China Economic Quarterly

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China 20/20

CEQ ends its run,
revisits the past, reads the future

The Last 20 Years

Two decades of beating the odds

The Next 20 Years

What the experts will get wrong;
how China will change the world (or not)

The Top 20 Reading List

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A Good Few Decades, But Not A 'Chinese Century'

By Arthur Kroeber

The *China Economic Quarterly* will cease publication with this issue, which also marks its 20th anniversary. *CEQ* started life as a newsletter for a small coterie of executives and observers interested in what was then a peripheral bit of the world economy. As China became more important and information about it in more demand, we built the Dragonomics research service around it. Today China is crucial in any discussion of global affairs, and the kind of understanding our readers require is better delivered by a steady stream of timely reports than by leisurely musings four times a year. We mark the end of *CEQ*'s run with an issue devoted to reflections on how China has changed in the last two decades, what we got right and wrong about those changes, and what might come next.

I. The past

In 1997, when the *China Economic Quarterly* put out its first issue, China was an interesting puzzle for nerds, but a distant sideshow for everyone else. Despite housing 21% of the world's people, it accounted for just 3% of world output and trade. Its economy was the world's seventh largest, but that was mainly due to an outsized population. In per-capita income it ranked about 100th (excluding tax havens and petro-states), with GDP per head of US$782—14% of the global average, about the same as Honduras and the Congo. Factory wages were about a quarter of the level of those in Thailand, the hub of the truly exciting growth story of the moment, Southeast Asia. Taiwan, a "renegade province" with a population just one-fiftieth of the mainland's, had an economy half as big.

Moreover, China seemed at risk of losing its way on the zigzag road from plan to market. Deng Xiaoping, architect of the "Reform and Opening" program that began hauling the nation out of Maoist autarky in the

Arthur Kroeber is editor of the *China Economic Quarterly*.

Measuring the China shock

China's changing role in the global economy

	1997	2017*	Share of global increase, 1997-2017
Population	**21.3%**	**18.7%**	**9%**
Urban population	15.4%	19.9%	28%
GDP	**3.1%**	**15.4%**	**23%**
Fixed capital formation	4.2%	26.5%	41%
Household consumption	2.4%	10.0%	16%
Manufacturing value added	5.5%	23.6%	40%
Exports	3.2%	13.1%	18%
Manufactured exports	3.9%	17.9%	26%
Imports	2.5%	9.8%	14%
Official military expenditures	2.2%	12.9%	21%
Per capita GDP (at market exchange rates)	US$782	US$8,200	
Per capita GDP (% of global average)	14%	76%	
Primary energy consumption	**10.5%**	**23.0%**	**49%**
Oil consumption	5.4%	12.8%	37%
Oil imports	3.0%	14.1%	34%
Electricity production	8.1%	24.8%	47%
Installed wind/solar capacity	39.1%	50.4%	50%
CO_2 emissions	13.7%	27.3%	57%
Energy intensity of GDP** (% of global average)	177%	139%	
Per capita electricity consumption (% of global average)	48%	122%	
Financial indicators			
Foreign exchange reserves	9.0%	27.9%	31%
Inbound FDI flow	9.4%	7.7%	7%
Inbound FDI stock	3.3%	5.1%	5%
Outbound FDI flow	0.5%	12.6%	18%
Outbound FDI stock	0.4%	4.9%	6%
Inbound portfolio investment stock	0.0%	1.5%	2%
Outbound portfolio investment stock	0.0%	0.8%	1%
Stock market capitalization			
Domestic only	0.8%	8.7%	11%
China stocks in all markets	0.8%	12.0%	15%

*Based on estimated 2017 figures or most recent year (usually 2016) figures
**Megajoules/US$1 of GDP

World Bank World Development Indicators, BP Statistical Review of World Energy 2017, World Trade Organization, IMF International Financial Statistics, UN World Population Prospects 2017, UNCTAD, WIND, Gavekal Dragonomics calculations

late 1970s, had died in February, and it was uncertain whether the commitment to reform would outlive him. State-owned enterprises still accounted for the bulk of production and less than half were profitable. The unprofitable ones were kept alive by constant infusions of so-called "bank loans," which in reality were social welfare payments to keep workers fed and housed. As much as half of banking assets were non-performing.

A short-lived investment frenzy in 1993-94 had led to monstrous excess capacity in virtually every industry. Unwanted, shoddy goods piled up in warehouses; inventories accounted for around 6% of GDP in 1995-97. Multinational companies had rushed into the country beginning in 1992, chasing the chimera of a billion customers. Many found success by exploiting China's cheap labor for export production, but those who went after the domestic market suffered death by a million headaches. Local partners stole their money and their intellectual property; government lured them in with tax breaks but then hemmed them in with rules limiting market access; consumers had no money to purchase their goods and bought cheap local knock-offs instead.

1997 was the year in which China made the move from sideshow to main event

As if these problems were not enough, on July 2 the bottom fell out of the regional economy with a massive depreciation of the Thai baht. This triggered devaluations throughout the region and the collapse of banking systems in Thailand, Indonesia and South Korea. China refused to devalue its own currency, but its exports flatlined and capital flight accelerated.

A decisive turning point

It all seemed pretty bad, but as it turned out, 1997 was the year in which China made the move from sideshow to main event, and the "Asian miracle" story shifted decisively, and permanently, away from the smaller "tiger" economies to China. At the 15th Communist Party Congress that autumn, conservative forces were put to rout and a strong government under Premier Zhu Rongji moved with dramatic effect on all fronts.

The achievements of Zhu's five-year tenure were little short of astonishing. Were it possible to measure such things precisely, he would certainly hold the world record for most economic reforms achieved in the least amount of time.

He broke up the old ministries that controlled the economy's commanding heights into state-owned, but competitive, oligopolies. He effectively privatized most of manufacturing, bankrupting tens of thousands of state firms and laying off around 30mn workers, while keeping social revolution at bay. He orchestrated the cleanup of the nation's banks. He chased the army out of most of its business interests. He conducted a major government reorganization, slashing agencies and headcount.

He privatized the world's biggest urban housing market. He built the first half of China's interstate highway system. He set in train the construction of communication and payments networks that would eventually enable China to have the most lucrative internet in the world. His boss, General Secretary Jiang Zemin, got the Communist Party's constitution revised to allow private businesspeople to join. And he brought China into the World Trade Organization, completing the country's re-integration into the global trading system and forcing a major opening of China's markets to foreign businesses.

China's economic record in the 20 years after 1997 exceeded even the most optimistic forecasts

It is obviously over-simplifying to attribute all these achievements to one or two people; many individuals and institutions were involved. But effective leadership was critical. By the time Zhu and Jiang left office in March 2003, the mess of the mid-90s had largely been cleaned up and China was primed for one of the biggest economic takeoffs in history.

Onward and upward

By 2007, a mere decade after the Asian Financial Crisis nadir, China was no longer a sideshow; it was central to most global conversations. The growth of its demand began to make the fortunes of resource-intensive emerging markets and many of the multinationals that had suffered through the threadbare 1990s. Its trade and currency policies were held responsible for a glut of saving that drove down global interest rates and the hollowing-out of manufacturing in the United States. Its burning of fossil fuels was deemed the biggest cause of climate change.

Another decade on, one could plausibly claim that China's role in the world economy was not just important, but decisive, at least in terms of cycles. Since American financial excess and regulatory economy drove the world into recession in 2008, the global economy has enjoyed two major upswings, in 2009-10 and in 2016-17. Both were driven at least as much by a resurgence in Chinese demand as by anything that happened in the US. Arguably, this marks the first time in a century that a country other than the US had played the leading role in the swings of the global economy.

II. The present

China's economic record in the 20 years after 1997 exceeded even the most optimistic forecasts. At present rates of nominal growth, China contributes more than half again as much to global economic growth as the US. China's model of bureaucratically managed state capitalism has apparently been vindicated by the country's robust performance since the global crisis, and by its success in wriggling out of a looming deflationary trap in 2015.

Xi Jinping has managed a necessary slowdown of the economy, curbed corruption at home, and lifted China's prestige abroad. Following the 19th Party Congress, he is in a position to dominate the nation for another decade. And rather than being preoccupied with shoring up weak economic foundations, as Zhu and Jiang were, he has set his sights on making China a geopolitical power by mid-century.

The main risk today is not economic failure but triumphalist hubris. The international investor community continues to fret over financial meltdown. Foreign economists warn of the middle-income trap, the end of the demographic dividend, and the failure to embrace productivity-enhancing reforms. These concerns are valid, but their severity or imminence is often exaggerated, and China's ability to respond to such challenges is underrated. The Chinese elite, meanwhile, is ever more confident that state capitalism, managed markets and authoritarian rule are the recipe for sustainable success—and clearly preferable to the quagmire of economic stagnation and political discontent in which the capitalist democracies now flounder.

One does not have to swallow all of this vision to admit that Chinese leaders have good reason to take pride in their record and be confident about the future. Any fair assessment of China's prospects must take account of four lessons from history.

1. The pessimists have always been wrong.

Ever since the days of Deng Xiaoping there has never been a shortage of people warning that China's economy would soon go off the rails, because of financial disaster, the malign influence of authoritarian politics, inadequate reformist zeal, or corruption. Many such critiques were well-reasoned; all of them proved wrong. This pattern of failure has gone on long enough that it cannot be put down to luck or bad timing.

Gloomy forecasters often concede that China's past record is impressive, but allege that the challenges of the next five or ten years are far more complex than anything that has come before. The problem with this line of argument is that people have been using it for at least 30 years. The challenges of the past look simple not because they were simple, but because they were overcome. As China develops, the complexity of its governance tasks rises. But so too does the capacity of the government. Any honest assessment of the country's economic prospects must acknowledge that China has a long record of defying the skeptics.

2. Effectiveness trumps efficiency.

A key reason that China's economy has consistently outperformed external estimates is that Western-trained economists and financial types focus on (and tend to overrate) efficiency, while China's leaders emphasize effectiveness. The two main ingredients of economic success are a) the ability to mobilize resources and b) the ability to put them to progressively better use over time. Critiques of China's insufficient use of markets to maximize efficiency often overlook the state's great effectiveness at marshaling resources. And they fail to acknowledge that while China's resource allocation falls far short of perfection, it is usually good enough to produce sustained growth.

The most basic resource that China has excelled at mobilizing is a high domestic saving rate. Financial repression plays a role (though much less now than in the past). But more important are policies that consistently favor business investment, technological upgrading, and infrastructure. So long as the high saving rate persists, China is likely to outperform most forecasts.

3. The financial system is stronger than it looks.

Now as in 1997, the financial system is widely considered the nation's Achilles' heel. The basic criticism has always been that too much money is lent to projects that deliver too low a return. The basic retort is that so long as the system funds itself from domestic saving—rather than borrowing from abroad or manufacturing funds within the financial sector—then it is unlikely to hit a liquidity crisis. And so long as the government pursues sustainable growth-oriented policies, banks will generate enough of a return on their good loans to pay for the losses on the bad ones.

It is also worth stressing that the present financial problems result in part from a successful tackling of earlier issues. A decade ago, the knock on China's financial system was that it was dominated by a handful of huge banks that lent only to state enterprises, at tightly regulated interest rates. Since then, interest rates have been liberalized, a profusion of new lenders has sprung up providing credit to a wider range of borrowers at a wider range of prices, and the role of capital markets (especially the bond market) has blossomed. With greater financial flexibility has come greater risk. But regulators are now working overtime to contain this risk within reasonable limits.

The financial problems of today result in part from success at solving the financial problems of the past

The hidden strength of China's financial system, however, also imposes a constraint. Because stability depends on a large pool of essentially captive domestic saving, and strict limits on borrowing from abroad, it is basically impossible for China ever to fully liberalize its capital account. This means, among other things, that it will be hard for China to achieve the same importance in the global financial system as it has in physical trade and infrastructure investment.

4. A dynamic economy can survive authoritarian politics.

The idea that economic growth inevitably leads to the rise of a middle class that will demand democratic rights is debatable. What a rising urban bourgeoisie wants is political stability, good governance and secure property rights. So far China's Communist Party has done an acceptable (though not perfect) job on all three, and as long as it continues to do so, it can maintain its monopoly on power without strangling economic growth.

Authoritarian regimes fall because their legitimacy is too narrow, they have no mechanism for leadership successions, or they are too rigid and fail to keep pace with changes in society and public demands. Again, the Chinese state scores well enough on all three counts. Its legitimacy, often ascribed to nothing more than economic growth, in fact rests as well on increasing attention to public goods such as education, healthcare and the environment, and on its success in making China a proud and powerful country on the international stage. Since 1992 the party has pulled off three successive peaceful leadership transitions. Some doubts remain over the next one, since Xi has nominated no clear successor. But in general he seems more interested in creating a resilient governance system that will outlive him than in making China his personal fief.

Perhaps most important, the Party has proved itself surprisingly adaptable to new conditions, and adept at collecting information and converting that information into policy. Its handling of the internet is a telling example. From the outset, the Party did not resist this new technology, nor (unlike less competent authoritarian regimes elsewhere) did it ignore it. Instead it devoted a lot of resources to building a powerful internet that

Demographic forecasts

	1997	2017	2040
Population (mn)	1,236	1,387	1,398
Working age population (15-59) (mn)	806	932	793
Working age population / over 60 pop. (ratio)	6.61	4.07	1.86
Affluent households* (mn)	4	104	297

*Households with income of at least Rmb136,000 (constant 2010 yuan)

UN World Population Prospects 2017

the government could use to control key messages, to gain information about popular opinion, and to foster as an engine of wealth creation.

III. The future

The central question about China in the next decade or two is not whether its economy will continue to grow pretty fast. Most likely it will, at least until the late 2020s when demographic gravity will begin to weigh rather heavily. (There are now four people of working age for every person over 60; by 2040 this ratio will fall to under two, similar to Japan today.) One can quibble about the definition of "pretty fast"; mine would be 5% or so until 2025, and slower but still above the growth of most OECD economies for a few years after that.

The two main arguments for a more pessimistic growth outlook are financial fragility and a lack of reformist zeal which will undermine future productivity growth. These are real problems but not necessarily crippling. As I argue above, the financial system is less shaky than often assumed, and so long as it is supported by a large pool of controlled domestic saving there is no reason for it to crumble. The need to corral domestic savings puts limits on how open China's capital account can ever be. But a fully open capital account may not be needed for China to achieve its domestic development goals.

No point in waiting for Boss Zhu

The hand-wringing over reform suffers from an unrealistic Zhu Rongji nostalgia. Since he left the scene, all reform efforts have been compared to the achievements of his term, and found wanting. This is unfair. Zhu's accomplishments came at a time when China was unusually malleable. It is natural that reforms in today's more intricate society should come more slowly and piecemeal. And in fact much was done in the past 15 years: the financial system was deregulated, management of land and natural resources were (imperfectly) liberalized, and public systems for pensions and health insurance, which Zhu left in disarray, were gradually built.

That said, it is troubling that Xi and his colleagues seem determined to retain direct state ownership over large swathes of the economy, and to subject the workings of the market to perpetual discipline by the Communist Party. Abundant evidence shows that state enterprises deliver a lower return on capital than private firms, so this choice implies a significant productivity cost.

But we need to be cautious here. Productivity growth has fallen in China over the past decade, as the state sector has reasserted itself. But it has also fallen in rich free-market economies without state enterprises. And a big state role may be an acceptable mechanism for insulating vulnerable populations from the shocks of economic change—a task which many of the rich economies, and especially the US, have done poorly. Despite the productivity drag from the state sector, enough economic momentum could still come from private firms springing up to cater to the demands of the "affluent class" (households with annual income of at least US$20,000). My colleagues project that this group could triple from 104mn today to nearly 300mn in 2040, even if GDP growth slows to 2%. Although it will be harder as the demographic headwinds strengthen, effectiveness may once again trump efficiency.

Will it be China's century?

Yet the real question for the coming decades is not whether China will keep growing, but how much impact it will have on the global balance of power and global economic arrangements. It is in a position to have a big effect. It has a strong economy and effective leadership. Its elites have a disciplined ambition to regain the great-power status it lost a couple of centuries ago.

Three aspects of this ambition are worth noting. First, China's leaders have studied the lessons of 20th-century history and realize that their aims are best achieved gradually, and in the main through economic tools, not military or political adventurism.

Second, this ambition now has a vehicle, the Belt and Road Initiative, which must be taken seriously despite its maddening lack of specifics and the woolly rhetoric that encases it. The Belt and Road is best understood not as a checklist of infrastructure projects in particular countries but as a vision of how the world economy should be integrated. Cross-border economic activity should be facilitated by better connectivity and improved infrastructure, not by rules and agreements to lower regulatory barriers to trade and investment. This is a clear challenge to the way the US has run the global system since the end of World War II.

Finally, however, the constraints on China's ability to mold the rest of the world—even if it does become the biggest single economy—are enormous. One example is finance. As the table on page 4 makes clear, China's global influence over the past 20 years has largely been in the physical realm. During that period it accounted for 40% or more of the worldwide increase in investment, manufacturing, energy consumption and carbon emissions, not to mention consumption of basic materials such as steel and production of major items such as cars. Its financial impact has been far weaker. Despite its reputation as an outsourcing hub, its share of global inbound direct investment has declined and looks distinctly ordinary. Outbound direct investment surged in 2012-16, but has since been reined in by a government worried about capital flight. Portfolio flows in and out of the country have been minimal.

China's years of influencing global interest rates through official reserve accumulation are probably done: in the last three years reserves have fallen by a quarter from their US$4trn peak. Efforts to turn the renminbi into a global currency have been fitful, and hampered by the government's addiction to capital controls. So long as the viability of the domestic system depends on capital controls, China will lack a globally trusted currency, and this will impose severe limits on its ability to steer the world system in a wholly new direction.

China lacks several other important things as well: military allies; a culture that anyone else is interested in or a political system that anyone else might want to adopt ("soft power"); companies that can reliably compete outside the protected cocoon of their home market; and—despite decades of industrial policy and hundreds of billions of dollars in subsidies—a convincing claim on technological leadership. All these deficits will constrain its ability to displace the existing global power structure with one of its own design. China will keep defying the skeptics and keep on growing, and its influence will grow too. But we are not headed for a "Chinese century."

The Last 20 Years

Lessons From History

By Joe Studwell

Confessions of an analyst who got China wrong in 1997, but created a successful business and career anyway.

The origins of the *China Economic Quarterly* (*CEQ*) were nothing if not mundane. Like so many entrepreneurial undertakings, it began with the idea that the whole thing would be easy.

I launched it in 1997, after five years spent wandering around China reporting stories that were usually about foreign businesses led by executives who—as Carl Crow wrote in his masterful 1937 account of Western commercial delusions, *400 Million Customers*—were possessed of "rosy day-dreams in which a private yacht occupies the foreground and a country estate can be seen in the middle distance." It was an era when, as one early subscriber put it, "we were all trying to find the light switch."

