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In the Balance

China's unprecedented growth and implications for the Asia–Pacific

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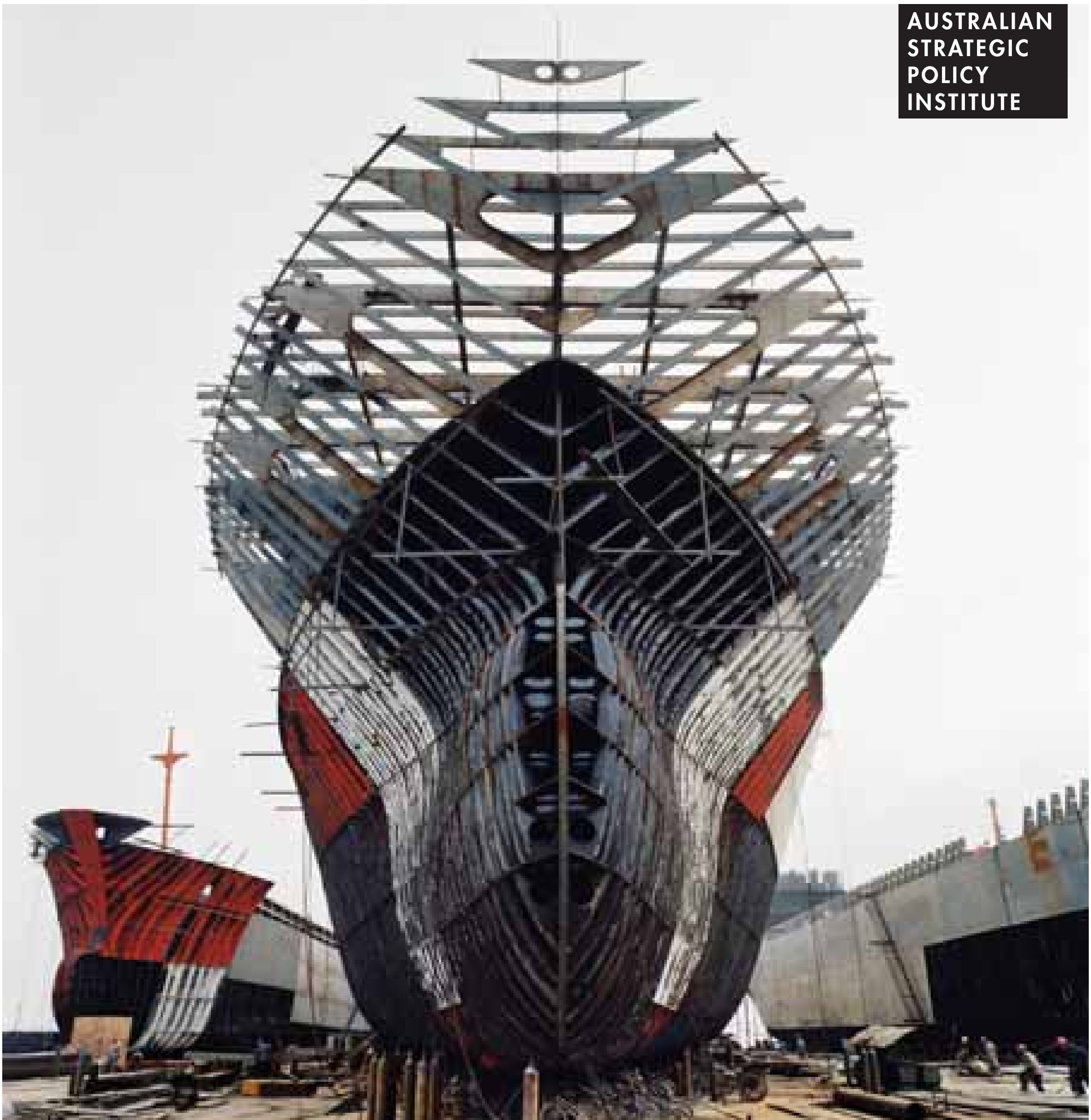

February 2006

David D Hale

David Hale is a Chicago-based economist whose clients include investment management firms, major hedge funds, and multinational companies in North America, Europe, Asia, Australia, and South Africa. He is the founding chairman of Hale Advisors and China Online, which provides daily business news on China. He formerly worked as chief economist for Kemper Financial Services from 1977 to 1995 and Zurich Financial Services which he joined as chief economist when it purchased Kemper in 1995. He advised the group's fund management and insurance operations on the economic outlook and a wide range of public policy issues until 2002, when he founded Hale Advisors. Mr Hale holds a B.Sc. degree in international economic affairs from the Georgetown University School of Foreign Service and a M.Sc. degree in economics from the London School of Economics. Mr Hale is married to Lyric Hughes Hale, publisher of China Online. They live in Chicago with their five children, and are currently writing a book on the Chinese economy.

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Cover image: Shipyard #11, Qili Port, Zhejiang Province, 2005. Photograph by Edward Burtynsky. Image Courtesy: Charles Cowles Gallery, New York—Robert Koch Gallery, San Francisco—Nicholas Metivier, Toronto

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Director's introduction

Few issues are more important to Australia's long-term strategic position in the Asia–Pacific than the health of China's economy and the nature of Beijing's foreign and defence policies. In this ASPI *Strategy* we asked David Hale to provide us with his assessment of China's economic prospects and the impact this will have on the Asia–Pacific region.

Chicago-based economist David Hale will be well-known to Australians as a frequent commentator in our media on Chinese and American economic issues. He is a regular visitor to Australia and an advisor to the Commonwealth Bank. David is a leading authority on the Chinese economy, an expertise he has built on many years of close study and contact with the country.

It is easy to be awed by the pace and scale of Chinese economic growth. David provides some startling data to illustrate how rapidly China is coming to dominate not only the Asia–Pacific economies, but also to be a fundamental driving factor in Europe and North America. A striking feature of China's growth is the degree to which it is built on interconnected trade, financial and commercial links with the rest of the world. As David argues: 'China could soon be the world's leading exporter, she has a great strategic interest in promoting an open multilateral trading system rather than a world characterised by regional trade agreements.'

While David is generally optimistic about China's prospects his paper assesses some of the serious impediments in the way of continuing high growth. These include a massive unemployment problem—over 60 million Chinese have lost their jobs from the old state-owned enterprises in the last decade; income and regional inequalities; an ageing population and shrinking workforce; an inadequate pension system; and environmental damage arising from industrialisation. Most critically of all, David argues that: 'The great challenge now

Photo opposite: Shipyard #15, Qili Port, Zhejiang Province, 2005. Photography by Edward Burtynsky. Image Courtesy: Charles Cowles Gallery, New York—Robert Koch Gallery, San Francisco—Nicholas Metivier, Toronto confronting China is to complete the transition to a transparent market economy with a democratic form of government.'

What are the likely foreign and strategic policy implications? David points out that China is increasingly active on the global diplomatic stage, pursuing resources in places as far afield as Zimbabwe, the Sudan and Venezuela. China has a growing strategic interest in Central Asia and the Middle East and this is creating a new dimension in Beijing's relationship with the United States and other major powers. China's uncomfortable relationship with Japan and the potential flash-points of North Korea and Taiwan remain serious concerns. China will remain overwhelmingly focused on economic growth and therefore look to develop stable trade and investment relations. Hale is quick to point out: 'The experience of 1914 is a warning that one cannot depend upon economic factors to resolve political conflicts, but the situation in East Asia today contains fewer political risks than Europe during the early 20th century.'

Notwithstanding the potential for China's growth to slow, Hale's overall message is optimistic. He argues that: 'The rise of China will be the first major test of whether [the global system of states] has the capacity to cope with a new great power. Despite the natural suspicions of China which exist in Washington, Tokyo, and elsewhere, the odds are high that the system will be able to accommodate China because it is in China's self interest to be a good global citizen.'

ASPI would like to thank David Hale for his work on this study and Lyric Hughes Hale for her support in bringing this project to completion.

I also thank Peter Jennings, then ASPI's Director of Programs and now with the Department of Defence, for commissioning the study and bringing it to fruition. Janice Johnson as always did invaluable work on design and production.

The beautiful illustrations for this study are the work of Canadian photographer, Edward Burtynsky. Over the last few years Burtynsky has spent time in China recording the effects of the massive economic transformations that country has seen. He writes: 'Nature transformed through industry is a predominant theme in my work. I set course to intersect with a contemporary view of the great ages of man; from stone, to minerals, oil, transportation, silicon, and so on. To make these ideas visible I search for subjects that are rich in detail and scale yet open in their meaning. Recycling yards, mine tailings, quarries and refineries are all places that are outside of our normal experience, yet we partake of their output on a daily basis.'

Portions of this study were based upon a paper, 'The Reemergence of China' by David Hale and Lyric Hughes Hale, published by the Chicago Council on Foreign Relations in September, 2005. The author wishes to gratefully acknowledge the Chicago Council for their valuable support.

Peter Abigail
Director

Photo opposite: Shipyard #12, Qili Port, Zhejiang Province, 2005. Photography by Edward Burtynsky.
Image Courtesy: Charles Cowles Gallery, New York—Robert Koch Gallery, San Francisco—Nicholas Metivier, Toronto

Executive summary

The rise of China as a great economic power will be one of the great geo-political challenges of the 21st century. After twenty-five years of economic reform, China's nominal GDP has grown to $2.2 trillion and is now the fourth largest in the world. If we adjust for PPP differences, China's real GDP is probably already at $5–6 trillion and thus number two in the world. China has enjoyed robust growth during recent years because of booming capital investment, robust exports, and steady expansion of domestic consumption. China has attracted over $600 billion of foreign direct investment since 1990 and now has the third largest stock in the world after the US and Britain. Foreign firms now produce nearly 60% of China's exports. China's exports are almost $800 billion or the third highest in the world after the US and Germany. In 2010, China will probably be the world's largest exporting nation. China's manufacturing output is now worth over one trillion dollars compared to $1.7 trillion for the US. In another five years, China's manufacturing sector will probably be larger than America's. China's boom has produced a surge in raw material demand. In 2003 and 2004, China displaced the US to become the world's leading consumer of most base metals (copper, aluminium, zinc, etc.) and displaced Japan to become the world's number two oil consumer. But while China now consumes nearly 20–25% of many base metals, her per capita consumption is only about one fifth of America's. The low level of consumption suggests that China could account for one third of global metal consumption in another fifteen or twenty years.

China's new economic status is having a major impact on her foreign policy. Her officials are stressing that they want China's rise to be a peaceful process and not threaten other countries. They do not want to be compared to Germany in 1914 or Japan during the 1930s. As a result of China's need for commodities, Beijing is attempting to negotiate free trade agreements with several commodity producing nations, including Australia, New Zealand, South Africa, Chile, and Saudi Arabia. In a recent tour of Latin America, President Hu Jintao committed China to $9 billion of infrastructure investment in Brazil and $15–20 billion of infrastructure as well as energy investment in Argentina. China made a $2 billion loan to Angola last year in order to improve her access to oil exploration permits from the government. During the past four months, Chinese companies have announced over $11 billion of new oil investments in Kazakhstan, Ecuador, Syria, and Nigeria. China is also playing a leadership role in Asia. Beijing is promoting the creation of a regional free trade zone in East Asia. China has joined the ASEAN regional forum in order to participate in dialogues about security policy in the region. China has helped to launch a new regional group in Central Asia called the Shanghai Cooperation Council. Its goal is to promote political dialogue and economic cooperation with Russia and former Soviet Republics in Central Asia.

