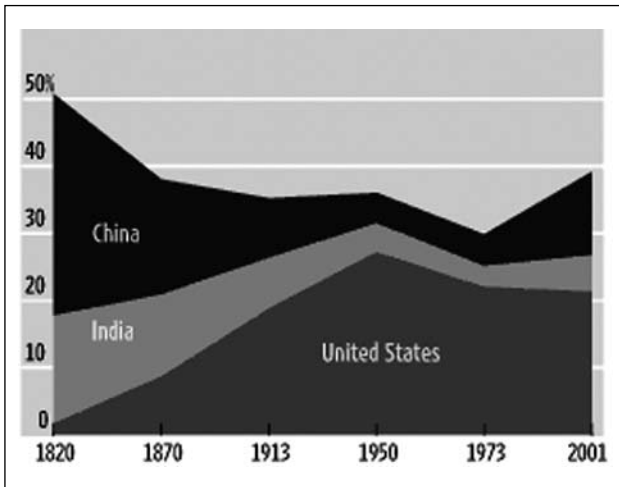
This Big Blue Earth is Big Enough for all of Us.

—Hugely popular poem on Chinese Internet and blog sites, March 2008<sup>406</sup>

Unlike many revolutionary regimes, the Party has intentionally promoted the rise of the Party as a modern chapter in the unfolding history of one of the world's oldest civilisations. The linking of ancient with modern (communist) China is very much part of the Party's positioning of itself as the legitimate and natural ruler of contemporary China. As one commentator observed, when the then Standing Committee Member Li Ruihan undertook the 'most uncommunist of acts' in laying a wreath at the tomb of the Yellow Emperor, who was the legendary progenitor of the Chinese people, the action 'was designed to link the Party with China's past.'<sup>407</sup> Part of the modern rhetoric is that the Party is uniquely placed to lead the return of China to its former dignity and status.

China's sense of greatness and humiliation has deep roots. Mao Zedong, Deng Xiaoping, Jiang Zemin, and Hu Jintao all share the same view of China's 'cultural exceptionalism' and the country's modern mission. According to the modern Chinese narrative, China's achievements over the past 5,000 years give it a 'mandate' to dominate Asia based on its perceived economic, cultural and moral superiority. Up to the fifteenth century, Chinese technological know-how was the most advanced in the world. It has been the largest economy in the world for 18 of the past 20 centuries. As recently as 1820, China could boast that it produced one-third of global output, and it remained the world's largest economy until around 1885.<sup>408</sup> In many respects, China's perception of itself is similar to America's: They both feel strongly about their moral rectitude, both feel their respective cultures and values have something unique and invaluable to offer the world, and both believe that they are destined to become truly great powers in human history.

**Figure 1.** US, Indian, and Chinese Share of World GDP 1820–2001 (cumulative)



**Source:** Angus Maddison, *The World Economy Historical Statistics* (Paris: OECD, 2003)

However, the historical trajectories of the two countries over the last two centuries have been markedly different. While America was rising from the early 1800s onwards, China was suffering a series of ‘humiliations’ at the hands of Western and Japanese powers. This began with the two Opium Wars (1839–42 and 1856–60), which ended in a humiliating defeat for the Chinese and with the government agreeing to the sale of British opium in the country. China was also forced to sign the treaties of Nanjing (1842) and Tianjin (1858), known from the 1920s onwards as among a series of ‘Unequal Treaties.’ Other humiliations included the failure of the peasant-led Boxer Movement, which was put down by a coalition of forces from eight foreign countries in 1901; and the eventual downfall of the 270-year-old Qing Dynasty in 1912. The invasion by the Japanese in 1937 led to the Nanjing Massacre, in which up to 300,000 Chinese were slaughtered. In more recent times, the fact that Taiwan—the renegade province to which the defeated forces of the Kuomintang under Chiang Kai-shek fled in 1949 following its defeat in the Chinese Civil War—remains autonomous only because of US protection continues to grate on Beijing.

Therefore, while America was rising, China saw its dynastic and imperial order collapse. China experienced more than 100 years of foreign occupation, wars, insurrections, and civil wars during this time. An important part of the narrative even today is that outside powers stand ready to divide and weaken China if allowed the opportunity. Prior to Deng’s reforms, China was responsible for a paltry 1.8% of global GDP (measured using PPP).<sup>409</sup> It now contributes around 8%. It is embedded in the modern Chinese political psyche that China’s modern mission is to remove the stain of these humiliations and return to its rightful place at the seat of great powers. For more than 5,000 years, China was at the centre of its own universe. In the last 200 years, it has been a pariah staring into a strange and often hostile outside world.<sup>410</sup> In this sense, while we may view China as a rising power possibly eager to transform the status quo, China largely sees itself as an existing great power attempting to restore the equilibrium that existed for all but 200 years of the past 2,000.