My idea was to provide that light switch, in the form of a publication coinciding with China's quarterly releases of economic data, which in that innocent era were the main statistical events of the year. (The days of useful high-frequency data on investment, credit and housing were still far in the future.) We would tell subscribers no more than they needed to know about how the economic and policy winds were blowing, and then add studies of topics such as the size of the private sector, the impact of this new thing called the internet, the problems of debt-collection, and which foreign companies were actually making money.

We tried not to be too serious. A pseudonymous column on the madcap stock market concealed the name of its various authors behind the

Joe Studwell founded the *China Economic Quarterly* in 1997, and is the author of three books: *The China Dream* (2001), *Asian Godfathers* (2007) and *How Asia Works* (2013).

byline “Chao Gupiao” or “stir-fried stocks,” an early and typically colorful Chinese term for speculative silliness. Each issue had a profile called “Monkey King,” focusing on a notable foreign business person—sometimes one who came a cropper thanks to excessive ambition.

For several years we handed out annual “Barton & Rupert Awards” to foreigners who excelled at absurd exaggeration of China’s market potential or craven kowtowing in search of business licenses. One eponym was the late Morgan Stanley strategist Barton Biggs, who returned from a brief visit to China and reported himself to be “tuned in, overfed and maximum bullish.” Biggs unwisely advised his clients to buy every China asset in sight, just as the leadership was organizing a multi-year austerity drive that would bring the early 1990s boom to a painful but necessary end.

The other was Rupert Murdoch, whose rococo obsequiousness to Communist mandarins in the hope of extending his media empire to the Middle Kingdom made him the laughing stock of the foreign press corps. It is an enduring regret that we discontinued the Barton & Ruperts before Mark Zuckerberg came along.

Asia hits the skids

Stimulating as it was, the *CEQ* in its early years was a marginal business. It delivered neither the yacht nor the country estate. Subscribers were loyal but not plentiful; China was still more an intriguing backwater than a main artery of the world economy.

Yet the timing of the launch was fortuitous. The first issue came out shortly after the Asian Financial Crisis began on July 2, 1997, with the forced free float and rapid depreciation of the Thai baht. In retrospect, this was the moment at which the “miracle growth” narrative shifted decisively and permanently from the smaller “tiger” economies of Asia to China.

While living in Beijing, I had worked regularly as a magazine writer in Southeast Asia, a region where my lousy, very slowly improving Chinese was less of an obstacle. I undertook an extended series of profiles of Southeast Asian oligarchs (which later evolved into a book, *Asian Godfathers*). The nature of the region’s economic problems became clear as I started to read between the lines of what these often charming billionaires told me in their refined English accents. (“I should like to lunch you,” my favorite tycoon once informed me.)

In a nutshell, Southeast Asian governments had allowed these post-colonial compradors to overrun their financial systems. They owned banks and lent themselves the deposits, frequently to do nothing more useful than speculate in real estate. They did little to foster technological learning in the local economies, and no manufacturing if they could avoid it. It was, as the Japanese scholar Kunio Yoshihara wrote long before the crisis, "the rise of ersatz capitalism."

Later field research for *Asian Godfathers* and *How Asia Works* helped me understand the deeper causes of the Southeast Asian malaise. Governments had failed to deliver land reform and high-yield household farming, thereby preventing broad-based development. Industry was something that multinationals did, not local firms. Brief flirtations in Malaysia, Indonesia and Thailand apart, there was an assumption that local firms simply could not make it to the technological frontier. And in finance, Southeast Asians just did what the clever white people from the IMF and World Bank told them to do.

Almost all foreign journalists lost the plot during Zhu Rongji's premiership

At the root of everything was colonialism-induced dependency. Mahathir Mohamad, Malaysia's prime minister from 1981 to 2003 and supposedly an apostle of modernization, summed up this defeatism by telling me: "We are not like Koreans." Senior politicians throughout the region rang variations on this dismal theme. Southeast Asia's political leaders did not believe, in their hearts, in the possibility of fundamental change.

Zhu Rongji keeps China on track

Back in the land of the *CEQ* in 1997-98, the Asian crisis failed to arrive, despite abundant forecasts that China would be the next domino to fall. Editorially, I kept with the trope about failing foreign businesses, and many were indeed failing (or at least flailing). Yet it became gradually clear that something was changing.

Zhu Rongji, vice premier with special responsibility for economic matters since 1993, and premier from 1998, was attempting what both the Japanese (back in the day) and Chinese called "structural adjustment"—seeking to shift the economy to a new organizational track. My view at the time was that, while Boss Zhu was to be taken seriously, he was not achieving enough, and from late 1997 was forced to backpedal because of the external shock of the Asian crisis.

How wrong I was. My best defense is that I was not alone. Pretty much the entire foreign journalistic community lost the central plot-line during Zhu's premiership. Low growth, domestic corporate failures, and foreign investor disillusion were the headlines. But these reflected only the symptoms of change, rather than the economic near-revolution that involved the layoffs of tens of millions of state workers, the sale or closure of almost all small state enterprises, and the introduction of oligopolistic competition among big, upstream state companies. These structural reforms laid the foundation for spectacular productivity gains throughout industry in the early 2000s.

Agriculture also benefited, an oft-overlooked point. It became clear from survey data that some 2mn laid-off workers had returned to family farms in the late 1990s. Unlike Southeast Asia, where there had been no land reform and the Asian Financial Crisis created an indigent rural proletariat, Chinese agricultural output increased in this period, lifted in part by all the extra hands. (The same thing happened, on a smaller scale, in Taiwan and South Korea during the oil shocks of the 1970s.)

Another crucial difference with Southeast Asia was skillful financial policy. A learning experience I will not forget was provided by a young Fan Gang, subsequently a member of the Chinese central bank's Monetary Policy Committee and today one of China's best-known economists. One reason that I and many others were pessimistic about China in the late 1990s was the scale of non-performing loans, which were in the range of 40-50% of banking assets. But Fan was unconcerned.

"The maths are OK," Fan said to me one day, nonchalantly, after a *CEQ* seminar. "Zhu is arresting the debt growth, and so long as China continues to grow at 10%, the economy will run away from the problem." Seven years and a doubling of GDP later, non-performing debt was indeed no longer a problem (at least until the post-2008 cycle, when a new government let rip once more with low-return investment). It took me some time to accept Fan's logic.

China gets serious

The next several years brought changes both to China and to our business. I compiled my researches on corporate miscues into my first book, *The China Dream*, which came out just as the China boom began. Although I made the error of reading into the future my narrowly constructed understanding of the past, lots of people read it. Still yachtless, I was able to purchase a bargain-basement country estate in Italy.

Arthur Kroeber, who like me had spent much of the 1990s reporting on economics and business in China, returned after a brief American exile to run the magazine in Beijing. We added new products, renamed the business Dragonomics, and picked up hedge-fund clients in London and New York who realized it was difficult to understand their investments anywhere in the world without figuring out the China impact.

As China became a more important topic, we had to become more serious. I found myself enjoying my ride-on lawnmower on a hilltop in Italy, and faced a moment of truth when one of our smartest clients in London gently asked me, "How often are you going to China?" My wife, then pregnant with our third child, was unwilling to resettle in the Beijing smog. In 2007 I went through my *amakudari* or "descent from heaven," as Japanese bureaucrats refer to their retirement, and left Dragonomics in Arthur's hands in a new partnership with Gavekal.

Piercing the gloom

With more time on my hands, I set about researching and writing *How Asia Works*, an effort to describe the economic history of all nine major economies of East and Southeast Asia. The central thesis was that Japan, South Korea and Taiwan had all in various ways applied a time-tested recipe of agricultural reform, export-oriented industrialization and financial repression, and had as a result become rich. The Southeast Asian countries failed to follow the recipe and got stuck at a lower income level.

An important question was whether China would wind up looking more like Japan and South Korea, or fall into a Southeast Asian-style trap. By the time I set out on the China chapter, in early 2013, a new era of pessimism among China-watchers had set in. Whether because I am perennially contrarian, or because I had actually learned something, I found the gloom unconvincing.

Many people said (and continue to say) that because of the huge fiscal stimulus applied from 2008, China was going to collapse under the weight of domestic debt. Given a largely closed capital account, liquid banks and an economically contented population, I did not take this apocalyptic prediction seriously, even though it was widely enough held to cause regular gyrations in the Chinese stock markets.

Two more subtle variants on the bad-news story were proposed by people I respected. The first was that China was unusual, relative to its East Asian neighbors, in turning to new and more aggressive industrial policies, and demanding that foreign firms part with core technology as the price of market access. This is an incomplete reading of history. None of the East Asian success stories followed a smooth course towards market liberalization. In fact they bounced around between periods of opening and greater dirigisme in their quest for the two, often uncomfortable bedfellows of industrial development: efficiency and technology acquisition.

Japanese economic nationalism peaked in the 1960s, after the heavy industrialization drive of the 1950s, when Sahashi Shigeru took charge of the Ministry of International Trade and Industry's (MITI) Enterprise Bureau. Sahashi famously compelled IBM to license its computer patents to Japanese firms, at a maximum 5% royalty, or face exclusion from the market. Japan at this time was already rich enough to join the OECD, in 1964.

In South Korea, Park Chung-hee's government undertook a major liberalization program from 1965, only to return to the most extreme statism in modern East Asian history with its Heavy and Chemical Industrialization (HCI) program launched in 1973. This was accompanied by mercantilist strategies in everything from automobiles to semiconductors that continued through the 1980s.

In Taiwan, the key vehicles for industrial policy in the information technology sector, the Industrial Technology Research Institute (ITRI) and its subsidiary the Electronics Research and Service Organization (ERSO), were only set up in 1973 and 1974 respectively, and made their most aggressive infant industry moves in the 1980s.

Forced liberalization

All three economies did subsequently liberalize, but not entirely of their own volition: American pressure was essential. Only after Nixon first put the boot into Japan in 1970-71, and then the Reagan-era heavies turned up in Japan, South Korea and Taiwan simultaneously in 1985-86, did fundamental change begin. A key mechanism was the 1985 Plaza Accord that forced massive appreciation of Asian currencies.

Japan's corporates went offshore for cheaper money, and the state's control of finance and industrial policy eroded. Taiwan's mercantilist current-account surplus peaked at a monstrous 19% of GDP in 1987; subsequent currency appreciation led to the growth of private finance and the retreat of state control. South Korean banks were privatized in 1985, and state-led industrial policy was greatly weakened. The background to all of this was acute US political pressure.

Viewed in this context, China's latest wave of industrial policy targets—including "Made in China 2025"—seems nothing more than par for the historical course, and from a national development perspective perhaps not unjustified. On the other hand, the US has soaked up more imports of manufactured goods from protectionist, infant-industry developing states than any other country since the end of World War II, and is surely within its rights to say: "Enough is enough, especially if you are going to point missiles at us."

The second nuanced negative storyline was that China's growth would have to slow to an annual rate of 2-3% as it paid down its gargantuan debts. A very competent economist friend made this case in front of Goldman Sachs' Asia partners at a conclave in 2014. Again, I struggled to see the inevitability of this outcome. In the late 1990s many observers, including myself, were slow to pick up on the incremental changes that were improving economic conditions and enabling debt pressures to be eased by growth and productivity gains. Much commentary today may suffer from the same affliction.

China can keep growing, but that does not mean it will be a happy place

Private consumption's share of the economy bottomed at 35.6% of GDP in 2010, and has since risen to 39.2%, as the consumer-oriented service economy began to gain traction. Nicholas Lardy's excellent book *Markets Over Mao* documented the manner in which the financial system has evolved to price credit better and deliver a rising share of that credit to the private sector.

At the corporate level, there is little doubt that sub-scale capacity in everything from mining to steel production is slowly shutting down. This is slow, in part, because it is not as clear as it was in Zhu Rongji's time which companies are the bad guys. "Grasp the big and let go of the small" was an effective binary choice in the late 1990s. Today, the market has to play a greater role in weeding out the weak, and that takes more time.

And at the new-growth end of the economy, meanwhile, the central government has allowed private internet firms to venture into banking and fund management, to challenge other vested state interests in telecommunications and logistics, and to buy whatever productive foreign assets they want. There is a reason why Tencent's market capitalization is now about US$500bn, on a par with Facebook. In 2014, after my economist friend made his low-growth case, I said I thought that China could keeping growing at 6%, and I still do.

Déjà vu all over again?

China can keep growing, but that does not mean it will be a happy place. And in looking ahead I am confident that I do not misjudge Xi Jinping as badly as I did Zhu Rongji.

The nation's post-Tiananmen tragedy is that since its near-death experience of 1989 the leadership has done little that was necessary in terms of institutional reform—everything from education to judicial fairness and efficiency to separation of powers. Such institutional development is essential to a more complex, innovative and competitive economy, not to mention a happier one. For all its triumphalism, the Communist Party is just kidding itself when it talks about alternative, "Chinese" solutions to the need for institutional progress.

The management-by-shouting-and-intimidation techniques employed by both Zhu and Xi are no longer appropriate. Xi, and his anti-corruption hatchet-man Wang Qishan, have scared, imprisoned and tacitly sanctioned the torture of many thousands of people. This style may restrain the Party elite from their worship of the golden calf of graft, but will not lead China to the promised land of a high-income state.

To be fair, none of the fast-growth-era leaders in Japan, South Korea and Taiwan recognized the essential interplay between economic and institutional systems after an economy enters the middle reaches of development. But it is disappointing that China could not learn from history and show us something new and interesting. For creative approaches to balanced economic and political development, I put my hope in Ethiopia and Rwanda, Africa's break-out developmental states.

In many respects, Xi is reminiscent of South Korean president Chun Doo-hwan. Chun came to power after Park Chung-hee was assassinated by a colleague in 1979, and to everybody's surprise made government even more repressive. Chun combined this with an anti-corruption drive and some substantial economic reforms (partly, as noted, under US duress). South Korea's economy prospered. But did Chun and his party, as a result of his actions, rule without challenge for another generation? They did not.

By 1987 the Korean people had had enough, and were out on the streets in record numbers, despite the best efforts of the military and the Korean Central Intelligence Agency to terrify them. Chun was ushered into retirement and spent several years living in a Buddhist temple. Since then, South Korea has been a successful economy (it was the only Asian Crisis country to make a strong recovery after 1997), a thriving democracy, and a successful if fractious society.

China is different enough from South Korea that a simple repetition of this story is unlikely; and the timeline is unpredictable because tipping points are inherently uncertain. But I have no doubt that current economic and political policy in China can neither sustain the Chinese Communist Party as a monopoly ruler indefinitely, nor allow China's economy to grow to a point where it seriously challenges American hegemony.

A Tarnished Triumph

By Barry Naughton

China's economy has grown faster than even the biggest optimists imagined two decades ago. Yet social and political change has lagged behind, while policy has become less reformist and more statist. As Beijing pours ever more resources into low-productivity prestige projects, the economic future is unlikely to be as bright as the past.

In 1997, China was in bad shape. The partial shift to a market economy had ravaged the state-owned enterprises (SOEs) that formed the nation's economic core. Hundreds of SOEs were shutting down every week, with no clear successors. The number of urban unemployed spiked to 15mn, and would stay there for five long years. The government was begging foreign investors to bring in up-to-date technology. In midsummer, the Asian Financial Crisis erupted, crushing neighbor economies, depressing China's exports, and triggering four years of regional deflation. The government seemed to have lost the capacity to deliver social goods. The rural health care system had collapsed; education in both urban and rural areas was obviously inadequate, with no clear signs of improvement.

Yet we economists, as a group, were overwhelmingly optimistic. Chinese policymakers had begun to tackle the hardest problems: a round of economic reforms that started in earnest in 1993 had begun to bear fruit. These reforms laid the foundation for sustained rapid growth. An incident

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in January 2000 can serve as a benchmark. The government's top think-tank, the Development Research Council (DRC), had received an internal report arguing that China's growth would slow in the next decade. It organized an informal workshop to discuss the question, and seven or eight foreign economists were gathered around a conference table in a Beijing hotel and asked to make brief remarks.

As we went around the table, everyone delivered the same verdict: positive structural and systemic factors were in place; demographics were still favorable; policies were right and would succeed. The view was unanimous: stay the course and the Chinese economy would be full speed ahead for at least a decade. At about the same time, veteran China analyst William Overholt—who had spent two decades in banking in Asia and was en route to heading the RAND Corporation's Asia research team—coined a nice phrase: "China is in about as deep a hole as anybody but it is digging itself out faster than anyone else."

Economic success ≠ social liberalization

Our optimism was vindicated by the subsequent decade's spectacular growth. The economic reforms of the 1990s triggered the release of capital and labor from under-performing SOEs into entrepreneurial firms, unleashing explosive productivity growth. Entry into the World Trade Organization in 2001 amplified these gains by sweeping away barriers at home and opening up new markets abroad. Yet the China that emerged from this economic golden era was very different from the China we anticipated. What happened?

Our first miscalculation was that, for all our optimism, we significantly underestimated the country's growth potential. No one back then foresaw the magnitude of the housing boom, or the speed with which China would rebuild the heavy industrial sectors it seemed to have dismantled. Nobody predicted that China would raise steel production from 100mn tons (a bit less than Japan) in 1997 to nearly 1bn tons (half the world total) by 2013. Nothing like that had happened before, anywhere, ever.

More important, we misjudged the impact that fast growth would have in other areas. I personally believed that economic success would catalyze other sweeping changes in society. Growing prosperity and the emergence of diverse social groups in cities would lead to a groundswell of support for further opening and reform, since these were the obvious causes of this prosperity and growth.

The late 1990s and early 2000s offered plenty of grounds for this belief. Liberal intellectuals were actively discussing the next steps. High on the agenda was constitutionalism—meaning the constraint of Communist Party power by constitutional norms, and a gradual formalization of legal rights. Even within the Party, institutionalization was taking hold.

No one knew exactly where these first steps to political liberalization might lead—though almost certainly not to representative democracy—and the apparatus of political repression was not dismantled. But a more relaxed, liberal and open society seemed to be emerging. It was far easier for people to live the lives they chose, ignoring politics if they preferred. Yet these expectations of an ever more reformist economic path and an ever more relaxed society were disappointed, thanks to three interrelated counter-trends that gradually shifted the arc of policy.

The impetus for economic and political reform faded in the 2000s

Reform loses its mojo

First, the impetus behind economic reform faded, in part because a social consensus in favor of market solutions never quite solidified. Incomes rose rapidly in the early 2000s, but the rise in unemployment and the loss of old social insurance plans weighed more heavily in people's minds. Public opinion surveys of personal happiness troughed in the early years of the decade. As in Russia, though not so traumatically, the initial transition to a market economy was profoundly disturbing and many people wanted reassurance and safety.

Whether or not as a response to these sentiments, the government under Premier Wen Jiabao, who took office in 2003, adjusted the policy agenda to emphasize social protections and defer economic disruption. Wen continued to talk about economic reforms but did little to advance them. He muffled the impact of WTO entry on domestic industries, especially agriculture, ramping up subsidies to farmers and rolling out regulations to slow the entry of foreign businesses into service sectors. He also invested heavily in rebuilding rural health insurance and extending pension coverage beyond the SOEs.