There is great apprehension in Washington, Tokyo, and other capitals about the rise of China as a new power. The US Congress is alarmed about the large American trade deficit with China. The Pentagon is concerned about China challenging American military supremacy in East Asia. While it is natural that traditional powers should be concerned about the rise of new powers, China's capacity to pursue an aggressive foreign policy will be very contained by her new economic circumstances. China's ratio of exports to GDP is now 38% or three times higher than that of the US, Japan, and Europe. It is unusual for a country as large as China to be so heavily dependent upon foreign trade but as a result of low labour costs, good infrastructure, and pro-business economic policies the global corporate community has turned China into a workshop of the world. China has become so integrated with the global economy that she can no longer pursue a high-risk foreign policy without jeopardising her economic prosperity.

China is likely to become a threat to other countries only if she experiences domestic political instability which produces an upsurge of nationalism or a search for external scapegoats to blame for local problems. The Communist regime appears to be firmly entrenched and is unlikely to lose power any time in the near future. But when a fifth generation of leadership assumes power in ten to fifteen years, China could become more open and tolerate greater dissent. Such a political opening could then open the door to forces such as nationalism and populism. There is no way to predict exactly how Chinese politics will evolve in a more democratic era, but it is a development which could produce new challenges for the countries of East Asia after 2020. An authoritarian China has been highly predictable. A more open and democratic China could produce new uncertainties about both domestic policy and international relations.

Chapter 1

CHINA'S ECONOMIC TAKE-OFF

China's rise as a great economic power has become one of the dominant issues of our time. The Chinese economy has enjoyed nearly two and one half decades of 8–9T output growth. On the basis of recent GDP revisions, the nominal value of the Chinese economy is about $2.2 trillion—the fourth largest in the world after the US, Japan, and Germany. Adjusted for purchasing power differences, China has a real GDP of about $5–6 trillion or the second largest in the world. At the recent Davos World Economic Forum, Vice Premier Zeng Peiyan announced that China wants to double its per capital income to about $2,600 over the next five years. The new size of China's economy is demonstrated by the fact that China is now a larger consumer of many industrial raw materials than the United States. Resource rich countries such as Australia have benefited from the rising Chinese commodity demand on raw material prices. As China's per capita consumption of many metals is only one fifth of America's, her influence on commodity prices is likely to become even greater in the future.

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It is critical to understand that the reemergence of China will have profound implications for geopolitical relationships, not just trading interests. China now spends about $20–30 billion annually on defence and could be spending over $100 billion in another decade.

Photo opposite: Manufacturing #8, Textile Mill, Xiaoxing, Zhejiang, 2004. Photography by Edward Burtynsky. Image Courtesy: Charles Cowles Gallery, New York—Robert Koch Gallery, San Francisco—Nicholas Metivier, Toronto

[Unless otherwise stated, all figures are in US dollars.] China has begun to play a regional leadership role by creating a new regional forum for political dialogue in central Asia and proposing a regional free trade zone in East Asia. China is also pursuing many new bilateral economic cooperation agreements with countries as diverse as Indonesia, Australia, and Vietnam. Australia has responded to China's economic opportunities by starting negotiations on a free trade agreement. The proposed FTA could be the first step towards China emerging as Australia's leading trading partner within the next ten years.

As China becomes an essential cog in the machine of world trade, the health of the Chinese economy has become a central concern for both policy makers and business people. A boom implies a coming bust, a rise an inevitable fall. There is now widespread confusion about China's economy, even among experts, because of lack of transparency. There is considerable anecdotal evidence that the economy is slowing, but official statistics continue to indicate robust growth. In fact, the investment share of GDP has risen to levels which no economist ever imagined possible. In addition to statistical anomalies, there are clearly divisions among Chinese policy makers about both the goals of policy and appropriate policy instruments. The National Development & Reform Commission, for example, has opposed attempts by the Chinese Central Bank to reduce credit growth.

In spite of this, the odds are good that China's growth rate will remain at high levels for several more years simply because there is so much potential to boost productivity and allow living standards to catch up with more developed nations through increased consumption. But there will be fluctuations in China's growth rate and there is a serious risk that a slowdown could occur by 2007 due to weaker consumer spending in the US, and a moderation of the capital investment boom which has been driving China's economy since 2002.

Historic comparisons

While many regard China's recent economic takeoff as a unique historical event, it should actually be regarded as a reemergence of China as a great power. The fact is China was the world's leading economy for many centuries before the British industrial revolution of the late 18th century. Angus Maddison estimates that China accounted for a third of global output in the mid-18th century while India accounted for another quarter. China and India were also pioneers in many forms of technology. As Jared Diamond notes: 'Until 1450, China was technologically much more innovative and advanced than Europe. Chinese inventions before or during this period included the wheelbarrow, gunpowder, matches, cast iron, porcelain, magnetic compasses, sternpost rudders, paper, printing, paper money and a meritoric civil service. Indian inventions from this period included the decimal system, (and the concept of zero), the water wheel, cotton ginning, cloth dyes, brass and the extraction of crystalline sugar from cane.'

The decline in the economic importance of both China and India resulted from several factors. Britain launched the Industrial Revolution during the 18th century which vastly reduced the cost of producing many goods. Britain and other European countries also dispatched seafaring adventurers to the far corners of the world to establish settlements and carve out colonies. The growth of trade promoted both Britain's economic takeoff and the expansion of the British Empire. China had an active trading relationship with many other Asian countries one thousand years ago and collected tribute from several states in the region. Many Chinese also emigrated to Southeast Asia and established settlements there. In the 15th century, China dispatched great fleets to locations as far away as Africa but the emperors turned inward during the Ming dynasty and remained isolationist for most of the Qing dynasty.

The European powers penetrated China during the 19th century while colonising India. The 20th century brought the end of the monarchy in China, regional civil wars, and a Japanese invasion during the 1930s. The Communists established control in 1949 and promptly nationalised most of the economy. Mao's Great Leap Forward produced a severe famine in the late 1950s in which 30 million people died. He then launched the Cultural Revolution and produced nearly a decade of chaos which caused China's per capita income to decline by over 10%. Between 1953 and 1977, China's share of global trade fell from 1.5% to 0.6%. An examination of the relationship between the Indian and Chinese economies is very useful in understanding Chinese history. In the 1950s, India's per capita income was 40% higher than China's. It remained greater than China's until the late 1970s, when China's per capita income exceeded India's for the first time in the 20th century. After 25 years of economic reform, China's per capita income is now more than double India's.

China's economic success is not unprecedented, although it is certainly unparalleled in terms of scale. There were several countries in Asia and Europe which also enjoyed high rates of growth during their periods of economic takeoff in the decades after World War II. Japan's economy grew at an annual rate of 8.8% during the 1950s and 10.5% during the 1960s. West Germany's economy expanded at an annual rate of 8.2% during the 1950s. South Korea's economy grew at annual rates of 8.7%, 9.6% and 9.1% during the 1960s, 1970s and 1980s. Taiwan enjoyed growth rates of 8.5%, 10.0%, and 9.2% during the 1950s, 1960s, and 1970s. Singapore's growth rate was 9.2% during the 1950s and 9.0% during the 1960s. Israel grew at an annual rate of 10.7% during the 1950s while Iran achieved a growth rate of 10.0% during the 1960s. Brazil had a growth rate of 8.1% during the 1970s. Vietnam has enjoyed a growth rate of 7.6% since the early 1990s. China's high growth rate has produced a real per capita income for the people equal to about one quarter of Korea's. If China could sustain its current high growth rate for another three decades, its per capita income could catch up with Korea's in three decades. In such a scenario, China would have a real GDP adjusted for PPP twice as large as the United States.

The contrast between previous high-growth countries and China lies in both the sheer scale of the takeoff and far less favourable initial conditions.

The contrast between previous high-growth countries and China lies in both the sheer scale of the takeoff and far less favourable initial conditions. China has over 1.3 billion people compared to 4 million for Singapore, 22 million for Taiwan, and 120 million for Japan. China also entered its era of economic reform after 30 years of communism as well as a decade of chaos during the Cultural Revolution (1966–1976). Other high-growth countries had also suffered great damage during World War II, but they had the advantages of the framework of a market economy with private ownership of property. China is still establishing the institutions of capitalism and the rule of law. The great challenge now confronting China is to complete the transition to a transparent market economy with a democratic form of government.

China's successful policy choices in the reform period

Several factors explain China's economic success since the 1970s.

First, Deng Xiaoping introduced incentives to maximise agricultural output in the late 1970s. These incentives produced a large rise in the incomes of farmers and thus created a greater market for a wide range of consumer goods. China's farm output grew by 21% during 1979, 12.1% during 1980, 11.5% during 1981, and 11.7% during 1982. It then averaged a growth rate of 8.1% for another six years. China's per capita food availability in the countryside rose from 1700 kcal/day in 1960 to 2570 kcal/day in 1995, well above the World Health Organization's minimum standard of 2100 kcal/day.

Second, China has pursued a policy of market opening and integration with the global economy far more aggressive than occurred in Japan and Korea during their initial years of economic takeoff. China's export share of GDP is about 38% compared to only 10% for Japan during the 1950s and 1960s. China has attracted over $600 billion of foreign direct investment (FDI) or the third-largest stock in the world after the US ($1.7 trillion) and Britain ($650 billion). In 2004, multinational firms in China generated a trade surplus of $14.6 billion compared to a deficit of $14.1 billion during 1996, when they were importing capital goods. It is estimated that two thirds of China's FDI comes from other Asian countries, especially Hong Kong and Taiwan. The Asian companies which have invested in China have turned the country into a final assembly point for components and parts produced in Korea, Taiwan, Malaysia, and elsewhere. As a result, a large share of the value added in China's foreign trade belongs to other Asian countries. During the first four decades after World War II, Japan and Korea discouraged FDI in order to protect local companies from foreign competition. On the eve of the East Asian financial crisis in 1997, there was only $17 billion of FDI in Japan and $12 billion in Korea. This policy helped to nurture highly successful global companies in Japan but it produced great trade tensions with the US and other countries. It would not be an exaggeration to say that China now has an economy far more dependant upon foreign trade than the US, Europe, and Japan. China therefore has a greater stake in an open global economy and the Doha trade round than any other industrial country.

Third, China has the highest savings rate in the world. The Chinese are incentivised to save because of the disappearance of social welfare provided by the state. As a result, China has been able to finance an investment share of GDP which approached 47% last year while still running a current account surplus. When the investment share of GDP exceeded 40% of GDP in Thailand, Malaysia, and Korea during the early 1990s, they all ran large current account deficits. It was this dependence upon foreign capital which helped to set the stage for the great East Asian financial crisis of 1997–1998. Most of the East Asian countries generated high growth rates during the 1970s and 1980s because they had high levels of both savings and investment. China's experience is very similar but its savings and investment rate is even higher than was the case in other Asian countries. As a result, it has the potential to generate an even higher growth rate without running the risk of a balance of payments crisis.

Fourth, China has placed a high priority on the establishment of hard infrastructure for promoting industrial development. China has 30,000 kilometres of expressways or 10 times more than India. China has privatised several expressways on the Hong Kong Stock Exchange. China suffered power shortages last year but is now investing billions of dollars in new power-generating facilities, including nuclear power stations. The *Financial Times* recently reported that China could have a power surplus by 2008. China loses only 7% of its power output in distribution and transmission compared to 26% for India.

Fifth, China has made it easier for entrepreneurs to establish businesses than many other developing countries. It takes 75 days and costs 55% of annual per capita gross income to establish a business in China compared with 126 days and 97% of per capita GNI to start a firm in India. It takes 41 days to register ownership of property in China compared to 85 days in India. It takes 33 days to enforce a contract in China compared to 103 days in India. China's long-established informal lending market (estimated to be at least 50% as big as the banking system) has fuelled small businesses.

Sixth, China has been more successful at restraining corruption than many other developing countries. The most commonly used measure of corruption is the Corruption Perceptions Index compiled by Transparency International. This index is a composite of more than a dozen independent surveys of businessmen and country analysts carried out by organisations such as the World Bank, Freedom House, the Economist Intelligence Unit, and the World Economic Forum. In 2004, China ranked 71st out of 145 countries with an average score of 3.4. In the rankings, zero is the worst possible score and 10 is the best. China's score does not appear very impressive but when adjusted for income levels it appears highly competitive with other countries. Within emerging Asia, China scores well above Indonesia, the Philippines, India, and Pakistan. It is on a par with Thailand but below the rich Asian economies of Korea and Taiwan.