Identification with a 5,000-year-old cultural history and civilisation is one part of the story. In the nineteenth century,

China saw itself as less a 'nation-state' within Asia and more as Asia's 'dominant civilisation.' But as prominent China expert Suisheng Zhao explains, Chinese political elites began to embrace modern *nationalism* only after China's disastrous defeat by British troops in the Opium War of 1840–42. According to Zhao, 'Almost all powerful Chinese leaders from the early twentieth century through today have shared a deep bitterness at this humiliation and have determined to restore China's pride and prestige, as well as its rightful place in the world.'<sup>411</sup> In other words, modern Chinese nationalism is very much rooted in the painful humiliation of national defeat at the hand of foreign powers since the Opium Wars; in addition to the profound desire to return Chinese civilisation to the former greatness that it enjoyed over five millennia. An important reason behind the success of Mao and the Party was that the regime successfully portrayed itself as the defender of Chinese unity, identity, culture, and nation *against foreign threats and influences*. Reclaiming Taiwan, for example, is at least as much about wiping away China's past humiliations as it is about removing America's 'unsinkable aircraft carrier' from the region.

A strong sense of one's cultural history and nationalism does not in itself presage a disruptive China in the region, and can indeed be a positive cohesive force. However, President's Hu's 'New Left,' which taps into this extant nationalism and blames many of the domestic problems on foreign influences and players, clearly indicates the emergence of a new *chauvinism* in Chinese political direction. It is not really surprising that taking this path would be an appealing tactic for China's leaders facing mounting domestic dissatisfaction. It presents a readymade tactic to deflect blame, unite its people against perceived foreign enemies, depict calls for political reform and democratisation as insidious foreign ideas, and further entrench the idea that the Party remain the champion of restoring China's national and cultural dignity in the world. Moreover, walking this path also allows the regime to increase its appeal to senior PLA leaders who tend to be suspicious of these same foreign threats and influences. Crucially, these tendencies will likely intensify should the domestic situation deteriorate for the Party.

A prominent China watcher, Peter Gries, warned a decade ago that an emotionally popular nationalism empowered by 'victim narratives [was] beginning to influence the making of Chinese foreign policy.'<sup>412</sup> Although such narratives exist in every country to some extent, it is of greater concern when authoritarian governments encourage and nurture them for their own purposes. In such systems, the battle of ideas is limited. Alternative interpretations of official histories are limited. Therefore, individuals in society have a limited ability to discriminate between myth and fact, question official history, and ridicule blatant absurdities.

In Australia, although the history of white settlement and treatment of Aborigines is a national wound, these issues are openly and critically examined. In Japan, there are public debates about the Nanjing massacre and whether the nation has adequately faced up to this dark chapter of its past. But in China, schoolbooks and official histories still ignore or gloss over the famines of the Great Leap Forward and praise Mao's communists (rather than the Americans and the two atomic bombs) for defeating the Japanese in 1945. The point is that in societies where the regime's historical interpretation of events, current affairs, and historical 'truth' already dominates, government-backed chauvinism depicting 'foreign devils' and 'demons' waiting at China's doorstep to corrupt its people with 'foreign' ideas is immeasurably troubling. The possibility of the regime fuelling the fires of a chauvinism they helped nurture to placate a restless and frustrated people is a distinct danger. Professors at Chinese universities report that students are far less interested in liberal democracy and are much more nationalistic than they were a decade ago. They are also much more likely to agree with using force to deal with China's 'enemies.'<sup>413</sup> This is additionally of concern when viewed alongside a recent Pew Global Attitudes survey in which an overwhelming 95% of Chinese respondents viewed their growing military power as a 'good thing.'<sup>414</sup> Importantly, according to Ying Ma, who worked for the US Congressional Commission on China, Chinese nationalism is becoming focused against the United States. Many Chinese 'increasingly view America as a bully ... thwarting the rise of their country's international influence.'<sup>415</sup> In my recent study of more than 100 articles

on foreign affairs by prominent Chinese scholars within the state-funded Academy of Social Sciences network, around four-fifths of them were to do with the binding, circumventing or superseding of American power and influence.<sup>416</sup>

National and cultural pride can be a strong indicator of a cohesive society. But chauvinistic nationalism is something more dangerous. To cite an earlier account of the potential dangers of this sentiment, a testimony by Joshua Muldavin (who has about 18 years of field research experience, mainly in China) to the *US-China Economic and Security Review Commission* is edifying:

I was in Beijing in a car that hit a bicycle in the mid-1990s. We were surrounded by a crowd of about 200. They started rocking the car; they broke the windows. They threatened us. And the chants were about national pride and how we rich foreigners could go knocking down a person there ... We zipped away in our smashed up car. But what was a key moment for me was how clear the nationalistic aspects of response could be utilized at any given moment in a threatening way.<sup>417</sup>

Since then, displays of aggressive nationalism have included massive anti-US demonstrations following the accidental bombing of the Chinese Embassy in Belgrade in May 1999 (most Chinese immediately assumed the bombing was deliberate); spontaneous eruption of nationalist sentiment following the collision between a US Navy EP-3 surveillance plane and a Chinese fighter jet over the South China Sea in April 2001 (in which the Chinese pilot killed was declared a 'martyr of the revolution' and praised as a heroic defender of the motherland<sup>418</sup>); and even mass public outrage misdirected against the United States when Beijing missed out on the Olympics in 2000 (many Chinese were quickly convinced the United States had thwarted Beijing's bid). But the series of protests against Japan in 2005 serve as the best illustration of China's aggressive nationalism. Tens of thousands of Chinese took part in demonstrations in around 20 major cities such as Beijing, Shanghai, Shenzhen, Guangzhou, Chongqing, and Zhengzhou. Protesters drew on issues such as Japan's wartime atrocities as well as Japan's pledge to help defend

Taiwan in the event of an invasion to fuel the demonstrations. Significantly, China's leaders did little while these protests took place—an act of tacit approval. In the same year, an Internet posting in China attracted 20 million Chinese signatures opposing Japan's bid to join the UN Security Council.