The cost of this reform slowdown was not immediately evident. Growth accelerated from the turn of the century to 2007, and exports exploded. After the completion of bank recapitalization in the middle of the decade—arguably the last major reform undertaken—fears of financial crisis faded. The mindset of the ruling elite shifted from one focused on aggressive reforms to one more concerned with deferring disruption and avoiding negative consequences.

Next, as market-oriented reform lost its position as the main goal of economic policy, leaders began to target multiple (and often inconsistent) objectives, causing a decline in the coherence and quality of economic management. This second counter-trend contributed to a rise in volatility.

Disagreements about macroeconomic policy blended into a debate about exchange-rate policy. Wen vetoed currency appreciation even as China's trade surplus yawned to an astonishing 8.7% of GDP in 2007 and inflation accelerated. In November 2007 the central bank was belatedly allowed to take dramatic action. It tightened sharply (with a stock-market crash as collateral damage) until it was forced to shift gears by the eruption of the global financial crisis in September 2008.

China's response to the crisis was a massive stimulus, with a flood of bank lending to finance infrastructure and property spending. It worked, but China's monetary policy has never recovered. Rapid credit growth has continued, notwithstanding the economy's emergence from the global crisis. After 2010, as a long-foreseen structural economic slowdown began to emerge, Beijing kept the credit spigot open to maintain growth at an artificially high level.

Policy inconsistency persists

The ascension of Xi Jinping has not restored consistency to economic policy. The much-touted reform program of the November 2013 Third Plenum only guided policy for about 18 months. The power of the growth target remained evident, and policy remained riven by contradictions. The government first encouraged a stock-market bubble and then intervened to support prices when the market predictably crashed in June 2015. Promises of fiscal reform and a tighter rein on local government spending were replaced with an open-ended local-government bond program that enabled provinces to pile on more debt than ever.

Some blame the policy inconsistency since 2003 on the influence of entrenched interest groups. This may be true, but we should recognize that the loss of focus by the leadership and the rise of economic nationalism (which is often just a cover for protectionism) opened up more space for interest groups to influence policy. In turn, the belief that effective policy-making was being stymied by interest groups led many in the elite to support Xi Jinping's strong-man autocracy and anti-corruption campaign

As policymakers continue to lean against the economy's inevitable slowdown, a third counter-trend has become increasingly prominent: the desire to steer China to a high-tech future through heavy state intervention. It is worth stressing how peculiar this is, and how poorly we anticipated it 20 years ago.

The economic slowdown is driven by inevitable structural forces, including the end of the demographic dividend, the loss of easy "catch-up" growth as China gets closer to the global technological frontier, and the shift from industry to services where productivity gains are harder to come by. The other successful East Asian economies—Japan, South Korea, Taiwan—responded to this inevitable slowdown by reducing government direction and shifting to "light-touch" policies of technology promotion. China's trajectory has been precisely the opposite. Beginning in 2005-2006, China began to promote large (but selective) industrial policy projects in a number of sectors. This program blossomed into the "Strategic Emerging Industries" in 2010, and has spread to a number of adjacent industries in the years since.

Techno-industrial policy has become Beijing's main tool to offset declining growth

In the past few years, industrial policies such as "Made in China 2025" and "Internet Plus" have envisioned a new set of emerging industries that will equip and revolutionize the traditional industrial sectors on which China's growth has been based. Government-dictated techno-industrial policy has become Beijing's main tool to offset declining growth and drive China to the front ranks of the world economy.

Beijing knows best

Techno-industrial policy is just one element of a far more sweeping resurgence of a dirigiste approach. "Supply-side industrial reform" injects the government into the old rust-belt industries via centrally determined capacity-reduction quotas. Plans to rebuild the greater Beijing area have morphed into grandiose designs for an entirely new city at Xiong'an in Hebei. The Belt and Road Initiative envisages construction of six overland transport and communication corridors linking China with all its neighbors, not to mention improved maritime links farther afield.

The common characteristic of these programs is strategic ambition married to a disregard for cost. Put together—provided they do not conflict and cancel one another out—they place the government in a position of direct economic control far beyond anything we could have imagined at the turn of the 21st century.

China's economic growth of the past two decades is really no surprise. Attentive economists saw it coming, even though they may have underestimated the magnitude of its effects. Similarly, the middle-income society that has emerged is as prosperous, socially diverse, capable and complex as we imagined it would be.

What has not played out as expected is that instead of loosening its grip on the economy and society, the state has instead tightened it. In the economic arena this has resulted both in a failure to execute much-needed reforms and in an increasingly ambitious, but often contradictory, set of policy objectives. To be sure, China will succeed in some of these ambitious goals, while falling short in others. There is no gainsaying the continuing strength and dynamism of the Chinese economy.

But the overall long-run impact of China's current embrace of ambitious economic interventions will almost certainly be negative. Resources today are pouring into nascent sectors, fueling a sense of optimism, and even triumphalism. As time goes on, though, this over-investment is likely to produce a sustained drag on productivity growth—precisely the opposite of the intended impact—and create new risks in handling the resulting over-capacity and indebtedness. Twenty years from today, it is doubtful that the glittering success stories will be enough to outweigh the embarrassing white elephants.

The Last 20 Years

Never A Brother In Arms

By James Kynge

Over the past 20 years, China failed to follow the path Western powers had scripted for it. Instead, it is emerging as a different type of global leader, defying conventional wisdom and generating new challenges for the supporters of the old order.

"Now you and me go parallel, together and apart," sang Dire Straits, a British rock band, in 1980. "And you keep your perfect distance and it's tearing at my heart." These lyrics were never intended as musings on geopolitics, but they are an apt description of the state in which the West and China find themselves today: interdependent, yet living increasingly in parallel.

It was not expected to be this way. In 2001, when China joined the World Trade Organization (WTO), the international elite believed that China would evolve to be more like the West and would duly be integrated into global governance structures. This has happened in some ways, but crucially not in others. China remains an active member of the United Nations, the WTO, the World Bank and the International Monetary Fund (IMF)—all of which are mainstays of the post-World War II order created by the US and its Western allies. But it has also created or taken part in a plethora of parallel structures that overlap with existing institutions.

The Beijing-led Asian Infrastructure Investment Bank (AIIB) replicates some of the work of the Asian Development Bank. The "16+1 mechanism" between China and 16 Central and Eastern European countries embraces 11 members of the European Union. The Belt and Road Initiative, through which China intends to boost commerce between Asia and

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Europe, offers a partial alternative both to ASEAN, the 10-member group of Southeast Asian nations, and to the Russia-led Eurasian Economic Union. In all these structures, China calls the shots.

Yet probably the most crucial way in which China has "kept its perfect distance" has been in its resistance toward becoming a fully-fledged market economy. Washington and Brussels were so convinced this would occur that, back in 2001, they promised to give China market economy status within 15 years of WTO accession. But when that period expired at the end of 2016, they failed to deliver on their pledge, arguing that China had not lived up to expectations in liberalizing its economy. High levels of state ownership in key industries, combined with a pervasive culture of state subsidies, were cited as the key justifications.

Sultans of bling

These developments, taken together, represent what Lawrence Summers, the former US treasury secretary, calls the challenge of "how we are going to shape a world in which China is going to loom ever larger." In a speech in late 2017, Summers expanded on China's refusal to play the global game:

> Right now I would describe the *modus vivendi* that the world has found as being parallel play. The West does its thing; China does its thing. Countries get a bunch of money from China and they do it China's way. Countries get a bunch of money from us and they do it our way. And we all sort of move forward together and periodically we have some dialogue with China about how this system is going to work and everybody is very polite to everybody else.

Summers fears what will replace the Bretton Woods system when, as increasingly seems inevitable, it breaks down. "And so the last challenge I would say is," he concluded, "what is the system of global governance in which the United States and the West and China are all going to participate in, in common?"

This challenge is not a new one, but the context is. For much of the time since China launched its era of "Reform and Opening" in 1978, public opinion in the West has tended to discount the implications of China's rise, seducing itself with a variety of scenarios that envisaged Asia's giant falling short of its potential. Some argued it would collapse under the weight of internal contradictions; others that it would run into a debt crisis, or that its authoritarian system would sap the entrepreneurial vigor and innovative urges that propel Western economies forward. Inspiration, such narratives held, was the birthright of the liberal democracies—whereas Leninist, single-party states were destined for perspiration alone.

As we stand at the end of 2017, however, such arguments are losing traction. It is clear that China can innovate and nurture a start-up culture that is proving remarkably successful. China is catching up with the US in its creation of "unicorns"—start-ups valued at US$1bn or more. In June 2016, one in three of the world's 262 unicorns were Chinese, making up 43% of the total US$883bn value that these companies commanded worldwide, according to a McKinsey report.

China has nurtured a remarkably successful start-up culture

If the funds being channeled into "big data" innovation in China are any indication, this trend is set to continue. As of 2016, the world's second-largest economy ranked in the top three countries for venture-capital investment in important types of digital technology, including virtual reality, autonomous vehicles, 3-D printing, robotics, drones and artificial intelligence, according to McKinsey.

Money from nothing

These trends are not driven merely by money. The Chinese consumer is more digital than anywhere else—so much so, says Duncan Clark, author of *Alibaba: The House that Jack Ma Built*, that "when you leave China these days, no matter where you go, it can feel like you are traveling back in time." The value of Chinese mobile payments—using digital money—outstripped America's by about 10 to one last year, and China's e-commerce market is about double the size of its US counterpart.

Companies such as Alibaba and Tencent are well into a global acquisition spree, powered by the huge profits they are making in their home market. In terms of stock-market capitalization, Shenzhen-based Tencent recently overtook Facebook to rank as the world's fifth-most valuable company. Baidu, online retailer JD.com and others are similarly eyeing global opportunities. But the biggest technological disruptions may yet be to come. The next phase of this "big data" revolution will be one in which data is deployed to make traditional products "smarter," changing the way we interact with basic things such as our cars, our fridges and our homes.

Jiang Zili, vice president of Beijing Auto, is blunt about the fate awaiting those companies that fail to keep up with innovations in driverless cars, electric cars and ride-sharing vehicles. "They will go the way of the horse and cart," he said in November 2017, noting that his company had recently agreed to cooperate with Baidu, the Chinese internet giant.

Such technological prowess, powered by rapid GDP growth and the nurture of a single-party state, is on track to turn China into a very different type of global leader. Within the coming few years, it may become all the following things simultaneously: the world's biggest economy, but one that is nevertheless still "emerging"; the world's biggest consumer market, but one in which people's average income lags far behind "developed" standards; and the world's biggest trader, but one which sternly protects against foreign investment in key domestic industries. It will also be a non-market economy crackling with entrepreneurial energy; a leader in technology and innovation in thrall to an authoritarian government; and the world's biggest emitter of carbon, hailed as a trailblazer in the fight against climate change.

Not only do such contradictions make the head spin, they also defy Western narratives. Twenty years ago as China prepared to join the WTO, conventional wisdoms were largely bifurcated. China would either espouse capitalism and, in so doing, be integrated into the global system. Or it would reject free market reforms and slip back into brooding authoritarianism. The current reality of a state capitalist behemoth supremely confident in its hybrid vigor was rarely envisaged. Even now, policymakers in the West are struggling to understand how Beijing could have diverged so utterly from the destiny they scripted for it.

Avoiding financial dire straits

Of course, there remains a possibility that things could come unstuck. It is undeniable that big chunks of China's progress have been bought with unsustainable dollops of debt. Non-financial sector debt has surged from US$6trn in 2007 to US$29tn today, according to data from the Bank of International Settlements. Such a high level of borrowing, equivalent to about 260% of GDP, has brought with it a dramatic decline in credit efficiency. The International Monetary Fund pointed out that in 2016 it took four units of credit to raise GDP by just one unit—a clearly unsustainable ratio that is up from just 1.3 to one a decade ago.

Beijing has responded with a blizzard of policy initiatives to bring the debt mountain under control. With economic growth still strong and asset prices rising across the country, it is possible that over time the various state-led debt resolution strategies being pursued could prove at least partially successful. Western governments must hope that this is indeed the outcome; a Chinese collapse would throw the world economy into a certain depression. Nevertheless, China's success is also bringing its headaches.

Having spent much of the last 38 years praising China's "open door" policy, Western governments are starting to close their door to China. So far such moves amount to little more than a gentle creak of the hinges, but they could gather pace as popular frustration with globalization builds in the US, and as EU leaders fret over imbalances in access for M&A activities. Jean-Claude Juncker, the president of the European Commission, told the European Parliament in September that he was "in favor of international trade agreements [but was] not a naïve free-trader."

After nearly four decades praising China's "open door" policy, Western governments are starting to close their door to China

Brussels is proposing a European scheme to vet sensitive purchases by other countries, a move not explicitly directed at China but one which has Beijing in its sights. Similarly, there is bipartisan support in the US Congress to broaden and deepen the remit of the Committee on Foreign Investment in the United States (CFIUS), the government committee that scrutinizes—and sometimes blocks—acquisitions by foreign companies of US counterparts. A further symptom of the dissipating momentum behind globalization is the lack of progress in talks on bilateral investment treaties (BITs) that Beijing initiated with the EU and the US several years ago.

At this stage, such moves are gradual and have only a minor impact on global commerce. But they spring from basic shifts in attitudes toward China's rise within Western elites and among its electorates. In a nutshell, a European diplomat said, the problem is that China "keeps its own market to a large extent closed to acquisitions by our big companies while making the most of our open markets to buy up our technological leaders. This imbalance cannot continue indefinitely."

Parallel play, paradigm shift

The increasingly parallel progress of China and the West may not be a stable state. Just as in human relationships—the subject of the Dire Straits ballad—diminishing opportunities for connection can presage disharmony. This is particularly the case as Beijing constructs nodes of financial, commercial and diplomatic power that stand as alternatives to established Western structures. As competition between such parallel structures inevitably intensifies, countries that deal with both China and the West sometimes find themselves obliged to choose sides.

Viktor Orban, Hungary's prime minister, shows this dynamic in action. In October 2017, he reaffirmed his government's backing for an "eastern opening," shifting attention away from western Europe to focus on luring investment from Asian countries, above all China. "It is now obvious that the world economy's center of gravity is shifting from West to East," Mr Orban said. "This is not my opinion—this is a fact."

Twenty Years Of Gain, And Much Pain

By Joerg Wuttke

The China that foreign businesses operate in today is immensely different from the one they ventured into 20 years ago. Challenges have multiplied for MNCs along with China's economic and political rise.

Nineteen ninety-seven. What a turbulent year. Deng Xiaoping died in February; Hong Kong saw a teary handover from Britain to the then still-emerging superpower China on July 1; and days later the financial crisis started in Thailand and spread across Asia, wreaking havoc on the region's economies and sending shockwaves through global markets. While the financial and economic spheres were in turmoil, and the world of many of his prospective customers crumbled, Joe Studwell decided to launch the *China Economic Quarterly* (*CEQ*).

A time of great uncertainties, 1997 ultimately proved to be a good year to kick-start an economic news service on China. Despite the challenges that Asian economies faced, China's was firmly in the able hands of then-vice premier and economic czar Zhu Rongji. Zhu realized the value of China's WTO accession negotiations as a tool for changing its economic landscape, took on the "triangular debt" problem weighing down state-owned enterprises (SOEs), forced major SOEs to get ready for capital markets, and instilled a sense of market-driven reform that has been lacking ever since. Those were pioneering days, for Zhu, Studwell and all of us.

The changes China has undergone since are enormous, and the nation that foreign businesses face today is immensely different from the one they ventured into 20 years ago. In many respects, MNCs' growing expo-

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sure to an economy that has transformed into the world's second largest came with mounting challenges—many linked to China's increasing self-confidence. Foreign companies are now calling for China to deliver on its 2013 reforms promises, and its pledge to become the new global champion for free trade and economic openness. Expectations, however, are limited.

From pipsqueak to global giant

What has changed since 1997? In short: everything. In 1997 China already held great economic promise, but it was not yet a global player. Multinational companies' average global sales exposure to China was only about 1%, and China's impact on global growth and profits was limited. But the allure of a market with 1.3bn potential customers was already overwhelming.

In contrast, China today represents about 30% of global growth and accounts for 15% of global trade. By a mere 2% devaluation of its currency, it can cause global markets to shudder. Today most of the *CEQ*'s corporate subscribers see China representing at least 10% of their company's global sales. The country's comeback story now drives revenues, profits and growth for most firms. My own company, BASF, saw its turnover in China grow more than tenfold since 1997.

In the late 1990s, the top concern in China for foreign companies was IPR violations, with grotesque stories of bad experiences and lessons learned making standard dinner conversation. Today MNCs have fewer concerns on this front. A more pressing worry is that many Chinese firms are catching up in terms of their capacity to innovate, and are no longer willing just to develop "me too" products. The ongoing technological gains China has made, combined with the entrepreneurial spirit of its people, represent an intensifying source of competition for foreign companies.

In 1997, I had to scream into a landline telephone to make myself understood in Qinghai Province. Two decades later, over half a billion PRC nationals are gadget crazy, using their mobile phones far more intensively than the average European or North American. About 80% of Chinese citizens can accept the possibility of going out without any cash in their pocket, often using their smartphones to make purchases. China was the first to invent paper money—and it might now be the first nation to do away with it!

Until the global financial crisis in 2008, the West was viewed as an economic teacher. Many Chinese politicians and businesspeople were not only interested to learn about the "global economic system," but also to model their own administration and organizations after the "Washington Consensus." Today, most of the country's policymakers no longer see the

West in such favorable light. Furthermore, at least at the local grassroots level, the appeal of offering opportunities for democratic participation has faded away. Democracy is now associated with Brexit and Donald Trump, and in many quarters of China has lost its allure as a political alternative.

Twenty years ago, the G7 countries were in the driver's seat in negotiations leading up to China's accession to the GATT/WTO, which they used to push Beijing to open up its economy. It was then that many foreign business chambers were established in China, among them the EU Chamber in 2001. With the Chamber, I had the pleasure of leading the best business advocacy group in China twice, from 2007 to 2010 and again from 2014 to 2017. But after a decade in the lobbying trenches, the victories often remained small.

An enormous amount of effort is needed to get the attention of Chinese leaders on why they should reform further and truly open up the country's economy, instead of just paying lip service to the idea of liberalization. Unlike the hopeful years around 1997, I now find that the Chinese leadership exhausts itself in making promises of economic reform and putting forward largely symbolic acts like the free trade zones, but with very little of real substance ultimately resulting. In 2014, the EU Chamber estimated that, during the previous year, its members had missed out on €21.3bn in revenues in China as a result of market access and regulatory barriers.

Despite the many success stories, doing business in China has not become easier since 1997

Yet foreign companies have a tremendously beneficial impact on the country. Accounting for only 3% of all businesses, their fixed-asset investment grew 7.5pp faster than the national average in 2016. The same year, foreign companies provided 9.9% of jobs, paid 18.3% of corporate taxes and contributed 25.2% of industrial business revenues, as well as 43.7% of China's exports.