There are many signs that the government is attempting to crack down on corruption. In 2004, 2,960 officials at or above the county level were investigated for corruption, including 11 officials at the ministerial or provincial level. While the number of corruption cases prosecuted by the government has remained in the range of 22,000–24,000 annually since the late 1990s, the number of senior officials being prosecuted has been steadily increasing. The Communist Party has also been significantly improving the educational standards of the people it appoints to high office. Among the 62 people running China's provinces, 32% have an engineering degree, 21% studied economics, and 6% have a math or physics degree. One third also have advanced degrees. Shaanxi is now the first province to be run by two Ph.D.s.

Seventh, labour mobility, both legal and illegal. Once prohibited, the migration of rural workers to urban manufacturing hubs has been critical to China's economic success. It is the unleashing of this labour force which has changed the global balance of work and trade in the last ten years. During the Cultural Revolution, urbanites were sent to the country for reeducation. Deng Xiaoping reversed this trend.

The combined effect of these factors has been two decades of very rapid economic growth. The driving force of robust output growth has been large gains in productivity, starting with agricultural reforms during the last 1970s and culminating in the structural changes which resulted from the decision to join the WTO five years ago. Economists estimate that China's total factor productivity growth has averaged about 3.6% per annum and thus accounted for about 36% of all growth. The surge in productivity coincided with the state-owned enterprises' share of industrial output declining from 80% in 1978 to about 20% recently. According to a recent OECD study, the TFP growth of private industrial enterprises was more than twice as fast as that of the direct state controlled enterprises and at least 60% faster than that of the indirect state controlled enterprises. The state-owned enterprises, which have survived twenty years of economic reform, are also now improving productivity.

China's export-driven success

It is the globalisation of China's economy which has provoked widespread concerns in Washington and elsewhere about the rise of China as a competitive force and potentially unfair trading partner. The trade statistics for China since the 1980s are truly daunting. China's exports have grown by 13% per annum since 1981 and by 18% per annum since 1991. China's share of world exports has risen from 1.1% in 1981 to 6.8% in 2005 and thus made China the world's third-largest exporting nation after the US and Germany. If the growth rates of the past decade can be sustained, China could overtake the US in 2008 and Germany in 2009. China's merchandise imports also have grown rapidly. Their growth rate has averaged 16% since 1991 and they are now 6.1% of the world total.

The rise of both China and India as players in the global economy is having a profound impact on how firms conduct business all over the world. It has greatly increased price competition and produced large savings for consumers everywhere. Despite the large rise in oil prices since 2003, bond yields have remained subdued because of investor confidence that inflation is going to remain restrained. The rise of China has coincided with a large rise in the profit share of GDP in all the industrial countries and a sharp slowing in the rate of wage growth. Corporations have told trade unions and their employees that China is forcing them to restrain costs in order to remain competitive. Some politicians have protested the income distribution consequences of globalisation but they cannot reverse the effect without resorting to highly protectionist trade policies.

There has been a major change in the composition of China's foreign trade during the past decade. There was great excitement in early 2005 about a surge of China's textile exports as a result of a relaxation of global quotas but the textile share of China's exports has declined from 24% in 1997 to 14% in 2004. Footwear has likewise fallen from 4.5% of China's total exports in the mid-1990s to only 2.5% recently. Conversely, exports of high and new technology products have climbed from less than 15% of the total in 2000 to nearly 28% in early 2005. China's trade balance in these products has swung from a $17 billion deficit in 2001 to a $4 billion surplus last year. China also became a net exporter of auto parts during the first half of 2005.

The Chinese development model is in many ways unique but the closest historical analogy is Japan.

The Chinese development model is in many ways unique but the closest historical analogy is Japan. Japan began to industrialise during the early 20th century and it had a manufacturing sector which produced about 23% of national output compared to over 50% for China. The manufactured sector relied heavily on foreign capital goods but it did produce light manufactured goods for export primarily because of the market in China. The US was Japan's largest export market because of demand for silk. China was Japan's number two market but in contrast to the US it purchased industrial goods, not primary products. Chinese imports from Japan were cotton piece goods, matches, timber, paper, and machinery. In fact, China accounted for 75% of Japan's manufactured exports before the First World War. The Great Depression and World War II disrupted Japan's rise as a major exporter. During the late 1950s and 1960s, the rise in Japan's share of global exports was nearly as large as China's during the past ten years. Japan also had a voracious appetite for commodities and increased its imports from Australia tenfold between 1959 and 1974. But the export share of GDP averaged only about 10%, so Japan never came to depend as heavily upon foreign trade as China has during recent years.

There is little doubt that China's export success has been a by-product of the country's FDI boom. Foreign firms now produce over 55% of China's exports. If we look at the country's top 10 exporting firms, four are from Taiwan, three are from the US, two are from China, and one is from Finland. The two leading Taiwan export firms have sales of $8.1 billion each. The third-largest exporter is Motorola with sales of $5.7 billion followed by IIPC with sales of $4.1 billion. Nokia has exports of $3 billion while Intel has exports of $2.1 billion. Among the next 20 largest exporters, nine are Chinese, eight are from Taiwan, and three are from the US. The 31st-largest exporter is LG of Korea with sales of $1.3 billion. The largest exporter from Japan is Toshiba Information Systems. It ranks 44th with $1.1 billion of sales.

It is obvious from the data that Taiwanese firms are playing a decisive role in establishing China as a major factor in high-technology products. Taiwan accounts for 19 of China's top 100 exporters compared to eight each from Japan and Korea. Taiwan's investment is now officially estimated at $41 billion compared to $11 billion in 1997. Many analysts think it is really over $100 billion. Taiwan's exports to China have quadrupled from $10 billion in 1997 to $48 billion in 2004. China displaced the US as Taiwan's largest trading partner in 2003 and took a hefty 36.7% of the island's total exports during the first half of 2005. There are also nearly 1 million Taiwanese expatriate workers or 10% of Taiwan's labour force working on the mainland.

This change in trade flows is apparent in the composition of America's trade deficit. In 2004, the US ran a trade deficit with China of $171.1 billion compared to only $32.1 billion during 1994. The trade position with other Asian countries changed far less. The US ran a deficit with Korea of $21.5 billion during 2004 compared to $13.5 billion during 1994. It had a deficit of $2.3 billion with the Philippines during 2004 compared to $2.1 billion during 1994. It had a deficit with Malaysia of $17.9 billion during 2004 compared to $7.5 billion ten years ago. The US also has a few trade surpluses in the region. In 2004, it had a trade surplus of $6.4 billion with Australia compared to $6.3 billion ten years ago. In 2004, it had a surplus of $3.8 billion with Singapore compared to a deficit of $2.6 billion in 1994. US imports from China grew by 500% since 1994 compared to 70% for Thailand, 100% for Malaysia, 133% for Korea, and zero for Singapore. The Korean and ASEAN share of US imports has shrunk from 10.9% in 1994 to 8.2% during 2004 while the Chinese share has grown from 6.0% to 13.7%. In fact, China has also displaced Mexico to be America's number two trading partner after Canada.

China's export boom has also greatly increased its level of trade with other East Asian countries. China is now running large trade surpluses with the US and Europe offset by large deficits with Korea, Taiwan, ASEAN and Australia. In 2004, China had a trade deficit of $51.2 billion with Taiwan, $34.4 billion with Korea, $20.9 billion with Japan, $20.1 billion with ASEAN, $3.2 billion with Australia, and $1.8 billion with India. In East Asia, China had a trade surplus only with Vietnam ($1.8 billion). The East Asian countries have emerged as major suppliers of components and other material for reassembly as final manufactured goods in China. Korea, Taiwan, and Japan also provide China with a large volume of capital goods to help facilitate its investment boom. As a result of these changing trade flows, America's imports from East Asia have declined as a share of total imports while imports from China have increased sharply.

China has also changed the relative weightings of Asian countries in global trade. The total Asian share of global trade during 2004 was 36.2% compared to 34.8% during 2000 and 35.0% during 1994. China's share of global exports has increased to 8.8% from 5.3% during 2000 and 3.7% during 1994. Korea has also increased its share of global exports to 4.0% from 3.0% during 1994. Thailand has boosted its share to 1.5% from 1.4% ten years ago. Malaysia has increased its share to 1.9% from 1.8% and the Philippines has risen from 0.4% to 0.6%. All other Asian countries have lost market share. Japan's share of global exports has slumped from 12.5% in 1994 to 8.9% last year. Singapore has dipped from 3.0% to 2.7%. Taiwan has slipped from 2.9% to 2.7%. Hong Kong has fallen from 4.8% to 4.0%. Indonesia has dipped from 1.3% to 1.0%.

China has been reducing tariffs for many years but the most dramatic breakthrough in its trade policy was the decision to join the World Trade Organization in 1999. Membership in the WTO reduced tariffs to only 6% from 32% in 1992 while subjecting China to the global rule of law on matters pertaining to trade and investment. American firms still have many complaints about China's protection of intellectual property rights but membership of the WTO is forcing China to accept far more convergence with global business standards and laws than was the case previously. Former Chinese Premier Zhu Rongji sought WTO accession because he felt it would be a spur to forcing more modernisation and productivity improvement on Chinese companies.

Exchange rate policy

The great new issue in China's international economic relations during the past two years has been the exchange rate. China had maintained a fixed exchange rate against the US dollar from 1994 until July of this year. During this period, there were large fluctuations in the real value of the renminbi because of volatility in the dollar exchange rate and the East Asian financial crisis. During the late 1990s, the real value of the renminbi appreciated by over 30%. But there was never any change in the nominal value of China's currency vis-à-vis the US dollar.

In 2003, members of the US Congress became concerned about the rapid increase in the US trade deficit with China ($125 billion) and began to allege that China was maintaining an undervalued currency to promote exports. They pointed to China's purchases of US Treasury bills as an example of currency manipulation. China responded that it had maintained a stable currency through the East Asian financial crisis, when other countries devalued sharply, and was not guilty of currency manipulation.

In early 1998, British Prime Minister Tony Blair joined (French president) Chirac in lavish praise of China's responsible behaviour during the Asian financial crisis and described Beijing as a pillar of stability and responsible behaviour. …Chirac declared that by choosing not to devalue the yuan, Beijing had shown 'an extremely responsible and co-operative attitude.' China's leaders clearly recognised the usefulness of this reaction to its currency policy. Their thinking was forthrightly summarised by the editors of the pro-Beijing Hong Kong newspaper, Ta Kung Pao: 'Recently China would rather suffer losses by itself by persistently guarding against devaluation of renminbi. By demonstrating to all people in the world its image of being a large country that assumes responsibility and honours its word, China is extensively praised by the international community.' Indeed, on his visit to Beijing in October 1998, European Commission President Jacques Santer reacted to assurances from China's central bank governor that the PRC would hold the line on the yuan in 1999 'as part of (its) 'responsible attitude' to the Asian financial crisis,' by echoing the comments from Blair and Chirac and lauded China as 'the pillar for the region's economic and financial stability.'

China does not only regard its prudent behaviour during the late 1990s as a good defence of its exchange rate policy. It also is concerned about exchange volatility at a time when its banking system is attempting to reduce $200–300 billion of non-performing loans. The government is apprehensive about public confidence in the financial system and the ability of Chinese companies to manage currency risk. The government has recently introduced forward markets for currency but it does not yet have any markets for financial derivatives. Moody's has warned that it might lower the credit rating of Chinese financial institutions if the government created greatly increased currency volatility.