Protests and demonstrations occur in many countries but rarely do such mass demonstrations protest the actions of *other* countries. Public sentiment is fickle and can easily change. Edward Friedman cautions that there is 'no public opinion in China, only public sentiment.'<sup>419</sup> We should therefore be careful about reading too much into these fickle sentiments. However, when such public sentiment is partly created and strongly encouraged by the authoritarian government for its own interests, and is generally in line with long-standing PLA opinion, it becomes something more. As Suisheng Zhao asks:

Pragmatic nationalism is an instrument that the CCP uses to bolster the population's faith in a troubled political system and to hold the country together during its period of rapid and turbulent transformation ... The question remains, can Beijing keep this nationalism reined in, or will it begin to accelerate out of control?<sup>420</sup>

## **Taiwan—the rebellious province**

As the regime struggles against growing domestic hardship and disorder, splits within the Party will certainly occur. These splits may be public or behind closed doors. No doubt the so-called 'Democratic Faction' within the Party will find a louder voice. However, it is doubtful whether even sustained economic and social crises could propel any faction to power. Prominent liberals, such as those led by Zhao Ziyang, were purged from the senior levels after the Tiananmen massacre and have never regained their influence. Short of profound regime incapacity and disintegration, the influence of the PLA will increase as leaders work to shore up the army's all-important support. Importantly, the Democratic Faction does not enjoy the support of the PLA; the latter will unlikely see democratisation as a solution to worsening woes. Instead, there will almost certainly be increasingly forceful and



desperate appeals to nationalism and national unity by senior leaders. As I speculated above, the confluence of a growing chauvinistic nationalism with the increased influence of what remains an inherently conservative and hawkish PLA<sup>421</sup> is a potentially volatile meeting of circumstances. These conditions make prudent crisis management much more difficult.

It is important to realise that despite the rhetoric about China's 'peaceful rise,' China remains the only major power dissatisfied with her territorial borders. Border disputes with India remain. China still claims sovereignty over the disputed territories of the Spratly Islands, and repeatedly claims the whole of the South China Sea as its 'historic waters.' Taiwan and the Diaoyu Islands are still unresolved; and Tibet and Xinjiang provinces, although now under the control of the PRC, remain a sore point. A quick look at standard Chinese geography textbooks reveals the drawing of borders and territory are out of step with internationally accepted norms.

Taiwan as an issue has probably become the most potent manifestation of nationalistic sentiment for the Chinese: the regime, the PLA, and the people. Taiwan is both an affront and an immense symbolic threat to the regime. It stands as an 'alternative' China that is also a prosperous and thriving democracy. Moreover, the continued *de facto* independence of Taiwan has come to represent the conspiracy of foreign powers and foreign devils (especially the United States) that work to frustrate what the Party and the PLA see as China's legitimate ambitions as a great power. Back in 2001, Evan Feigenbaum, executive director at Harvard University's Asia-Pacific Security Initiative, observed that 'Taiwan remains the single issue to which China continues to subjugate any broad conceptions of grand strategy and, indeed, virtually its entire national security strategy.'<sup>422</sup> Forcing Taiwan back into the fold has been made into an issue of 'national dignity'; for a regime that has staked a lot of its credibility on 'returning Taiwan to the Motherland,' the loss of Taiwan would be a serious blow to the legitimacy of the Party in the eyes of the people and the PLA. Given that the regime is already suffering profound legitimacy problems within China, the stakes *vis-à-vis* the Taiwan issue are raised even more. The Taiwan question is an unusual one because Taiwan does not in itself pose a security threat to China. Beijing's fear is a 'loss'

of territory (and face) that it presently does not actually control, and that this territory will be lost not by force but by fiat emanating from that territory. As Thomas Christensen puts it, “The danger to the PRC is that Taiwan might eventually move from de facto independence to legal independence, thus posing an affront to Chinese nationalism and a danger to regime stability in Beijing.”<sup>423</sup>

In one sense, Taiwan possibly represents the sum of Chinese irrationality. Staking one’s internal (and external) power projection and prestige on recapturing a territory that is neither an existential threat nor even presently under one’s control is a dangerous perversion of sound and prudent national interest. The problem is that having raised the political stakes over the issue—in the name of nationalism and for the sake of regime legitimacy that is otherwise in trouble—to such an elevated level, the pressure to remain unbending and ultimately secure an outright ‘win’ is immense. This makes managing any Straits crisis much more difficult for two reasons, even more so should China’s domestic situation deteriorate.