Despite the many success stories, doing business in China has not become easier since 1997. Instead, nearly 50% of European firms reported that it had become more difficult in 2016 to operate in China than in the previous year. Similarly, the American Chamber of Commerce reported in 2017 that over three-quarters of its member companies felt less welcome than before. The World Bank's ease-of-doing-business ranking, which places China 78th out of 183 countries, reflects this complex reality. So does the OECD's ranking of countries according to their restrictions on foreign investment, which for 2017 placed China fourth-to-last among the 62 countries evaluated. This is a poor showing given the country's economic importance globally.

Changes in FDI flows are particularly telling. Chinese investment into the European Union (EU) in 2016 leaped 77% on the year before to more than €35bn, much of it used to acquire technology firms; but funds flowing in the opposite direction declined by 23% to €8bn. European investment into China fell again in the first half of 2017. That lack of reciprocity is now a serious political concern.

The great state-sponsored tech heist

Twenty years ago, China wanted foreign capital, technology and knowhow. Today, cash-rich China primarily wants the latter two only. In 2015, it announced the highly ambitious "Made in China 2025" industrial policy, with goals for achieving higher market shares in 10 global industries. It also wants to attain self-reliance for key components and turn the concept of "indigenous innovation" into reality.

The modernization of China's industrial base is a necessary undertaking, both for the sake of China's environment and for the long-term sustainability of its economy. But such a carefully orchestrated, top-down industrial strategy—based on subsidies, support for inefficient SOEs, market-access restrictions and state-backed foreign acquisitions—risks stoking tensions with international trade partners. Recent Chinese legislation in the new-energy vehicle industry requires European businesses to turn over advanced technology in exchange for market access. In the field of industrial robotics, government subsidies are stoking overcapacity that threatens the viability of European firms, while market access for European IT businesses is shrinking further. The list goes on.

The modernization of China's industrial base is needed for the country's environment and the long-term sustainability of its economy

In 2017, Beijing renewed its commitment to reforming SOEs and other areas of its economy (the service sector in particular). However, as the Conference Board put it, the reality is much closer to a "re-form" of these companies. China's breeding of bigger and stronger SOEs, with seemingly unlimited access to capital on noncommercial terms and a mandate to go out into global markets, should concern us all. It is nearly impossible for a publicly listed or privately owned European company to win against state-sponsored Chinese enterprises in global acquisitions.

In short, the heady reform days of Premier Zhu are now long gone. Instead, state planners are falling back into their old habits of top-down decision making and attempting to steer the future direction of the economy. Foreign business hears a lot of talk of economic reform, but it never seems to arrive. The best example was President Xi Jinping's speech during the World Economic Forum in Davos in January 2017, when he claimed that China would protect free investment. It also came in writing that same month with the release of the State Council's Document No. 5 on promoting further openness and making use of inward investment.

I hope these positive signals provide the necessary impetus to follow through on the to-do-list left over nearly 20 years ago by the Zhu administration. European business would invest more in China if the following criteria were met: a simplified regulatory environment, freedom to enter into new business areas or product segments, a reduction of barriers to acquisitions in China, and more leeway to take control of their China operations by reducing the need for a local business partner or JV. Otherwise, European investors will seek more open economies elsewhere, and China will miss out on its potential to attract foreign capital.

China has a great capacity to surprise, but such substantive reforms cannot be taken for granted. The newfound distrust of market forces after the bruising summer of 2015, when Chinese equities collapsed and the fall in the renminbi caused global jitters, may encourage a more statist approach to economic management. In short, we should remain optimistic but not be naïve.

Still magical Middle Kingdom

If there is one thing that I have learned during my nearly three decades of living in China, it is to stay away from straight-line extrapolations. The growing complexity of the Chinese economy will challenge the planning patterns of the Chinese government.

Where will China be in another 20 years? I hope that, as a football-crazy nation, China will have had a chance to host the World Cup. But will the country's political masters continue to play a central role in steering the direction of the economy, with markets relegated to a supporting role? Will foreign business still be permitted to participate in the economy in a meaningful way if China successfully strengthens its technological capacity in a large number of sectors? And will China have become a truly responsible stakeholder within the international economic system from which it has benefited so much?

Regardless of whether China realizes its government's stated goals during the "new era," I suspect that it will continue to confound and amaze. Over the past two decades, readers of the *CEQ* have witnessed the Middle Kingdom make a comeback of historic proportions. I hope that for the next 20 years, the magic of China will remain for my five children as it still does for me.

From The Archives: The Internet Master Plan

By Simon Cartledge and Peter Lovelock

Don't say we couldn't have seen it coming. In this condensed reprint from the March 1999 CEQ, *we explain Beijing's strategy for building an internet that would promote growth, spur technological development—and vastly increase the state's ability to exercise centralized coordination and control of the economy, and everything else.*

China has shown a huge love for everything electronic. By 1997, it had more than one color television for every urban household. Cable TV now reaches more than 56mn households. In telecoms, about 10mn new local subscribers are added every year, and in 1998, some 11mn people became mobile phone users. With sales of personal computers forecast at 10mn in 1999, China will be the world's third biggest computer market.

The same will be true for the internet. From a handful of users in mid-1995, China officially had more than 2.1mn people online at the end of 1998. Unofficial estimates are much higher, and the total is set to grow exponentially. But how does this make sense? Aren't China's rulers obsessed with controlling information? Can they be expected to make an exception for the internet?

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We suggest that the leadership's embrace of the internet is not only unsurprising, but downright predictable. The internet makes sense for China's sustained economic development, and for increasing Beijing's ability to coordinate and control that development. Information networks offer the potential to reinforce power structures rather than weaken them. The only real surprise is that many foreigners seem to be having more trouble grasping this than the Chinese technocrats who run the country.

The top-down internet

Information networks have a vast but contradictory potential to make both markets and hierarchies more efficient. Increased efficiency is mostly born out of the reduction in coordination costs. This can increase the proportion of economic activity coordinated by markets, which are more communication intensive than hierarchies. But market growth leads to an increase of economic actors which in turn requires an increase in the amount of communication required by the market to operate efficiently. To leaders in Beijing this sounds like an increasing demand for administrative oversight, not a lessening of their role.

China's embrace of the internet was not only unsurprising, but downright predictable

To emphasize the informality and geographic dispersal allowed by networks is to ignore their minimum requirement in order to function. Any network must have agreed standards and protocols. If standards are controlled or enforced from a center, they give the center a greater say over the form in which any activity takes place.

The Chinese government's motivation for building out a national information infrastructure is twofold: to promote economic development and to exercise greater administrative control across the country. From the very start, it has believed that extensive wiring of China could increase central coordination power while at the same time achieving improved productive efficiency and performance.

This has a lot of appeal. One of the most profound outcomes of Deng Xiaoping's economic reforms has been an unwanted but sustained decentralization of political power—manifested most clearly in Beijing's ongoing struggle to rein in Guangdong's freewheeling economic ways, which have led to stunning growth but also to the accumulation of huge unrecorded foreign debts. New information networks seem to offer tools to enable both the expansion of market forces that will drive economic growth, and greater central control and monitoring of those market forces.

It's the infrastructure, stupid

People might like to think of China's internet as a bottom-up explosion of individualism. But it is not: it is instead a carefully crafted centralized network running largely through a single carrier, China Telecom. Understanding the Chinese internet is more about understanding the infrastructure than the users.

China's first move to build out a national information infrastructure was the "Golden Projects." Launched in 1994 under the aegis of a State Council leading group (the Joint Committee of National Economic Informatization), the projects had three overarching goals:

1. To build a national information highway as a path to modernization and economic development.
2. To drive development of information technology industries.
3. To unify the country by tying the center to the provinces and by allowing the government to act across ministerial, industrial and administrative lines.

The third is clearly the most important, and the driver of the other two. Realizing it will allow the central government to regain administrative control by acting as the country's information gatekeeper.

Golden schemes

The Golden Projects started with three elements: Golden Bridge, Golden Card and Golden Gate.

Golden Bridge is the infrastructure for "informatizing" the national economy. At its core is a project to build the infrastructure backbone over which other information services will run. First proposed in March 1993 by then vice-premier Zhu Rongji, it combines satellite and landline networks. Tying together its 30 provincial and regional nodes is a network center in Beijing. So far the Golden Bridge network has been constructed as a medium-speed "information highway," but the goal is to roll out a wide bandwidth multimedia network over which other Golden projects can transmit and receive data.

Golden Card, an electronic money project, is linked with President Jiang Zemin's June 1993 call for accelerating the development of banking and credit card systems in major cities within China. The project aims at setting up a credit card verification scheme and an interbank clearing system. One of its key goals was to have 200mn credit cards in use across 400 cities within China by 2000.

Golden Gate was first proposed in June 1993 by then vice-premier Li Lanqing. It is a foreign trade information network aimed at improving import-export trade management by linking the Ministry of Foreign Trade and Economic Cooperation and the Customs Bureau. Before 1978, only the foreign trade ministry and its 12 trade corporations were permitted to engage in international trading activities. By the early 1990s, more than 9,000 organizations provided international trade services. Golden Gate aims to re-centralize administration and control of China's foreign trade activities.

Since the first three projects were proposed, a dozen other "Golden" programs have been implemented, by a plethora of agencies including the Ministries of Agriculture, Health and Finance; the State Statistical Bureau; and the Customs Administration. These later projects have generally involved user-driven applications designed to promote economic reform. With most of these Golden applications, government agencies are trying both to increase economic efficiency and to centralize control of information.

Of these other Golden projects, one is particularly noteworthy. The Golden Sea project interconnects China's top government leaders and provides them with immediate access to reference data from other institutions, organizations and offices under the direct jurisdiction of the Communist Party Central Committee. It was the first Golden Project to be completed, in 1995—underscoring the point that enhancement of the central government's capacity for control is a core objective of its internet strategy.

The government roots of e-commerce

The leadership bases its claim to legitimacy heavily on economic growth. It is therefore no surprise that the government is egging on the development of e-commerce. At an Asia-Pacific Economic Cooperation (APEC) forum meeting in Kuala Lumpur in November 1998, President Jiang Zemin described e-commerce as "the future of business," and called on developed countries to provide less-developed countries with the technology and other assistance needed to promote it.

What confuses many outsiders is that e-commerce, like the internet, is supposed to be a "bottom-up" development: lots of little retailers employing new technology to begin innovative business practices. What they find in China instead is the government, in its myriad forms, moving in as the central player.

One example of state-led e-commerce architecture is the Centralized National Automated Payments System built by the People's Bank of China (PBOC). This national bank clearing system has enabled the PBOC to replace provincial branches with regional offices. At the same time it forced the state-owned banks to restructure their hierarchies in parallel—on a regional, not provincial basis. These steps serve to centralize decision-making and minimize the sway of local authorities. As a result, the PBOC is slowly but surely achieving far greater command over monetary policy, thereby realizing an increase in administrative efficiency and economic control.

Chinese officials have always believed they would be able to control the internet's information flows

Another instance: in the summer of 1998, the Ministry of Foreign Trade and Economic Cooperation opened its China Market web site (www.chinamarket.com), the country's first official export-oriented business-to-business e-commerce site. More recently, the government has announced a number of initiatives aimed at providing nationwide standards and infrastructure for e-commerce. In November 1998, a project headed by Beijing vice-mayor Liu Qichu and including representatives from the Ministry of Information Industry, Bank of China and tax and customs authorities, was launched to set up credit-card verification and secure payment systems, draft laws and regulations, and develop a front-end for an "e-commerce city."

To say that these are merely government-to-government businesses misses the point. In China, most large-scale business is still done by state enterprises and government entities. Consumer-oriented e-commerce will develop, but it will build off the back of networks developed and controlled by the government.

Scrubbing the content

Information networks offer the promise of stronger economic development and greater centralized administrative control. But they also threaten the Communist Party's control over information flows. This is not a trivial matter, but the government believes it can cope, and it probably can. Certainly, it is not complacent. It is experimenting with several strategies for information control: repression, restricting access, and using the internet as a legitimizing tool.

Repression tops the list. As internet use surged in 1998-99, the government has shown itself neither ignorant nor complacent about the use of email or websites to disseminate anti-government material. Hence the jailing for two years of a Shanghai man, Lin Hai, for selling 30,000 email addresses to a New York-based dissident group. In January 1999, the Ministry of Public Security was reported to be setting up computer crime monitoring units in the police departments of every city. The same month the government announced new registration requirements for internet cafes aimed at limiting anonymous use of their facilities. February saw various moves to shut down online discussion groups which explored political issues such as the student-led democracy movement of 1989.

A second option is to build alternative networks that are shielded from the rest of the world. The vast majority of Chinese internet users, directly or indirectly, log in via the ChinaNet system controlled by China Telecom, the monopoly provider of fixed-line telephone services. (ChinaNet is usually known as the 163 network, after its dial-up access number.) The one alternative is the 169 network—again named after its dial-up access number—which is also run by China Telecom via its Data Communications Bureau.

From the start, the Communist Party saw the internet as a tool that could help legitimize its rule

Started in 1998, this is an attempt to build a China-only internet. Despite its title, it uses the same telecom backbone as the 163 network. Its main distinguishing feature is that all its material is in Chinese. It is also difficult to access the network from outside, making it more secure than the internet proper, while at the same time it allows users controlled access to the real internet. The future of this approach is by no means assured. It is the latest in a series of ventures aimed at developing Chinese-only versions of the internet walled off from the rest of the world; the others have failed, unable to attract more than a few thousand users.

Most interesting of the information-control strategies is the effort to deploy the internet as a legitimizing tool. One vehicle is the Online Government project, a scheme to get ministries and state agencies to have an online presence, via the more controlled 169 network. Stage one is to connect around 800-1,000 government offices and agencies to a network. Stage two, planned to take place over the next two to three years, involves getting the offices and agencies to move their information systems into sharable electronic form. Stage three calls for all offices and agencies to move to paperless working.

As with the Golden Projects, the purpose is to create a centrally accessible and controllable system, which collects data both from government departments and from the public, and enables the central authorities to monitor and control the activities of both. (This project has the added benefit of allowing the government to co-opt some of the very people who might otherwise question it: the technical and administrative elites.) Overall, the leadership is combining traditional repressive techniques with attempts to build a Chinese-only alternative network and a leaner, better-informed and more coordinated government. They clearly believe the internet will both be something whose opportunities it can exploit and whose threats it can manage.

The thin red line: manage less, control more

Because of the benefit a national information infrastructure offers to centralized administration, it will continue to be rolled out forcefully. Because of e-commerce, people will be encouraged to use it. And because it meets real consumer needs, they will flock to it. The number of internet users in China will grow at a stunning rate over the next few years. The government believes it can control what goes on, and just in case will continue to explore closed networks.

Anyone looking to the internet as the great equalizer—the mechanism by which individuals in China can rebalance themselves vis-a-vis the state—will be disappointed. From the very start of the Golden Projects, officials have regarded information networks as powerful coordination tools—powerful enough to resuscitate the state's flagging role as a mediator and arbiter of economic activity. Working through information networks, a centralized and powerful state can play a crucial role as a mediator in the marketplace, and minimize both private transaction costs and its own coordination costs.

A national communications network also allows greater political monitoring and control. In theory it could also provide a national platform for the organization and dissemination of political dissidence. But officialdom seems to believe that an adequately designed network will serve first and foremost the interests of the central government.

The development of China's internet must be understood against the background of the Communist Party's governance challenges. The party is as obsessed with control as it has always been, but over the last two decades, China's economy and society has become infinitely more complex and fragmented. One response to this complexity was the government restructuring announced at the National People's Congress in March

1998, which aims to produce ministries focused on policy development and regulation, not line management. The goal is to manage less but control more.

The information technology strategy is a tool with exactly the same purpose: to increase the central government's ability to coordinate and control the economy and society, by decreasing the cost of that coordination. China's internet growth is far less surprising than it first appears, and will almost certainly proceed at a pace that will continue to astonish observers.

Misreading The Past, Misjudging The Future

By Yukon Huang

Smart observers have repeatedly got China wrong over the past three decades, selling short its growth potential and exaggerating its fragility. Chances are that many of today's dark forecasts will prove wrong as well.

For years, skeptical analysts have predicted that China's unique growth model was doomed to run aground, and for years they have been wrong. Along the way they have persistently mistaken the strengths of the Chinese economy—such as sky-high investment rates, state-led debt finance, an authoritarian political system—for weaknesses. China has defied the skeptics and kept growing, despite major shocks such as the Asian and global financial crises. Understanding China's past, and why so many people got it wrong, is critical for thinking about its future, and how we might get it wrong again. Here are three common myths about China's development history, followed by three popular predictions that may also prove off-target.

Myth #1: China's unbalanced growth was a problem

The claim that China's growth was dangerously "unbalanced"—because the investment share of GDP was abnormally high and the consumption share abnormally low—surfaced more than a decade ago when China's huge trade surpluses were seen as driving global imbalances. Emotions heightened during the global financial crisis when many argued that

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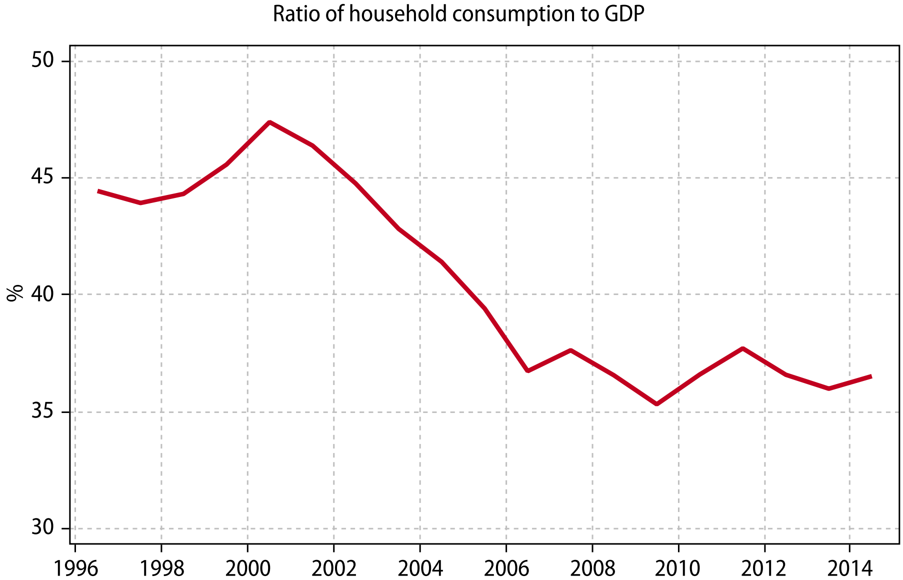
Household consumption fell as a share of the economy...



Gavekal Data/Macrobond

China needed to boost consumption both to facilitate the West's recovery and, for its own sake, to escape the "middle-income trap."

