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From the editors' desk

The members of the fifth-generation leadership, with President Xi Jinping and Premier Li Keqiang at its core, have been in their party places for a year and in government positions for half a year. Now is a good time to assess how they are doing and the context in which they have to operate, especially as the party plenum to be held in late 2013 will articulate their economic policies more fully.

As the articles by international experts in this issue of *EAFQ* make clear, this is a leadership that practices incremental reform. In internal issues, like managing the falling growth rate and the structural issues of increasing consumption, supporting sustainability and making the Chinese economy more competitive, it is a leadership that maintains faith in the market but also in state control. Its members support private-sector development and greater international access to the domestic market—but only up to a point.

On China's international role, they inherit from the previous administration the problem of managing the country's increased profile and importance while maintaining constructive relations with America, Japan and other key countries. They continue to plan policy around what they perceive as US attempts at containment and a Japan whose behaviour over the Senkaku–Diaoyu islands is curtailing their strategic space.

At the heart of both these issues is the dominant contradiction in China's current role—a major country central to global growth and stability, but one that feels beset by immense internal challenges and the need to give these priority rather than involving itself in the affairs of others.

The Xi–Li leadership has been working within a framework created by its predecessors, but one which put GDP growth ahead of almost everything else. Its language of a 'China dream' and of needing to create a more urban, sustainable economic model starts to move away from this GDP dominance. But as these articles show, the challenges in creating political consensus among a highly fractured polity remain dauntingly high. And it is too early to say just how radical the new leaders will be as reformers when the time comes to make choices between the options available to them.

Richard Rigby and Kerry Brown

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COVER PHOTO: Presidents Xi Jinping and Barack Obama stroll in the grounds of the Annenberg Retreat, California, before sitting down to the formal business at their bilateral meeting on 8 June 2013. Picture: Pete Souza / The White House.

KEEPING CONTROL

Whither the leadership?

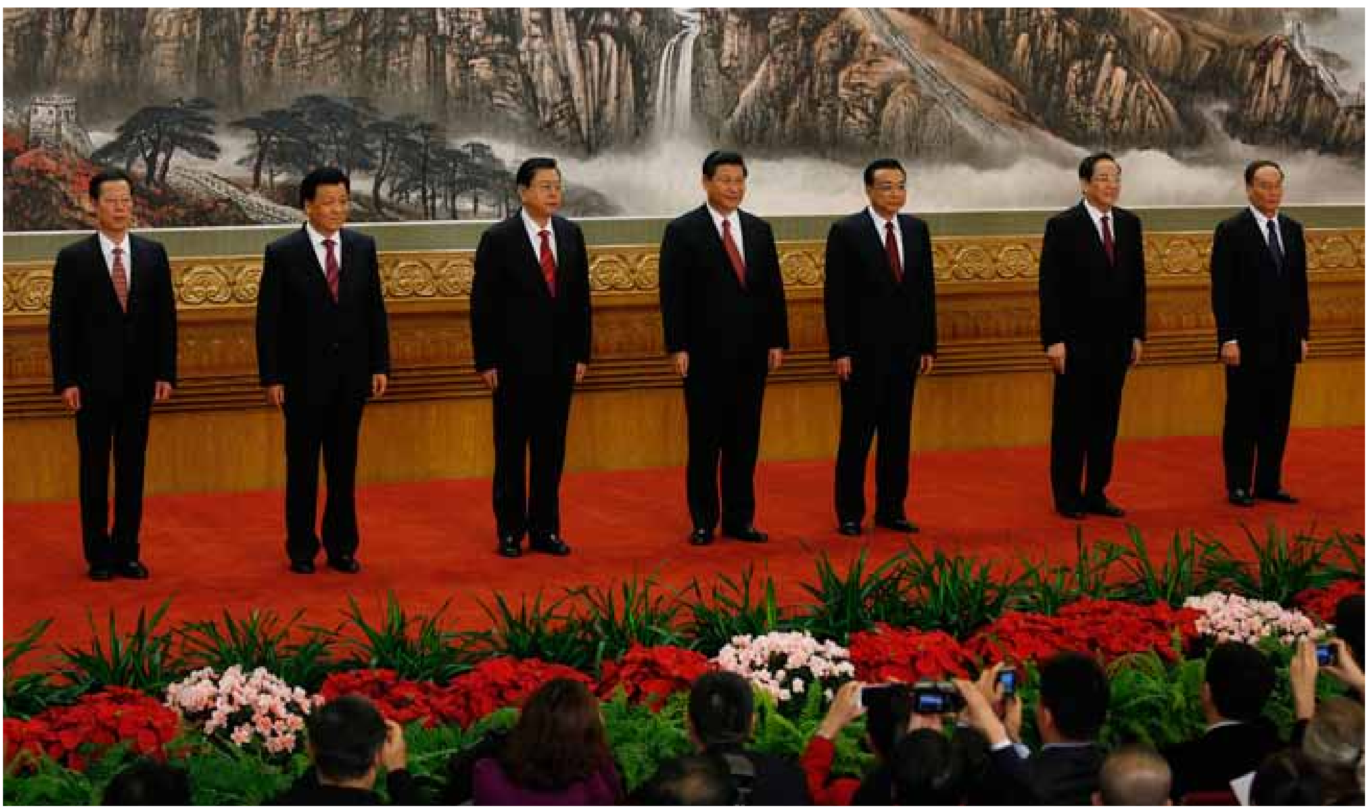
RICHARD RIGBY

THE Xi Jinping–Li Keqiang leadership is still relatively new, but enough time has passed since last year's 18th Party Congress and this year's National People's Congress (NPC) to give us at least some sense of where things might be going.

There are big changes in the nature of the new Politburo Standing Committee (PBSC). The overall numbers are reduced from nine to seven, and of those seven, five are new. It's also worth noting that five of these are due to be replaced at the time of the next party congress—late 2017, if things go to plan. Not only the numbers, but the characteristics of the membership have also changed. The age of the engineers and technocrats is over, their replacements including a lawyer, an historian, two economists, a former schoolteacher and a ballistic missile engineer. They have a broader range of experience, prior jobs and workplaces. They also represent a new factional balance.

In addition to the PBSC, there have also been sweeping changes in the broader leading groups: over half of the politburo, seven out of 10 of the Central Military Commission, and similar infusions of new blood in the NPC, the state-owned enterprises, the People's Liberation Army (PLA) and at the provincial level. Arguably this has been the largest transition over the past 30 years.

Whatever differences there may be within the leadership, one thing on which they all agree is that in the party state (党国)—that is, the People's Republic of China (PRC)—it's the party that comes first. Whether a leader is a 'princeling', a China Youth League man, a protégé of Jiang Zemin or of Hu Jintao, there is the same sense of entitlement and ownership—China is us. This is very much the case with Xi Jinping, already showing signs of being more than *primus inter pares* (unlike Hu Jintao). He presents as strong, confident and clear (although



China's inner circle: the new Politburo Standing Committee–Zhang Gaoli, Liu Yunshan, Zhang Dejiang, Xi Jinping, Li Keqiang, Yu Zhengsheng and Wang Qishan–are presented in the Great Hall of the People in Beijing on 15 November, 2012, the day after the 18th Chinese Communist Party Congress ended.

PICTURE: VINCENT YU / AP PHOTO / AAP

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not too clear: he can articulate his 'China dream' in general terms, but leaves it to others to fill in the detail; if they get it wrong, then they have misunderstood the leader's intentions).

While confident, though, and capable of speaking and acting in ways that appeal to ordinary Chinese, Xi clearly senses serious problems in the credibility of the party vis-à-vis society. This includes the party's moral credibility, crucially tied to legitimacy in the Chinese political context. Similarly, he sees this as an issue within the party itself. Hence the renewed attacks on corruption, which have had an immediate impact on banqueting habits and other more egregious manifestations of party members behaving badly. But restricting menus to four dishes and one soup has been tried and abandoned repeatedly since first mandated during the Ming dynasty, and such is the degree to which far worse forms of corruption have now become systemic that most are sceptical, if not cynical, as to how successful the current campaign will be. In recent months dire warnings of the dangers of corruption have also focused on the PLA; the mechanisms for dealing with these now endemic problems are still designed by the party itself, and the dilemma of self-policing within a closed system has been widely recognised.

At the same time, we are seeing a significant ideological hardening coupled with a crackdown on lawyers, journalists, bloggers and human rights advocates. Party members are being told they have to strengthen people's confidence (道路自信) in the vision of socialism with Chinese characteristics, a sure sign that at least in some circles the vision is fading. So we have Xi's recent pilgrimage to Xibaipo, Mao's last stopping point before the surrender of Beiping (Beijing) in 1949, and his reminder of the continuing importance of Mao's 'two musts' (a modest demeanour, commitment to arduous struggle)—repeating similar exhortations from the revolutionary site by Jiang Zemin in 1991 and Hu Jintao in 2002.

> It seems quite clear that Xi genuinely believes the party needs to be called to order, and few would question that

Attempts to stymie a very vigorous discussion of constitutionalism, or constitutional governance, as the way forward for China need to be seen in this context, as do recent much-discussed guidelines regarding the 'seven things not for discussion' in educational institutions, the media and so on, and the two 'cannot negates'. The former are: universal values, media freedom, civil society, citizens' rights, the Chinese Communist Party's historical aberrations, the privileged capitalist class and independence of the judiciary. The latter refers to not using the first 30 years of the PRC to negate the latter (that is, Mao and post-Mao, pre- and post-reform and opening), or vice-versa. It now appears that both of these are based on Document No. 9, issued by the Central Party Office in April 2013, and can thus be taken as an authoritative reflection of Xi's thinking.

Again, these are interesting indications of just what people are indeed talking about, and it's little wonder that the leadership may find

PICTURE: ADRIAN BRADSHAW / EPA / AAP

President Xi Jinping and Premier Li Keqiang at the National People's Congress in March 2013. The leaders share a commitment to pursue economic reform.

this worrying. Equally of interest is that despite a recent spate of arrests, there has been pushback. A well-connected figure speaking to a group of veterans and their descendants earlier this year specifically attacked the 'two negates', and also strongly criticised another statement known to have been made by Xi concerning the collapse of the Soviet Union. Similarly, when in August 2013 the overseas edition of *People's Daily* published an editorial attacking calls for constitutionalism as part of a Western conspiracy, almost simultaneously the Central Party School's *Study Times* argued that it was imperative for China to push on with political reform. This is significant; in the longer term it could be very significant. For now, though, the main trend is not going the way of such reform.

It seems quite clear that Xi genuinely believes the party needs to be called to order, and few would question that. And while political reform, despite the hopes of some, does not appear to be on Xi's agenda, economic reform is another matter. The evidence points towards a genuine commitment to this, shared with Li Keqiang. Precisely because Xi knows this is not going to be easy, that powerful vested interests stand in the way, he wants consensus. He wants to ensure the whole leadership is on the team—including the by no means insignificant number of people who are still sympathetic to Bo Xilai, or at least to his way of doing things—and he wants no distractions from the job in hand. Li is known as a good economist, and will not be as easily rattled by a downturn in growth as was Wen Jiabao. Precisely what is in store will be made clearer at the forthcoming Third Plenum, but we can expect Xi to provide Li with the necessary backing and measures needed to push on with restructuring, because they all know that this is essential if the party is to have any hope of maintaining control of the nation. And that is what it is all about.