First, the political and security culture would move closer to that of the PLA’s, which is generally hawkish, intransigent and favourable towards coercive or military ‘solutions’ rather than diplomatic ones. Senior PLA generals have periodically and unilaterally (without going through bureaucratic channels) warned Taiwanese leaders that the consequences of pursuing independence would be dire.<sup>424</sup> This means that any attempt by Taiwanese leaders to redefine the status quo or the terms of engagement, even if it falls far short of actually declaring independence, will be viewed in a more extreme light rather than as the usual diplomatic manoeuvrings inherent in any disagreement. For example, in an analysis of crises over the past decade between China and Taiwan, Richard Bush argues that attempts by Taiwanese presidents Lee Teng-hui and Chen Shui-bian to merely redefine what future relations between the two entities might mean was treated as the beginning of an independence play and, therefore, in principle a *casus belli* as far as the Party was concerned.<sup>425</sup> As an illustration, Lee Teng-hui’s use of the term ‘state-to-state’ negotiations in 1999 was far from the declaration of independence that Beijing instantly took it to mean, and the subsequent PLA Air Force patrolling of the Straits was ordered with little measured or considered thought.

Beijing also obviously ignored the fact that its intransigence in these matters made the steering of a middle course much more difficult for Taiwan.

Second, there is a danger the fires of rampant, indignant and chauvinistic Chinese nationalism regarding the Taiwan issue in the event of future crises could drive a defining and forceful response. In a 2004 survey of about 2000 Chinese, 97.4% of respondents opposed Taiwanese independence.<sup>426</sup> If the people perceive any leader as being tricked or out-negotiated by Taiwan and its allies (i.e. the United States), it would seriously if not fatally undermine the Party's legitimacy and the leader's position within the Party. By contrast, leaders perceived as having 'put one over' Taiwan and its allies would have enhanced their personal and Party image. In the latter case, stubborn and inflexible action appears less risky than restraint and flexibility. Standover tactics, even if irresponsible, appear to be a more viable approach than the prospect of appearing weak and losing face over the issue. Having fuelled and facilitated public anger against certain countries, factional and personal competition between leaders would increase the temptation to outshine or discredit rivals by proposing 'strong' rather than 'weak' responses. This offers every prospect of tragic and unintended escalation.

The analysis here has been brief for such an important question, but Taiwan is simply presented as the scenario in which political opportunism, chauvinistic nationalism, and a desperate regime is most likely to intersect with potentially disastrous consequences. The same kind of speculation could be applied to China's territorial dispute with Japan over the Diaoyu Islands (and to a much lesser extent, the disputes with several ASEAN members over islands in the South China Sea). With the Diaoyu Islands in particular, the path is clear for China to portray Japan's stance as refusing to acknowledge the affront to the Chinese nation between 1895 and 1945.<sup>427</sup> The more general point is that if 'national dignity,' rather than sober calculations of national interest, becomes the dominant force behind foreign policy decision-making the peaceful resolution of any crisis becomes immeasurably less likely.

## **China's 'peaceful rise'—an untested proposition**

'Peaceful rise' is a strategy, not an end game. The Chinese had quickly learnt that overt aggression would be counter-productive. ASEAN nations, despite their differences, were generally united in the 1990s against what they saw as Chinese aggression in the South China Sea. China's clumsy manoeuvres both provoked the attention of the United States and Japan (the two mainstays of Chinese 'encirclement') and threatened to drive regional states closer to these two powers. China was no match—militarily—for the United States, let alone the coalition of the United States and the region. Moreover, China learnt the power of softer diplomacy in terms of both winning friends (e.g. refusing to devalue their currency during the Asian financial crisis and gaining the gratitude of the region for doing so) and influencing countries (e.g. giving of unconditional aid in the region, leading security dialogues, etc.). Finally, economic development and leadership were seen as much better strategies to increase Chinese power and prestige. The world was happy to welcome China into the global market, and China needed a stable and peaceful region to build a primarily economic foundation as a great regional and global power. 'Peaceful rise' was the happy compromise, but it has never been articulated as an end game in itself, and should not be axiomatically assumed to be one.

The difficulty with any scenario planning for China is that although Beijing has been undertaking a process of transition since Deng's reforms, contemporary China is remarkably undeveloped in terms of institutionalising its decision-making processes, which are controlled by little known personalities still exercising an inordinate amount of influence. The point really is that in the scenario of the continued rise of a chauvinistic nationalism and the deterioration of conditions for the Party and the people, an ambiguous and highly individualistic decision-making process, especially during a crisis, throws up real possibilities of a much more disruptive Chinese foreign policy.

Except regarding the issue of Taiwan, China at this time would be reluctant to risk any direct conflict with the United States. Its military capability and projection is still far short of the United States. Instead, elements of any disruptive foreign

policy will largely involve other aspects of 'comprehensive power' projection and acquisition—international prestige, strategic aid, cultural influence, and regional leadership—to gain influence at the expense of the United States and its allies. Chinese moves into Africa, Southeast Asia, and the Pacific are well underway. However, for the future, Willy Lam, observes:

Seasoned analysts have pointed out that the current leadership had decided late last year (2006) to make a clean break with Deng's cautious axioms and instead, embark on a path of high-profile force projection ... A new generation of generals and strategists within the PLA apparently believes that Beijing has more to gain by attaining a 'balance of terror' between China and the United States.<sup>428</sup>

Are such arguments unduly speculative and treacherously alarmist? There are reasons why this may not be the case.