This line of argument is misguided. Unbalanced growth is the natural result of successful urbanization and industrialization, as workers shift from labor-intensive rural activities to more capital-intensive, industrial jobs in cities. In the process, an ever greater share of national income goes into investment, but surging profits also lead to wage gains that drive rapid growth in individual consumption. This explains how per-capita consumption grew faster in China than in any other major economy even as the consumption share of GDP fell.

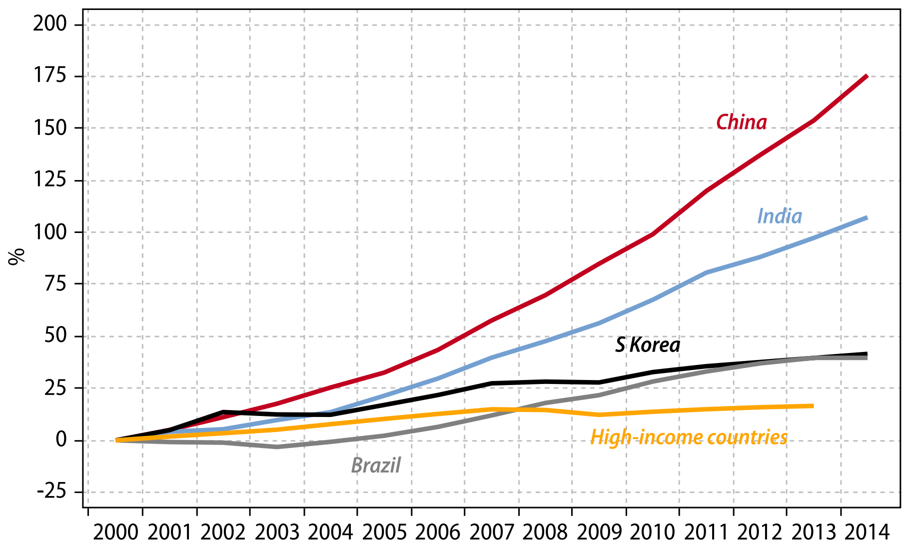
Unbalanced growth made China a manufacturing and trading power and dramatically increased living standards—much as it did in Japan and South Korea decades earlier. This cannot last forever: as an economy matures, the pace of urbanization slows and capital-intensive industry gives way to labor-intensive services. But just as this natural rebalancing played out over several decades in Japan and South Korea, so too will it do so in China, where the urbanization ratio remains under 60% and poorer regions still have pressing investment needs.

Myth #2: China is at high risk of financial crisis

Much negative commentary in recent years has focused on China's surging debt-to-GDP ratio, and the rise of poorly regulated "shadow bank-

...but consumer spending grew faster in China than anywhere else

Household consumption, change from 2000



Gavekal Data/Macrobond

ing." The IMF and Bank for International Settlements both warn that all economies with comparable debt bubbles have experienced a financial crisis. Why should China be different?

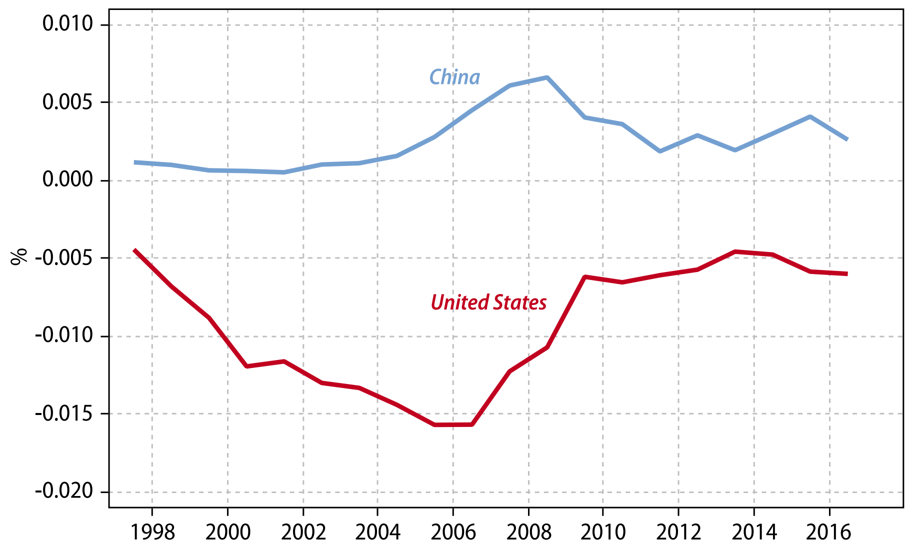
Optimists point out that China's debt is largely public rather than private, borrowing is funded domestically rather than externally, and household balance sheets are strong. And for all its heady growth, China's financial system is still basically a plain vanilla one, without the exotic derivatives and securitization that masked risk in the US, or the cronyistic links between banks, companies and government that stoked financial problems in Asian countries from Thailand to Japan.

A more important, but often overlooked, factor is the role that the belated emergence of a private property market has played in driving up debt. The private real-estate market did not exist in urban China before the privatization of state-owned housing in the early 2000s, and it took off only when land auctions were institutionalized in 2004. Credit expansion helped establish a market price for urban land, whose value was previously hidden in a socialist system.

Much of the "excess" credit growth of the past 15 years—defined as credit growth above the rate of nominal GDP growth—financed the rise in asset prices from their artificially low starting point to values that are broadly consistent with market realities. Rapid credit growth is as much a sign of beneficial financial deepening as it is evidence of a property bubble or capital misallocation.

China is not responsible for the US trade deficit

China and US current account balances as share of world GDP



IMF, author estimates

This process has nonetheless led to increased risks that warrant stronger regulation. And since early 2017, the crackdown on shadow banking suggests a shift in policy emphasis away from financial deepening to tighter risk control. The risks are real, but do not portend an imminent crisis.

Myth #3: China's trade surplus caused the US deficit

China's large trade surpluses have given rise to popular perceptions that its export prowess is to blame for US trade deficits and manufacturing job losses. But historical data clearly show that the trade balances of the United States and China are not directly linked. As a share of global GDP, the US current-account deficit rapidly expanded from 1997 to 2006. China's current-account surplus did not start rising in globally significant terms until 2005. And as China's surplus increased, America's deficit shrank.

America's important bilateral deficit is not with China but with the broader East Asian production chain—especially Japan, South Korea and Taiwan, where most high-value components are produced. The US deficit was with these countries directly in the 1990s, and then shifted to China when it became the final assembly point for this production chain.

A deeper misconception is that China's export strength is rooted in its deliberately undervalued exchange rate. The reality is very different. Even as the renminbi steadily gained in value in 2007-14, China kept picking up global export market share. Its export competitiveness mainly stems from huge infrastructure investments and structural reforms that boosted labor productivity, in addition to geographical advantages that enabled it to become the hub of an already powerful Asian production network.

So much for the past. What will we miss next?

The bad track record of pessimistic forecasts about China should make us skeptical about gloomy predictions for the coming decades. Here are three frequently-made prognostications that are also likely to prove wrong.

Bad prediction #1: China is doomed to a major growth slowdown

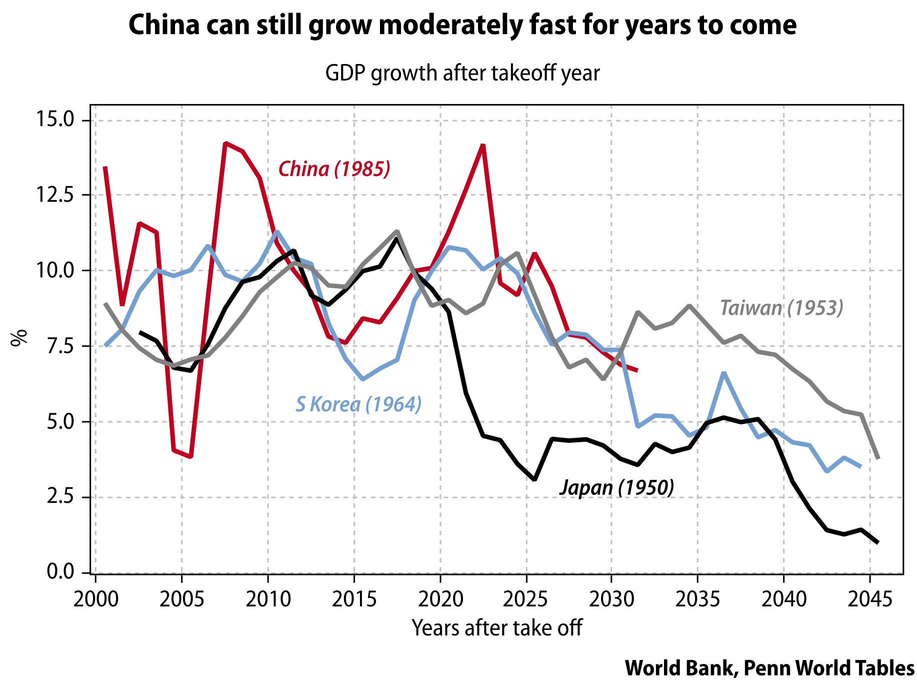
Optimists and pessimists agree that China's growth rate will moderate in coming years. They argue over how sharp the decline will be. One pessimist is former US Treasury Secretary Lawrence Summers, who predicts that China's GDP rate will converge to the global mean of around 3% by the end of this decade. Yet China most resembles the strong-performing East Asian economies of Japan, South Korea and Taiwan, all of which sustained relatively high growth after reaching China's present income level, not a global average. Based on these precedents, further annual growth of 5% or more should be achievable for some years to come.

Optimists and pessimists agree China's growth rate will moderate. They argue over how sharp the decline will be

An even more pessimistic argument is made by Michael Pettis, a professor of finance at Peking University, who asserts that "every country that has followed a consumption-repressing investment-driven growth model like China's has ended with… either a debt crisis or a lost decade of very low growth." But as I have shown, China's "unbalanced" growth is actually a sign of successful industrialization. So long as macro policy remains sensible—and, crucially, leaders implement reforms to address the many distortions and inefficiencies that still plague the economy—both a growth collapse and a financial crisis are avoidable.

Bad prediction #2: China can't innovate

Central to China's future economic success is whether the country can improve its innovative capacity. The leadership has long promoted schemes to foster innovation, starting with 2006's long-term science and technology plan (which introduced the concept of "indigenous innovation") and continuing with the recent "Made in China 2025" industrial policy initiative. Skeptics say these programs will fail, pointing to China's



heavily centralized system, state control over resources and information flow, and a learning environment generally depicted as stifling for creativity. They also note that the efforts by Chinese firms to acquire technology via M&A abroad have triggered a strong protectionist backlash in the US and Europe.

Can China succeed in this environment? The answer is likely to be yes. Research suggests that the five key factors driving innovation are: learning, human capital, competition, scale, and ownership structure. China scores well on the first four of these factors. Trade and foreign direct investment promote learning of both hard technologies like industrial processes and soft knowhow such as management, while China now boasts more researchers than the US and outspends Europe on R&D. But what really sets China apart is the combination of a huge market and exceptional competitive pressures. Chinese firms can achieve scale economies at home before having to venture abroad, while competition arises both in this huge domestic market and in markets overseas. These factors are probably more important than the top-down innovation policies that attract so much attention and criticism.

The combination of bottom-up energy and state support for key projects has already yielded significant achievements. China is widely recognized as a world leader in high-speed rail, while Ofo and Mobike's GPS dock-less bikes are already expanding into Europe and the US. In e-commerce and payments, Alibaba and Tencent are ahead of their Silicon Valley stalwarts in the race to provide mobile payment services. In just a decade, China's share in e-commerce transactions has leaped from 1% to 40% of the global total.

Bad prediction #3: Corruption—or ending it—will bring China down

For years, skeptics have claimed that corruption would destroy China's economy. Cross-country studies show that corruption generally impedes growth because it dampens investment. But in China's quasi-socialist system, corruption has actually stimulated investment by transferring the use of state-owned assets to private hands, where they generate higher returns. Perhaps the best example is the transfer of state-owned urban land to private developers. Corruption is one reason why China has done so well economically in the absence of any broad-based program to privatize state assets.

Still, this model cannot last forever. In addition to fostering moral decay and encouraging wasteful rent-seeking, President Xi Jinping views corruption as a threat to the credibility of the Communist Party. In response, he has launched both a sweeping anti-graft drive and a major initiative to strengthen the rule of law. Pessimists fear that the anti-corruption effort will fail or that an overly draconian crackdown will stifle the risk-taking necessary for a vibrant economy. Both outcomes are possible, but neither is pre-ordained.

The crackdown is more likely to benefit the economy if it is accompanied by reforms enabling the private sector to operate efficiently without resorting to corrupt behavior. Efforts are ongoing to formalize a civil code and define acceptable commercial practices. Other measures could include liberalizing the investment regime for foreign and domestic private firms, and instituting a more equitable system for converting state-owned land into private commercial use. More far-reaching and politically sensitive reforms will be needed to promote the private sector's ability to manage resources without seeking license from the state.

Don't underrate China's strengths

China's economic progress over the past three decades has been impressive, and has repeatedly defied the skeptics who forecast its demise. But as it seeks to evade the middle-income trap, China must overcome a long list of fiendishly difficult challenges: an underdeveloped fiscal system, excessive reliance on state banks, a bloated state enterprise sector, unproductive urbanization, local protectionism, a rapidly aging population, and severe environmental degradation. If left untreated, these problems will at the very least retard growth; worse, they could lead to economic stagnation or provoke a full-blown crisis.

The problems are real and serious. Yet outside analysts have missed the mark in the past, not because they failed to spot problems, but because they underestimated China's strengths. There is a fair chance that those talking down its prospects today are making the same mistake.

The Environmental Horizon: Still Murky

By Angel Hsu

At long last, Beijing is getting serious about tackling the huge environmental problems caused by breakneck growth. Much more improvement is needed to clean up China's environmental record both at home and abroad.

At the 19th Party Congress, President Xi Jinping set a goal for the Communist Party to build an "ecological civilization" and secure a "good and beautiful life" for its people. This reflects an understanding that China's growing urban middle class is demanding a cleaner environment, and that the Party can no longer expect rapid economic growth to placate a populace suffering from the costs of rapid industrialization.

These costs are huge and still growing. An estimated 1.5mn deaths a year are attributable to China's air and water pollution. Around 80% of the nation's water is "unfit for human consumption," according to the Ministry of Water Resources. The world's worst air pollution readings are now mainly in India, but China still accounts for 116 of the 256 cities with average fine-particulate concentrations of at least 50 micrograms per cubic meter—five times the World Health Organization's recommended safe level. The impact of China's pervasive soil pollution is only beginning to be understood, yet has already sparked a boom in demand for organic produce by Chinese shoppers. At the global level, China's greenhouse-gas emissions nearly tripled between 2000 and 2014, and its share of the world total doubled in that period, to 26%.

China is at a critical environmental crossroads. Government action against pollution has slowly intensified in recent years, with a visible positive

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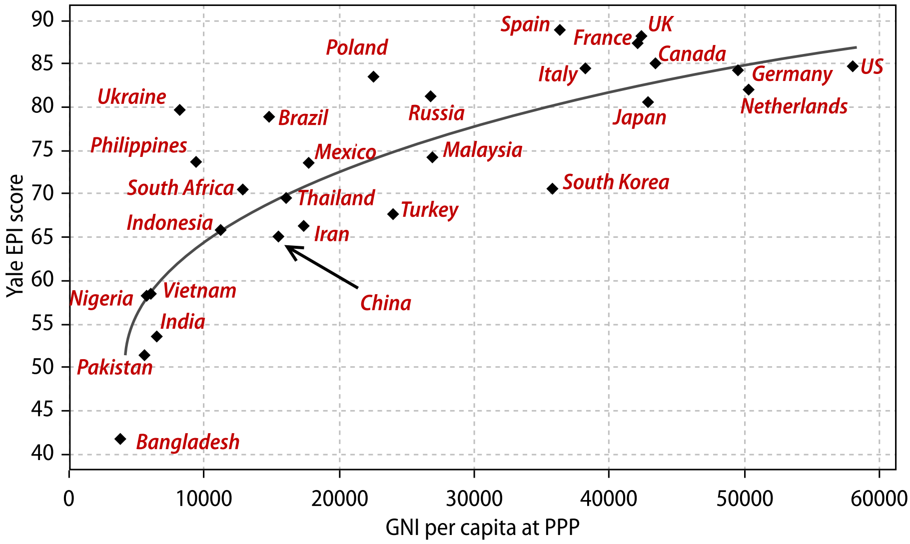
China's environmental performance should be better

Environmental Performance Index and national income, 2016



Environmental Performance Index, Gavekal Data/Macrobond

impact. Both to satisfy domestic demands and to show that China is capable of responsible global leadership, environmental performance and regulatory enforcement must meet a higher standard.

Getting better, glacially

China's environmental outcomes have improved in recent years, but slowly; and China's environment is still worse than one would expect given its level of income. The 2016 Environmental Performance Index (EPI), a global ranking of national environmental results, placed China 109th out of 180 countries. Its performance improved by 1% over the previous decade. These results are unimpressive compared with other emerging economies, including Brazil (46th), South Africa (81st) and Turkey (99th), which elevated their performance much more sharply in the past 10 years.

In general, environmental performance correlates with a country's income—a relationship sometimes called the "environmental Kuznets curve." The chart above creates such a curve for 30 industrial countries of reasonable size (city-states and economies disproportionately reliant on agriculture or resource extraction are excluded). In 2016, China's environmental score was about 8% lower than would be predicted by its income. This is better than in 2014, when its score was 14% below the predicted level, a shortfall matched by only two other countries (the United States and Russia). This suggests that China is heading in the right direction, polluting less each year per unit of economic output, and achieving an environmental trajectory similar to that followed by developed countries.

But consistent, rapid progress remains elusive, in part because of the conflict between economic and environmental goals. In 2016, Beijing stimulated the economy by pumping up construction of housing and infrastructure in order to reverse a sharp economic decline the year before. The stimulus succeeded, but at the cost of worsening air quality. Greenpeace China found that levels of fine particulate pollution (PM2.5) worsened in nearly one-third of 367 monitored cities that year, including in economic and population centers such as Shanghai and Guangzhou.