At the same time, one does not have to be a Marxist to know that changes in the economic base need to be reflected appropriately in the superstructure. Or, put another way, apart from land, capital, labour and technology, institutions are an equally vital economic input. Sooner or later the calls for judicial independence, greater media freedom and all the other issues covered by demands for constitutional government—in other words, political reform—are going to have to be heeded. Otherwise history will prove, to adopt the language of the party, that not only the bourgeoisie have the capacity to be their own gravediggers. EAFQ

Professor Richard Rigby is head of the China Institute at the Australian National University and was formerly an Australian diplomat and analyst specialising on Chinese and Asian affairs. He is executive director at the ANU China Institute and located in the Crawford School.

PICTURE: PETER PARKS / AFP PHOTO / AAP

Onlookers watch a new suspension bridge spanning the Yangtse River at Chongqing, formerly controlled by Bo Xilai. Expansion has intensified problems of corruption, and a significant number of cases have been related to infrastructure projects.

Bold political reform needed at the local level

YAO YANG

CHINA'S economic success has been closely tied to its unmistakable move toward the market since reforms first began in 1978. In the first 20 years of reform the role of the state diminished substantially, and it is only in the last 10 years that the state has come back to the forefront of economic activities. There appears to be a consensus within the Chinese establishment and among many international China-watchers that state dominance has been a salient factor behind China's economic success. But, against this view, most economists in China believe that state dominance has impeded rather than propelled China's economic growth.

The significant presence of large state-owned enterprises (SOEs) and a mercantilist approach to foreign trade have been cited by many China-watchers as evidence of China's state capitalism. From an international perspective, these are major issues that have constantly caused tensions between China and its trading partners. But as China moves away from its export-driven growth model—a natural process consistent with the country's structural change—these problems will eventually abate.

The same cannot be said for the expansion in local government spending that has been the main reason behind the revived role of the state. Local government officials must develop local economies because their opportunities for professional advancement are tied to local GDP growth. They have been correct to invest in infrastructure, new urban development, highways, industrial parks and the like. Yet instead of opening up investment opportunities to the private sector, almost all local governments have opted to borrow money from banks and invest it themselves. The booming real estate market has made them confident that their investment will pay off. Along the way they have also set up new financial companies and delegated to them the task of managing infrastructure building and finance.

> Local officials have a short tenure in a city, and so it is perfectly rational for them to prop up local growth rates in the quickest way possible

The consequences of this round of government expansion are severe. Local governments have become seriously indebted. Although most of the debts are secured against some form of collateral (meaning that a financial meltdown is unlikely to happen), they will still be a big burden for many cities in the years to come.

Another problem is that government investment in infrastructure acts as an in-kind subsidy to industry, especially to the secondary sector (composed of manufacturing, transportation and construction industries), which is more capital intensive and therefore pays its workers less than the service sector. As the share of labour income in the national income declines, so too does the share of household consumption in the national GDP. In essence, local governments' excessive investment in infrastructure contributes to China's structural imbalances problem.

The current round of state expansion has also intensified the problem of corruption. A significant number of corruption cases have been related to infrastructure projects. In Henan province, for instance, four consecutive bureau chiefs of the transportation department have been caught in corruption scandals.

Additionally, government projects and government-owned companies have had a strong crowding-out effect on private businesses. In the past several years, infrastructure lending has taken up more than one third, sometimes close to one half, of the total bank lending. This inevitably squeezes the already confined space left for small- and medium-sized private companies.

The government is likely to roll out some major plans for reform in the Chinese Communist Party's Third Plenary Meeting of the 18th Congress, scheduled for this November. Adjustment of central–local fiscal relations is likely to be one of them. One of the rationales for this is that local governments take part in economic activities, especially real estate development, because their regular revenues are not enough to pay for their regular expenditures. The hope is that by adjusting the central and local shares of revenues and expenditures, local governments will retreat from those activities. But this is probably just wishful thinking. Local officials have a short tenure in a city, often limited to three to four years, and so it is perfectly rational for them to prop up local growth rates in the quickest way possible, which has been through investment, especially in real estate.

To change local government behaviour the root of the problem must be addressed, which involves asking why the role of the state has been expanding in China. This has to do with the lack of checks and balances in the country's governance structure, most significantly the lack of accountability on the part of the officials toward their constituencies. In such a system, officials are free to pursue the one goal that affects their careers the most, that being short-term economic growth. Real change therefore demands bold political reform to strengthen democratic participation in policy formation.

Yao Yang is Director at the China Center for Economic Research and Dean at the National School of Development, Peking University.

ECONOMIC REFORM

Can China's leaders harness support for change?

SUSAN SHIRK

ALL EYES are on Premier Li Keqiang and the economic team that is drafting the proposals for a new set of economic reforms to be rolled out at the Third Plenum of the 18th Chinese Communist Party (CCP) Central Committee, convening in November 2013.

The individuals designing the reform package are well-respected market-oriented economic experts, and the central authorities are sending signals of resolve. Hopes are stirring that the reforms will be serious and substantive.

Yet scepticism remains about whether China's political leaders have what it takes to actually implement the reforms. Analysts argue that today's leaders lack the authority that Deng Xiaoping had in the 1980s when he was the moving force behind the first wave of China's market reforms. This is certainly true. But to attribute the success of those reforms to Deng alone is to misunderstand the Chinese system of that time. Deng was not a dictator. He and his reformist lieutenants had to formulate a strategy to get different powerful groups on board.

Many people also predict that the vested interests in the current state-dominated economic system will thwart a new round of market reforms. But are the vested interests of today—state-owned enterprises, corrupt officials and their families—any more entrenched than the vested interests in the command economy that existed in China in 1979—central planners, government bureaucrats, heavy industry?

The greatest challenge to economic reform is always the political one: how to overcome the resistance of powerful groups favoured under the current system and build constituencies for reform?

What kind of strategy will Xi Jinping and Li Keqiang adopt to create a reform coalition? What groups might potentially support the reforms?

The logical first place to look is the private business sector. Private business is frustrated by the systemic bias toward state-owned companies in obtaining bank loans and other preferential treatment. In the absence of a functioning domestic capital market and legal system, private businesspeople have to invest much of their effort in cultivating relationships with government officials. They also reduce their risk by sending their wives and children, and their fortunes, overseas. But private business has no voice in the Chinese Communist Party or the central government and therefore can't serve as a political counterweight to the powerful state sector.

> Local governments face a severe mismatch between revenue and expenditure

What about provincial and local officials? The officials who run China's 33 provinces are a very important potential constituency in China—they constitute the largest bloc in the CCP Central Committee. Where do provincial and local officials stand today? Are they a vested interest in the status quo or a potential constituency for a new reform drive?

The 1980s reforms succeeded because Deng Xiaoping and his lieutenants counterbalanced the political weight of the central bureaucracy by the power of provincial leaders within the Central Committee—a strategy which at that time I called 'playing to the provinces'. They won the support of provincial officials by making the decentralisation of economic decision-making and fiscal revenue a key component of the reform package. Decentralisation created incentives for provincial and local governments to promote growth through the market.

Some provincial and local officials were also rewarded with special economic zones and other targeted preferential policies, which greatly benefited them and their regions. Special zones and opportunities to access the market were allocated selectively only to some particular regions, not everywhere across the country. Once local officials started envying those regions that had been

PICTURE: ED JONES / TOPSHOTS / AFP PHOTO / AAP

An ethnic-minority delegate arrives at the Great Hall of the People for the National People's Congress in March 2012. Officials who run the 33 provinces are an important potential constituency in China.

granted special treatment, they clamoured to get some of these lucrative market opportunities for themselves. Over time this strategy of playing to the provinces built a bandwagon of support from provincial and local officials for the market reforms, which subsequently overwhelmed the vested interests in the command economy that were once so strong in the central planning bureaucracy and the heavy industrial ministries.

Of course fiscal decentralisation had a serious downside. The central government became very poor because most of the revenues were left at the local level. Beijing lacked the funds to build the infrastructure, social safety nets and modern national defence that China needed. To increase the central government's share of total government revenue, fiscal reforms were introduced in 1994, whereby value-added tax was shared between the central and local governments. While these reforms were an important and necessary readjustment for increasing central revenues, they left local governments without an adequate revenue base as the tax-sharing scheme was enormously skewed in favour of the central government.

How will this imbalance be addressed in the 2013 reforms? Local governments face a severe mismatch between revenue and expenditure. They are responsible for providing pensions, education and health care, and addressing environmental concerns, but do not have the adequate fiscal revenue to pay for them. They adapted as best they could by depending on earnings from land development—many local officials are making good money privately and for their localities from land development. But this dependence on land development is unhealthy and distortionary.

After the 2008 global financial crisis, Beijing stimulated the economy by ordering the banks to open the spigots of credit for local projects; as a result, local governments started relying once again, as they had under the pre-1994 system, on a blank cheque from local banks.

A new wave of fiscal reform could introduce new local revenue sources such as property taxes, a value added tax on services, and a higher share of the total value added taxes. Another approach would be to relieve the financial burden on local governments by increasing transfer payments from the central treasury and shifting responsibility for education, health, and pension spending to Beijing. Another crucial issue is whether local officials will be left holding the bag for repaying these past bank loans.

As they design the reform package, Xi Jinping and Li Keqiang have to be thinking about what would constitute an effective political strategy of reform. What kind of fiscal changes would turn provincial and local officials into a powerful constituency for overall market reform?

Where will provincial and local governments stand on the new reform proposals? Will they find the plans a better solution than the status quo in which they rely on land development and cozy relations with local bankers? Or will they worry that the reforms will leave them in a tighter, more financially constrained situation than the situation they are living with today?

Given the limited options of other groups that could help build a reform bandwagon to overwhelm the vested interests in the status quo, won't China's central leaders decide to once again 'play to the provinces'? EAFQ

Susan Shirk is Chair of the 21st Century China Program and Professor of China and Pacific Relations at the School of International and Pacific Relations, University of California, San Diego. She is the author of The Political Logic of Economic Reform in China *(1993).*

The importance of Bo Xilai's day in court

JOHN GARNAUT

IT IS ironic that President Xi Jinping has deployed the Maoist model of 'rectification' to revitalise and impose his will over the world's largest and most powerful political party. This is the model of 'self-purification' that Mao applied to instil discipline and consolidate personal power from the early 1940s. It requires tight control of an internal security apparatus to forcefully extract confessions, and it works by rooting out the patronage networks of perceived rivals. More recently, Bo used such stratagems to transform the Communist Party in Chongqing city and build a formidable power base in ways that are not widely understood. Now Xi is applying the same underlying political logic to establish his own authority across the country, with some important innovations. And he is doing it by purging Bo.

It is easy to forget, amid the sordid hypocrisy exposed by his fall, that Bo Xilai was a leader who identified a problem and wanted to get things done. Bo was making his run for high office at a time when it was getting harder to restrain the predatory instincts of the bureaucracy and harder still to explain why the Chinese Communist Party, of all political movements, had created one of the least egalitarian societies in Asia. In Bo's judgment, desperate times demanded desperate measures. He offered himself as the surgeon to remove the Communist Party's cancerous tumours and fetid organs. 'Without help, the disease will become fatal', said Bo in December 2009, borrowing the metaphors of bodily disease that Mao used to commence his own 'rectification campaign' in 1942.

Bo mapped the city's channels of patronage and nodes of political and financial power, planted key people, and uprooted the existing networks of propaganda and coercion which he did not personally control. His key target was the old Chongqing police chief, Wen Qiang, who, like most established police chiefs in China, enjoyed power well beyond his official portfolio. Wen's patrons included one of Bo's powerful predecessors, who had been promoted to the Politburo Standing Committee, and his protégés were stacked throughout the municipal political-legal establishment. Wen controlled many of the city's bath houses, for example, where business was often done. In other words, Chongqing was an ordinary mainland city in which a new leader who lacked deep local patronage ties had little hope of getting anything done—unless he found a way to purge the old regime and make it his own.