As a result of Congressional pressure, the Bush Administration began to lobby China for a change in currency policy. At the 2003 IMF meeting in Qatar, it helped to produce a G7 communiqué encouraging more currency flexibility in Asia. In 2004, US Treasury Secretary John Snow made numerous appeals for China to modify its exchange rate policy. In April 2005, the US Treasury produced a report threatening to allege that China was engaging in currency manipulation if it did nothing to modify the policy. The US Senate also passed a resolution threatening to impose a 28% tariff on Chinese imports if the renminbi was not revalued significantly.

China finally succumbed to this pressure in July 2005 by announcing a 2.1% revaluation of the renminbi and the move to a managed currency basket. The central bank governor has not provided any details about the precise weights of the currencies in the basket but he has acknowledged the currencies include the US dollar, the Japanese yen, the Euro, the Korean won, the Russian ruble, the Singapore dollar, the Malaysian ringitt, the British pound, the Australian dollar, and the Thai baht. The great surprise was the omission of the Taiwan and Hong Kong currencies because each country accounts for over 10% of China's foreign trade. If China used a trade weight for each country, the US dollar would have a share of 19.5%, Japan would have a share of 21%, Europe a share of 20.7%, Korea 9%, and the other countries about 2–3% each. As China still denominates about 80–90% of its trade in dollars, it is quite likely that the dollar has a much higher weighting (say 60–70%) but there is no way of knowing exactly how high. China's decision to introduce the new basket represents a major change in both its exchange rate policy and monetary policy, but it is not yet clear exactly how the new policy will work. Most investment banks believe it will set the stage for a 3–5% revaluation of the renminbi during the next 12 months but these forecasts are still highly speculative.

China's decision to revalue in July has helped to buy it time with policy makers in Washington. The Senate has deferred any vote on its tariff bill. The US Treasury recently issued its regular report on global currency policy and declined to accuse China of currency manipulation. It said that China should be given time to continue its transition to a more flexible exchange rate policy. The Treasury wants to pursue a cooperative relationship with China but it has to pay close attention to the changing mood of Capitol Hill.

The geopolitical manoeuvres behind China's currency policy changes reflect highly divergent agendas in the world's capitals.

The geopolitical manoeuvres behind China's currency policy changes reflect highly divergent agendas in the world's capitals. The US has called for revaluation because of concerns among its manufacturers about Chinese competition. The US has neglected the interests of retailers such as Wal-Mart which imports over $50 billion of goods from China, as well as the homeowners who benefit from the low interest rates resulting from China's currency intervention. The Bush policy is high risk because one of the reasons he was reelected in 2004 was the fact that he had presided over more housing inflation than any other president during the 20th century. During his first term, real house prices rose by 35% compared to a previous record of 24% for Ronald Reagan's second term. If East Asian central banks had not spent hundreds of billions of dollars on currency intervention, US bond yields might have risen and thus dampened the housing boom.

The Europeans supported a renminbi revaluation because they are concerned about the large US current account deficit. They fear that if Asia maintains stable currencies the full burden of adjustment to the US current account deficit will fall upon the European exchange rate and that it will appreciate sharply. The French would also like to weaken the dollar's grip on East Asia and encourage East Asia to diversify its currency reserves to include more euros. The French have long been obsessed with the issue of dollar hegemony and the capacity it gives America to finance large current account deficits easily. The Japanese were reluctant to lobby China for a currency revaluation because they also have intervened to hold the yen in a narrow trading range but they recognise that most of America's new protectionist sentiment is focused on China rather than Japan. As Japan has deployed troops in Iraq, they also do not expect the Bush Administration to criticise their currency intervention. It was therefore a low-risk policy for Japan to support a Chinese revaluation.

Will the Chinese economy slow?

After two years of robust economic growth, most economists have been projecting that the Chinese economy would slow during the next year. In 2004, the Chinese Government tried to restrain the capital-spending boom by imposing credit controls on bank lending and raising interest rates for the first time in nine years. In 2005, it imposed new taxes on property speculators in order to dampen the real estate boom gripping Shanghai and other cities. During recent months, the growth rate of credit has slowed to the 12–14% range from numbers as high as 26% during early 2004.

Despite the policy gestures to restrain the boom, there have been few signs of a significant slowdown. In the third quarter of 2005, output growth remained at 9.4%. There was continuing strong growth in capital investment (25%) and a 30% gain in exports. Consumption continued to grow at a nominal rate of 13–14%. As import growth slowed in response to reduced construction activity during the first half of this year, China's trade surplus could exceed $100 billion this year while the current account surplus could rise to $130 billion.

Some economists are projecting that business investment will slow because many firms have been experiencing a profit squeeze. There have been large increases in raw material costs and wages which they cannot pass on in the prices of finished goods. There is little doubt that some manufacturing firms will curtail investment because of excessive capacity and declining profit margins, but the government has been redirecting investment to sectors which have suffered supply bottlenecks, such as coal mining, electricity production and the railways. As a result of these developments, the investment share of GDP rose to 54% during the third quarter or the highest level ever recorded in any Asian country. Some brokerage houses are even projecting that the investment share of GDP could rise to 60–70% by 2007. Such an investment boom would raise profound long-term questions about the structure of China's economy. Would the country have massive excess capacity creating a profit squeeze which would set the stage for an investment collapse? Would China have to expand exports even more dramatically to absorb the capacity? Would there be a large increase in non-performing bank loans because of firms losing money on new capital spending projects?

The recent decision of the Chinese to revalue the currency could also squeeze the profit margins of export companies which do not have any pricing power. But the revaluation will enhance the profit margins of companies which depend heavily upon imported components and raw materials. The steel industry, for example, is anticipating a cost savings of 3 billion yuan ($308 million) from reduced iron ore import costs as a result of the revaluation. The cost of cooking oil imports could also decline by 500 million yuan.

The Chinese economy will be vulnerable to any slowdown in the US or the European economies because of the major role which foreign trade now plays in the economy.

The Chinese economy will be vulnerable to any slowdown in the US or the European economies because of the major role which foreign trade now plays in the economy. The growth rate of exports has slowed from over 40% one year ago to 30% recently and could easily fall to 20% if the US economy slows in response to Federal Reserve tightening and a cooling of the housing boom. But if the growth rate of exports does stabilise at 20%, China's exports will rise to $1.3 trillion by 2008. Such a development would make China the world's largest exporter and could produce new protectionist pressures in the US and Europe if there is not further revaluation of the yuan.

The sector which is likely to remain robust is consumer spending. The National Annual Economic Work Conference organised by the State Council, which sets the policy agenda for the following year, concluded this December 1st in China. According to Jun Ma, China economist for Deutsche Bank, one of the top directives to emerge from the conference was a broad-based stimulation of consumption:

'We think consumption policies in 2006 will feature income tax reform, elimination of agriculture taxes, provision of free basic education in the rural area (timetable now speeded up to within two years), health care reform, increases in minimum wages and civil servants' salaries, as well as relaxation of urban restrictions on the use of small cars. Thirdly, the government will further control the pace of investment growth. We expect this to be done via maintaining relatively tight project approval procedures and reducing capital spending in the government budget… Overall, these policy messages point to a worsening macro environment for investment goods but favor consumption—especially those companies that can enjoy sufficient entry barriers to protect their margins.'

Indeed, China's economy has been expanding because of growth in employment and wages. Chinese households have a strong pent-up demand for many consumer goods, as well as better residential properties. If carried out, the government's plan to reduce income taxes on all wage earners and greatly lower the tax burden on farmers should further increase consumption.

China's economic success has had a major impact on the country's quality of life. In the 1970s, the major goal of Chinese consumers was to purchase a bicycle, a wristwatch, and a sewing machine. In the 1980s, it was to purchase a washing machine, a refrigerator, and a colour television. In the 1990s, it was to purchase a cellular telephone (there are 300 million) and a computer (one third of all urban households have one). Today it is to buy an automobile. Sales are currently running at 2 million per annum and could rise to 7 million within a decade.

In terms of a consumer base and an emerging middle class, comparisons with India are again instructive. China's adult literacy rate is 90.9% compared to 61% for India. The literacy rate of Chinese women is 86.5% compared to 46.4% in India. China's life expectancy is 70.9 years compared to 63.7 years for India. China suffers 39 infant deaths per 1,000 births compared to 93 for India. China has only 46.7% of its adult population living on less than $2 per day compared to 79.9% for India. The consumer market in China will be far more buoyant than India for the foreseeable future.

The key question is—will an increase in Chinese domestic consumption help avert a possible slowdown in the manufacturing sector, should US consumers lose their huge appetite for Chinese goods?

Financial sector reform

Retail spending should also benefit from the large foreign investments now occurring in the Chinese banking sector and the government's plan to privatise three of the Big Four state-owned banks. In 2004, HSBC announced plans to invest $2 billion in the Bank of Communications for a 20% share. In June, the Bank of America announced a $2.5 billion investment in the China Construction Bank. In July, the Royal Bank of Scotland announced a $3.1 billion investment in the Bank of China. In August, Goldman Sachs announced plans to lead a foreign consortium in making a $3 billion investment in the ICBC Bank. Foreign banks have invested $14 billion in Chinese banks during the past year. In October, the China Construction Bank listed its shares on the Hong Kong stock exchange and raised $8 billion of new capital at a price nearly twice what Bank of America paid. The Construction Bank now has a market cap of $70 billion and is thus among the world's top ten financial institutions in terms of market value.

> ... China already has the largest banking system in the world. The government's attempts to reform the financial system are a critical component of its long-term strategy for improving the economy's performance.

In fact, China already has the largest banking system in the world. The government's attempts to reform the financial system are a critical component of its long-term strategy for improving the economy's performance. Its ratio of lending to GDP is about 150% or nearly twice as high as in most OECD countries. These large numbers are a by-product of the fact that the state-owned banks played a major policy role during the past two decades propping up state-owned companies with cheap credit. The challenge now facing China is to turn the banks into truly commercial organisations providing credit only to high quality borrowers rather than to firms enjoying political favour.

China experienced a major capital-spending boom during 2003 and 2004 in part because of political pressure from local governments to fund big new development projects. As the banks are privatised, they will shift from policy lending to commercial lending and will attempt to significantly increase the retail share of their business. The foreign banks have been attracted to China because they see huge opportunities for mortgage lending and credit card lending. Mortgage lending has already grown to 10% of GDP from practically nothing ten years ago, but it is greater than 70% of GDP in the Anglo Saxon countries, so there is ample opportunity to expand it significantly in the future.

The creation of a viable banking system will also have important consequences for the conduct of monetary policy. China has relied more on administrative guidance than interest rates to restrain credit growth because of concern about the quality of its large stock of bank loans. Policy makers have been concerned that rising interest rates would produce an upsurge of non-performing bank loans. If the banking system can improve its balance sheet and greatly reduce the stock of bad debt, it will give the central bank more freedom to use interest rates in guiding monetary policy.

Chapter 2

RISKS AND CHALLENGES

There are at present three major risks to China's boom:

1. There will be a significant slowing of US consumer spending during 2006 and 2007 which will dampen China's export growth.

2. The capital investment share of GDP has risen to such lofty levels that it raises far-reaching questions about the threat of excess capacity and eroding profit margins.

3. The government has been increasingly focused on the theme of sustainable development and the need to address concerns such as the environment and growing income inequality. If the government significantly increases the allocation of resources to environmental protection or raises taxes on high income people, it could slow the economy's growth momentum.

While China's economy has enjoyed impressive achievements during the past decade, the country still faces major hurdles in maintaining a high level of economic growth.