Consistent, rapid progress remains elusive, in part because of the conflict between economic and environmental goals

Policy gets into gear

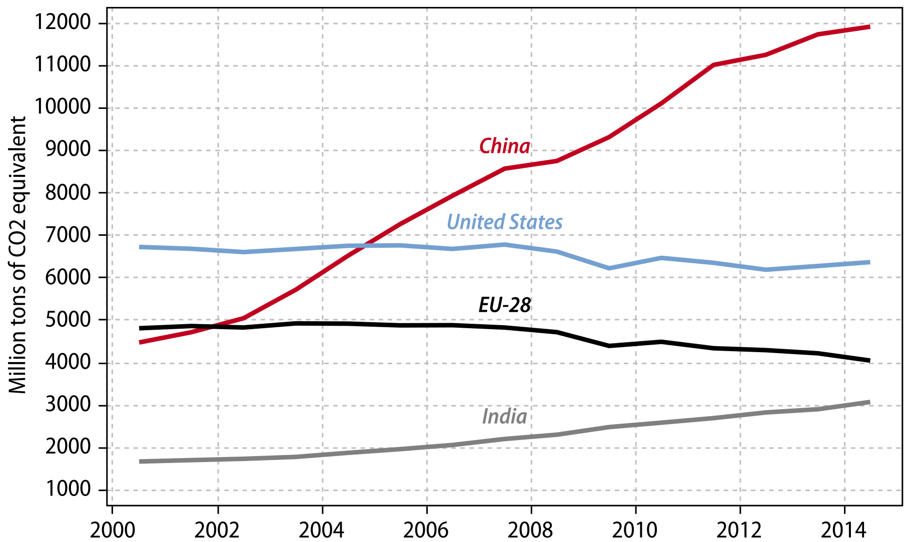
Nonetheless, environmental policy and enforcement in China have become more systematic in the past few years. In 2013, the State Council approved a comprehensive action plan to abate air pollution, which was followed by water and soil pollution plans in April 2015 and May 2016, respectively. These plans establish local and national targets and timelines for pollution reduction, taking aim at high-polluting sectors. If fully implemented, the plans would amount to the world's largest ever environmental clean-up effort.

The air pollution plan alone had an estimated cost of US$277bn in 2013-2017 and features top-down measures such as mandating a cap on coal's share of the national energy mix at 58% by 2020, down from the current share of over 60%. Revisions to its 30-year-old Environmental Protection Law, which went into effect in 2015, encourage more vigilant watchdog action by civil society. The ministries of environment and urban development created an app within WeChat that enables citizens to report urban air pollution violations on their smartphones.

Air pollution is the most visible problem and attracts the most headlines—but the hardest nut to crack will be soil pollution. Soil contamination levels are still considered a state secret. The 13th Five Year Plan, which began in 2016, included the first national action plan on soil pollution. But details are still hazy. It is inherently difficult to assign responsibility for soil clean-up. One option would be to follow the US Superfund model, which combines public and private financing to restore contaminated land to economic usefulness.

China accounts for most new greenhouse emissions

Total greenhouse gas emissions



World Resources Institute; Gavekal Data/Macrobond

Over the past two decades, China has been by far the biggest contributor to the growth in the greenhouse-gas emissions that cause climate change, thanks to its rapid industrialization and breakneck buildout of coal-fired power plants. But this is beginning to change. In some ways China's response to the climate problem has been more aggressive than its attack on local pollution.

China is now, by a comfortable margin, the world's biggest investor in renewable energy technologies. Its 13th Five Year Plan on Energy Development, released in early 2017, set a target of US$360bn in solar and wind power investment by 2020. Installation of renewable energy capacity has galloped ahead of schedule. The original 2020 target for solar electricity generation capacity, 105 GW, was exceeded in July 2017, prompting the National Energy Administration (NEA) to set a new 2020 target of 213 GW—five times current solar capacity in the US. China accounted for nearly half of the world's installation of new windpower capacity in 2016. By 2020, China will account for more than one-third of the world's installed wind capacity.

This shift to renewables is motivated as much by economic self-interest as by a desire to be a good global citizen. The NEA has set a target to create 13mn jobs in the renewables sector by 2020, and will probably exceed it. Industrial planners hope that Chinese firms can assume global leadership in renewable energy and environmental technology sectors.

Whatever the causes, it seems increasingly plausible that China has bent the steep arc of its carbon emissions. Thanks in part to the renewables push, China's consumption of coal (the biggest culprit behind its climate emissions) appears to have peaked in 2014. At the Paris climate talks in 2015, China pledged that its greenhouse-gas emissions would peak by 2030, but the decline in coal use could mean that these emissions have peaked already.

China is still a major problem for the climate

Despite these achievements, Climate Action Tracker, a research group that gauges countries' climate pledges, has deemed China's greenhouse gas reduction efforts as "highly insufficient" in the drive to limit global temperature rise. Climate scientists generally agree that for the world to have a chance of meeting the climate targets set by the Paris agreement, China must not only cap its emissions but reduce them sharply.

China's aggressive export of dirty-energy technology undercuts the credit it gets for greening its domestic energy mix

Practically, this will be hard to achieve, and politically, China has been unwilling to assume the burden of leadership that such reductions would imply. In climate negotiations, it has consistently maintained that wealthy regions such as the US and EU should bear the brunt of responsibility for climate mitigation, citing those countries' historic emissions and a "right to development" for emerging economies. But now that China accounts for a quarter of global greenhouse-gas emissions, and has a per-capita GDP above the world average, these righteous claims are beginning to ring hollow.

This is especially true because China's climate footprint now extends well beyond its own borders. With the 2013 launch of its "Belt and Road Initiative," Beijing has made clear its ambition to expand its political and economic reach throughout Asia and beyond. One of the largest categories of Chinese investment in the developing world is coal-fired power plants. The Global Environment Institute found that, from 2001 to 2016, China developed 240 coal-fired power projects in 68 countries associated with the Belt and Road, for a total of 251 GW of generating capacity—equal to about a quarter of China's domestic coal-fired capacity.

Beijing has not established principles to guide environmentally sound investment abroad, and its aggressive export of dirty-energy technology undercuts the credit it gets for greening its domestic energy mix. Unless it shifts its stance—for instance, by embracing responsible investment rules such as the Equator Principles—China's global environmental impact will draw increasing criticism.

Notwithstanding its spotty record abroad, China is making real efforts to step up the pace of environmental policy innovation at home, with credible initiatives in carbon pricing, clean-energy finance, and electric vehicles. In November 2017, its lead climate negotiator, Xie Zhenhua, announced at the annual UN climate conference in Bonn the launch of China's long-awaited national carbon emissions trading scheme, which could become the world's biggest carbon market. The government has made green finance a priority in the current Five Year Plan. In June 2017 it rolled out a pilot program for green finance in five provinces in the hope of eventually catalyzing US$440bn in spending on pollution abatement and environmental protection.

Beijing has also intimated that it may join the EU in banning traditional internal-combustion engine vehicles by 2040. It is busy trying to ramp up production of electric vehicles through a combination of buyer subsides and producer mandates. In 2016 the country produced more than half a million electric vehicles (including buses and trucks), accounting for 45% of global production that year; by 2022 the government wants this figure to rise to 5mn.

The elephant in the room: governance

With its effective command-and-control government, China can surely mobilize a lot of investment in new and environmentally friendly technologies. But it will never be able to realize its green dreams without addressing the most critical piece: its governance system. Local government officials still mainly work towards economic targets, not environmental ones, and until this incentive structure is changed, they will keep pushing development priorities at the expense of meeting pollution and climate goals. China's environmental critics note that in 2015, despite government pledges to cut coal use, 51.3 GW of additional coal-fired power capacity was installed. Much of this additional capacity has been underutilized and may wind up as stranded assets.

Addressing this implementation gap—the divide between national government policy and local enforcement—is the biggest obstacle standing in the way of the "ecological civilization" the Party says it wants to create. The country's leaders must harmonize local incentives with its national vision if China is to build a green environmental future.

Waiting For Their Generation

By Alec Ash

Young Chinese who came of age during "Reform and Opening" have more liberal notions than their elders for China's future. The tectonic plates of government and society are moving in opposite directions, but we will have to wait at least 20 years for a decisive shift to occur.

China watchers increasingly despair over the nation's future, as Xi Jinping revives uncomfortable memories of the Maoist past. Xi has consolidated Party power and stymied civil society, reversing the trend of gradual liberalization. Ideological control over schools, universities and cadres has been tightened; scores of human rights lawyers imprisoned. The enshrining of "Xi Jinping Thought" in the Party constitution heralds a less progressive, more nationalistic era.

Yet an era is not decided by one man. While China's regressive politics are becoming more authoritarian, generational shifts could yet propel the nation towards a more liberal long-term future. Reason for hope is evident in social trends, from life choices to individual action; in attitudes to rights and politics; and in opinions voiced both online and in private. The tectonic plates of government and society are moving in opposite directions, and pressure is building under the surface.

The generation of young Chinese born after 1980, known as "post-80s" or *balinghou*, are rarely viewed as principled. More often they are stereotyped as coddled, materialistic, selfish, brainwashed and apathetic. Zhang Shihe, a blogger in his 60s, dismisses them as the "stupid genera-

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tion," raised on "Coca-Cola and Western movies." Novelist Yan Lianke has dubbed them "the amnesiac generation," while dissident artist Ai Weiwei accuses them of "lethargy."

But these stereotypes of Chinese millennials are misleading. Take Dahai, a lanky engineering supervisor whose nickname means "Big Sea." Born in 1985, he grew up in a military compound near Beijing, neither coddled nor materialistic, but rather with dreams of playing in a band and rebelling. Nor is he brainwashed or apathetic: with a strong anti-authoritarian streak, in his 20s he routinely reposted government scandals online. One afternoon he told me he was "waiting for Xi's generation to die so we *balinghou* can take over."

People try to put us down

Derogatory labels fail to capture the pressure of being a *balinghou*. They are the first generation born under the one-child policy, each bearing the expectations of four grandparents and two parents—a burden known as "4-2-1." They are also the first generation to grow up in a competitive economy, without the support of a socialist state. Their parents never had the stress of having to own a house and a car before they could get married. Moreover, they enjoy a youth culture and broad range of expression that was unavailable to their parents' generation.

China has changed so quickly since the *balinghou* were born that 10 years can encompass decades of generational change. For me, the real dividing line between the old generations and the new is 1985—the "post-85s," or *bawuhou*. Those born after that year have no memory of the Tiananmen protests and their bloody end, let alone of the Cultural Revolution and its aftermath, which their parents by and large do not tell them about. They never experienced the deprivation that China was still emerging from in the 1980s, nor the bloom of liberal expression in the same decade and how it ended. These lacunae of knowledge rob young Chinese of essential information about their country's past—but they also unshackle them from an instinctive, learned fear of dissent that previous generations internalized.

New modes of online expression have produced a generation more supportive of free speech

Instead, the "post-85s" grew up during the economic boom of the 1990s. They celebrated at school as China joined the World Trade Organization in 2001, and came of age during a period of renewed national confidence after the 2008 Beijing Olympics—a feeling that has only deepened since Xi

Jinping became leader, thanks to China's growing bullishness on the world stage. The "post-85s" are children of an international, internet-connected and richer China, natives of a plugged-in present whose confidence and aspirations are quite unlike their elders'.

This environment has nurtured new ways of looking and thinking. The Western movies they grew up streaming online didn't make them stupid—they made them receptive to the outside world, and better English speakers. My friend Mia, a fashion designer who wants to live abroad, perfected her spoken English watching *Friends*. A climate with new modes of expression online has also produced a generation that is more supportive of free speech, according to surveys of young Chinese. One Party official's daughter I also write about in my book is as passionate a supporter of political reform and free speech as she is of Communist rule.

Book of changes

Attitudes to women's and LGBT rights are often good litmus tests for liberal values in a society. In a 2016 survey by Peking University's sociology department, just 9% of post-90s youth said they would reject a child who was gay, compared with 35% of those born before 1970. In 2016, a gay *balinghou* couple went to court to demand the right to marriage. (They lost the case, but the very fact it was heard is a mark of progress.) And even as censors suspend the social media accounts of feminists, their voices indicate a willingness to speak out despite the risks. In this socially liberal generation, post-95 youth are on average first having sex at 17.7, more than four years ahead of their counterparts born 15 years earlier.

Surveys also indicate that educated urban Chinese are generally quite open to the world. A Pew study in 2016 found that 60% of young Chinese aged 18 to 34 had a favorable view of the US, compared with 35% of over-50s. A joint Harvard and Peking University study published in early 2017 reported less nationalistic sentiment among young Chinese in Beijing than their elders. Moreover, 73% of domestic Chinese college students surveyed in 2015 by the University of California at Merced agreed that "Western political systems are very appropriate for our country." There is much discussion over whether Chinese students abroad—over 330,000 in the US, 170,000 in Australia and 90,000 in the UK—return home with minds more open or closed than before. But by leaving the Chinese education system they are voting with their feet.

Nevertheless, it is important to draw a distinction between the privileged, internationalist youth in big cities and their more conservative counterparts elsewhere. Across much of the country, nationalism is as strong as ever among young Chinese. The more than 400mn Chinese born after 1980 grew up under the Campaign for Patriotic Education, introduced in 1991 as a response to the Tiananmen protests. All school children watch the national flag rise above the playground and, when they're older, take part in compulsory military drills. Will the new values of the city elites translate into a new China—or will the nation's youth choose to follow the Party's mass line?

The spring that never comes

China's urban youth has a valiant tradition of protest, rooted in the New Culture Movement of the early 20th century. "Youth are like early spring," wrote Chen Duxiu in 1915, then dean of Peking University and later co-founder of the Chinese Communist Party, in his essay "Warning for youth," published in *New Youth* magazine. He called for the "fresh, vigorous cells" of young Chinese to "drive out the rotten, corrupted cells" of the sclerotic old guard that were holding China back.

This new youth of a century ago took to their feet in the May 4th protests of 1919, just as their successors did as Red Guards in 1966-7, after the death of Zhou Enlai in 1976, during the Beijing Spring of 1978, and throughout the late 1980s, culminating in the Tiananmen protests of 1989. It is those born after 1985 who appear to have lost the thread of China's legacy of youth protest. There is little expectation of an unsanctioned gathering at Tiananmen Square nowadays, nor appetite for it. The vigorous cells of youth are today found at the fringes of China, in Hong Kong and Taiwan, where the Umbrella and Sunflower movements of 2014 were led by college students. Where is mainland China's early spring?

With no real say in their nation's direction, many young people report feelings of powerlessness

Avenues for expressing dissenting views, or taking an active role in social change, have been stoppered in Xi's China. Without any real say in their nation's direction, many young people feel powerless, which translates into political apathy and lack of action. Meanwhile the tiger of nationalism snarls within other young Chinese, diverting their anger beyond China's shores. Nationalistic youth protests such as anti-Japanese riots in 2005 and 2012 are to some extent the true inheritors of the May 4th legacy. But the anger vented in them can turn inwards on their government, especially if it loses a war or is perceived as weak.

Dahai used to identify as an "angry youth" of the kind who would protest. Then he turned 30, got promoted, got married and got a flat. Now he is the first to admit he has compromised on his youthful verve. Yet his more liberal views remain, as do those of his generation and younger Chinese: shoots of spring that can weather a long winter. If the current government fails in its promise of prosperity with a major economic downturn or a housing bubble crash, then this new middle class comprised of younger generations may yet show some May 4th spirit of their own.

Bring on the fourth era

Since the founding of the People's Republic of China in 1949, there have been three major eras, each lasting roughly 30 years. The Mao era was one of revolution, social destruction and reconstruction. The Deng era, from 1978, was of economic growth and rapid urbanization. The current 30-year period, presently billed as the Xi era but which we could take from 2008, seems set to be one of political control and national strength. Yet the authoritarian politics of China today are also an attempt by Xi's generation to rein in the progressive social and generational shifts, led by post-85 youth, that challenge them. China's fourth era, when it arrives 20 years from now, will be defined by this younger generation.

Today, Xi Jinping is pushing China towards a more illiberal future—but there are deep opposing forces of change at play, however various and occasionally self-contradictory they might appear. Dahai and hundreds of millions like him have absorbed the Party's nationalist message, but they are, at heart, much more liberal and open to the world than their elders. We may have to write off Chinese politics for the next 20 years, but we cannot write off the nation.

The "post-85s" are a crucial generation to understand as we look ahead to the China of 2037—or of 2050, when Xi triumphantly predicts China will have become a "great modern socialist country." He will not be around to witness it. By then there will be a new guard in charge.

The Next 20 Years

Why India Will Never Be China

By Pallavi Aiyar

Drawing a comparison between Asia's two giants is tempting, but differences outnumber similarities. Despite the appeal of China's economic model, there is little chance that Asia's oldest democracy will follow in Beijing's footsteps.

Large-scale corruption, environmental degradation, yawning inequalities, food contamination scandals and historical revisionism in school textbooks: this could be a laundry list of the challenges faced by 21st century China under the rule of its authoritarian Communist Party. Or, it could be an accurate summary of 21st century India celebrating its 70th year of secular, democratic politics. When looked at with India-habituated lenses, China's pathologies, so often ascribed to its one-party rule, become less about the political system than the contradictions and trade-offs that result from populous, poor nations undergoing fundamental transitions.

This is not to argue that China and India are Asian birds of a feather. They might both be large, transitional economies, but they are markedly divergent in temperament and culture, as well as on contemporary parameters of economic development and geostrategic heft. They have an uncomfortable relationship with each other. India, with its urban slums and overwhelmed infrastructure, is China's go-to cautionary tale about what could go wrong were it to abandon its authoritarian, paternalistic mores. India views China with a confused mixture of pride and prejudice. It wants to be both China and not-China: a six-lane-highway filled, man-

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ufacturing powerhouse that is praised for its political openness and liked for its yoga.

As it struggles to spread its wings in the shadow of its northern neighbor's ascent, India is arguably more influenced by Beijing at this moment than ever before in its modern history. China lurks below the surface of the nation's dreams and nightmares. It creeps into imaginings of what India might be and what it should be. It informs debates about values. It shapes considerations of how to act in the world. It is bogeyman and siren. It warns against military complacency. It whispers seductively that to get rich is glorious.

India's rightists, leftists and opportunists are united in their invocation of China. For those on the economic right China proves that single-minded GDP growth is the tide that can lift all boats: make money and the rest will follow. For those on the left, China is evidence that basic health care, literacy and land reforms are a prerequisite for capitalist-style economic reforms. When liberals advocate their message of peace and love towards India's prickly neighbors, they warn it is necessary to make strong bridges or risk having them being taken over by China, the world's infrastructure sugar daddy. Industrialists complaining that India suffers from a surfeit of democracy point to China as a paradise where labor is disciplined, hardworking and knows its place.

Bullet trains and filthy air

Part of the explanation for China's current influence on India rests on the shoulders of Indian prime minister Narendra Modi, who swept to power in 2014 with a reputation—cultivated over a 12-year stint as chief minister of the western state of Gujarat—as a China-style economic reformer. As chief minister, Mr Modi visited the Chinese mainland on four occasions. He returned each time with a bad case of SEZ-envy.

Modi went on to attract investments in large manufacturing and power projects in Gujarat, introducing business-friendly measures aimed at cutting red tape and making land acquisition easier. He borrowed liberally from Chinese initiatives like instituting a "single window" system to fast-track government approvals. Under him, Gujarat enjoyed double-digit economic growth. Since graduating to prime minister, Modi has tried to introduce similar reforms across India. His ideal is an India of bullet trains and disciplined citizens bursting with an officially sanctioned version of national pride.