First, as is expected of any large power, Chinese strategists and 'think-tanks' are undoubtedly advocating a 'great power mentality' in foreign affairs.<sup>429</sup> But doing so takes on a special urgency given Chinese perceptions of its humiliation by outside powers. As Li Shaohun, director of international politics at CASS, puts it:

In China's concept of security, there is no doubt that the pursuit of self-strength and strategic independence is an important factor. The concept has developed fundamentally, as the result of the unequal interactions between the Chinese and Western civilizations since the 1840s ... China will not be able to stand firm in the international world and will be humiliated and threatened unless China has strong comprehensive national power.<sup>430</sup>

Losing Taiwan would be a humiliating blow against China as a 'great power.' In a slow-motion illustration of escalation, China now has between 1,300 and 1,500 missiles pointed at Taiwan, rising from 700 in 2005 and 800 in 2006.<sup>431</sup> The 2007 Chinese missile test, which successfully knocked out an old satellite 535 miles above Earth, was partly designed to raise the stakes in the hitherto balance of force and technology between mainland China and the US-backed Taiwanese forces. It was an indication

that China could target US satellites, which would be crucial to the early warning systems of any Chinese attack on Taiwan. American leaders might be able to exert significant influence on the Taiwanese, but middle powers such as Australia and even a superpower such as the United States should be modest about the extent to which they can 'manage' the Chinese response to the Taiwan question.

Second, the assumption of China's 'peaceful rise' or 'peaceful development' emanating primarily from within China is itself an untested proposition. Remarkably, this proposition is accepted without contest in many parts of the world. The interlocking segments of the 'peaceful rise' thesis—that China will continue to rise as an economic power; that it seeks to smoothly and seamlessly slip into the regional and global status quo as its economic status grows; and that it has or will remove the military solution from the table of still critical and unresolved disputes—can each be seriously questioned. Just as war and conflict are never inevitable, neither is peace. To uncritically accept China's 'smile diplomacy' at face value betrays both prudent political practices and principles developed over centuries of international relations and discounts existing Chinese posturing and behaviour. Opening (some of) China's markets and entering the global economy has served the regime enormously well. While there is no doubt that 'peaceful rise' presents a compelling logic with which to further economic growth, it is not the only objective. Power and security, prestige, national honour and dignity, and most important of all, regime preservation, encompass the other goals.

The Party needs rapid economic growth to maintain its legitimacy. Even now, strategic competition is looming over access to energy supplies and commodities needed to sustain rapid economic development in China—something only temporarily abated by the current global financial crisis. China's belief that these resources will be denied to it in the event of rising tensions with other great powers is a genuine source of potential conflict. For example, more than 80% of China's energy imports pass through the US patrolled Straits of Malacca, and more than 90% of China's trade pass through the waters of the South China Sea. It is no wonder Beijing claims the whole of the South China Sea as its 'historic waters.'

China is upgrading and expanding its naval prowess with the aim of projecting its influence far beyond the Taiwan Straits. Its submarine fleet has grown faster than any other in the world, and these submarines have ballistic missile—as well as nuclear—capabilities. China now has a large arsenal of conventional and cruise ballistic missiles, including next-generation anti-ship cruise missiles, and has announced its intentions to build and deploy two conventional aircraft carriers by 2015. There are also plans to deploy and build two nuclear-enabled aircraft carriers by 2020. The PLA is investing in 'next-generation' military technology designed to cripple America's satellite and computer capacities. While some strategists point out that military expansion is expected from any growing economic power, Beijing's poor commitment to strategic and tactical transparency is of concern. Recently, one influential PLA publication explained that Beijing's power projection will extend its 'national interest frontier.' The new frontier will include all areas in the world where China has interests.<sup>432</sup> This is a significant reorientation away from a 'defensive' posture of protecting its territorial integrity (which for Beijing includes Taiwan). Protecting its merchant fleet and supply lines is one thing. Attempting to alter the balance of naval power in the Pacific—even if it is to protect its access to resources and supply lines—is another. The official line from Beijing is that it faces no discernable external threat in the foreseeable future—a diplomatic line at odds with its military capacity building. The Chinese Navy has begun to harass unarmed American naval vessels conducting legitimate operations in the South China Sea.<sup>433</sup> These were relatively minor incidents but would have been unthinkable a few years ago. Clearly, ill-conceived and reckless political and economic priorities can override policies that are conducive to long-term economic growth. China would not be the first or the last country to go down that path.

Third, China and Chinese society are in rapid transition. It is surely important to examine the disturbing aspects of Chinese polity and society—the resolute but dysfunctional authoritarian system, the rise of chauvinistic (alongside civic) nationalism, the deepening of economic, social and government deficits, etc.—to try to understand the ways they might interact and play out. Given these challenges, and combined with the uncertainty

of external events, to argue that China will be an impeccably behaved, prosperous, and successfully governed great power in the future is clearly more the product of unsighted speculation and hope than evidence.