While China's economy has enjoyed impressive achievements during the past decade, the country still faces major hurdles in maintaining a high level of economic growth. The risks posed by the global trading system are well known. The other challenges include sustaining domestic social and political stability, providing retirement income for a rapidly ageing population, and protecting the environment. Chinese

Photo opposite: China Recycling #7, Wire Yard, Wenxi, Zhejiang Province, 2004. Photography by Edward Burtynsky. Image Courtesy: Charles Cowles Gallery, New York—Robert Koch Gallery, San Francisco—Nicholas Metivier, Toronto leaders increasingly talk about the theme of 'sustainable development'. Such a concept will require China to invest far more in conservation and protection of the environment than would have been possible under a command economy whose sole purpose was to maximise output. Other interrelated issues include:

- **Unemployment.** A major concern of social pundits following China is unemployment. During the past decade, China has lost over 60 million jobs in the old state enterprises. The job losses have caused the official unemployment rate to rise from 2.0% in 1985 to 4.0% recently. But these numbers are misleading for a variety of reasons. First, they do not include people who have lost their jobs but are still kept on the books of defunct companies while enjoying a modest income from the state. Nor does it include millions of workers from rural areas who have moved to the city and do not register as employed. There are no precise numbers of this population but many analysts believe that it exceeds 100 million. It also could rise sharply in the future as the productivity of the agricultural sector improves. If we make adjustments for these factors, China probably had an unemployment rate of 10% five years ago but the recent boom in the economy has reduced it to about 6.0%.

  According to government data, China has 752 million employed people. The largest sector is agriculture with 353 million people. The service sector is second with 230 million workers compared to 169 million in 1995 and 120 million in 1990. Construction is third with 169 million compared to 156 million in 1995 and 139 million in 1990. Manufacturing employs 83 million compared to a previous peak of 98 million in 1995. The government sector and party agencies employ 10.8 million or the same as in 1990. Total urban employment is now 265 million compared to 186 million in 1995 and 170 million in 1990. Rural employment has declined to 487 million from a peak of 490.4 million in 1997.

In theory, farmers began to enjoy property rights several years ago but the reality is they were often vulnerable to changes in land use dictated by local officials…

- **Income inequality.** Many analysts are also concerned about the growing level of inequality resulting from the economic takeoff and transition to capitalism. According to UN data, China's Gini coefficient[1] has risen from 24.0 in 1970 to 34.6 in 1990, and 44.7 recently. The increase in the Gini coefficient suggests that China has the potential for greater social tensions but it is important to compare the new data to other countries. China's Gini coefficient compares to 52.2 for Hong Kong, 48.1 for Singapore, 49 for Malaysia, 43 for Thailand, and 46.1 for the Philippines. Among other Asian countries, scores are lower for Japan (30.1), India (32.5), Korea (34.4) and Taiwan (33.0).

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1 The Gini coefficient is a measure of inequality. It is usually used to measure income inequality, but can be used to measure any form of uneven distribution. The Gini coefficient is a number between 0 and 1, where 0 corresponds with perfect equality (where everyone has the same income) and 1 corresponds with perfect inequality (where one person has all the income, and everyone else has zero income). The Gini index is the Gini coefficient expressed in percentage form, and is equal to the Gini coefficient multiplied by 100.

What makes China distinctive is the sharp increase in the Gini coefficient since 1970. The other countries all had much higher Gini coefficients in the 1970s. China has simply caught up with them because of the transition from communism to a market economy. If we compare farm incomes, China also ranks well compared to other countries in the region. China's agricultural per capita value added is about $375. Such a number seems modest but it is higher than in India, Vietnam, and Pakistan and broadly on a par with Thailand and Indonesia. China's farmers are not poor compared to other Asian farmers. They now appear poor only in comparison with China's urban residents. In 2004, Chinese farmers had an average income of 2,800 rmb compared to 10,000 for urban residents. In 2004, farm income was equal to 50% of urban disposable income. It is now 30%. The government is very aware of these growing income differentials. It is attempting to help the farmers by greatly strengthening their property rights over land and abolishing taxation of them during the next five years. In theory, farmers began to enjoy property rights several years ago but the reality is they were often vulnerable to changes in land use dictated by local officials who took bribes from property developers. Under the new regime, farmers will be able to enjoy permanent land use rights for thirty years unless there is an extreme disturbance such as an earthquake. This policy will allow farmers to invest more with the confidence they have secure property rights. When Taiwan introduced land tenure in the early 1950s, its annual rice yields rose by 60% and farm incomes grew by 150%. There also was a significant increase in China's food prices during 2004 which reversed years of decline in agricultural prices. In fact, the uptick in commodity prices slowed the flow of surplus rural workers to southern China and helped to produce a labour shortage there.

The financial press is now full of stories about China's new population of millionaire entrepreneurs. These people have earned large fortunes from sectors as diverse as food manufacturing and the Internet. Forbes magazine publishes a list of China's wealthiest people every year. In 1999, a Chinese businessman needed $6 million to make the list. In 2004, he needed $144 million. The wealth of the 100 people on the list has increased from $15 billion in 2001 to $29 billion last year. In 2005, Forbes estimated that China had ten billionaires compared to only 3 in 2004. Their net worth was nearly $12 billion. It is instructive to compare the Forbes data on wealthy people in China with Russia because both countries have been in transition from communism. The Russian millionaires are much wealthier than their Chinese counterparts. In 2004, they had a net worth of $137 billion compared to $29 billion for the Chinese. They controlled assets equal to 25% of Russia's GDP compared to less than 2% for the Chinese. The source of wealth in China is also far more diverse than in Russia. The wealthy in China made their fortunes in sectors such as retailing, electronics, agriculture, property, finance, and heavy industry. There is not one sector which dominates. In Russia, the wealthy obtained their riches primarily from privatising state-owned companies in the natural resource sector. The Russian list of the wealthy is also relatively static whereas there is a 30–35% turnover rate for the Chinese list every year.

- **Regional inequality.** The other great concern of China's social critics is regional inequality. During the first decade of economic reform, the growth rate of real GDP in western and central China was less than 1% slower than the growth rate of the east. During the second decade, the growth differential grew to 2%. As a result, real per capita income in central China fell from 65% of the coastal level in 1980 to 53% in 2000. In western China the ratio fell from 53% to 41%. The differential resulted from both fiscal decentralisation and an over concentration of foreign direct investment in the coastal provinces. Investment in the west fell from 48% of the east coast level in 1980 to 33% in 2000. The government has recently attempted to reduce the regional income disparities by boosting infrastructure investment in the west and encouraging foreign firms to look inland for plant locations. The fact that there are now labour shortages in southern China could also force foreign firms to look west for surplus labour.

China's need for commodities has also recently given a boost to some of the inland provinces which have natural resource endowments. Inner Mongolia's economy has enjoyed three years of 16–20% GDP growth because of its rich land and mining resources. Shandong province has been number two in growth because of its mining, electricity, gas and water industries.

- **Demographic issues**. The country is ageing and will someday have a shrinking population. The introduction of the one child policy in the early 1970s means that from a population of 1.3 billion today, it will likely peak at 1.45 billion by 2030 and then begin to decline. This pattern is in striking contrast to China during the 1950s and 1960s. Between 1949 and 1957 China's birth rate was high by emerging market standards, averaging 33 births per 1000 population. There was a temporary dip during the late 1950s because of the Great Leap Forward but the birth rate rebounded to 43 per 1,000 people in the mid 1960s and remained above 30 until the early 1970s. The high birth rate caused the population to grow from just over 540 million in 1950 to 924 million in 1975. The introduction of the one child policy caused the birthrate to plunge to 9 per 1,000. As a result of the falling birthrate, population growth has declined to 0.7% from 2.6% during the early 1970s.

The one child policy along with a cultural preference for male offspring have encouraged female infanticide and sex-based abortion among rural families.

The one child policy along with a cultural preference for male offspring have encouraged female infanticide and sex-based abortion among rural families. As a result, the newborn gender ratio of girls to boys is 1: 1.17 and the number of boys under the age of 9 is 12.7 million greater than the number of girls. Among the global population, the ratio of boys to girls is 1:1.04. If China's birth trends continue, there will be 30–40 million more men of marriageable age in 2020 than women.

The other factor influencing the composition of the population is rising life expectancy. It has increased from 42 years at birth in 1950 to 60 years in 1970 and 71 years recently. As a result, China's baby boomers should live 50% longer on average than their grandparents. The combination of a low birth rate and rising life expectancy is going to produce a significant ageing of the population. In 1975, the elderly population of China was only 60 million. In 2003, it was 120 million. In 2025, it will double again and by 2050 it will exceed 400 million people. The total share of the elderly in the population was 7% in 1975 and is about 10% today. According to the forecast, it will rise to 20% by 2020 and 33% by 2050. Conversely the working age share of the population will decline from 67% today to 60% in 2030 and 52% in 2050.

Other Asian countries are also experiencing ageing populations. Japan's population will soon shrink and it will have 35% of its population retired by 2050. Korea also is ageing and will have dependency ratios higher than Japan or China in 2050. What distinguishes China is its poverty. The Chinese are concerned that they will grow old before they grow rich.

The ageing of the population raised a number of disturbing questions. How will China finance pensions for such a large population of elderly people?

- **The pension system.** The ageing of the population raised a number of disturbing questions. How will China finance pensions for such a large population of elderly people? Can China sustain high growth when it has to divert significant resources to the retired? What will happen to the national savings rate? In the past China's state companies had a pay as you go pension system. It funded retirement out of ordinary cash flow. Under the so called 'iron rice bowl', workers obtained pensions, health care, housing, and education from their employers. There were no pensions or retirement savings. China is now trying to create pensions for the urban population. In 2003, there were 155 million urban people in the government's pension system.

  Under the new scheme, retirement income is provided on the basis of pay as you go contributions and private savings. There is a 13% tax on salaries which provides pay as you go income. There is a further 11% payroll tax which is accumulating in pensions. Individuals are also given the choice of contributing to enterprise annuity funds if they want to save more.

  The current system is likely to run a surplus until the year 2030. Some banks estimate it could be as large as 4–6% of GDP per annum until 2020. But a present, pension contributions are averaging only 2% of GDP per annum because of low participation rates for workers and high participation rates for the retired in collecting income. As a result, the accumulated pension surplus is only 0.4% of GDP. The outlook for the surplus is far from precise because it is necessary to make assumptions about factors such as the rate of return on assets. In recent years, China has offered a low return on fixed income assets and negative returns on equities. If the government can restructure the stock market to improve returns, the pension fund surplus could earn higher returns and thus delay the period when a deficit might develop.

  The other critical factor is the level of income the government offers to retired people. In the old days, state-owned companies offered workers 80% of their traditional income in pension payments. If the government lowers this to 60%, it will still create a significant drag on the system. The system would run a small surplus through 2010 and then begin to experience modest deficits. The deficits would rise to 3% of GDP in 2030 and 4% in 2040. Bankers estimate such an outcome could produce an IPD (implicit debt) of 250% of GDP during the middle decades of the 21st century.

There are various ways China could attempt to resolve this problem. It could reduce benefits, raise taxes, issue debt, or sell state-owned assets. As with the debate about America's social security system, all the choices are controversial. But a few options stand out as the most promising. The government debt/GDP ratio is only 30% so borrowing is clearly possible. China also has more opportunities for asset sales than many other countries. The government still owns about 150,000 non-financial enterprises with a potential market value of nearly 10 trillion rmb or 80% of GDP. These assets are of varying quality but the fact that government has closed many loss-making enterprises means that its remaining portfolio has more potential market value than in the past.

Another by-product of an ageing population is potential labour shortages. At the end of 2003, China had about 800 million registered rural people. This means there was a working age population in the countryside of about 500 million people. Current data suggest that about 375 million people work on farms while the rest have jobs in the towns and villages. Many have left the countryside for jobs in the urban centres of southern China. Young rural women migrants tend to get jobs in factories while young men work in construction. It is estimated that China could feed itself if only about 150 million worked on the land, so there is a potentially large surplus rural population available for redeployment elsewhere. But the supply of workers in the age group 15–29 years is only 185 million and about 100 million of it has already left the land for urban centres. The great growth now occurring in the labour force is among older workers and it is not clear if they will be as mobile as the younger workers. As a result of the low birthrate, the growth rate of China's labour force is going to slow sharply during the next decade. After expanding at an annual rate of ten million per annum during the period 1990–2005, the growth rate of the labour force is going to slow to 6 million per annum during the next ten years and zero after 2015. Such a slowdown will inevitably curtail FDI in China and create opportunities for other developing countries with more rapid population growth, such as India and Africa.