Will Modi be successful? He has huge challenges to overcome. India is set to beat China in every race to the bottom over the next 20 years, from over-population to air pollution. Current estimates have India, with a landmass less than a third of China's, nosing ahead as the world's most populous country by 2024. India's population is then projected to continue growing for several decades, to about 1.66bn in 2050. China's will peak at a little over 1.4bn in 2030, after which it may begin a slow decline. Although demographic dividend-cheerleaders believe this labor-abundant trend to be in India's favor, India has so far been unable to prove that it can educate and employ its young at anything near the levels needed.

> There are signs that India's middle classes would support a more Chinese approach if it delivered similar results

India is also arguably already more polluted than China. In 2014, a World Health Organization study ranked Delhi's air as the world's filthiest. Neither Beijing nor any other Chinese city even figured in the top 20, but 13 Indian cities did. According to NASA satellite data, PM2.5 levels across India rose by 13% between 2010 and 2015, while China's fell by 17%. If Modi succeeds in bringing further economic development, pollution is likely to get worse.

The unattainable Shanghai dream

The Chinese Communist Party (CCP) has an easier time devising and implementing policies to deal with large, complex challenges than India, where the line between the democratic and the populist is a fine one. Consequently, Beijing tends to deliver on its promises more than democratically elected Indian governments. Political legitimacy in India is derived from process, whereas performance is more important for the CCP. In India, the business of getting elected provides governments with their authority. In other words the means (winning votes) becomes more important than the end (such as the delivery of public goods and economic growth).

There are signs, though, that India's middle classes would support a more Chinese approach if it delivered similar results. In a 2017 survey conducted by the Observer Research Foundation, a Delhi think tank, a majority of respondents said a strong leadership that provided economic goods was more important than a democratically elected one. A Pew Research Center survey backed this up: 55% of Indian respondents supported autocratic rule by a strong leader unfettered by legislatures or courts, 53% supported military rule, and 65% thought technocracy—a government run by unelected experts—to be a good idea.

A public that supports a "strong" leader is likely to re-elect Modi in India's next general elections in 2019. Many voters will be willing him to conjure up Indian Shanghais. But he will not. If wishes were horses, India's beggars might still not ride, but its middle-class and upper-caste urbanites would be galloping along butter-smooth highways imported straight from their China fantasies. But India is not China, something that Mr Modi and other would-be Indian autocrats including the Congress Party's Indira Gandhi have inevitably discovered.

To project forward, it helps first to look back. Independent India's sole brush with the suspension of the democratic process was a 21-month period from 1975 to 1977 when then prime minister Indira Gandhi declared a state of emergency. It was a period when trains ran on time, labor strikes ceased, petty crime declined and beggars were removed from the streets. Many among the upper and middle classes cheered believing it to have been proved that what India needed to function well was a dictator.

Riding high on this tide of boosterism Mrs Gandhi called an election. She found herself booted out of office by the legions of poor for whom the suspension of their vote had taken away their only power. Materially deprived, illiterate and malnourished they might have been, but their vote had stood between them and forcible sterilizations and the demolition of their slum homes. It was the poor, not the middle classes, who really needed democracy, a fact that remains true today.

India's political miracle

As prime minister, Modi has not had the kind of untrammeled reform successes he did in Gujarat. He has had to compromise in dealing with powerful constituencies that have genuine, contesting political power, from state chief ministers to organized labor. He has had to contend with institutional checks like the Supreme Court. Despite his large majority in parliament Modi has been unable to push through some of his most cherished legislation, like the land acquisition bill. He needs to find accommodation with regional coalition partners with different agendas from his. He needs to win Muslim votes and those of the lower castes. He needs farmers as much as industrialists. India's urban, Hindu upper castes do not speak for India, because India never has and never will speak with one voice.

India is simply not suited to authoritarianism. Debate and contestation are existential for it. Historically India has been a civilizational rather than territorial entity, more metaphysical than geographic. It is a nation held together not by language (the constitution lists 22 official languages), religion or geography, but by an idea. Multiplicity is foundational to this idea. It is what has allowed India to persist and flourish as a political unit, despite the once widespread belief in the West that an independent India would inevitably balkanize.

India's crowning political achievement has been the development of institutional mechanisms for negotiating large-scale diversity and accommodating frequent, aggressive disagreements. Arguably, this political achievement is as deserving of awe as China's economic miracle. It might be less shiny and more chaotic, but it is, in its own way, quite spectacular. It is also what will eventually keep India from submission to the China model, even at the cost of slower, more uneven growth. Modern India emerged out of a freedom movement, and freedom is valued, especially by the poor. Voter turnout among the rural poor is markedly higher than among the urban middle classes.

India's crowning political achievement is its institutional mechanisms for managing dissent and diversity

The freedoms many among the poor use their vote to protect—to have children without restriction, or to sleep on footpaths when they have nowhere else to go—may not always be congruent with a rational analysis of what is in India's long-term interests. Change in India will therefore limp, walk and trot rather than gallop and leap in China fashion. But there will be change, and the bulk of the transformations to come will emerge not because of diktats from above, but as a result of organic social shifts from below.

Strength in weakness

Unlike China, India wears its weaknesses on its sleeve. Although this may make it appear fragile, at its core it is resilient, able to withstand major external and internal shock without fears of implosion. The coming collapse of India has not been up for serious discussion in decades.

Ultimately, despite its seductive visions of discipline and infrastructure, the China model will only have limited cachet in India because it does not present robust solutions for managing dissent and diversity. Beijing's propensity to ignore or criminalize dissenting opinions leaves China with a question mark over its political future—one that India for all its surface anarchy no longer has.

Pax Americana-Sinica

By Richard McGregor

China's rise is making it increasingly costly for the US to uphold Pax Americana *in Asia. China wants to replace it, but scant regional enthusiasm means* Pax Sinica *is some way off. For the next two decades, an uneasy truce should hold in Asia.*

Donald Trump, as uncomfortable as it may be for some to admit, has a knack of raising the kinds of difficult questions that rivals do not dare. Chief among them, during his presidential campaign, was: why are US troops still based in Japan and South Korea, protecting two advanced, wealthy countries more than six decades after the wars fought on their territories ended? Why, in short, are Asians not running Asia?

Silly, naïve, irresponsible Donald, the experts mocked. If the US precipitously drew down its military forces in East Asia, then Japan and South Korea would go nuclear, with ominous consequences. Unlike Europe, Asia has never managed to develop a collective political and security mechanism to prevent its disputes from spiraling out of control. And if the US withdrew its commitment to Asia, the experts warned, the region would simply fall to the new regional hegemon—China.

The establishment critique has some merit: Xi Jinping himself has backed an "Asia for Asians," pressing for a new regional order that would inevitably be led by China. Any weakening of the US commitment to Asia, then, plays

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into China's hands. But, in truth, the 70-plus years of *Pax Americana* are unlikely to give way to *Pax Sinica* any time soon, not least because most countries in the region do not want to be ruled from Beijing. China may eventually prove too strong to resist, but it is more likely to exacerbate existing tensions in the short term than bring stability. Moreover, there is still a chance that American power in the region will survive Donald Trump.

***Pax Americana*: overlooked, under threat**

The succession of economic miracles in East Asia—starting in Japan in the 1950s, through to Taiwan and South Korea in the 1960s, and then China in the 1980s—was built on many platforms: clever bureaucrats, ambitious entrepreneurs, an often low-cost and diligent workforce, managed currencies, and protectionism in various guises. But largely overlooked in the stories of happy, homegrown success is the United States.

The US market, the largest in the world, was deliberately opened to waves of exports from Asia, with the aim of building strong allies in Japan, South Korea and Taiwan, and in Southeast Asia. In the case of China, the US hoped to develop if not an ally, then at least a good global citizen aligned with Western interests.

Even more important was the role of the US military, stationed throughout the region, most numerously in bases in Japan and South Korea. The forward deployment of American troops kept, by and large, the peace in East Asia after the Korean War (Vietnam aside), allowing each country in its own time to concentrate on economic development rather than regional rivalries.

> Is it inevitable that some kind of *Pax Sinica* will displace the US in the security sphere?

The factors that drove high-speed growth in Asia, such as cheap workers and a wide-open US market, are increasingly only viewed through a rearview mirror these days. Asian economies, like mature markets in the West before them, are adjusting to a new world of slower growth and reliance on consumption at home. But what if *Pax Americana* is past its use-by date as well? Just as China has taken over from the US as Asia's predominant economy, is it inevitable that some kind of *Pax Sinica* will displace Washington in the security sphere?

Based on a number of factors, it is reasonable to assume that China will surpass the US as the world's largest economy in about a decade. Sure, China faces immense challenges to maintain its upward trajectory—but it also enjoys a competent, if illiberal, leadership; an ambitious, educated population; increasing technological and managerial sophistication; and a formidable back stop of cash reserves to handle a financial crisis. From this economic power flows geopolitical clout. Beijing has made it clear that it expects over time to become Asia's dominant power, and that other countries, including the US, will have to trim their sails accordingly.

Tangled rivalries

This brings us back to the original question: what is wrong with Asians running Asia, free of the US? If all Asia needs is a large country to balance and stabilize the region, then why can't China simply step into the role that the US has filled in the past? After all, so long as China remains on a steady economic trajectory, it will tower over its neighbors. But there are good reasons why a genuine *Pax Sinica* will struggle to emerge.

The first reason is that, unlike America, China is a party to the region's multitudes of disputes, not an outside mediator. Until recently, the region's economic success overshadowed its greatest post-war political failures: the divided Korean peninsula, China's claim over Taiwan, and Sino-Japanese tensions. But all these longstanding conflicts, kept at a simmer under *Pax Americana*, are re-emerging with a vengeance. Then there are the other tensions crisscrossing the region—between Japan and South Korea; Vietnam and China; Malaysia and Thailand; China, the Philippines and India; China and rival claimants in the South China Sea; and so forth. Unlike the US, China cannot be the arbiter of such disputes, as it is in the middle of most of them.

The multitude of quarrels, real and potential, give rise to the second fallacy which underpins much of the debate about Asia's future security architecture: that if only the US and China could get along, then the rest of the region could sort itself out.

It is true that the US and China now dominate different realms in the region. The headquarters of Continental Asia—China's Eurasian hinterland—are in Beijing. The capital of maritime Asia remains in Washington, even if China is nipping at America's heels on the high seas. It is also true that the US-China relationship is immensely important, both in terms of bilateral trade and in terms of global governance, on everything from climate change to financial stability and regional security. The two countries' predominance has prompted numerous strategists to place regional problems into a "G2" framework, as if they simply require a concord between the US and China to be sorted out.

But just because the US and China tower above other Asian nations does not mean they can carve up the region between them. Taiwan, to take one example, is not America's to give away. As a thriving democracy, it is hard to see how there could be any lasting political settlement with China unless the self-governing island's citizens had a say. Another example is the Korean peninsula. China might be persuaded by the US to accept a deal unifying North and South Korea if Washington agreed to remove its troops from the peninsula. In that respect, the US and China would be pivotal to a diplomatic settlement. But they could not make such a deal without first consulting Japan and Russia.

Multilateralism, with Chinese characteristics

The difficulties with an "Asia for Asians" approach to security can generally be traced back to the region's two superpowers, China and Japan. In the postwar period, when Japan was ascendant, China had no interest in joining a Japan-led regional order. Now that their positions have been reversed, in all likelihood for good, Japan is hostile to a Sinocentric regionalism.

What, then, could serve as anchor institutions to preserve the "long peace" the region has enjoyed since the end of the war, or, to be more accurate, since the late 1980s? Two regional forums stand out. The first is the Association of Southeast Asian Nations (ASEAN), which brings together 10 nations. Founded in 1967 at the height of the Vietnam War with five core countries—Indonesia, Malaysia, Singapore, Thailand and the Philippines—ASEAN has emerged over time as the quiet achiever of regional diplomacy. Yet its unity has recently been compromised by China, which has effectively managed to peel off Cambodia and Laos, and is pressuring Thailand, Myanmar and the Philippines.

The other forum touted as a possible foundational institution is the East Asia Summit (EAS). When the idea of an EAS got off the ground in 2005, more than a decade after being first envisioned by Malaysian prime minister Mahathir Mohammed, it was attached to ASEAN's annual get-togethers. At first, three countries—China, Japan and South Korea—were added. It soon became "ASEAN plus six," with the addition of India, Australia and New Zealand. Later, Russia and the US joined. For the moment, the EAS—now "ASEAN plus eight"—remains the most viable possible start to solidify and institutionalize regional integration. But the process nonetheless remains at the mercy of China.

As long as China's power, wealth and stature are growing, Beijing has little incentive to negotiate over the establishment of a new regional organization. The more powerful Beijing becomes, the better its position to dictate terms. And although it is increasingly willing to use multilateral forums to its advantage, it still insists on solving the thorniest problems bilaterally, which gives it the upper hand as the larger counter-party. It has steadfastly resisted allowing any of its territorial disputes with its regional neighbors—including Japan, Indonesia, Vietnam, Malaysia, Brunei and the Philippines—to be mediated multilaterally.

No clean solution

China's message to Asia is that its presence in the region is a geopolitical fact. It does not want to consecrate a permanent role for the US in Asia, as much as other countries in the region might want Washington to remain an Asian power. But Beijing's failure to reassure its neighbors, exacerbated by the haughty, hostile rhetoric it directs towards its critics, would make for a sour regional compact. Asia is not yet ready to embrace Chinese leadership, even if China's growing heft means that some kind of *Pax Sinica* might be inevitable in the longer term.

Over the next 20 years, the balance of power is set to shift in Beijing's favor—but China will still struggle to dislodge the US from Asia

For the US, sustaining *Pax Americana* for a few more decades is a geopolitical choice, and one that Beijing intends to make increasingly expensive. Trump offered some reassuring words during his trip to Asia in November 2017, but his administration has no coherent regional policy. Asian countries looking to hedge against Chinese dominance must hope that a new, reinvigorated America emerges after Trump's presidency—one that is both comfortable with, and competent in, managing tensions with China. So far, that president, and his or her administration, is not in sight.

Over the next 20 years, the balance of power is set to shift in Beijing's favor—but China will still struggle to dislodge the US from Asia. America's allies will do all they can to keep it engaged. It also has too much invested in the region simply to pull out. Short of the US retreating from Asia with its superpower tail between its legs, Sino-US tensions will persist, with increasing risk of some kind of military conflict. But the most likely scenario is that the US and China remain tangled up with each other, and with the other countries in the region, in an uneasy *Pax Americana-Sinica*.

The Next 20 Years

Handicapping The Global Power Shift

By Melanie Hart

China still oscillates between a desire to promote consensus and collaboration on the international stage, and powerful hegemonic and self-interested urges. More concerted international efforts will be needed to make sure the former prevails.

At the 19th Party Congress, Xi Jinping set out his vision for a "new era" in which the Chinese Communist Party strengthens its grip over the nation's economy, society and military. China is a "socialist consultative democracy," he said, but one in which the Party controls every lever of power and ultimately makes all decisions. Yet his vision for China's foreign policy sounded quite different. "China stands for democracy in international relations," he told the Congress, and "will never seek hegemony or engage in expansion." In other words, the Party will be a hegemon at home, but a democratic, consensus-building partner abroad.

Xi's domestic and international visions for China are rooted in conflicting values. Experience shows they are not always reconcilable: Chinese leaders are generally willing to play by the international rules only so long as they benefit China. On issues ranging from maritime territorial disputes to economic coercion to exerting political influence over foreign universities and scholars, Beijing has proven time after time that it is more than willing to exploit its global reach at the expense of other nations.

Countries around the world are keen to welcome a friendly, consultative China, but are less sure how to respond when it plays bully. As global

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power shifts in China's favor in the coming decades, they will have to learn both how to work with China and how to push back. The United States has a particularly important role to play in prodding China to become a responsible global leader, while simultaneously holding it to account. Where China fails to meet that standard, the US will need to become much more adept at creating roadblocks to constrain China's influence. That effort is only just beginning.

Reconfiguring the global order

Today, most Chinese international relations experts believe the West is in decline, the developing world is rising, and powerful centrifugal forces—globalization, technology diffusion, the digital revolution—are bringing about a more egalitarian distribution of power. Where they disagree is on what that means for the international order. Some believe these modern trends have already brought about a new configuration. Others believe change is occurring at the margins but the prevailing system is still a unipolar one.

At the Party Congress, President Xi suggested the system is still unipolar but rapidly shifting toward a new multipolar order. This has two important implications for Chinese foreign policy. First, Beijing still views America as the dominant global power, but believes it will increasingly be able to constrain Washington and shape global outcomes. Second, since China has not yet amassed enough power to counterbalance the US on its own, Beijing's best strategy is to work collaboratively with other nations. This will be the case for some years, but could change once China is strong enough to go it alone.

Beijing believes the current US-led unipolar order is illegitimate because Washington leads in a hegemonic fashion, leveraging its economic influence and military strength to shape global outcomes that benefit the US at the expense of China. Chinese leaders claim that, although China is becoming a major power, unlike the US it has no desire to be a global hegemon. Chinese scholars often describe their nation's rise as a force for equality, counterbalancing the US to bring about a more consultative and democratic international system in which a much wider array of nations—particularly developing nations—will shape international institutions and outcomes. Because they view China as freeing other nations from American domination, they generally assume the world will welcome Chinese leadership.

In reality, Beijing's foreign policy actions are often neither consultative nor democratic. On truly global issues, such as climate change, its actions generally do match its multilateralist rhetoric. But on issues closer to home—particularly regional security issues—Beijing prefers to use a combination of bribes and coercion to compel smaller nations to support its interests. This pattern raises concern that Beijing's true aim is to behave in a democratic, consensus-building manner only when other nations' interests are well-aligned with its own, or when it does not have sufficient muscle to resort to coercion. If that is the case, an ever-more powerful China may embrace hegemony not only at home but increasingly abroad as well.

Exploiting Trumpageddon

There is a heady sense in Beijing today that the US-China power balance is at an inflection point. America-watchers in Beijing view President Trump as inward-focused and isolationist. They believe his moves to exit the Trans-Pacific Partnership, step back from global climate leadership, and reject multilateralism across the board weaken US influence and give China new opportunities to fill the gap.

From a Chinese perspective, the US has constrained China's operational space for far too long. There are plenty of examples of Washington's apparent attempts to stifle China's global influence: its resistance to reforms to increase China's voting rights at the International Monetary Fund (IMF), its reaction to Chinese island-building in the South China Sea, its suspicion of China's Belt and Road Initiative, and its initial knee-jerk response to the Asia Infrastructure Investment Bank (AIIB). In China's view, the US is resisting a shift in the international system that is both necessary and legitimate. Beijing is already using its growing economic and military leverage to push back against or work around what it perceives as illegitimate American constraints, and that is likely to accelerate in future.

> Can China's claim that it does not want to be a global hegemon be taken at face value?

It is natural that China should exert more influence in the international system as its economy grows and it gains new commercial, diplomatic and military reach. International norms and institutions are not intended to be static—they should evolve along with the nations that operate within them. The problem is that, from a US perspective, China violates international rules for its own benefit. In turn, this undermines the US and prevailing international institutions. Washington could overlook that behavior when China was at the early stages of its development, but today China has the economic and military heft to cause serious damage. Whereas Beijing thinks the US has been constraining China and needs to back off, there is a growing consensus on the other side that America has been much too lax.