> Alleged gangsters were asked to testify against wealthy entrepreneurs who, in turn, were forced to testify against higher political targets

Bo's first major political move was to appoint his own man, Wang Lijun, to act as his scalpel in the rectification operation. He moved Wang to be Wen's deputy police chief, from where he could collect intelligence and map Wen's patronage ties. In March 2009 Bo shifted Wen Qiang sideways, to be the minister of justice, while promoting Wang Lijun to take his place and arresting Wen's key police department deputies and protégés. One of them reportedly died of a heart attack in custody. Another reportedly died by smashing his head against a wall. Wen's sister-in-law was dubbed the 'Godmother of the Underworld' and sentenced to 18 years' jail. Wen's wife was shown pictures of her husband with an underage prostitute—and she reportedly led police to the family millions, buried under a gold fish pond.

With potential critics silenced (including the head of Chongqing TV, who was concerned that viewers were boycotting Bo's 'red' programming), the completion of Bo's ascendancy was announced with a text message, the substance of which appeared on the front page of the next day's *Chongqing Daily*: 'Wen Qiang Is Dead, The People Rejoice, Chongqing is at Peace'.

Bo and his scalpel, Wang Lijun,

sliced through the city's commercial precincts. Police were given quotas of 'black society' members to detain in each district, just like the bad class elements in Mao's day. Alleged gangsters were asked to testify against wealthy entrepreneurs who, in turn, were forced to testify against higher political targets. 'Basically, the 20 richest guys in Chongqing, he sent them all to jail and confiscated all their assets', said Wang Boming, publisher of *Caijing Magazine*, in an interview.

The system of justice, based mostly on lies extracted by torture, proved to be a phenomenally powerful tool of political control. Bo became locally popular for articulating social concerns and cleaning up the streets. Nationally, he became the hero of China's growing neo-Maoist and New Left movements. Ambitious scholars, entrepreneurs, officials, generals and international statesmen were drawn into his orbit. By the new year of 2012 he seemed to be on the cusp of breaking into the top leadership sanctum.

It could have been Mao at Yan'an, 65 years before.

Mao's 'scalpel' was the internal intelligence chief, Kang Sheng. Kang's torture-based extraction of false confessions and testimony was instrumental in Mao's consolidation of power at Yan'an. It also triggered a substantial internal backlash which forced Mao to sideline Kang Sheng before bringing him back to prominence in the 1960s, to resume the work of rooting out the patronage networks of Mao's perceived and potential rivals. One of Kang's victims was Xi's father, a vice premier, in 1962, which led to 16 years in purgatory. Another was Bo's father, also a vice-premier, during the Cultural Revolution of 1966. Both men were jailed, and tortured, and a member of each family was 'persecuted to death'.

Bo's methods were so brutal, and so out of kilter with the values of China's increasingly sophisticated and pluralistic society, that they galvanised lawyers, editors, historians and other intellectuals to fight to protect their interests and restrain him

Bo applied the Maoist strategies of purge and rectification beneath the barest of judicial facades. By then, however, China had changed in ways that meant the old torture-based confession methods didn't work so well any more.

Bo's methods were so brutal, and so out of kilter with the values of China's increasingly sophisticated and pluralistic society, that they galvanised lawyers, editors, historians and other intellectuals to fight to protect their interests and restrain him. The only weapon they had was to talk truth, in and outside the courtroom, and let events take their course—an approach whose ultimate success relied on China's information revolution and an increasingly engaged public. Several of them warned of a return to the methods of the Cultural Revolution.

Eventually, the pressure forced open cracks in the political elite. Bo's court room persecutions of his rivals were so perverse and so public—despite his prodigious propaganda efforts—that enemies sharpened their hatchets and allies found it harder to defend him. Indirectly, as I argue in *The Rise and Fall of the House of Bo*, this is what brought Bo crashing down.

Bo is likely to be convicted of misdeeds that are marginal to the political reasons that brought his downfall. His downfall followed the interrogation of dozens of associates, with each detainee testifying against the one above. The national crisis of injustice and inequality that Bo articulated, however, has only become more pressing.

It must bemuse Bo to see Xi using the Maoist language of life-and-death struggle and bodily decay. Public revolt at 'vile' cases threatened to 'doom the party and the state', said Xi when he took the stage in November last year, six weeks after the Politburo pre-announced Bo's guilt: 'There must first be decay for maggots to set in.'

Immediately before Bo's trial, the Xi administration announced the promotion of a new deputy police chief, Fu Zhenghua, whose crazy-brave assaults on power had previously earned him comparisons with Bo's old police chief, Wang Lijun. Fu quickly made news with high profile arrests of alleged rumour-mongers on the internet.

Straight after Bo's trial the *South China Morning Post* and *The New York Times* reported previously suppressed court evidence that linked Bo's abuse of power to Zhou Yongkang, China's bulldog-headed former petro-security czar. The news was followed by the detention of the recently-removed chief and remaining top executives at PetroChina, which is arguably the most powerful of all Chinese state-owned companies. Most tantalizing,

PICTURE: CCTV / AFP PHOTO / AAP

Bo Xilai fronts the court in Jinan. His revolutionary prestige, ties with other ruling families and cult-like status among neo-Maoist sections of the party helped afford Bo the opportunity of contesting accusations in a relatively open fashion.

the *Post* reported a link between Bo's corruption and the former president who refuses to actually retire, Jiang Zemin.

Xi's strategy of manipulating the coercive apparatus to purge enemies and use their confessions to taint and intimidate rivals comes directly from Bo's Chongqing and Mao's Yan'an. Xi's propaganda apparatus is brandishing 'swords' to enforce discipline across the contested spaces of the internet. His security apparatus has renewed the previous administration's attack on lawyers and constitutionalism. And Xi's personal willingness to extend the Bo investigation to the doorstep of some of the most powerful patrons in the country shows that the winner-takes-all logic remains firmly in place.

But the fact that Bo was given probably the most transparent trial in the history of the People's Republic shows the rules are continuing to evolve.

Bo's revolutionary prestige, his clan's ties with other ruling families, and his cult-like status among neo-Maoist sections of the party encouraged (or possibly forced) President Xi to afford him the dignity of contesting the accusations in a relatively open fashion.

The rise of Bo Xilai showed that extreme measures may well be necessary to get anything done in an ageing one-party system. His demise, however, shows that Maoist political methods don't sit easily with a modern economy, an increasingly fragmented political elite and a society that is empowered by prosperity and informed by new networks of information. Several of Xi's supporters within the elite say it is too early to rule out the possibility that Xi wants to leave China with something closer to a credible legal system than the one he has inherited. Many say he is blasting a path through webs of patronage and a hopelessly self-interested political-bureaucracy to enable urgent economic reforms. Whatever Xi's plans, it is ironic, and potentially dangerous, that he first has to borrow from Bo's playbook in order to give himself a chance. EAFQ

John Garnaut is the former China correspondent for Fairfax Media.

U.S. RELATIONS

The question of containment

XINGHAI FANG

CHINA is the only country in the world that could potentially surpass the United States in total economic size, and whose currency, the renminbi, may one day dethrone the US dollar as the dominant international medium of exchange.

So why doesn't the United States want to contain China's rise?

My American friends have different answers to the question. One says that most Americans simply don't care about comparing the total GDP or GDP per capita of different countries; they care about human rights and democracy. This means the growth of the Chinese economy is not a threat to US interests in the minds of most Americans. Another explains how America's interests can be better served by a growing Chinese economy than by a shrinking one. A third went into the history of US containment, pointing out the fundamental difference between China and the former Soviet Union: the latter threatened the existence of the American way of life, while China does not. Therefore, concerted containment of China is not possible in the context of the American political system and how China relates to it.

The truth is that America has not been containing China. If it had, it would not have agreed to China's entry into the WTO; it would not have permitted massive US trade with, and investments into, China; it would not permit hundreds of thousands of Chinese students to study in America's best universities; and it would not have proposed the recent Annenberg meeting between President Obama and President Xi and agreed that a similar meeting should be held in China.

But in the eyes of most Chinese citizens, the United States is trying to contain China. It regularly holds military exercises with South Korea; it recently strengthened its military alliance with Japan, and openly committed to the defence of islands whose sovereignty is disputed by China and Japan; and it has expanded military relations with Vietnam and the Philippines. It is plain to them that America is forming a military containment line around the east and southeast of China. This adds to China's difficulty in resolving disputes with neighbouring countries.

Is there then an inconsistency in the US policy towards China—economic cooperation but military containment—because the former eventually defeats the latter? Or does its dichotomous policy strategy merely reflect a disconnection between the US public and its military and foreign-policy establishment?

A sophisticated analysis would show that the United States is in fact pursuing a hedging strategy towards China. If China turns out to be a prosperous country that cooperates to strengthen the existing international order, then these military alliances around China will not be put to use and all parties will be satisfied. But if China becomes a country like Japan or Germany before World War II, then these military alliances can function to help defeat China .

This raises the all-important question of what kind of country China will become. It should be

Kobe Bryant of the USA and China's Yao Ming battle for a rebound at the 2008 Olympics in Beijing. If the USA had been containing China, Yao might not have played for the Houston Rockets.

PICTURE: ERIC GAY / AP PHOTO / AAP

clear, I believe, that China will, as its power grows, participate actively in the existing international order to better reflect and protect its own interests. But it will certainly not try to dismantle the existing order, since it is basically a good order and China, like other countries, benefits hugely from it. China will claim its legitimate territorial interests in a forceful way. That is because for a country that has lost so much territory in its modern history, territorial issues have become an emotional national touchstone, even though their economic value tends to be insignificant. If the United States somehow stands in China's way in resolving these issues, then it will be very dangerous for both countries.

What, then, are the values of an American hedging strategy?

Imagine at some point in the future there is a conflict of some military kind over disputed territories between China and a neighbouring country with which the United States has military relations. Will the United States come to the aid of its partner? Hopefully it will not, because there will not be enough US interest involved.

But wouldn't these military alliances with countries around China help the United States in its negotiations with China in trade and other areas? Don't they put at least a certain psychological pressure on China? While these circumstances may be somewhat vexing for China, it should relax and simply view them as an indulgence of elements in the American military and foreign-policy establishment, whose purposes are at best fuzzy. EAFQ

Dr Fang Xinghai is Adjunct Professor of Strategy at the China Europe International Business School (CEIBS), Shanghai. The views expressed in this article are his own.

SINO-AMERICAN TIES

Building relations beyond Washington's rebalancing policy

DAVID M. LAMPTON

THE principal objective of Chinese and US foreign policies in Asia should be to avoid military competition. That diverts the United States and China from their primary strategic task: rebuilding themselves. China needs a more sustainable growth model and a revitalised social compact, both of which require social, economic and political reform. For its part, the United States must rebuild the foundations for sustainable comprehensive power, not least its human resources, physical and institutional infrastructure, and national balance sheet. The US policy of 'rebalancing' fails to address these objectives. For this reason, both nations must think more productively about how to establish the strategic foundation for peaceful and prosperous bilateral ties.

International politics usually works according to Newton's Third Law: a change in one nation's policy produces an equal and opposite reaction by others in the system. Immoderate action begets immoderate reaction, potentially spawning an upward spiral of contention. So far, Beijing has reacted cautiously to US foreign policy changes, but its long-term approach is still unclear.