If China is to cope with an ageing population, it will have to move millions of ageing workers from the countryside to the cities during the next three decades.

At present, China is about 38% urban compared to 20% in 1970. Its urbanisation level is equivalent to the UK in the 1850s, the US in 1911, and Japan in 1950. If China is to cope with an ageing population, it will have to move millions of ageing workers from the countryside to the cities during the next three decades. Most demographers are projecting the country will be 70% urban by 2030. But urbanisation will mean providing employment for an ageing labour force as the country gets steadily older.

- **The environment.** The economic boom of the past two decades has taken a toll on China's environment. Damage from the use of coal—which accounts for 68% of China's primary power production—is equivalent to 8–10% of GDP and causes over 250,000 deaths annually. Acid rain now falls on about 30% of China's land area.

In 2001, China accounted for 13% of global carbon emissions, ranking as the second largest producer of CO_2, and the government expects that by 2020, China will account for 18–19% of global emissions. When a team of experts and Yale and Columbia Universities ranked 146 countries in the 2005 Environmental Sustainability Index, China came in at 113th, below Angola, Burundi, and Iran. In 2001, the World Bank reported that for sulphur dioxide, 13 of the 20 most polluted cities were in China. About 75% of China's lakes and almost all coastal areas are polluted.

China's arable land base has been steadily contracting because of urbanisation and infrastructure development. Between the early 1980s and mid 1990s, net annual farmland loss averaged between 100,000 and 1 million hectares. A recent report alleges that 6.7 million hectares has been taken out of cultivation since 1996, with 2.3 million leaving in 2003 alone. The average per capita availability of farmland in China has fallen to less than 40% of the world average and is now below the FAO's warning line of 0.05 ha. The per capita farmland available to US farmers is 200 ha while in Europe it is 50 ha. In Asia as a whole, it is 1 ha. China has laws which say that only 5% of arable land within a locality can be transferred to alternative uses but the law is widely ignored. In 2004, the Chinese Government's newspaper reported that there were 6,015 new development zones with a total land area of 35,000 km—more than the total land area of China's cities and Taiwan.

In the 1990s, China overtook the US to become the world's leading water consuming nation.

China also faces growing problems with access to water. China ranks fifth in global water supply but its per capita availability of water is only 25% of the world average. In the 1990s, China overtook the US to become the world's leading water consuming nation. China has an abundance of water in its southern provinces but major shortages in the north. The north has 24% of China's water but two thirds of its arable land and half of national grain output. China does not use water efficiently because the government has tried to restrain the price. As a result of poor resource management, it is estimated that water shortages cost the economy output losses equal to 5% of GDP during the 1990s.

China has problems as well with energy supplies. Its per capita endowments of energy are well below global averages. Its reserves of crude oil are less than 11% of the global average. Its natural gas reserves are a mere 5% of the global average. Despite an abundance of coal, its per capita reserves are half of global averages. Nuclear power and hydro power play a small role. China has magnified its problems with energy demand by restraining prices. The cost of gasoline in China is well below global levels and recently helped to produce shortages. The government announced plans recently to improve the fuel economy standards of automobiles in the future. While such a policy is laudable, China cannot address problems with either energy inefficiency or carbon emissions unless it is prepared to increase the price of energy to consumers.

Chapter 3

CHINA'S FOREIGN POLICY

China's new role in the global economy has several implications for her foreign policy.

Firstly, China has been stressing that her rise as a great economic power should not be viewed as a threat by other nations. In a recent issue of *Foreign Affairs*, the chairman of China Reform Forum, Zheng Bijian, produced an article elaborating on the theme that China wants to become a great power through peaceful means. In recent speeches, President Hu Jintao has invoked the theme of 'harmonious world' in order to stress China's benign goals and make a contrast to America's role as a hegemon. Other officials and academics constantly echo this idea.

Washington has very conflicting views about China's claims because Chinese defence spending has increased fivefold over the past fifteen years.

China has reserved the right to use military means to resolve the Taiwan problem if that country attempts to pursue formal independence but it has abandoned the threat of military force to resolve territorial disputes over the Spratly Islands. Washington has very conflicting views about China's claims because Chinese defence spending has increased fivefold over the past fifteen years. China says that it needs to modernise its military but Secretary of Defense Donald Rumsfeld has alleged that China's military spending is a potential

Photo opposite: Three Gorges Dam Project, Wushan #8, Yangtze River, China 2002. Photography by Edward Burtynsky. Image Courtesy: Charles Cowles Gallery, New York—Robert Koch Gallery, San Francisco—Nicholas Metivier, Toronto threat to the region. The US will therefore continue to take a cautious view of China's foreign policy promises.

Secondly, China is striving to have a good relationship with the United States. In the early days of the Bush Administration, there was a tense relationship because a Chinese Air Force plane forced a US surveillance plane to land on Hainan Island. Many of the administration's neo-cons also were wary of the re-emergence of China as an economic power. The events of September 11th transformed the situation. China promptly became a US ally in the war against terrorism and shared intelligence information on the Taliban. The administration hawks became totally focused on the Middle East and lost interest in Asia. New tensions have developed during the past year over issues such as textile imports but they have been addressed through conventional trade diplomacy. In a recent speech, Deputy Secretary of State Robert Zoellick attempted to outline a new administration attitude towards China. He spoke of a 'cauldron of anxiety about China', welcoming China's introduction of a market economy but warning about possible conflicts over issues such as Iran, the Sudan, and Taiwan. Mr Zoellick stressed that China was very different from the former Soviet Union because it did not see itself in a 'twilight conflict against democracy around the globe' nor as being in a great struggle with capitalism. But he warned against the Communist Party attempting to secure its monopoly on power through economic growth and heightened nationalism. He said China could reduce anxieties by being more open with its military intentions and spending. As the Bush Administration has few people with extensive Asian experience, Mr Zoellick has emerged as the dominant player in setting China policy. As a former trade representative, he has a keen appreciation of China's new economic role as well as its potential geo-political consequences. He will attempt to engage China in constructive ways while remaining apprehensive about the long-term consequences of China's military build-up.

Thirdly, China is now clearly challenging Japan as the dominant economic power in East Asia. China is now a larger trading partner for many countries than both Japan and America. China is starting to make large investments in countries such as Indonesia and could ultimately become an investor all over the region. But China lags far behind Japan in both official aid programs and the kind of emergency relief which occurred after the Tsunami disaster last December. As a result of a long historical legacy of distrust, there has been a sharp deterioration in Sino–Japanese relations during the past year. China has sharply criticised the visits to the Yasukini Shrine by Prime Minister Koizumi. China strongly opposed Japan's bid to obtain a seat on the United Nations Security Council. China has a territorial dispute over some islands east of Japan and sent its naval vessels into the waters near the islands during 2004.

Prime Minister Koizumi recently appointed some new ministers, such as Shinzo Abe, who have a history of advocating a hard-line in relations with China. The Japanese corporate sector has made a large investment in China and would like the government in Tokyo to pursue a better relationship with Beijing. But reflecting Japanese public opinion, Prime Minister Koizumi has not been prepared to accommodate China. The relationship is therefore likely to remain tense but the desire of both countries to pursue new trade agreements with other Asian countries could ultimately force them to cooperate on the creation of a regional FTA. The Chinese Government could also decide at some point to de-emphasise historical issues and focus more attention on the opportunities offered by Japan's large domestic market. In the 1970s, Japan was China's largest market and took nearly 30% of the country's exports. In those days, China exported oil to Japan.

China now has a voracious need for raw materials which is encouraging her to improve relations with commodity-producing countries.

Fourthly, China now has a voracious need for raw materials which is encouraging her to improve relations with commodity-producing countries. China now consumes a larger share of global output of copper, aluminium, nickel, lead zinc, and iron ore than the US. China's steel production is over 300 million tonnes per annum or twice as large as the US and Japan combined. China displaced Japan as the world's second-largest oil consumer two years ago and will soon be consuming over 7 million barrels of oil per day. Despite the large growth in Chinese demand for raw materials, her per capita consumption of copper and nickel is only 25% of America's. China is now attempting to negotiate free trade agreements with Australia, New Zealand, South Africa, Chile, Saudi Arabia, and Kuwait. She has signed an economic cooperation agreement with Canada which could ultimately evolve into an FTA. China has deployed 4,000 troops in the Sudan to protect an oil pipeline she built there five years ago with Petronas of Malaysia. Chinese firms are also attempting to invest in natural resource projects in many countries. They have obtained oil concessions in Angola, Iran, Algeria, Egypt, Indonesia, Gabon, Nigeria, Argentina, Venezuela and Ecuador. They have signed contracts to buy a large volume of LNG from Australia. They are committed to developing a billion-dollar nickel mine in Papua New Guinea. When Hu Jintao travelled to the APEC summit conference in Santiago last November, he announced $30 billion of infrastructure investments in Brazil and Argentina to facilitate trade with China. China has been trying to persuade the Russians to construct an oil pipeline to northern China in order to facilitate imports of Siberian oil. Russia initially decided to construct an oil pipeline to the Pacific coast to accommodate Japan but there has been renewed discussion about a side pipeline to northern China. President Putin has also suggested that China might be allowed to invest in the oil reserves of Yukos, the large oil company that was renationalised last December. Yukos produces over 1% of global oil output. China's trade with Russia has grown from $5.5 billion in the mid-1990s to $28 billion during 2005. Officials in both countries hope it will rise to $80 billion by 2010.

The National Security Council in Washington is concerned that China's need for oil could encourage her to pursue agreements with rogue states such as Iran in which weapons might be exchanged for oil. China has signed a treaty which would preclude her from selling Iran nuclear weapons, but she could provide other forms of military technology in return for access to oil and gas reserves.

It is likely that China will compensate for the Unocal defeat by attempting to purchase other oil reserves in Canada, Australia, Central Asia, and the developing countries which are open to foreign investment. China could also undermine America's national security interests in Venezuela by doing deals with President Chavez to lessen his country's dependence upon the US. In fact, after his recent visit to Beijing, he announced plans to sell Venezuela's refining operations in the US (Citgo). The odds are high that China will also develop significant new oil reserves in the Sudan. Since the collapse of the Unocal bid last August, Chinese companies have announced five major acquisitions of global energy assets. They launched a $4.5 billion takeover bid for PetroKazakhstan, a Canadian listed company with large oil reserves and refineries in that country. They then purchased over $1 billion of oil fields in Ecuador from the Canadian company Encana. They next announced a joint venture with India's national oil company to purchase petroleum reserves in Syria. This development was considered significant because in the past India and China had often competed for oil reserves in developing countries. In December, China announced a $2.3 billion bid for Nigerian oil reserves. In January, Cnooc announced a $2 billion takeover bid for another Canadian company with oil reserves in Kazakhstan, Nations Energy. As these deals have a collective value exceeding $11 billion, they demonstrate that China remains very committed to acquiring new energy assets. China is not content to simply purchase oil on the global market. It wants to maximise its energy security by purchasing petroleum reserves.

China will compensate for the Unocal defeat by attempting to purchase other oil reserves in Canada, Australia, Central Asia, and the developing countries which are open to foreign investment.

Finally, China is now attempting to promote more economic cooperation in East Asia. After rejecting Japan's proposals for an Asian IMF in 1997, China has joined the ASEAN +3 group of regular meetings between finance ministers and central bank governors. It is also discussing a variety of bilateral and regional free trade agreements. It has played a leadership role in encouraging a regional heads of government conference in Kuala Lumpur which excludes the United States. Nor is China unique in promoting regional forms of economic cooperation. After many years of relying solely on the GATT framework to promote trade, many Asian countries are pursuing bilateral and regional trade deals. The emergence of these new trading relationships will pose a major challenge for Australia's foreign policy.