Finally, where China's nationalism will take it in the longer term is unclear. Many commentators such as Henry Kissinger proceed on the basis that China is not a threat to the existing order and its rise should be seen as a peaceful one; only Western provocation would make it be otherwise.<sup>434</sup> But in the event of a politically unreformed country, the broader question beyond Taiwan is whether a stubbornly authoritarian China (whether it is rising or declining) will happily 'integrate' into a liberal world order and a regional security structure dominated by democratic (and liberalising) powers. James Mann poses this question in his recent book *The China Fantasy*.<sup>435</sup> Despite the degree of economic integration between China and the United States, Beijing has long been suspicious of Western, especially American, intentions in the global economic system. As Xiao Lian, a prominent member of the North American Institute at CASS, argued more than a decade ago:

The United States has all along controlled the WTO, the World Bank, and has a bigger say in the IMF to date ... [the] United States has time and again succeeded in consolidating and enhancing its control over the world economy. [This includes] controlling and manipulating the foreign exchange markets the world over to get huge profits by virtue of its economic and financial strength.<sup>436</sup>

Even former US Deputy Secretary of State (and current World Bank President) Robert Zoellick's sensible and well-received calls for China to be a 'responsible stakeholder' in the global system promise a difficult path ahead. Responsibly working with the United States and other powers when it comes to 'win-win' economic integration and trade policy strategies is one thing. Agreeing on global issues such as the relationship between defining and upholding 'sovereignty' on the one hand, and the legitimacy of regimes based on adherence to (even minimal) democratic norms and so-called 'internationally recognised standards'<sup>437</sup>



on human rights on the other will prove far more problematic. The controversy that dogged the Olympic Torch Relay from Athens to Beijing after Beijing's clampdown on protests in Tibet in March 2008 angered Beijing and many Chinese people. More generally, Beijing's willingness to accept American and Western leadership of a global order (within which China is urged to be a 'responsible stakeholder') is far from certain.

The point is not to predict China's future. No one can claim to know it—neither the Chinese nor the rest of the world. Chinese leaders are well aware of the country's weaknesses and have so far pursued a cautious foreign policy primarily designed to placate regional fears of its re-emergence and avoid unnecessary conflict with the United States. However, the fate of China's political-economy model will largely determine Beijing's future foreign policy. The foreign policy of a weak, insecure China is much more unpredictable than that pursued by a strong and confident country. In Beijing's eyes, real and imagined foreign demons may grow in stature. Like its economic model, China's self-proclaimed 'peaceful development' should be closely examined rather than too easily passed over or praised.





Part B  
**CHAPTER THREE**

Conclusion



## Chapter 3

# Conclusion

In mid-2007, an engaging article titled 'A World without the West' appeared in the *National Interest*.<sup>438</sup> Its authors speculated about a world order without the West: a set of non-Western ideas about governance, as well as non-Western countries with the resources and capacity to enforce these ideas. China as well as Russia and India were the most likely giants in this world.

Former *Time* magazine World Editor, Joshua Ramo, who coined the term 'Beijing Consensus' quite intentionally, links the domestic and external 'virtues' of the Chinese political-economy model, which together form the basis for the 'new physics' of development. According to Ramo, China is driven by both 'a ruthless willingness to innovate (domestically)' and a 'strong belief in sovereignty and multilateralism.' The Chinese political-economy model offers both hope to developing countries by providing 'a more equitable paradigm of development' and a model that 'safeguards the peaceful environment needed to secure its prosperity.'

In a sense, aspects of the 'Beijing Consensus' have given a new twist to and presented a new stratagem against the ascendant liberal economic and political positions that are now under attack for a number of reasons. Following the Soviet collapse, the relationship between liberal values, democratic systems, 'limited government' under the rule of law, and open economies on one hand, and prosperity on the other was once again confidently reasserted. The rhetoric about the inevitable march of political liberalism and free-market economics was at its most compelling. The confrontational language of administrations such as those of Ronald Reagan in the United States and Margaret Thatcher in Britain immediately prior to the Soviet collapse appeared to have been justified. Liberal values and democratic regimes were no longer just the desirable product of post-Enlightenment Western culture but the indispensable and reinforcing complements to prosperous societies.

Asian models such as those from Japan, Taiwan, South Korea, Malaysia, and Singapore provided only intermittent and piecemeal challenges to liberal logic. These countries might not have been as liberal and as democratically mature as their Western counterparts, but they were ultimately democratising and moving away from centrally planned and protected economies, albeit sometimes at snail's pace. The link between open markets and democratisation was not really severed by these examples. Moreover, although leaders such as former Malaysia Prime Minister Mahathir bin Mohamad went on the front foot by vociferously defending the right of individual countries to define their own standards of human and individual rights, Malaysia was not significant enough in the global scheme of things to signal an alternative to a model that had won over its adversary in the global Cold War. This war had absorbed the attention of the best minds from both sides lasting decades. An effective rabble-rouser leading a small but successful state was never going to seriously threaten hard-won liberal orthodoxy.

However, what leaders like Mahathir did represent was the beginning of post Cold-War resistance against Western ideological pre-eminence in general and US hegemony in particular, of which the emphasis on linking legitimate sovereignty with human rights and *individual* dignity was seen as a tool of the hegemon. Moreover, this perceived American hegemonic order intimately linked individual rights with free and open economies, both of which were seen to be mutually reinforcing. This provided an obvious basis for criticism of countries that failed the standard, a criticism made more intimidating as it was delivered with the backing of the world's sole superpower.