This caution stands in contrast to Beijing's actions in 2009–10, when it threw three decades of successful foreign policy out the window. At the mid-2010 ASEAN Regional Forum meeting in Hanoi, China told its neighbours that they were small, China was big, and that was a fact they ought not to forget. Beijing also seemed to back North Korea after its military provocations of 2010 resulted in South Korean civilian and military deaths, and then, when South Korean and US navies wished to sail in those waters as a deterrent to North Korea, implied that the Yellow Sea was a 'Chinese lake'. It linked rare earth exports to a small maritime incident with Japan, engaged in a number of confrontations in the South China Sea, and overreacted to events better ignored—for example, threatening Norway over awarding the Nobel Peace Prize to Liu Xiaobo.

In October 2011, the United States reacted. Then Secretary of State Hillary Clinton wrote an article in *Foreign Policy* titled 'America's Pacific Century' in which she said that the 'United States stands at a pivot point' and called for 'forward-deployed' diplomacy. The article was followed in close succession by presidential speeches, remarks by other ranking US officials, and visits to Asia by President Barack Obama, Secretary Clinton and Secretary of Defence Leon Panetta, among others. It was an impressive, coordinated set of activities that was generally well received in the region. While the abrupt and muscular-sounding pivot was promptly renamed 'rebalancing', Beijing and

Chinese citizens more broadly saw containment where Washington saw regional stabilisation.

It could be that China has become slightly more cooperative as a result of the pivot—China's recent policy towards North Korea and Iran seems to provide evidence on that point—but ultimately rebalancing will compound mutual strategic distrust between Beijing and Washington.

Of Washington's genuine policy changes, all but the decision to reach out to Myanmar provoke scepticism. Is it wise to place a small number of US marines and air assets in Darwin and elsewhere in Australia on a rotating basis, given that these forces are located so remotely as to be largely irrelevant? Surely all this does is signal hostile intent to Beijing. Is it unwise to insert the US more centrally into disputes over rocks and atolls in the South China Sea (since great nations do not fight over rocks)? None of the parties to these disputes have the best interests of the United States in mind.

The promises America makes also lack credibility. With the US budget under considerable pressure, can Washington be believed when it says that defence resources in the Pacific will be entirely insulated from cuts that will affect every other government program and every other theatre of military operations? Is it feasible to think that Japan, with its recent history of government dysfunction and weakened economy, will be able to share the military burden, as the United States seems to expect? In short, rebalancing is premised on US resources that may not be forthcoming and on the provision of allied resources that may not fully materialise.

On the other side of China, the United States will be able to move resources from Central Asia and the Middle East to the Asia Pacific only if the countries in those regions cooperate with Washington's plan. And in South Korea, with each new government comes a new way for Seoul to position itself in the complex Washington–Beijing–Pyongyang triangle. Although Washington had an unusually cooperative partner in the South Korean Lee Myung-bak administration, successors, like Park Geun-hye, could prove to have different ideas.

PICTURE: GLENN FAWCETT / US DEPARTMENT OF DEFENSE

US Defense Secretary Chuck Hagel and China's Minister of National Defence, General Chang Wanquan, at the Pentagon in August 2013.

Another dimension of the rebalancing effort that must be examined relates to the genuine need for the United States to strengthen its position as a free trade leader in the region. A great first step was the Korea–US Free Trade Agreement, which came into force in March 2012. But the Trans-Pacific Partnership (TPP) includes just nine modestly sized Pacific Basin economies, plus Japan, which is not certain to participate. China has not been invited. The United States ought to be doing what it can to come up with feasible arrangements with the region's major financial and economic players, including China. By relying on a 'high-quality' arrangement with smaller economies the United States sends the message that it is not interested in Chinese participation except on US terms.

There is less to rebalancing than meets the eye. To the degree that there is substance to the policy, some of it is unnecessarily provocative, and some of it is infeasible. The military soundtrack has the volume turned up too loud, while the volume on the economic soundtrack is too low. It sends mixed strategic signals to Beijing and, more importantly, diverts resources from the national renewal that both the United States and China need. In the end, such renewal is the only sound basis for Sino–US cooperation and a more peaceful future. Just as the anti-Soviet rationale provided a foundation for relations that proved durable in the 1970s and 1980s, and as economic mutual interests buttressed productive ties in the 1990s into the 2000s, the imperative today is to rebuild the respective homelands. Commitment to that project is the foundation for the sound ties on which both Beijing and Washington should build in the second decade of the new millennium. EAFQ

David M. Lampton is Hyman Professor and Director of China Studies at the Johns Hopkins School of Advanced International Studies (SAIS). He is the inaugural winner of the Scalapino Prize awarded by The National Bureau of Asian Research and the Woodrow Wilson International Center for Scholars.

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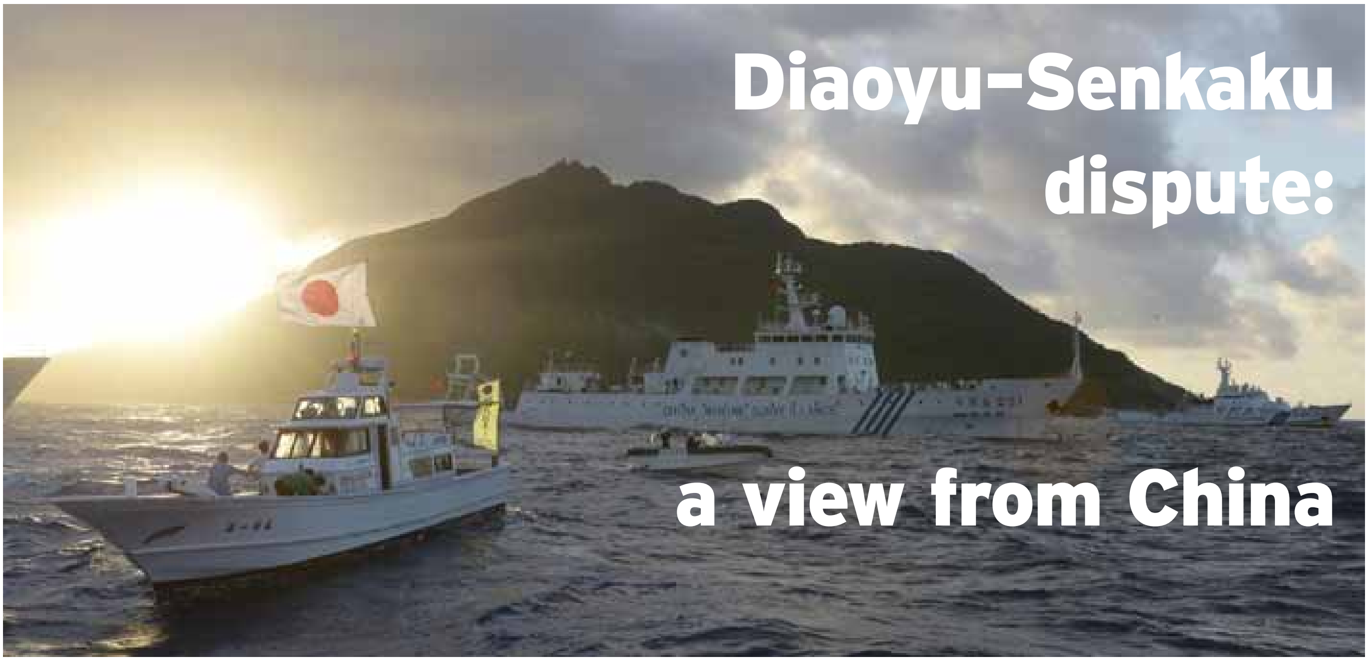

Diaoyu–Senkaku dispute: a view from China

REN XIAO

THE territorial dispute between China and Japan over the Diaoyu–Senkaku islands is once again disrupting regional security in East Asia. It hasn't always been like this. How did the situation become so sensitive?

China and Japan have come a long way since they normalised diplomatic relations 40 years ago. Bilateral trade now exceeds US$300 billion annually. Every day, dozens of flights travel between multiple destinations in Japan and China, ferrying tourists and businesspeople across the East China Sea. China has opened six consulates-general in different parts of Japan, highlighting the intensity of bilateral contacts.

This success was made possible because Japan and China decided to shelve their dispute over the Diaoyu–Senkaku islands back in the 1970s. Over the past 40 years, there have been all kinds of 'incidents' related to the island dispute, but the two countries have always handled them in a relatively cool-headed way. Their attitudes meant that no 'incident' developed into a major crisis.

But things seemed to change in September 2010, when a trawler incident in the East China Sea seriously affected Sino–Japanese relations. The issue has gone from bad to worse. In September 2012, the Japanese government went ahead with 'nationalising' the islands, as a response to Tokyo governor Shintaro Ishihara's attempt to purchase them, and a serious crisis broke out.

'Nationalisation' means 'becoming the nation's', and, in the case of Diaoyu–Senkaku islands, becoming the Japanese government's. For China this was an unacceptable change to the status quo, and Beijing reacted fiercely to Japan's move. In China, the feeling among the people was that between 1972 and 2012 Japan had taken advantage of China's restraint and systematically strengthened its control of the islands. Japan's change in position, from agreeing that a dispute existed to denying one entirely, was a fundamental shift. For people in China, this is a position that had to be rebuffed outright. It is a position even mainstream Japanese scholars have reservations about. And there is a strong belief that if China did not react to Japan's 'nationalisation' decisively, Japan would probably claim sovereignty over the islands some time later. This Japanese action triggered the worst setback in relations since 1972.

At the time, then Vice-President Xi Jinping was put in charge of handling the Diaoyu–Senkaku crisis. Following the leadership change of March 2013, Xi assumed full charge of domestic and foreign policies. This means there will be strong continuity and little room for making concessions on the island dispute.

It is unfortunate that relations have become so problematic. For a long time, China has regarded the relationship with Japan as a vital part of its foreign policy. Between September 2006, when Shinzo Abe became Japan's prime minister for the first time, and September 2010, when the fishing boat clash resulted in a crisis, Beijing made strenuous efforts to mend the bilateral relationship, which was damaged during the period of Japan's Koizumi government.

Unfortunately, at the time of the trawler incident the inexperienced Democratic Party of Japan government was ill-equipped to maintain calm. Nonetheless, after the 3/11 great earthquake, China extended considerable disaster relief, which was in part aimed at bringing the relationship back on track. Meanwhile, the two countries began to prepare for the upcoming 40th anniversary of the normalisation of their relationship in 2012.

Both parties agreed to a long list of activities—high-level visits and cultural or educational exchanges, for example—which would create a positive atmosphere and improve relations. But later developments overwhelmed this effort. Japan's move to nationalise the Diaoyu–Senkaku islands presented a bigger and more-difficult setback than the two countries had bargained for. There remains a wide and fundamental gap between the two governments as well as between their research communities.

This difficult situation is exacerbated by history. China was invaded by Japan and suffered atrocities at the hands of Japanese imperial forces. These acts live on in China's collective memory, especially because Japanese politicians insist on touching this wound again and again. Relations with Japan have always been a complex and sensitive issue in China's foreign policy. Every time Japan and the Diaoyu–Senkaku dispute comes up in the news, people in China become emotional and angry. Chinese leaders and officials cannot afford to be seen as soft towards Japan.