Regional economic integration

At the turn of the century there were 184 bilateral and regional free trade agreements around the world but the only one in Asia was the emerging ASEAN free trade agreement. During the past five years there has been a proliferation of new FTAs both within the region and with other countries far away. Japan signed an FTA agreement with Singapore three years ago and is now negotiating new ones with Thailand, the Philippines, and Korea. China has proposed the creation of a regional free trade zone with ASEAN. Australia has negotiated an FTA with the US and Thailand and is now seeking to create another with China. New Zealand has launched a bilateral trade agreement with Singapore and is also working on another with China. Korea has signed an FTA agreement with Chile. Thailand has an FTA with Laos. Singapore has created FTAs with the US, Japan, and India as well as Australia and New Zealand. There is recurring discussion about creating an APEC free trade zone.

There are several factors which explain the new enthusiasm for bilateral and regional FTAs in East Asia.

1. The Asian Financial Crisis of 1997–98 has encouraged Asian countries to explore new forms of economic cooperation. They have launched a framework under ASEAN plus three for regular discussions among central bankers and finance ministers. They have created

a network of currency swaps worth potentially $36 billion and are prepared to expand them further in the event of a new financial crisis. As East Asia now has over $2.5 trillion of currency reserves, compared to $500 billion in 1998, the region clearly has the potential to insulate itself from financial crisis on the scale which occurred seven years ago. The East Asian countries also planned to hold a summit conference among heads of government in late 2005 with India, Australia, and New Zealand but excluding the United States. Prime Minister Mahathir of Malaysia had often advocated such a gathering during the 1990s but he was not able to overcome opposition from other countries. The fact that the summit occurred is a confirmation of how much importance the East Asian leadership now attaches to regional cooperation.

2. There is great concern about whether the Doha global trade round will be able to produce a successful outcome. The Europeans have refused to make significant concessions on agricultural subsidies, so many developing countries are reluctant to offer concessions on manufacturing and service trade.

3. The rise of China as a great economic power is producing major changes in both regional and global trade flows. China is trying to reassure other Asian countries that it will not be a threat to their economies. Most Asian countries currently have trade surpluses with China and are anxious to enhance their access to the Chinese market.

4. Japan is concerned about China displacing it as the leading regional economic power and is trying to use trade diplomacy to enhance its relationship with other countries in the region.

5. Small countries such as Singapore are attempting to promote both trade and investment through new FTAs. Singapore's state holding companies, such as Temasek, have become major investors all over the region.

6. East Asia has a high level of trade integration without any FTAs. According to the World Bank, intraregional trade in East Asia represented 26.5% of the region's GDP in 2002 which is more than in any other developing regions. As a result, there is natural support for promoting further economic integration in the region.

Until recently, the US played a dominant role shaping East Asian's trade and international economic policies because it was the leading export market for most countries in the region. The US is still a very important market for the region but is increasingly being eclipsed by China. China has displaced the US as the leading trade partner of Japan, Korea, and Taiwan. But, ironically, the US remains critical because it has become the market for nearly one quarter of China's exports. If the US were to experience a recession with falling imports, China's growth rate would drop by at least 1–2%.

China's trade relations with East Asia have been increasing steadily since the 1980s. China joined APEC in 1991. After joining APEC, China unilaterally reduced its tariff barriers with the group from 44.1% in 1991 to 15.3% in 2001. At the Vancouver APEC summit in 1997, China promised to reduce customs duties on industrial goods to 10% by 2005. China also pledged to gradually reduce all non-tariff barriers and increase their transparency. This was followed by promises to open the service sector, increase the transparency of investment policies, and reinforce protection of intellectual property rights. In April 2005 China joined the Bangkok agreement which was the first regional trade agreement with preferential arrangements for China. In 2001, China's prime minister proposed the creation of a regional free trade zone with ASEAN. In the first half of 2005, Chinese firms invested $1.9 billion in other Asian countries or 75% of the country's total outward investment.

As China could soon be the world's leading exporter, she has a great strategic interest in promoting an open multilateral trading system rather than a world characterised by regional trade agreements.

As China could soon be the world's leading exporter, she has a great strategic interest in promoting an open multilateral trading system rather than a world characterised by regional trade agreements. But China has a limited capacity to resolve the issues which are now hampering the completion of the Doha trade round. Those issues do not centre on trade in manufactured goods. The great conflicts centre on agriculture, especially European and American subsidies for farmers, as well as various aspects of service trade. China will therefore pursue a two-track policy. She will encourage an open global trading system but also pursue regional FTAs for both economic and geo-political reasons.

Other East Asian countries will be happy to cooperate with China because they are concerned about competing with her. They fear that China will consume too large a share of the region's FDI. They are concerned about China undermining their competitive position in sectors which depend upon low wages. The potential for a benign relationship is apparent from the tremendous trade growth occurring without an FTA. China now consumes 44% of Hong Kong's exports, 37% of Taiwan's exports, 22% of Korea's exports, 13.% of Japan's exports, 11.4% of the Philippine's exports, 8.6% of Singapore's exports, 7.5% of Indonesia's exports, 7.3% of Thailand's exports, and 6.7% of Malaysia's exports. The character of the exports has also been changing. Ten years ago, ASEAN relied heavily on exports of commodities whereas it now exports primarily manufactured goods. In 2000, electrical equipment represented 32% of ASEAN's exports to China compared to 6% in 1990. The energy share, by contrast, slumped from 32% to 13% while the wood share fell from 22.6% to 2.75%.

China demonstrated its capacity for regional cooperation during the East Asian financial crisis of 1997–98 by not devaluing its currency. The crisis was one of the dramatic economic shocks to strike Asia since the Great Depression of the 1930s. It caused unemployment to rise threefold in Thailand, fourfold in Korea, and tenfold in Indonesia. As the exchange rates of Thailand, Korea, Indonesia, and other countries plummeted, China recognised that a devaluation of its currency would only magnify the financial contagion. As a result, Beijing decided not to devalue and to instead stimulate the economy with a large infrastructure-spending program. The fiscal stimulus helped to sustain output growth despite a 30% rise in the real exchange rate and a sharp slowing of export growth.

Japan has been a regional leader for much longer than China because of overseas development assistance, foreign direct investment and trade. Japan accounts for 13–14% of ASEAN's exports and 17–18% of imports. ASEAN accounts for 11.8 trillion yen of Japanese foreign direct investment or 9.9% of the total while China accounts for 3.1 trillion yen or

2.8% of the total. In 2003, Japan sent 67% of its overseas development assistance to Asian countries, with the largest beneficiaries being Indonesia (19%), China (12.6%), the Philippines (8.8%), and Vietnam (8%). Japan's influence diminished during the 1990s because her domestic economy entered a prolonged period of stagnation while Japanese banks helped to set the stage for the East Asian financial crisis by greatly curtailing their lending in the region. Japan attempted to contain the crisis by proposing the creation of on East Asian monetary fund but the US rejected the idea while China failed to support it. After the crisis, Japan offered a $30 billion aid program (the Miyazawa plan) while collaborating in the ASEAN plus three talks on regional financial cooperation.

In 2002, Prime Minister Koizumi proposed the creation of a Japanese ASEAN Comprehensive Economic Partnership. Despite Mr Koizumi's pledge to pursue new trade agreements with ASEAN, the talks have founded over sectoral disputes. Talks with Malaysia have been road-blocked by Tokyo's refusal to scrap tariffs on plywood imports while Malaysia is reluctant to fully abandon its car tariffs. The Philippines wants Japan to lower its high sugar tariffs. Thailand and Indonesia want better access to Japan's highly protected rice market. The fact that Mr Koizumi recently won re-election with the support of urban voters could weaken the influence of Japan's rural lobby in future trade talks but it is not clear if he will make the ASEAN trade issue a major priority for economic reform. There has been no discussion yet about Japan pursuing an FTA with China despite the fact that China still has high tariffs on important Japanese exports such as autos. There has been a sharp deterioration in the Sino–Japanese relationship during the past year because of Mr Koizumi's decision to continue visiting the Yasukini War shrine. Both China and Korea have protested these visits but the prime minister has been unwilling to give them up. There has also been a growing conflict over a set of islands (Senkaku/Diaoyu) east of Japan which are thought to have large oil and gas reserves. Both Japan and China have given drilling rights to the islands to their own companies. In 2004, China also sent naval vessels into the waters around the islands. The two countries are scheduled to negotiate over the island dispute but China has described Japan's decision to grant drilling rights to its companies 'as highly provocative'.

The ARF forum is still evolving but China clearly views it as important for promoting good relations and holding in check any American attempt to create an anti-Chinese alliance in the region.

Security relations

The focal point for China's security relations with East Asia is the ASEAN regional forum. China joined this group when it was formed in 1994. The membership of the forum is extensive, bringing together 23 countries from both sides of the Pacific as well as Europe. The organisation's primary mission is promoting dialogue, not to create formal alliances. It allows countries to discuss issues of common interest and share information. China has not attempted to use the organisation to achieve particular goals but it has helped to promote peaceful discussion about territorial disputes in the South China Sea. China claims a variety of islands in the region and has occasionally deployed military forces to promote its ownership of them. But after 1994, it used the ARF meetings to say that it would use the United Nations Conventions on the Law of the Sea to resolve its claims rather than pursuing a unilateral solution. The ARF forum is still evolving but China clearly views it as important for promoting good relations and holding in check any American attempt to create an anti-Chinese alliance in the region.

China has also helped to create a new organisation in central Asia called the Shanghai Cooperation Organization (SCO). The demise of the Soviet Union led to the creation of several new independent states in central Asia bordering China. China played a major leadership role in encouraging them to come together in an organisation to promote both security and economic cooperation. In contrast to ASEAN, all the central Asian countries have authoritarian political regimes, many holdovers from the communist era. They all share a common interest in suppressing Islamic fundamentalist and allowed the US to develop a military presence in the region to pursue its war against the Taliban in Afghanistan. The SCO is unique because it is the first organisation in which China has played a founding leadership role but it remains highly informal without a precise agenda. It may also become more economic in character because of China's desire to purchase oil from the region.

Between 1997 and 2003, China announced $9 billion of investments in Kazakh oil deposits and proposed to construct a pipeline to western China. In September 2005, China's National Oil Company launched a $4.2 billion takeover bid for a Canadian oil company with large Kazakh deposits. In 2000, China also signed an agreement to help develop oil deposits in Turkmenistan and build a pipeline to China.

The Shanghai group has recently produced a divergence between Chinese and American foreign policy in the region because of the authoritarian regime in Uzbekistan. The regime in that country used violence to put down an uprising during May that killed hundreds of people. The uprising came only a few weeks after a sudden revolution in Kyrgyzstan; so all the regimes in the region were very apprehensive about demonstrations. The US and other western countries condemned the killings. China, by contrast, welcomed the leader of Uzbekistan to Beijing and announced support for him, as did the Russians. As a result of western criticism, the president of Uzbekistan told the Americans that he wants them to vacate the Air Force base they have been using since the war in Afghanistan. In July, the SCO also called on the US to withdraw all military forces from the region.

There is little doubt that China will continue to support authoritarian regimes in central Asia because they will both protect its oil supplies and restrain Islamic fundamentalists. The US will promote democracy but it will also have to be concerned that it could produce support for Islamic fundamentalist regimes. The Chinese will also be sensitive to Russian views on the region because both countries are showing an increasing willingness to collaborate. China is a major arms buyer from Russia. Both countries have recently conducted joint military manoeuvres. China hopes to greatly increase its imports of oil from Russia. The Russians have been supporting the incumbent regimes in central Asia because they have been long standing allies. They resent attempts by the US to promote revolutions comparable to the one which occurred in the Ukraine last year. The desire of China to have a good relationship with Russia will be one of the anchors of the Shanghai group and will bias policy towards supporting the status quo.