That illiberal regimes (and authors like Ramo) would eagerly welcome a model to rival the liberal one was helped by strategists and leaders in the West abandoning rule-of-thumb (realist) principles guiding the use of force that were generally ascendant (with some exceptions) during the Cold War. With the threat of global war subsiding, Western governments flirted with a new ethics of force deployment away from more guarded realist ones. These included the humanitarian intervention debates in the 1990s culminating in NATO's Kosovo action against the Serbs in 1999, as well as the most recent Iraq War in 2003

in which the logic of removing a dictatorship and establishing democracy played a strong part in both the strategic and political justification. Although invading Iraq was also the result of preemptive principles in which the construction of what constituted an imminent 'threat' was significantly enlarged after the 9/11 attacks, the point is that the decision to invade Iraq and the ongoing problems with replacing Saddam's regime with a stable 'democratic' one for many discredited the notion of building liberal and democratic regimes through the use of force and from without.

The US-led Iraq war represented different follies to different groups. Realists from almost all camps (who certainly rejected the logic of regime change) viewed Saddam's then-believed arsenal of weapons of mass destruction as an insufficient threat to the United States to justify a full-scale invasion. Those states and regimes sneering from the sidelines rejoiced at the limits of US military power and what it could achieve. Importantly, a diverse collection of regimes and groups who craved an alternative to, or at least a lessening of, US hegemony and dominance for varying reasons focused on the violation of Iraq's sovereignty as the point of attack against an increasingly confident if not arrogant superpower. For regimes and interests that either rejected the logic of liberal economics and politics championed by the United States, or felt threatened by it, the Iraq action and its aftermath were cited as compelling evidence that regimes and countries should be left alone to do as they pleased without outside interference. Predictably, the loudest of these voices were regimes that felt most threatened by the 'neo-conservative' democratising agenda.

It is within this context that the Chinese political-economy model—preferring sovereignty and non-interference to human rights—suddenly stood up strong as a counter-model to the liberal one. Although advocating liberalism or liberal society is a very different thing to supporting the American penchant for spreading democracy abroad (by force if necessary), distinctions between different questions in which one is about desired ends and the other about viable means are not reliably made in political and public discourse. Indeed, such distinctions are often intentionally ignored in order to make broad-ranging

political points. Subsequently, whereas the United States was until recently viewed as the defender of the global order after the Soviet collapse, the deep irony confronting us now is that authoritarian China is increasingly seen as the global champion of state sovereignty and a praiseworthy counterpoint to a United States that many accuse of seeking to rewrite the rules of engagement for international relations. In other words, China is increasingly seen as the new defender of realist prudence in the world—Ramo's champion for stability and new global order. The 'live and let live' philosophy of the 'Beijing Consensus,' of China's 'New Security Concept' in Asia, stands opposed to what many would see as the destabilising American liberal agenda for the world.

This has all been a diplomatic boon for China and the 'Beijing Consensus.' As the United States struggles to help establish viable democratic governments in Afghanistan and Iraq, the confidence and strength of liberal voices criticising the Chinese mix of authoritarian politics and hybrid (planned and free-market) economics is diminishing. Supporters of the 'Beijing Consensus' and authoritarian systems drew breath and strength from the deflating of the American democratisation project (in Afghanistan and Iraq). Beijing suddenly appeared to be prudent and Washington reckless. Beijing's lack of regard for individual rights within its own system became irrelevant or at least was overlooked by liberals distracted by the struggling Iraq project. Importantly, aggressively advocating liberal or democratic agendas now appeared to be a failing Western obsession backed by an ailing hegemon.

Yet, there are manifold perversions of logic at work here. First, America's perceived mistake in entering Iraq is not a failure of liberalism but a failure to understand the dynamic of sectarian and ethnic rivalries deepened by decades of selective repression in a foreign land. In other words, even if the 'Iraq project' fails, it does not signify a failure of liberalism or its logic but the failure of an instance of US foreign policy. Second, the difficulty of establishing a workable democracy in Iraq (and indeed Afghanistan) should not confirm the virtue of, and strengthen the case for, authoritarian politics. The post-invasion turmoil in places like Iraq and Afghanistan is merely an argument against the viability of spreading democracy by force.



Third, even if we accept China's self-serving championing of sovereignty and non-interference as the more prudent terms of international relations, the issue of China's authoritarian model is a different question altogether. Arguing against interventionism in the name of upholding national sovereignty is not the same as vindicating authoritarianism within the Chinese domestic system. China's model still has to be judged on its own merits unaided by perceived failures of US foreign policy.

The last point is all-important. One must ignore illogical temptations to distribute in equal measure criticism of the United States and its foreign policy with praise of China's domestic and international model. The 'Beijing Consensus' must be judged by the evidence of what is occurring in China—whether the regime's poor enthusiasm for political reform and rejection of what it portrays as Western notions of 'individual dignity' and 'individual rights' present successful and plausible alternatives to liberal and democratic models.

Proponents of the 'Beijing Consensus' and admirers of 'market socialism' variously argue that China *is* getting it right, and that we should remain patient and optimistic. I have argued that the economics and politics behind the Chinese political-economy model are flawed, unsustainable, dangerously unstable, and unlikely if not incapable of providing a foundation for the continuation of China's 'peaceful rise' or 'peaceful development.' China has not developed a new and successful logic of political-economy—a new physics of development and power—despite the hype. They have not found a new logic to supplant the claims of liberal systems that put forward links between freedoms enshrined in the political and economic order and sustainable economic prosperity of broad benefit to Chinese society. Taking this sober and solemn look at what lies behind the 'market socialism' is critical to 'getting China right.'