One of the steps China has taken is to send in Chinese ships to the disputed waters for regular patrol and 'law enforcement'. The objective is to bring about *de facto* joint jurisdiction and joint patrolling in the relevant waters as a way to deny Japan's unilateral 'control' of the islands. Beijing wants to force Japan to change its 'no territorial dispute' position.

> In this environment, concessions are becoming increasingly hard to make

Another step was to create a National Maritime Affairs Committee (*Guojia haiyang weiyuanhui*), an inter-agency coordinating body, and to reinforce the State Oceanic Administration (SOA) by merging several separate organisations. This measure was especially important. These organisations were long criticised as being scattered and poorly coordinated. For years, China's five largest civil maritime agencies were controlled by different parent organisations, earning them the moniker 'five dragons governing the sea' (*wu long zhi shui*). Four of those dragons—China Marine Surveillance, the Border Control Department, the Fisheries Law Enforcement Command, and the Maritime Anti-Piracy Police—no longer exist. Instead, their functions have been combined under the SOA. Only the fifth dragon, the Maritime Safety Administration (MSA), remains a separate organisation.

The broad aim of this reform is to enable Chinese maritime law enforcement capabilities to be used in a more controlled manner while also retaining their effectiveness as an instrument of national power. In the meantime, both Japan and China are trying to beef up the capabilities of their coast guards by using retired naval ships.

Japan's 'nationalisation' of the islands was made worse by Abe when he returned to the prime ministership last December. He has made a number of provocative remarks and his stated intention to revise the Japanese Constitution has put China on alert. In this context, China decided to postpone the China–Japan–South Korea summit meeting originally scheduled for May 2013. Chinese leaders are wary of Abe's words and deeds and are reluctant even to meet with high-level Japanese officials in such a negative atmosphere.

After its victory in the July upper house election, Japan's Liberal Democratic Party now enjoys a stable majority in both houses of the Diet and will not face an election until 2016. But while this gives Prime Minister Abe an opportunity to recalibrate Japan's foreign policy towards better relations with China, it seems he is unlikely to take it.

In this environment, concessions are becoming increasingly hard to make. The two countries have to agree to talk about what they should do to avoid military conflict in the East China Sea before they are able to sort out the sovereignty issue. Five years ago, while LDP was in office in Japan, the two governments agreed to build a 'strategic and mutually beneficial relationship' which, if implemented, would bring about a favourable environment for both of them. Now is the time for both Tokyo and Beijing to rethink this strategic objective or relationship. EAFQ

Ren Xiao is Director of the Center for the Study of Chinese Foreign Policy at Fudan University, Shanghai, China.

Institutional reforms the key to growth, stability

DWIGHT H. PERKINS

PICTURE: AFP PHOTO / AAP

Yang Dacai, an official nicknamed 'Brother Watch' because of his expensive taste in timepieces, at his sentencing on corruption charges in the Intermediate People's Court in Xian in September 2013. Reducing corruption is one of the difficult challenges facing the Chinese government.

THERE is wide recognition that the policies and institutions that have served China well over the past three decades require radical change and reform if China is to sustain progress to high-income status. The slower growth rate of the past year and the likelihood of even slower but still substantial rates in the future is not itself a major problem. Middle-income countries, for a variety of reasons, cannot sustain GDP growth rates of 9–10 per cent per year decade after decade, even if they do 'everything right'.

Doing 'everything right' in the Chinese case, however, is going to be a particular challenge. Fundamental changes in many of the institutions governing the Chinese economy and society are likely to be required. This short essay will briefly describe some of these needed changes and then focus on one of the most difficult: the interrelated challenges of eliminating excessive regulation at all levels of the economy, strengthening and fundamentally reforming the legal system, and greatly reducing the corruption and rent-seeking that now undermines the productivity of the economy and threatens the stability of the political system.

Many of the reforms required are well understood, but are either technically or politically difficult to implement. The need to make major changes in the financial system has been accepted, and many changes are underway. Some, such as making the Shanghai and Shenzhen exchanges efficient and fair reflections of underlying economic forces, are technically difficult, and have not been fully solved even by exchanges in the highest-income nations. Wringing political influence out of lending decisions by the banks, in contrast, is technically easy but politically difficult. The problems of state-owned enterprises, particularly those with substantial political clout and/or monopoly power over their sectors, is mostly politically difficult, but not impossible—as Premier Zhu Rongji demonstrated in the late 1990s, with the use of World Trade Organization accession as a club to force fundamental changes on these enterprises.

More complex reforms that are partially understood include the interrelated reforms of eliminating the household registration (*hukou*) system, completing the transformation of China into a mainly urban society, setting market prices for rural land, dealing with the rapidly aging population, and general welfare reform that includes all citizens, including rural-to-urban migrants. This combination of related reforms has major financial implications for both central and local governments.

Then there is the need to rely more on domestic household consumption demand to propel the economy forward. Government leaders have been calling for greater reliance on the domestic market for years, but the only increases in the share of domestic demand were achieved through the massive infrastructure and housing construction programs—which have now run into sharply diminishing returns. Household consumption as a share of GDP remains at a low level, although there is considerable controversy over just how low. The problem is that the main vehicle for increasing household consumption is for wages to rise faster than GDP for a good many years, something that is not really under the government's control.

The challenge of controlling corruption is one of the best ways to illustrate the complexity of the reforms required in both the economic and political systems. China ranks 80th out of 176 total countries surveyed in Transparency International's Corruption Perception Index for 2012. That said, China's score of 39 out of a possible 100 is an indicator of the pervasive corruption that it is perceived to have. This level of corruption has not prevented high economic growth in the past but it is likely to become a bigger economic problem in the future as China has to depend more and more on productivity growth to maintain a high rate of GDP growth. Social stability may also become more difficult to sustain as the population becomes better educated and its access to information continues to rise through the internet and other sources.

The problem is that China's approach to corruption is to apply stiff penalties to those who are caught and convicted and, more recently, to put restrictions on the conspicuous consumption of government officials. Relatively little is being done to eliminate the underlying structures that foster much of the corruption and rent-seeking that occurs. In essence, there are two major structural contributions to corruption and rent-seeking in China. One is the enormous number of licenses and procedures that a prospective investor or producer must go through; procedures that, for the most part, involve discretionary decisions by officials from local levels up on through the government hierarchy. The other is the conflict of interest built into a system where the same body—namely, the Communist Party—appoints the heads of all state companies, their regulators, and the heads of bodies—most notably, judges in the legal system—whose job is to resolve conflicts between companies or between regulators and companies.

> . . . the built-in conflicts of interest inherent in the current system need to be greatly reduced

In the World Bank's ease of doing business index, China ranks 91st out of 185 countries. Although this doesn't seem particularly bad, only five or six of the 94 countries ranked below China are achieving any growth at all. China ranks an abysmal 151st in the subcategory ease of 'starting a business.' Given its size and diversity, it is reasonable for local officials to have considerable discretion to adjust rules to local conditions, but the number of rules that must be met, together with the discretion of local officials, provides hundreds of millions of opportunities each year to exact payments from businesses if the officials are so inclined—a number that would overwhelm any country's enforcement effort. The only way around this problem is to greatly reduce the number of rules that require discretionary decisions by officials, make the process as transparent as possible (for example, by putting the process online), and removing discretion of remaining decisions where possible. Everything else should be left to market forces that are likely in most cases to better reflect real local conditions and so be more efficient.

Finally, the built-in conflicts of interest inherent in the current system need to be greatly reduced. Many problems—the advantages of state enterprise management in bidding for contracts, for example—can only be addressed by having regulatory bodies that are truly independent of the companies. The party must get out of the business of appointing company heads and confine its role to appointing regulators. More importantly, there must be a body independent of both the regulators and businesses that can resolve disputes, and that normally means a legal system where the judges are not beholden to the same political authorities as the regulators and businesses. Politically, this is clearly the biggest challenge to reformers, and none so far have been willing to address the issue. In the absence of fundamental changes of this sort, individuals with political connections will continue to receive very large rents—some of them quite legal, but no less undesirable—by lending their names (and implied influence) to the highest bidders. EAFQ

Dwight H. Perkins is the Harold Hitchings Burbank Professor of Political Economy, Emeritus, at Harvard University. A more in-depth discussion of these issues can be found in Ross Garnaut, Cai Fang and Ligang Song (eds), China: A New Model for Growth and Development *(ANU E Press, 2013), presented at China Update 2013.*

SEARCH FOR BALANCE

A quest for dynamic stability

PICTURE: HOW HWEE YOUNG / EPA PHOTO / AAP

Copies of the *Southern Weekly*, which was embroiled in a censorship row in January 2013 after it called for reforms. The contribution that greater democracy can make to stability is the subject of continuing debate.

YU KEPING

THE 18th Party Congress, held in November 2012, reaffirmed that China will continue to struggle down the road of socialism in its search for modernisation. Yet the party also offered its own response to many of the challenges facing China in the coming years.

China has paid a steep price for its rapid growth, but two areas in particular stand out. First is the growing level of social injustice, which has been exacerbated by income disparities. Today, China's Gini coefficient is above 0.47, a relatively high number compared to most other countries. The second issue is the environmental damage caused by pollution and an over-use of resources. Some Chinese have begun to reflect on the relationship between economic development and justice and fairness—and this is leading to heated debates across the country. After 30-plus years of reform and opening up, people are now asking whether economic development should continue to be China's top priority. Should development continue to be China's guiding principle? Should justice continue to take a back seat to efficiency? How can China best contain the widening gap between individuals, between different regions, and between rural and urban areas? And will China fall into the middle-income trap?

The Communist Party of China (CCP) leadership has not shied away from these issues. The 18th Party Congress responded to them in two ways. First, it responded theoretically by formally establishing the status of scientific development as a guiding philosophy. This requires a balance between economics, politics, culture, society and the environment throughout the process of continued growth, as well as sustainable development. Secondly, it responded practically by accentuating the significance of justice and fairness. It laid emphasis on achieving the related goals of fairness and justice, establishing a fair social security system centred on equal rights, equal opportunities and equal rules, and narrowing the widening income gap. It's notable that the congress attempted to find an ideal path forward for China, one that sustains economic development but that also maintains fairness and justice.

CHINA, as a developing nation, must continue to make economic development its first priority. Yet the Chinese economy must also grow sustainably, by conserving resources and protecting the environment. The difficulty of maintaining this balancing act has triggered a whole range of worries for the Chinese people. Citizens are now asking whether the last 30 years of rapid economic growth have been worth it; if China can still afford the high price of ecological destruction and environmental deterioration; whether China's model of economic development must be changed—and if so, how? The question also remains as to what kind of economic development strategy should be adopted in future: development-oriented, environment-oriented, or something between?

The party congress proposed two strategies to address these issues. The first is to transform China's mode of economic development by deepening reforms to the economic system. Specifically, this would include the following measures: imposing an innovation-based development strategy, deepening the strategic adjustment of China's economic structure, tapping domestic consumption, optimising industry structure, developing a modern service sector and promoting emerging industries, as well as further enhancing the openness of the Chinese economy. The second strategy is to energetically promote the building of 'ecological civilization'. The congress openly put forward the principle of 'giving high priority to conserving resources, protecting the environment and promoting its natural restoration' and called for the whole party to strive for green, resource-efficient and low-carbon development. The congress also advocated building a systematic method of promoting ecological progress. Resource consumption, environmental damage and ecological benefits should be covered by a system of standards for evaluating economic and social development. Related evaluation methods and reward-and-punishment mechanisms should then be adopted.