Washington is particularly concerned about a growing lack of reciprocity in US-China relations. Chinese leaders are encouraging—and in many cases, directly funding—Chinese enterprises and state-run media conglomerates to expand their presence abroad, while simultaneously restricting foreign access to those same sectors in China. From an American perspective, if China insists on closing its doors to US investors, the only alternative for enforcing reciprocity is to close its own. That is a difficult step to take for a liberal democracy that values open markets, but it is one that looks increasingly likely.

As both sides become more assertive in defense of their national interests, US-China relations are set to grow increasingly turbulent

In November 2017, members of Congress in both the House and the Senate introduced legislation for expanding oversight over inbound Chinese direct investments. The US Department of Justice is forcing Russia's state-run news network to register its US media platform as a foreign agent—which brings additional scrutiny—and could target Chinese media outlets with similar action. Although the Trump administration has not yet taken significant action against China, a wide array of US interest groups are demanding a much tougher approach on trade, investment and commerce. Those demands are likely to trigger a wave of enforcement actions in the near future.

Who will stand up to China?

As both sides gear up to take a more assertive approach to defend their national interests, we are likely to see a period of increasing turbulence in US-China relations. The as yet unanswered questions are how long that period will last, and to what degree the US will be standing alone versus acting in concert with other nations.

China's engagement with the world is appreciated when it is reciprocal and inclusive. When China joined the World Trade Organization, the US and other nations welcomed Chinese goods into their domestic markets in exchange for the promise of greater market access in China. On climate change, the global community welcomed China's leadership role because Beijing was taking responsibility for its own emissions. Belt-and-Road nations are generally positive about that initiative because they see increasing Chinese engagement as an economic growth opportunity for themselves as well.

In contrast, when China engages other nations with a hegemonic, us-versus-them approach—dictating the terms and fueling its rise at the expense of others—that is likely to trigger a reaction. So far, other nations have been most successful at pushing back against China when they do so in a united front. But even the success stories have only produced change at the margins rather than a fundamental shift in China's strategy. In 2015, for example, Chinese leaders scrapped and then reworked their nation's draft banking cyber-security regulations in response to a coordinated international challenge. And, in 2016, China revised its draft Foreign NGO Management Law in response to broad international pressure. Yet, in both cases, Beijing made adjustments without changing its respectively protectionist and authoritarian goals.

Asia begins to get its act together

It is unfortunate that the Trump administration is abandoning multilateralism at a time when US leadership is required to rally other nations. A common approach is needed against Chinese moves that undermine broader regional and global interests. In the absence of American leadership, other nations are beginning to band together in interesting ways to address these common challenges. For example, India and Japan are conducting joint naval exercises to demonstrate their commitment to freedom of navigation in the Asia Pacific. On the economic front, the 11 remaining nations in the Trans-Pacific Partnership are attempting to negotiate a regional trade deal without US or Chinese participation.

When Chinese leaders aim to coerce other nations, they generally rely on China's economic clout, granting or denying market access at home or investment deals abroad. One way to reduce Beijing's leverage is to provide other nations with alternative options. Already, some governments that initially welcomed the Belt and Road Initiative with open arms are having second thoughts: many promised Chinese projects fail to materialize, and Chinese loans often come with high interest rates. The problem has been a lack of alternatives, but that is beginning to change. India and Japan are collaborating to develop sustainable infrastructure projects along a new "Asia-Africa Growth Corridor." And when President Trump visited Tokyo in November 2017, the US agreed to develop joint infrastructure projects with Japan in the Indo-Pacific.

Private enterprises are trying to get into the game as well, particularly on clean energy and climate finance. Five to 10 years from now, there are likely to be many new players on the scene and a wider array of options for both inbound investment and overseas market development. If so, that will make it much harder for Beijing to conduct foreign policy via economic coercion.

Times they may be a-changin'

It is too early to conclude that the power balance in Asia is tipping decisively in China's favor. In the US, Trump's election in 2016 suggested that the American people are ready for tough action on foreign trade, particularly with regards to China. Trump's approach will not provide the results voters are seeking, and that will soon become evident. But, by 2020, there is a good chance the US will shift from isolationism to a renewed interest in working with like-minded nations to craft new global and regional trade regimes. If Beijing maintains its coercive policy trajectory, that process will likely exclude China. By 2030, China could face an entirely new regional and global architecture that provides much less room for pursuing hegemonic objectives abroad.

Domestically, Xi Jinping has made clear that China's national interests are one and the same as the Chinese Communist Party's interests: there is no room for alternative voices. Internationally, he will face a very different playing field. It is not yet clear how Beijing will handle that discrepancy, but the international community can and should act to hold Beijing accountable in ways that the Chinese public cannot.

The Top 20 Reading List

Understanding China, In 20 Books (And One Movie)

An annotated reading and viewing list for those who just can't get enough of China.

Readers frequently ask us for recommendations of a book or two that can help them get up to speed on China. The question is basically impossible to answer. Imagine the difficulty of recommending a book or two that would explain the United States, and then multiply by five—to account for China's more than 2,000 years of recorded history, compared with America's 400.

China is too complicated to grasp in a couple of volumes, but 20 can just about do it, especially if one confines oneself mainly to the period since 1949, when the Communist Party took power, with a few dips into earlier history for context. We have culled the archives of *CEQ* book reviews and tapped the expertise of our erudite staff to offer an idiosyncratic selection of works that can help make sense of this intricate country.

History and politics

A good way to approach the psychology of China's ruling elite is to understand the nation's two primal traumas. Both occurred in the mid-19th century, and the project of Chinese leaders ever since has been to erase the legacy of those disasters and restore the nation to its former greatness.

The first is the Opium Wars of 1839-42 and 1856-60, in which the European powers crushed the Qing Dynasty armies, forced China to open to trade, created extraterritorial zones where foreigners were immune to Chinese law, and made clear the vast superiority of Western technology. The second, closely related, was the massive Taiping rebellion (1850-64), in which a messianic leader claiming to be the younger son of Jesus Christ raised an army and occupied several provinces. He fought a long civil war with the Qing state in which tens of millions are thought to have died, and which only ended after the Europeans who had just finished looting Beijing at the end of the second Opium War decided to team up with the Qing to suppress the rebels.

This story is well told in Stephen Platt's ***Autumn in the Heavenly Kingdom: China, the West and the Epic Story of the Taiping Civil War*** (Knopf, 2012). One of the best recent books on Chinese history, it illustrates the interplay between China's old history of revolts and the new forces of globalization. For a vivid account of the backdrop to the Opium Wars, read Amitav Ghosh's historical novel ***River of Smoke*** (Farrar Straus & Giroux, 2011). The second book of a trilogy exploring the opium trade between British India and China, it blends a rich novelistic story with penetrating analysis of the economy of mid-19th century maritime Asia.

> Mao reunified China, but his successor Deng Xiaoping set the nation on the course to regaining the wealth and power it had lost in the mid-19th century

Skipping ahead a century, the best account of the first three decades of Communist China is Andrew Walder's superbly researched and readable ***China Under Mao: A Revolution Derailed*** (Harvard, 2015). His verdict is not a kind one: "At the time of his death Mao had accomplished very little of what he hoped to achieve after the mid-1950s. His two major accomplishments—the establishment of a unified Chinese state and the installation of a socialist economy—were still basically intact. But both were severely damaged."

Mao may have reunified China, but his successor Deng Xiaoping was the one who set the nation firmly on the course long dreamt of by the elite: enabling China to regain the wealth and power it had lost in the mid-19th century. He is the subject of Ezra Vogel's lengthy biography ***Deng Xiaoping and the Transformation of China*** (Harvard, 2011), which contains a wealth of detail culled from Party documents and interviews with retired officials, and is particularly good at explaining how Deng managed to claw his way back into power after being exiled to a rural tractor repair shop during the Cultural Revolution. To understand his path-breaking reforms of the 1980s, though, a better read is Julian Gewirtz's ***Unlikely Partners: Chinese Reformers, Western Economists and the Making of Modern China*** (Harvard, 2017), which offers a good narrative of how Chinese officials tapped into foreign expertise to turn their economy around.

A useful companion to the Deng literature is Jay Taylor's ***The Generalissimo's Son: Chiang Ching-Kuo and the Revolutions in China and Taiwan*** (Harvard, 2000). This is the biography of Chiang Ching-kuo, who was born six years after Deng and studied with him in the mid-1920s in Moscow. But as the son of Nationalist leader Chiang Kai-shek he lay on the other side of the political divide and wound up in Taiwan, first as his father's security chief and later as the island's dictator. In the 1980s, while Deng was reforming the mainland economy, Ching-kuo was steering Taiwan toward democracy. The choices made by these leaders still loom over one of East Asia's most intractable political problems, the mainland-Taiwan relationship.

For an understanding of how the Communist Party works today, two works are indispensable. The first is ***The Party: The Secret World of China's Communist Rulers*** (HarperCollins, 2010) by Richard McGregor, former Beijing bureau chief for the *Financial Times*. In lively prose, McGregor documents how—despite the post-Mao liberalization—the Chinese Communist Party's tentacles reach into every nook of society. If the US had a personnel department like the CCP's, he writes, it would appoint "the entire US cabinet, state governors and their deputies, the mayors of major cities, the heads of all federal regulatory agencies, the chief executives of GE, Exxon-Mobil, Wal-Mart and fifty [other] US companies, the justices of the Supreme Court, the editors of the *New York Times*, the *Wall Street Journal* and the *Washington Post*, the bosses of the TV networks and cable stations, the presidents of Yale and Harvard, and the heads of think-tanks like the Brookings Institution and the Heritage Foundation."

The second is Bruce Dickson's ***The Dictator's Dilemma: The Chinese Communist Party's Strategy For Survival*** (Oxford, 2016). Using two extensive opinion surveys, he convincingly demonstrates that the CCP's legitimacy is robust and broad-based, and that its power stems from much more than simply fast economic growth and repression. This is probably the most realistic current appraisal of the Party's strengths and weaknesses.

Economics and business

As noted above, a good starting point for understanding China's economic reform era is Gewirtz's *Unlikely Partners*. Another essential resource is Xu Chenggang's classic article **"The Fundamental Institutions of China's Reforms and Development"** (*Journal of Economic Literature*, 49(4): 1076-1151). Xu argues that China's reforms succeeded because of the country's "regionally decentralized authoritarian" political system, which created incentives for local officials to promote market-oriented growth, and enabled experimentation with new ideas. This may be the best account of how China's economy actually works.

Oddly, one book that is quite thought-provoking about the challenges China faces today is not about China at all: ***From Miracle to Maturity: The Growth of the Korean Economy*** (Harvard University Asia Center, 2012). The three eminent scholarly authors—Barry Eichengreen, Dwight Perkins and Kwanho Shin—combine economic history, development economics and deep regional knowledge to paint a lucid picture of breakneck "catch-up growth" driven by massive investment, technology acquisition and export manufacturing. They describe South Korea, but much of the description applies equally to China, which has pursued a very similar growth model. Korea was eventually jolted out of this path by the 1997 Asian Financial Crisis, which forced it to accept slower but higher-quality growth. The question for China—whose closed system is built to prevent the kind of crisis Korea endured—is whether it can find another way to realize high-quality growth.

Continuing on the theme of understanding China through the lens of other countries, Chris Miller's ***The Struggle to Save the Soviet Economy: Mikhail Gorbachev and the Collapse of the USSR*** (University of North Carolina, 2016) reminds one that, more than two decades after its demise, the ghost of the Soviet Union continues to haunt the leaders of the CCP. Much of the Party's strategy since 1991 revolves around the belief that the USSR collapsed because it was too permissive of political openness. The lesson, for Chinese leaders, was that one must choose between stability and economic growth on the one hand, or political liberalization and chaos on the other. They may have learned the wrong lesson. Miller persuasively argues that economic mismanagement led to political collapse. And the main culprit for economic problem was not the liberalizing Gorbachev, but vested interests (the military, collective farms and factories, bureaucrats) who opposed him at every turn. Again there is a question for China in the coming years: will its interest groups stifle economic reform until it is too late?

The ghost of the Soviet Union continues to haunt China's communist leaders

China's financial system is a topic of perennial concern; an insightful if dyspeptic introduction to its pathologies is ***Red Capitalism: The Fragile Financial Foundation of China's Extraordinary Rise*** (Wiley, 2011) by Carl Walter and Fraser Howie. Walter was a long-time banker in Beijing and Howie for many years wrote *CEQ*'s Chao Gupiao column; they know where all the bodies are buried. And for a hard-nosed view of China's business environment, see Tim Clissold's ***Mr China*** (Harper Business, 2006), which tells the sorry tale of an ambitious American who came to China in the 1990s hoping to create an auto-parts empire and succeeded only in frittering away US$400mn of his investors' money. The story is a bit dated, since it reflects an earlier, poorer and more lawless China. But its insights into the pitfalls that await foreign businesspeople who come in pursuit of a billion customers remain relevant.

International relations

An increasingly important topic is how a richer, more self-confident China will interact with the rest of the world, and especially with its main economic partner and strategic rival, the United States. To understand the reactions China's rise provokes in the US and Europe, one only needs to pick up today's newspaper. Grasping the Chinese point of view is harder.

An accessible introduction is ***Ancient Chinese Thought, Modern Chinese Power*** (Princeton, 2011) by Yan Xuetong, a political theorist at Tsinghua University. Yan argues that the aims of Chinese foreign policy should be to reduce the power gap with the US, and to promote a model of "humane authority" or moral leadership in international affairs that is superior to American hegemony. Westerners will find much to disagree with, and residents of smaller Asian countries may reasonably wonder just how humane Chinese authority is likely to be. But Yan is a good window into the thinking of China's elite, and so worth paying attention to.

A creative approach to clarifying the conversation between Chinese and Western values is taken by Nina Hachigian in her edited volume ***Debating China: The US-China Relationship in Ten Conversations*** (Oxford, 2014). Each chapter pairs an American and a Chinese scholar who trade short letters on questions including economic relations, human rights, climate and energy, and regional security. A few chapters are infuriating dialogues of the deaf, but for the most part the volume offers valuable insights into Chinese points of view, and highlights how intractable the differences of opinion are likely to remain.

Society

History, politics, economics and international relations can all be usefully reduced to generalizations and grand narratives; the subtle texture of society resists all that. Most honest books describing Chinese life conclude that the country is a mass of baffling contradictions. So is every country, probably, but China's contradictions sit atop more layers than most, simply because of the civilization's age.

An entertaining but time-consuming way to begin unpicking the Chinese social puzzle is with what many consider to be China's greatest novel, ***Jin Ping Mei***, variously translated as *Chin P'ing Mei* (transl. Bernard Miall and Franz Kuhn, Putnam, 1940), *The Golden Lotus* (transl. Clement Egerton and Shu Qingchun, reprint by Heian Intl. Publishing, 1979) and *The Plum in the Golden Vase* (transl. David Tod Roy, Princeton, 2015). Written by an unknown author, it is a delicious social satire that paints a vibrant picture of all corners of Chinese society, with particular emphasis on sexual mores (Chinese censors have long deemed it pornographic) and the relationship between businesspeople and government. Although set in the 12th century and written in the 16th, much of what it describes remains recognizable today. The only problem is its length: the definitive Roy translation weighs in at five volumes, 14 pounds and 3,500 pages. The earlier Miall/Kuhn translation, based on a German abridgement, is sprightly and more manageable at 863 pages, but unfortunately out of print. The best approach is probably to dip in for taste from time to time.

Red Dust conveys China in all its geographic vastness and cultural variety—showing how much, and how little, the country has changed since the early 1980s

A much shorter and more recent book is Ma Jian's memoir ***Red Dust: A Path Through China*** (Pantheon, 2001), set in the 1980s, the harsh but hopeful early years of the reform era. "China feels like an old tin of beans that having lain in the dark for forty years, is beginning to burst at the seams," writes Ma, a novelist, poet, photographer, painter, dissident and free spirit. When art no longer offers an escape from politics, he flees Beijing for the farthest corners of the Chinese empire—wandering, meditating, writing, painting, drinking and dancing. A travelogue brimming with historical anecdotes, *Red Dust* conveys China in all its geographic vastness and cultural variety. It shows just how much, and how little, the country has changed since the early 1980s.

Three books by foreign journalists are worthy of note. Leslie Chang's ***Factory Girls: From Village to City in a Changing China*** (Spiegel & Grau, 2009) is a beautifully written and sensitive description of the lives of young women who leave the villages of their youth for the sweatshops of coastal China—and who, despite the brutality of their new lives, find the prospect of returning to their old ones even worse. There is no better way to understand the 250mn or so migrant workers who have built China's industrial machine.

Chang's husband, Peter Hessler, has written three books on China. The richest and most recent, ***Country Driving: A Chinese Road Trip*** (Harper, 2010) is built around a series of car journeys, and the use of car owners as symbols of a society in transition: inexperienced, careening this way and that, pushing ahead and bending rules. Along the way he creates masterful portraits of entrepreneurs, migrants and other strivers in China's booming, but chaotic and cruel new economy.

John Pomfret's ***Chinese Lessons: Five Classmates and the Story of the New China*** (Henry Holt, 2006) is unusual among journalistic books in presenting personal experiences over decades, rather than just a snapshot of a particular time. Pomfret was an exchange student at Nanjing University in 1981, the first year that such exchanges were permitted. He shared a dorm room with seven Chinese students. Decades later, as a correspondent in Beijing, he tracked down several of his classmates and unearthed the stories of how they navigated the dramatic changes in China's economy and politics from the Deng era of the early 1980s to the Hu Jintao period of the early 2000s. Page for page it is probably the best account of China's transformations during those two crucial decades.

Finally, the self-understanding of most societies in the 21st century is probably most fully expressed in film and TV, so we conclude our recommendations with an exhortation to go see ***Wolf Warrior 2***, an action flick that immediately upon its release in mid-2017 became the highest-grossing film in Chinese history, earning a box office of half a billion dollars in 12 days. Most English-language reviewers dismissed it as a cookie-cutter Rambo knockoff. But to many Chinese viewers, it is much more: a long checklist repudiating every sick-man-of-Asia slight that China has suffered since the Opium Wars. The message: those days are over; China is powerful; get used to it.

The director, Wu Jing, is a former martial arts champion who mortgaged his house to finance the film. The movie improves on the typical Chinese cinematic mish-mash by strictly, and successfully, following Hollywood formulas. But mostly, its swashbuckling hero, People's Liberation Army special-ops solider Leng Feng, demolishes one embarrassing stereotype after another: Chinese are unathletic, Chinese are uncool, Chinese military technology is second-rate, Chinese get no respect, and so on. It is probably too much to say that, with *Wolf Warrior 2*, China has finally expunged its century of humiliation. But it may signal the beginning of the end of one of the world's most enduring inferiority complexes.

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