Generic calls to either 'contain' or 'engage' China fail to capture the enormity of the challenge of 'getting China right.' For a start, such calls generally assume the rise of China as inevitable and do not consider the equally important question of 'containing' or 'engaging' a stumbling giant. Besides, whether we assume a rising or struggling power, China does not currently present the same

kind of challenge and threat to the West that the Soviet Union did after World War II. The Cold War strategies of containment and engagement cannot, therefore, be simply reworked to answer the China question.

The world has chosen to engage in some sense with China, and this is almost certainly a sensible strategy. It seems beneficial and in the national interest to primarily 'engage' China rather than 'contain' it in the classical Cold War sense of the term.

In a forceful and compelling essay examining the dialectic of nationalism and liberalism within Chinese society, John Fitzgerald argues that 'dignity' is the essential (albeit contested) concept that is common to discourses on individual rights and national prestige. Chinese nationalism has, therefore, inadvertently incubated an idea of human rights or 'individual dignity' in which 'resurgent nationalism ... offer[s] ground for hope that China's wheel is turning, slowly but surely, to recognising the inherent dignity of the individual.'<sup>439</sup>

We cannot do justice to the depth of Fitzgerald's argument here, but the essay introduces an important point. China's ambition is rooted deeply in its quest for recognition and a reversal of what it sees as its humiliation that has lasted for several generations. The world must come to grips with China's politics of indignation or what Fitzgerald calls *nationalist resentment*. China must therefore be engaged, not shunned. But from this point, future paths diverge. Engaging China cannot presume that such engagement will lead to the inevitable and seamless democratisation and liberalisation of the country and society; that the renewed dignity of Chinese nationalism will converge with respect for the dignity of the individual. China remains an authoritarian and repressive polity. Remaining so is precisely what aspects of the 'Beijing Consensus' or 'market socialism' imply and applaud. Chinese authoritarian logic asserted that retaining such a system was needed to avoid disorder and guard against the mounting of social and governance deficits that would surely arise during any transition process. Yet, this logic has been shown to be flawed, contradictory and duplicitous. China's rulers are explicit in that they do not intend a transition that will ultimately reduce their power, role and reach.

The regime's 'opening' up of China and engagement with the world is being done to entrench and salvage its own exclusive rule.

In 2006, John L Thornton, former President of investment bank Goldman Sachs and now Professor and Director of Global Leadership at Tsinghua University in Beijing, led a delegation to China that included the former Clinton Administration Deputy Secretary of State and current President of Brookings Institution, Strobe Talbot. In a 90-minute discussion with Chinese Premier Wen, the delegation asked the premier about the prospects of democratisation in his country. As Thornton informs us, Wen defined 'democracy' as having three pillars: elections, an independent judiciary, and effective oversight of the government. The Premier then spoke of recent advances in these areas, and argued that despite many problems China was heading in the right direction.<sup>440</sup>

Many Western delegations have related similar conversations with Chinese leaders. Premier Wen's definition of 'democracy' is flawless. Yet, the primary purpose of the Party is to remain in power. To this end, the logic and benefits of these freedoms (and restraints on government) are being denied to the country. What is offered to the Chinese people in return is a model of political-economy that is deeply flawed and dysfunctional in important ways. Consequently, any transition towards 'democracy' will likely be traumatic. Engagement must proceed with collective eyes that are wide open to these profound failings and contradictions (and not merely proceed on the basis of 'integrating' China as if it were a straightforward matter of accommodating just one more large country into the existing security and economic environment).

The China question presents a moral challenge, not just a strategic one. Both challenges are far more subtle, oblique and sophisticated than the one the Soviet Union presented to the West. China does not seek to explicitly defeat the West but to legitimately take its place as one of the genuinely great powers. However, despite reassuring conversations with Western delegations, the leadership seeks to do so armed with a moral and political reasoning that is at odds with the freedom and restraints on government that we take for granted.

The world wants China to succeed for economic, political and humanitarian reasons. The alternative would condemn more than a billion Chinese to an even more grim existence. That China's current model is not succeeding makes the moral and strategic challenge more profound, not less. In many respects, an uncertain and struggling giant state that is no less ambitious is a greater dilemma for the world than a confident and successful one.

Finally, our capacity to influence domestic developments within China is severely limited. Certainly, we should argue against and hope that the United States and Europe do not capitulate to uninformed and short-sighted calls to follow the path of protectionism that would both embolden the sceptics of free trade and global engagement within China and cause considerable damage to Chinese development and its people. This is particularly tempting for all sides in the current environment. As *Newsweek* Editor Fareed Zakaria pointed out to me, since the financial crisis began, countries around the world have proposed or implemented 78 trade measures. Of these, 66 have been restrictions on trade. We can also caution against any reckless and ill-considered 'independence' moves by Taiwan's leaders. And we can avoid outdated crude 'containment' strategies that unnecessarily provoke and are likely to be counter-productive. As Ross Terrill argues, 'being wary of authoritarian China yet engaging with emerging China is a dualism we can and should live with.'<sup>441</sup> But in 'engaging' China, we should be careful not to turn a blind eye to, or support, a reasoning that stands tragically in contrast to the one that sustains our continued good fortune.



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