As to the tension between social stability and democracy, congress participants expressed varying opinions based on their divergent standpoints and interests. Some elected stability as China's top priority, while others argued that rights should take precedence; some unswervingly advocated democracy and rule of law, while others did their utmost to block these efforts; some viewed the development of democracy as the best way to achieve stability, while others demonised democratisation, insisting that it would eventually ruin social stability. Some acknowledged the inseparability of democracy and respecting people's livelihoods, while others treated them separately; some insisted that both democracy and rule of law are indispensable, while others deliberately separated the two, arguing that China can only have rule of law at its current stage. As a result, these political questions have become the most contested issues in China today.

GIVEN the rapid transformation China is undergoing, social stability will continue to be a prerequisite for further development. But given China's current need for democracy, it no longer requires the static kind of stability that comes from keeping a lid on the public's complaints, but rather a dynamic stability focused on the free flow of opinion. The 18th Party Congress report outlined the concept of 'dynamic governance', indicating that the notion of 'dynamic stability' is achieving greater prominence than the notion of 'static stability', which the central authorities had long supported. According to the congress report, the ultimate objective of China's political development is to guarantee the fundamental position of the people as masters of the country and to develop people's democracy. Democracy, liberty, equality, justice and rule of law are all identified as core political values in China, while broadening socialist democracy and building a socialist country based on the rule of law are earmarked as the two cornerstones of socialist political civilization. Thus, the substantive plan for realising democracy in China should be an organic integration of Party leadership, the position of the people as masters of the country and the rule of law. One realistic approach to push forward China's democratic politics is to develop intra-party democracy and then create an enabling environment for the development of wider democracy.

China's progress so far in building

a market economy and democratic politics has provided the fundamental economic and political basis for defending individual rights. However, everything has its pros and cons. An overemphasis on individual rights can easily lead to a neglect of public goods and a watering down of the prominence of the state, family, community and work units. So it is a pressing task to reconcile the tensions between individual rights and public goods, given the new realities shaping China today. This topic also spawned much debate at the party congress: should the state deal first with public goods or with individual rights? Should China continue to emphasise the notion of 'the masses' or pay more attention to the notion of citizenship? Who has the right to define the boundary between public goods and individual rights? Centring on these issues, different opinions have surfaced in Chinese academia, and as a result divergent thinking on China's political and social development has emerged.

The congress did, however, make some effort to reconcile the relationship between public goods and individual rights, aiming to strike a balance between the two. On the one hand, it continued to emphasise the position of the people as masters of the country, justify the notion of 'the masses', uphold patriotism and collectivism, and enhance the ethical and moral standards of citizens. But, on the other hand, it also advocated the 'people first' principle and the all-round development of the people, and upheld such values as liberty, equality and rights. It promised to 'broaden the orderly political participation by the citizens in all fields and at all levels' and to 'ensure that the people enjoy extensive rights and freedoms as prescribed by law'. Upholding the rule of law is the most basic way to govern a country; where this principle is maintained, law becomes the basic guideline for both defending public goods and protecting individual rights. Any behaviour, no matter how lofty its ambition, must take place within the framework of the constitution and the law. In today's China, this will require the government and citizens to place even more emphasis on 'civic awareness' and 'respect of the rule of law'. Any action to enhance collective benefits must also protect individual rights to the greatest extent possible.

The congress did, however, make some effort to reconcile the relationship between public goods and individual rights, aiming to strike a balance between the two

It is undeniable that there is some tension between 'the China model' of social, political and economic development and the 'universal values' that are often discussed in the same domain. Striking a balance between the two in order to focus equitably on both public goods and individual rights will be a difficult task for China's leadership. To overemphasise China's particular characteristics—or to wantonly apply the label of 'with Chinese characteristics'—could lead China to reject universal values and lessen its desire to learn from other nations. Conversely, to overemphasise universal values is to deny that China has its own particular development model, and ignore the diversity of human civilization. The debate on the issue of 'China Model' vs. 'Universal Values' has intensified in Chinese intellectual circles. This debate gave rise to the formation of two groups that take contradictory positions. The 'China Model' group, which exaggerated its success and insisted that it should be exported elsewhere, discarded universal values and depicted them as 'beautiful lies'. The 'Universal Values' group denied the existence of 'China Model' and argued that, if it did exist, it should be jettisoned.

The congress report reaffirmed the importance of 'Chinese characteristics'. The report states that China is in a unique situation and that it should 'adhere to socialism with Chinese characteristics, develop it as required by the times, constantly enrich it in both practice and theory and enhance its distinctive national features in keeping up with the times'. It also states that China 'will never copy a Western political system'. The report does not, however, deny the existence of universal values, but rather establishes the concepts of democracy, liberty, equality, fairness and rule of law—basic values common to all mankind—as core elements of the socialist value system. It also calls for the whole country to 'actively draw lessons from the achievements of human political civilization' and to 'actively absorb and draw lessons from the successes of foreign cultural achievements'. EAFQ

Yu Keping is Director of the Center for Chinese Government Innovations, Peking University.


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REGIONAL POLICY

Still 'going west'?

TIM SUMMERS

THE dominant idea in China's regional policy since the beginning of the 2000s has been to close the development gaps between coastal and inland China. Since around 2007, aggregate GDP and industrial growth rates in western and central China have pulled ahead of those on the coast, suggesting some modest shift westwards—though parts of coastal China clearly remain the most prosperous.

This year has seen the completion of China's leadership transition, as well as an apparent shift to a slower pace of economic growth amid renewed efforts to rebalance, or change the structure of China's economy. What impact will these developments have on regional political economy? Is China still 'going west'?

The new leadership has demonstrated strong continuity in regional policy. Frameworks to develop the western regions, stimulate the northeast and old industrial base areas, and promote the rise of the central regions were reiterated in the 12th Five-Year Program for 2011–15 and have since been restated under the new government during regional visits by Premier Li Keqiang and Vice Premier Zhang Gaoli. Li and Zhang recently took charge of the related State Council Leading Groups, suggesting continuity in bureaucratic structures. In the case of the northeast, a new 10-year policy framework was approved in April 2013, a decade after the launch of the original policy.

Although there is continuity in regional policy, there are implications for the regions in the government's broader development policies. Inland China, especially parts of western China, benefited substantially from the surge in investment after 2008, a year that saw both the earthquake in western China's Sichuan province and the major stimulus package launched by the government in response to the global economic crisis.

This highlights a feature of many inland provincial economies. They are less exposed to international trade and so suffer relatively little from any decline in global demand. But they are also more heavily dependent on investment, and on central government financial and fiscal support.

The policy priorities of the central government could therefore squeeze the inland provincial economies. Shifting away from investment towards consumption is likely to find more fertile ground in coastal regions, and Li Keqiang has stated that eastern regions should be at the forefront of the desired shift towards domestic demand. Industrial policy which looks to clamp down on highly polluting and energy-intensive industries could also have a disproportionate impact on poorer inland provinces, such as Guizhou—though given that these provinces are coming from a lower base, their growth rates should still outperform those of places such as Guangdong or Zhejiang.

> Quiet efforts to improve the logistics capability of inland waterways, in particular the Yangtze, have opened up other routes

At the same time, there are several other structural trends which challenge us to think afresh about regional political economy in China.

The first is domestic. Plans to develop major urban clusters linked together by a network of road and rail transport arteries (including high-speed rail) bring coastal and inland China closer together, integrating urban markets in the process. As logistics improve, the gaps between regions will diminish, and the logic of thinking about western China as remote and distant from central China—or central China from the coast—will become less obvious.

Secondly, these logistics linkages are not limited to road and rail. Quiet efforts to improve the logistics capability of inland waterways, in particular the Yangtze, have opened up other routes. Along with port facilities, and the trend for inland cities to develop bonded customs zones, this means that trade processing can to some extent shift to central and western China, whereas traditionally it has only been feasible on the coast. This is what might be called 'bringing the coast inland'.

The third trend reflects a feature of the 'new round' of the 'develop the west' campaign, launched in July 2010

PICTURE: IMAGINECHINA / AP IMAGES / AAP

A rail-laying ceremony at a construction site in Yunnan province: as logistics improve, gaps between China's regions will diminish.

(and reiterated in the 12th Program): the idea that western China should be opened up further to China's west, across land borders to its Asian neighbours. This 'bridgehead' concept—which has been developed most fully in Yunnan—creates the space for new drivers of development in western border provinces, on the back of both transborder infrastructure development and rapid growth in trade and investment between China and many of the developing economies in Central, South or Southeast Asia. The recent agreement in principle between China and Pakistan to build an economic corridor linking the two countries is an example of the sort of development this might lead to.

Some of these networks are brought together by the long-distance train routes from cities in central or western China through Central Asia to Europe. Chongqing's Eurasian train route kicked off this trend back in 2010 (one of the Bo Xilai legacies to survive), and has since been joined by routes from Chengdu, Sichuan, and more recently Zhengzhou in central China's Henan province. It is too early to evaluate the impact of these routes, but the savings in cost and time—cutting the time to reach Europe from five weeks to three—give them the potential to change the longer-term structure of China's international trade and investment links.

Finally, energy security has regional elements to it. The geographic distribution of new resources, such as shale gas or solar and wind energy, will have implications for regional political economy as they increase their share of China's energy mix. Similarly, the growing geographic diversity of oil and gas imports will also have an impact: the impending import of oil and gas through pipelines from Myanmar's coast to southwest China is the latest example.

In many of these regions, the most developed and dominant areas still remain parts of coastal China. But western and central areas are becoming less peripheral as the structure of China's economic geography is transformed in a number of ways. In sum, China is still 'going west'. EAFQ

Tim Summers is Senior Consulting Fellow on the Asia Programme at Chatham House, and author of Yunnan—A Chinese Bridgehead to Asia *(Chandos, 2013).*

'Likonomics' the right policy for sustainable growth

YIPING HUANG

SINCE taking office in mid-March, the Li Keqiang government has taken a different policy path from that of its predecessor. Its key economic policy framework, although yet to be fully detailed, can be summarised as 'Likonomics', and appears to consist of three key pillars—no stimulus, deleveraging and structural reform. If so, this implies further downside risks for the economy and markets in the near term. But such policy measures are now necessary for China in order to avoid much more disruptive outcomes in the future.

The economic policy of the previous Wen Jiabao government is regarded as having been strong on growth but weak on reform. Public sentiment is now especially negative about the 2008 RMB4 trillion stimulus package for causing overcapacity in certain areas of infrastructure, significant fiscal risks due to reckless local government borrowing, inflation, asset bubbles and the threat of bad debt following the huge credit expansion. There now seems to be a consensus that China should tolerate slower growth and focus on structural reform. This is the foundation of the three pillars of Likonomics.

Li has pointed out repeatedly that there is now little room to rely on stimulus policies or government direct investment. This is the first pillar: 'no stimulus'. Relying on government-led investment for growth 'is not only difficult to sustain but also creates new problems and risks'. In fact, many heavy industries, such as steel, cement and aluminium, are already struggling due to serious overcapacity problems, and the government is downplaying the importance of fixed asset investment in China's new urbanisation drive.

The days of 10 per cent annual growth are over for China. Growth potential is now around 6–8 per cent. Of course, the government is not completely passive in this regard. Government-led infrastructure spending on energy, water and transportation has been accelerating since the beginning of 2012, but the scale is much more constrained compared with earlier programs. As long as the unemployment rate does not surge, the government is unlikely to adopt new stimulus measures to boost growth. The minimum acceptable growth rate has also shifted down, from 8 per cent at the beginning of last year to 7 per cent now. It could fall further in the coming years.

Policymakers are also probably aiming to strengthen market discipline as a preparatory step towards interest rate and capital account liberalisation

Li has stated that banks must make better use of existing credit and step up efforts to contain financial risks. Following implementation of the previous stimulus package, China's total credit had increased from US$9 trillion in 2008 to US$23 trillion by early 2013. According to Carmen Reinhart and Ken Rogoff, who investigated global experiences of financial crises during the past eight centuries in their bestselling book *This Time is Different*, countries experiencing rapid credit expansion for extended periods always end up enduring a painful economic adjustment. What is more worrisome for China is the divergence in growth rates between credit (above 20 per cent) and nominal GDP (below 10 per cent) in recent quarters.

The People's Bank of China's recent move to curtail the credit bubble in the interbank market underlines the authorities' desire to deleverage and reduce future financial risks. This is pillar two. Their actions are a clear warning signal to financial institutions. While the authorities are likely to intervene to stabilise the market if needed, interbank rates could remain high for a long period. Policymakers are also probably aiming to strengthen market discipline as a preparatory step towards interest rate and capital account liberalisation. This implies that deleveraging is likely to continue

PICTURE: AAP

Piles of money: clerks count the holdings at an agency in Nantong. Premier Li Keqiang Li has stated that banks must make better use of existing credit and step up efforts to contain financial risks.

and some of the smaller and weaker financial institutions may fail in the coming year.

Li has also advocated reform as likely to pay the biggest policy dividends for the Chinese economy: pillar three. While investors are anxiously waiting for the Third Plenum, due in November, for a clearer outline of economic policies, current policy discussion indicates reforms in the areas of financial liberalisation, the fiscal system, factor prices, land use, administrative controls, monopolies, income distribution and the household registration system—many of which could be approved before the Third Plenum.

Likonomics has some distinctive features. In Japan, Abenomics is about ending deflation and restarting economic growth. Likonomics is about deceleration, deleveraging and improving the quality of growth. Both Abenomics and Likonomics have also somewhat different approaches to the implementation of fiscal and monetary adjustments. But it is structural reforms that will determine the success or failure of both Abenomics and Likonomics. With the Chinese government actively preparing a wide range of reform measures, it will be up to the new premier to prove that he is a decisive leader.

Likonomics policy is exactly what China needs to put its economy on a more sustainable growth path. It is positive for the longer-term outlook of the economy. In the short run, however, such rebalancing and deleveraging point to further downside risks for both economic growth and asset prices, including the exchange rate. Based on an increasingly likely downside scenario, Chinese growth could experience a temporary 'hard landing', with quarterly growth dropping to 3 per cent or below within the next three years. But such a slowdown would only be cyclical, and would likely bounce back dramatically soon afterwards.

Yiping Huang is Professor of Economics at Peking University and the Australian National University. Yiping Huang, Jian Chang and Joey Chew first coined the term 'Likonomics' in their joint Barclays Capital report China: Postcard from Beijing—What to expect from Likonomics' *(27 June 2013, Hong Kong).*

AGEING SOCIETY

Can China escape its demographic bind?

PAUL FRENCH

AUGUSTE Comte, the father of sociology, famously said that 'demographics is destiny'. China now has an ageing population. The National Bureau of Statistics estimates that by 2015 there will be some 200 million Chinese people over 60, increasing to 300 million by 2030, and perhaps as many as 480 million by 2050. Average life expectancy is now 73 for men and 79 for women, up by more than 12 years since 1970.

The twin phenomena of enhanced longevity and the One-Child Policy, introduced in 1978, mean that China has seen the most rapid move from demographic 'sweetspot' to an ageing society. These days, discussions on how China will manage this transition are often referred to as the 'will China get rich before it gets old?' debate.

Here, China will inevitably see its economy challenged in two ways: a decline in the working population and a rise in fiscal deficits linked to increased government spending to cope with the ageing population. Healthcare spending, pensions, social welfare and long-term care will all be additional costs to China's social system. They come at a time when China's urban social welfare system, in terms of pensions, healthcare and labour-force reform (employer-funded retirement programs, mandatory retirement ages and so on) are still in a process of change.

Chinese people will face increased healthcare costs as they get older, meaning that they will increasingly need to make out-of-pocket spending from their pensions, to draw down on their life savings, or sell their homes in order to pay for expensive treatments for long-term, incurable illnesses that are gradually less likely to be covered by current healthcare insurance schemes. In addition to this, they will also be an ongoing financial burden on their families.

The general lack of appropriate state healthcare, despite reforms, means that many Chinese adults have to save heavily and plan financially to create their own safety net to deal with possible illness as they get older. This contributes to the large amounts of consumer cash locked up in savings accounts and out of the consumer economy. Chinese savers already suffer from 'financial repression'. Low or non-existent interest rates, combined with a limited range of personal financial products, mean that saving is a never-ending process for most Chinese and that, consequently, a secure retirement fund is difficult to achieve.

> Enhanced longevity among a greater proportion of the population will mean a greater incidence of health problems associated with old age

This is exacerbated by mandatory retirement ages that are low by international standards. Currently the retirement age to receive a pension is 60 for men and 50 for women. Beijing is considering raising these limits to create work for younger people but the concomitant strain on the pensions system is a concern. Worries over, for instance, ending work at 50 but not receiving a pension until the age of 65, and therefore having to self-fund the 15 years in between, have alarmed many older people (and their children) on internet discussion forums.

The Confucian ethic of filial piety, expressed in caring for elderly parents, remains strong in Chinese culture. And it seems the government will largely rely on that continuing (and seek to strengthen it through education). The Ministry of Health has established a target that by 2020 90 per cent of care for the elderly will be home-based (that is, within the family largely), 7 per cent community-based and just 3 per cent provided by nursing homes or hospitals. These percentages are thought to be based on the experience of Singapore, obviously a much smaller, wealthier country that has a longer history of healthcare reform and an active immigration policy to replace lost younger workers as the demographics move upwards.

Singapore has struggled to provide this amount of home-based care, indicating that China faces a massive, if not impossible, task. This places the major emphasis of elderly care on offspring, who largely do not have siblings with whom to share the burden and expense.

Geriatric specialists also point to the fact that enhanced longevity among a greater proportion of the population will mean a greater incidence of health problems associated with old age. For instance, recent studies from China suggest that the country may have more than nine million old people actually diagnosed as suffering from dementia, but that perhaps 93 per cent of cases are undiagnosed. However, at present there are fewer than 50 specialist dementia facilities nationwide in the PRC.

Chinese society does seem to be starting to respond to its ageing demographics. The government is slowly reforming the pension system while the savings rate remains high partly due to saving for retirement, or because people are setting aside funds to look after parents in their old age. Senior citizens' homes and care facilities have started to appear, overwhelmingly in the private sector.

An elderly man tills the soil near Bozhou. Many younger people have left rural areas to make a living in the cities. Mandatory retirement ages are low by international standards.

PICTURE: TOPPHOTO / AP IMAGES / AAP

Despite this, old age will increasingly be a major strain on the Chinese economy. At a time when the government is seeking to boost personal consumption, increasing amounts of income and savings will have to be diverted into care for the elderly, geriatric healthcare and medicines. While the quality of life of China's elderly will become a key 'quality of national life' indicator, the strain on family budgets will also see the cost of old age trickle down the system, forcing many to make hard choices between, say, paying for their child's overseas education or their parents' care.

China cannot escape its demographic bind. All China can do is realise it and make the best preparations possible. Providing quality of life for China's elderly will require the current economic reforms to successfully create jobs, maintain wage rises, allow for continued savings and permit a more regulated and participatory tax base to allow for additional government spending on geriatric care. It is impossible to divorce China's demographics from its macroeconomics—a secure and pleasant old age will, for most Chinese, depend on continued economic growth. EAFQ

Paul French was the founder of the Shanghai-based market research publisher Access Asia (now part of Mintel International). He is an independent China analyst and author based in Shanghai and London and is the author of various books on China, including Fat China: How Expanding Waistlines are Changing a Nation *(Anthem Press, 2010)*

Time for financial reform

JIAO WANG

BY THE time China becomes the largest economy in the world, the market will expect to see liberalised macro settings and an economy that is more open to the world. At present China's financial influence remains limited compared with its huge trading power, and its financial sector is still tightly regulated. Yet this might not be the case for much longer, as the government has announced its determination to push reforms forward and to deregulate financial markets during the coming years.

On 19 July the People's Bank of China announced the removal of controls on bank lending rates. This policy move was interpreted as the start of the new regime's financial reform agenda and was widely welcomed in the market. The market's enthusiasm reflected not only a belief in the new leadership's determination but, more importantly, its belief that conditions are now favourable to delivering financial reforms. Since the global financial crisis, the macro-economy has been relatively stable. The Xi–Li administration has repeatedly said that the government will actively push forward structural reform while the economic outlook is stable, within reasonable bounds.

As growth slows, China is also reaching a critical point where financial reform is necessary to achieving a new and sustainable growth path. The first step has to be interest rate reform. Manipulated interest rates have long caused enormous misallocation of capital, favouring state-owned enterprises and shielding the banking sector from the need to build risk-management capacity. This was not such an urgent problem while the economy was growing at double-digit rates, but now that it has slower growth potential, China has to restore market pricing mechanisms for capital to get rid of distortions and lift the banking sector's efficiency. The central bank's recent action of withdrawing the bank lending rate floor is a good start. But the key step will be to remove the deposit rate ceiling. Considering the broad impact that this action will have on banks' profitability and the risks that might ensue, full removal of the control on deposit rates will most likely take place gradually and more cautiously.

The other macroeconomic deregulations on the agenda in China are capital account liberalisation and RMB internationalisation, which will most likely be carried out simultaneously. Restrictions on short-term cross-border flows are the core impediment to capital movements. Without a more flexible exchange rate regime or a strong RMB, the sudden removal of capital account restrictions will induce more volatile arbitrage capital into and out of China, and cause undesirable financial instability. The RMB can only become an effective regional or international currency under a liberalised capital account.

The need for a convertible capital account, and for the RMB to become an international reserve currency, follows from the scale of China's cross-border trade and investment payments. But progress towards achieving actual capital account convertibility and a global currency is also closely connected to China's future capacity for economic growth. When the economy grows stronger, the process can move on more quickly.

There is no 'cook-book' for determining the order in which these three major reforms should occur, but a market-oriented interest rate system and a more efficient banking sector will need to be in place before any major actions are taken to institute capital account liberalisation and currency internationalisation.

The new leadership in Beijing has already taken decisive action to push forward financial reforms. It is clear that pursuing high economic growth is no longer the highest priority, and the world can expect a China with a new financial system that has more open macro settings within the next two decades. Nothing, however, is more important to the Chinese Communist Party than ensuring economic and social stability. While there is clear commitment to this course of reform, the pace of reform will depend on the strength of the economy, and China watchers should not be surprised if reform goes backwards or is postponed should the economy falter along the way. EAFQ

Jiao Wang is a PhD scholar at the Crawford School of Public Policy at the Australian National University.

Advancing domestic development through overseas investment

KARL P. SAUVANT AND
VICTOR ZITIAN CHEN

WITH US$84 billion of outward foreign direct investment (OFDI) flows, China became the world's third-largest outward investor in 2012, behind the United States and Japan. This signals impressive progress given that the country ranked only 20th a decade ago, when the 'going global' policy was launched and outflows during 2000–03 averaged US$3 billion. What are the salient features of these flows and why and how is the government helping Chinese firms to invest abroad?

Apart from the speed with which China's OFDI flows have grown, three features are particularly noteworthy.

The single most important feature is undoubtedly that the country's 115 central state-owned enterprises (SOEs) are responsible for the lion's share of OFDI, about 76 per cent of the country's non-financial OFDI stock in 2011. Their historically large size and strong political connections have put these firms into an advantageous position, with private firms only now beginning to catch up. SOEs are more in tune with the country's development strategy (an important criterion to receive special government support for OFDI) and they have better channels, both professional and personal, to shape the country's policy-making around such investment. At the same time, the dominance of SOEs has created concerns in a number of host countries.

Second is the fact that over 70 per cent of China's OFDI flows consist of FDI into tax havens and offshore financial centres (notably Hong Kong). These flows are, in most cases, not productive investments but rather transactions undertaken for such reasons as transshipment into other locations, round-tripping (to enjoy favourable fiscal benefits provided by Chinese local governments) or to benefit from very low or no taxes—or simply the desire for privacy or to park funds for future purposes. Some of these locations also make it possible to obtain easier financing, and they provide strong private property protection—a motive termed 'institutional arbitrage'.

In the case of Hong Kong (which accounts for the bulk of transshipment FDI), helpful are also geographic proximity, a facilitating environment, cultural ties and a favourable bilateral economic arrangement (notably the Mainland and Hong Kong Closer Economic Partnership Arrangement signed in 2003, and enticements for SOEs to locate subsidiaries there to use as a global platform). One implication of this phenomenon is that official data do not allow us to determine the real sectoral and geographic destinations of China's OFDI.

Third, China's firms benefit from an elaborate—even if cumbersome—regulatory environment that encourages OFDI within the framework of the going global policy. A range of promotional measures are available for eligible firms, including various information services, fiscal and financial incentives, investment insurance, bilateral and other investment treaties, and double taxation treaties—all meant to help firms undertake direct investment projects abroad.

Moreover, this help is even greater in areas that the government deems important for the country's development effort, specified in the government's Priority OFDI Projects for Credit Support, Outward Investment Sector Direction Policy, and The Twelfth Five-Year Plan for Economic and Social Development (notably its sub-plans on industrial reform and upgrading, and OFDI). For instance, building a research and development facility in a high-technology industry abroad is perceived as a highly desired OFDI project, and therefore can receive such support as expedited OFDI approval, priority to receive loans from banks, tax rebates (or waivers), and priority regarding information services about investment opportunities, consular services, risk assessment and control, and insurance. Other examples include projects that provide better access to foreign markets and distribution, explore and exploit natural resources, build transportation and infrastructure facilities in both developed and developing countries, and move light manufacturing (like textiles, household appliances) into developing countries.

But why is the government supporting Chinese firms to invest abroad? Two reasons stand out.

First, China's institutional framework for OFDI seeks to help such investment foster the emergence of globally competitive Chinese firms. This purpose, in turn, is the result of the interplay of two factors.

The first factor is the government's desire to have internationally competitive firms whose portfolio of locational assets provides better access to resources (natural and other resources) and markets and which themselves become a source of corporate competitiveness. For example, as early as 1997 former President Zemin Jiang stressed, in his report for the 15th National Congress of the Communist Party of China, that China should encourage OFDI to make better use of two markets and two types of resources (that is, domestic and international). This desire was reiterated later in many government reports and formulated into a major purpose of 'going global' in the 10th Five-Year Plan on Inward and Outward FDI in 2001. The second factor is the pressure on government from firms that seek to internationalise in response to domestic and international competition. Formal mechanisms through which firms can make themselves heard and exercise pressure on government policies include the National People's Congress and the Chinese People's Political Consultative Conference. For instance, major business elite representatives such as Dongsheng Li (President of TCL) and Shufu Li (President of Zhejiang Geely Group) encouraged the government to liberalise its OFDI review process and provide more resources and information to support OFDI. Deming Chen, Minister of Commerce at that time, responded that China's current approval process so far focused only on the direction and amount of OFDI, but would inevitably become less cumbersome.

Second, China's institutional framework for OFDI especially seeks to encourage investment that can be expected to contribute most to the country's national economic development. It does this by selectively supporting particular industries and activities in their internationalisation through FDI. For the national economy, broadening the scope and geography of investment means more options for economic restructuring and resource allocation optimisation. OFDI thus provides more resources and opportunities for economic growth. In addition, OFDI provides access to tangible and intangible resources directly relevant to China's development effort, beginning with raw materials but also including technology, brand names and others. This development objective is reflected in the fact that, as mentioned above, the government encourages OFDI through various instruments, in particular in industries and activities of special importance for the development effort.

These two objectives—the desire to nurture internationally competitive firms by helping them to establish a portfolio of locational assets and to use OFDI directly to advance the country's development effort—overlap to a large extent, at least for the time being, and they can be expected to be pursued for the foreseeable future. At the same time, in the framework of strengthening more market-supporting institutions in China, reforming the SOE sector and encouraging OFDI by private firms, Chinese firms can be expected to develop further their own firm-specific capabilities that will allow them to be successful in the world FDI market.

Plugging into the world: Lenovo's several foreign acquisitions include IBM's personal computer business.

PICTURE: AAP

Dr Karl P. Sauvant is Founding Executive Director and Senior Resident Fellow at the Vale Columbia Center on Sustainable International Investment, Columbia Law School/The Earth Institute, Columbia University.

Dr Victor Zitian Chen is Assistant Professor of International Management at the Belk College of Business, University of North Carolina, Charlotte, and EMGP Global Coordinator and Editor at Vale Columbia Center on Sustainable International Investment, Columbia Law School/The Earth Institute, Columbia University.

PICTURE: PETER PARKS / AFP PHOTO / AAP

Challenges in China's next stage of development

A water vendor in Chongqing: the government aims to create an 'all-round well-off society' by 2020.

SHUJIE YAO

CHINA'S GDP growth rate unexpectedly slowed to 7.7 per cent in the first quarter of 2013, down from 7.9 per cent in the final quarter of 2012. This is significantly lower than Reuters' prediction of 8 per cent growth, and now J. P. Morgan has cut the country's growth estimates for 2013 from 8.2 to 7.8 per cent. While China's growth is continuing to stabilise, a trend that began to appear from last year, it seems the new government is not pursuing fast growth as its top priority. This is the right call. While China faces a number of challenges, stable and inclusive growth will follow if the government focuses on five key reforms: restructuring economic and social imbalances, securing China's energy supply, reforming the financial sector, reducing inequality and fighting corruption.

China encountered many internal and external challenges in 2012 following the global financial crisis and the European debt crisis. Externally, export growth and foreign capital inflows slowed due to a sharp contraction in bilateral trade between China and its largest trading partners, including the EU, the United States and Japan. Despite Chinese government efforts to diversify international trade, the volume of trade grew by only 6.2 per cent, compared with 22.5 per cent growth in 2011.

Internally, asset bubbles (especially high house and land prices), increased labour costs and currency appreciation reduced China's international competitiveness. Numerous small- and medium-sized enterprises specialising in export processing in Guangdong and Zhejiang were closed down or downsized due to rising production costs and weak foreign demand.

But there are signs that these asset bubbles are ballooning more slowly than before. The growth rate in the value of China's fixed-asset investments was 3.4 percentage points lower than in 2011, mainly due to a real-estate market slowdown. Property still accounted for about 22 per cent of the country's total fixed asset investment, and fixed assets investments in the central and western regions grew significantly faster than in the eastern or coastal region. The large discrepancies suggest that China's less-advanced inland provinces are catching up to their prosperous neighbours on the coast.

China also changed its export structure, giving priority to general exports, which are increasing much faster than processed exports. General exports tend to have a larger proportion of domestic-made components and hence can generate more value than processed exports. This shift implies that China has been forced to accelerate its trade reform, focusing more on value-added and technology-intensive manufacturing than processing in response to the external shock caused by the global financial crisis.

Despite rising labour costs and an economic slowdown, China remains attractive to foreign investors. But after increasing its financial strength in recent years, China's outward direct investment (ODI) in non-financial sectors is increasing rapidly. In 2012, it was up by 28.6 per cent, reaching US$77.2 billion, placing China among the world's five largest foreign investors. As China's ability to invest in other countries grows, it is expected that its ODI will rise to US$150 billion by 2015. This implies that China's ODI will soon surpass its investment inflow and the country will become a net foreign investor.

China is also starting to build its consumer base. In 2012, retail sales reached RMB21 trillion, up by 12.1 per cent in real terms from a year earlier. According to the National Bureau of Statistics, consumption is expected to contribute over half of China's growth in 2013, overtaking investment to become the economy's key driver. If this pattern holds, China will gradually transform itself from an investment-driven to a consumption-led economy.

LAST year could be marked as a turning point for the country. The complicated internal and external environment China faced in 2012 forced the government to slow down and think carefully about its development path. Looking ahead, China will face a number of challenges.

First, it must restructure its unbalanced economic and social development. There are six important structural imbalances in the Chinese economy and society. First, the share of manufacturing is too high, accounting for about 45 per cent of GDP; second, heavy industry, particularly the most polluting industrial sub-sectors, is too dominant in the industrial sector; third, China has depended too much on exports and investment for growth, while domestic consumption has contributed substantially less to growth than in any other industrialised or emerging economy; fourth, the persistent regional divide between the coastal and inland areas means there are effectively two Chinas; fifth, there is a persistent urban–rural divide in terms of per capita income, education, healthcare and employment; and, sixth, all this means rural poverty remains a serious problem. Although China improved its position in all these areas in 2012, the imbalances remain. They are stubbornly difficult problems to solve and the government will take years to get the balance right.

Second, China must secure its energy supply. In 2012, China consumed 3.6 billion tonnes of coal equivalents and 5 trillion kilowatt hours (kWh) of electricity. Rising energy demand has caused various social and economic problems, and China's heavy coal use leads to pollution that exposes its population to potentially devastating health problems.

Third, China must reform its financial sector. In 2012, the total profits of all Chinese banks reached RMB1.24 trillion, up by RMB194 billion from a year earlier. Together, they now contribute nearly one-third of total global profits. But there are troubles hidden below. The number of non-performing loans Chinese banks hold is increasing. Expanded infrastructure construction over the past few years prompted local governments to borrow a great deal of money. If local governments start defaulting on their debt and surging property loans go bad, the proportion of non-performing loans could be as high as 20–30 per cent. More effective policies need to be implemented to break up the monopoly position of a small number of major banks and to further improve the efficiency and transparency of the whole banking system.

FOURTH, the government must reduce income inequality. During the 18th Chinese Communist Party (CCP) National Congress, the new leadership re-emphasised the government's mission to develop an 'all-round well-off' society by 2020. In order to achieve its goal, the leadership proposed that by 2020 China would double its GDP and per capita income from 2010 levels—the first time that China has linked personal income to GDP growth. According to the National Bureau of Statistics, the Gini coefficient was 0.474 in 2012, making China one of the world's most unequal societies. It needs to reduce inequality not just to make people happier but to make the country more stable, socially and politically. There were over 200,000 mass demonstrations in the country in 2012, compared with 78,000 one decade earlier.

Finally, corruption is a serious issue embedded deeply within China's political system and society. In 2012, Wang Qishan, China's new Secretary of the Central Commission for Discipline and Inspection, was chosen to lead the country's anti-corruption campaign. But despite the majority of Chinese welcoming this move, many remain unconvinced that the government can indeed eliminate corruption. EAFQ

Shujie Yao is Professor of Economics and Chinese Sustainable Development at the University of Nottingham.