China's other great multilateral initiative has been encouraging talks with five other countries to end North Korea's nuclear weapons program. China is North Korea's oldest ally but the two countries now have little in common. While China enjoys growing trade and investment links to South Korea, the economy of North Korea is moribund. North Korea produces refugees for China, not trade or any other economic benefit. China is very concerned that North Korea's nuclear weapons program could encourage Japan to become a nuclear power while provoking the Americans to play a more aggressive role in the region. It wants North Korea to end the weapons program but it has so far been unprepared to take forceful action against North Korea for fear of destabilising the region and possibly triggering large refugee flows. It has instead lobbied North Korea to take part in the talks and reach a solution through negotiation.

As the economic integration proceeds, the odds are high that South Korea could revert to its medieval status as a Chinese ally.

China has been unenthusiastic about Korean reunification because of concern that it could bring the American military to its border but once the country is reunified the odds are high that American forces would simply leave. The US is now pre-occupied with the Middle East and there is less support for the US in South Korea than was the case in the past. Conversely, there is growing excitement in South Korea about the economic opportunities offered by China. South Korea invested $6.5 billion in China last year. Thousands of Korean companies have opened China operations. There are a growing number of Korean students studying Chinese, not just English. As the economic integration proceeds, the odds are high that South Korea could revert to its medieval status as a Chinese ally.

The six-nation forum on North Korea is unique because it has brought together major powers which have a long history of conflict rather than cooperation, including China, Russia, Japan, and the US. There are some pundits in Beijing who hope that the forum could evolve into a permanent institution for addressing a variety of security issues in the future. There has been no discussion in the US about using the forum for other purposes but if it is effective at resolving the North Korea problem it will set a useful precedent for multilateral cooperation on security issues in the region. It could open the door to other forms of dialogue on security concerns with potentially benign consequences for all the parties.

Chapter 4

IMPLICATIONS FOR US FOREIGN POLICY

The rise of China as a great economic power and the new experiments with multilateralism in East Asia will pose a challenge for US policy. The US has to recognise that there are new forces at play in the region which will alter the traditional balance of power and that the East Asian financial crisis of 1997–98 profoundly altered Asian views of how the world works. There is now far more willingness to collaborate in the region than was the case before the 1997–98 crisis. The countries in the region now hold regular conference on financial and economic issues. They also have $2.5 trillion of foreign exchange reserves or nearly two thirds of the world total in order to insure they will never again be vulnerable to sudden changes in global capital flows. Japan has over $800 billion of reserves while China has over $770 billion. Korea and Taiwan have over $200 billion each. Hong Kong and Singapore each have over $120 billion. Until the recent oil price shock, all the East Asian countries were also running current account surpluses.

The US clearly has the potential to remain a major player … but it will be critical to develop an effective relationship with China …

The US has criticised China for accumulating reserves rather than allowing its exchange rate to appreciate, but the fact is China's intervention has helped to finance the US budget deficit and propel a great housing boom.

Photo opposite: Urban Renewal #1, Factory Construction, Outside Shenzhen, Guangdong Province, 2004. Photography by Edward Burtynsky. Image Courtesy: Charles Cowles Gallery, New York—Robert Koch Gallery, San Francisco—Nicholas Metivier, Toronto

Since the September 11th attack on New York and Washington, the US has been pre-occupied with the Middle East and downplayed its relationship with East Asia. At the APEC summit conferences, President Bush gives speeches about the war against terrorism, not economic cooperation. Prior to the APEC summit in Korea, he had spent only 13 days in Asia compared to 46 days in Europe. But US policy has not been totally static. The US has signed free trade agreements with Australia and Singapore. The US is negotiating a new FTA with Thailand and there is talk of pursuing additional ones with Malaysia and Korea. It has significantly expanded foreign aid in the region. The Bush Administration greatly impressed Indonesian public opinion by providing significant emergency relief after the Tsunami struck Aceh last January. The US clearly has the potential to remain a major player in the region but it will be critical to develop an effective relationship with China because of the rapid growth occurring in intra-regional trade.

There is a natural suspicion in Washington about the geo-political and military consequences of China's new status as an economic power. Many fear China will use its new wealth to develop sophisticated weapons and challenge America's traditional military dominance in the region. Some Pentagon analysts estimate that China's defence spending could be two or three times as large as the official estimate of $22 billion. There is concern that if China continues to spend about 2.7% of GDP on defence, its defence budget could rise to $120–130 billion in ten years or be the second largest in the world after the US. But the fact remains that China has become so engaged in the global economy that it now has a diminishing capacity for radical foreign policy action. China has the world's third largest stock of FDI. China's ratio of exports to GDP is three times higher than the US, Europe, or Japan. China could be the world's largest exporting nation within two or three years. As a result of these circumstances, China must be a good global citizen because it now depends upon other countries to absorb nearly half of its manufacturing output.

The US has long wanted to promote democracy in China but it is far from clear that a democratic regime in China would be benign for American interests.

The US has long wanted to promote democracy in China but it is far from clear that a democratic regime in China would be benign for American interests. The current regime in Beijing is firmly committed to economic modernisation and market opening which will lead over time to the emergence of a large middle class. If China had a democratic regime, there is a great risk that the increasing income inequality in the country could produce a populist regime which would suspend economic reform and plunge the country into the kind of inflationary crises which have characterised Latin America for much of the modern era. The potential for trouble is apparent from the fact that the Chinese Government itself admits there were 74,000 protest marches and demonstrations last year or seven times more than occurred ten years ago. Many of these protests were by rural people upset about the loss of their land to property developers or urban people concerned about job losses at state-owned companies attempting to bolster productivity. What China needs today is more freedom of the press, greater transparency, and other developments which would increase government accountability and allow more debate about policy choices. The Chinese

Government undermines its own reform program when it arrests journalists for publicising corruption or other injustices. Its role model should not be the old Soviet Union but rather Singapore and Mexico—countries with a long tradition of one party rule which also tolerate dissent and political debate.

The US should support the experiments in regional cooperation such as the ASEAN plus three meetings on financial and economic policy. They do not threaten any American interests. There are some in Washington who would like to create an organisation in East Asia comparable to NATO in order to challenge China. As a result of East Asia's rapidly growing trade with China, it is doubtful that any country in the region would support such an organisation. In fact, the Australian foreign minister recently suggested that his country would not support the US in a conflict over Taiwan because of its own rapidly growing economic links with China. If the US cannot persuade Australia to join an anti-China coalition, it will be difficult to get any other country in the region except possibly Japan to pursue an alliance against China.

There is concern everywhere that a China–ASEAN free trade zone could become discriminatory against other countries and regions. But ASEAN has a tradition of encouraging openness rather than increased protectionism. The US should lobby the ASEAN countries to continue this tradition. China also has little self-interest in highly discriminatory trade policies because of a heavy dependence upon markets in North America and Europe.

The US has been critical of China for pursuing relationships with rogue states such as the Sudan, Iran, and Venezuela in search of oil reserves. The US naturally fears that China might give these countries military supplies in return for preferential access to raw materials. But the US effectively encouraged China to cultivate such relationships when the Congress attempted to veto the Chinese takeover bid for Unocal a few months ago. The fact is a Chinese takeover of Unocal would not have posed any threat to American security but it would have given China access to new oil reserves off the coast of Thailand. The decision to block the bid revealed an extraordinary insecurity about China which can only undermine America's ability to pursue a constructive relationship with the country.

After an initial period of hostility, the Clinton Administration came to speak of a partnership with China. The Bush Administration regarded China as more of a rival and began to distance itself from Beijing until the events of September 11th forced it to rethink who its enemies really were. Since 2001, the Bush Administration has attempted to pursue a more collaborative relationship while remaining apprehensive about the long-term implications of China's rise as an economic power. There is no way that these apprehensions can go away because the re-emergence of China as a great power is a truly unique event. It is somewhat comparable to the rise of Germany and Japan during the early 20th century but it has the potential to be even more significant because of the sheer scope of China's population size and land mass. Germany and Japan aimed to be regional powers. China has the potential to be a global power.

The fact that Germany helped to launch a war with Britain in 1914 is a reminder that economic integration does not guarantee that a country will have a benign foreign policy. On the eve of the First World War, Germany had 76% of its foreign trade with other European countries, including 14% with Britain 8% with France, and 7% with Holland. The UK had only 36% of its trade with Europe but Germany was number one with an 8% share.

France had 71% of its trade with Europe and Germany was the second largest partner at 13% compared to 22% for Britain. Austria-Hungary had practically all of its trade with Europe and 65% of its exports went to Germany compared to only 3.8% for Russia, 3.5% for Britain, and 2.1% for France. As Norman Angell wrote in 1911, there should never have been a European war because it would be economic madness for the players. Angell was vindicated by events but Germany nevertheless allowed her alliance with Austria-Hungary to set the stage for a conflict which engulfed all the major European nations.

The great hope for East Asia in the 21st century is that it does not have the same potential for conflict as existed in Europe ninety years ago. Germany and Austria-Hungary were concerned about the rise of Slavic powers such as Russia and Serbia. The decline of the Ottoman Empire had created a power vacuum in southeastern Europe. Some German military officers feared that Russia's economic takeoff would make her a far more formidable military foe in ten years than she might be in 1914. East Asia does not have any declining empire comparable to Turkey. There is no rising power which could threaten China. The major potential flash points for conflict in the region are North Korea and Taiwan. China is trying to persuade North Korea to give up her nuclear weapons. China has threatened Taiwan but there is unlikely to be a conflict when China has the possibility of achieving its goal through peaceful means. In fact, the Taiwan election of 2008 could set the stage for a rapprochement if the KMT reclaims the presidency.

The experience of 1914 is a warning that one cannot depend upon economic factors to resolve political conflicts, but the situation in East Asia today contains fewer political risks than Europe during the early 20th century. The challenge for the US, China, and Japan is to continue minimising the potential for conflict through effective dialogue while pursing the economic integration which will encourage further political cooperation. The US can have conflicts with China over commercial issues such as intellectual property rights but such disputes do not have to set the stage for great power confrontation.

As a result of China's high level of integration with the global economy, her capacity for radical foreign policy adventures is greatly diminishing.

The new geo-politics of Asia

The re-emergence of China as a great economic power is going to be a central issue for policy makers in all East Asian countries for many years to come. There is little doubt that China is going to play a dominant role as a market for all countries in the region. As China's corporations globalise they will also become an important investor at some point.

China is stressing that it wants to become a great power through peaceful means and not threaten other countries. As a result of China's high level of integration with the global economy, her capacity for radical foreign policy adventures is greatly diminishing. East Asian countries have mixed feelings about the re-emergence of China as a great power. Their memories of Chinese imperialism during the Middle Ages have dimmed because there was an intervening period of European and Japanese imperialism. Most countries in the region have a close relationship with the US which they want to maintain. They hope that the US and China will find ways to cooperate, so that they will not be forced to take sides in a confrontation between two great powers. As a result of the economic opportunities offered by China, both the private sector and government organisations in the region are pursuing a policy of active engagement. They want the benefits of trade and tourism links with China. They are concerned about competition with China but since such a large share of the value added in China's foreign trade consists of imports from other Asian countries they have clear evidence that China also offers benefits. Their primary concern is probably the long-term balance of power in the region. In thirty years, the Chinese economy could be as large as the American economy and the Chinese defence budget could be $200–300 billion compared to $22 billion recently. The US will still be a player in the Asian region but it is not clear if the US will want to retain its current structure of military forces in Asia or challenge a China with an economy equal in size to its own. It is possible to imagine scenarios in which China could become the clearly dominant power in the region without any serious rivals.

If China were to be the dominant power, it is not clear how it would manage relations with other countries in the region. Instead of practising the deference which its policy markers currently advocate, it could return to the style of the Middle Ages and regard its neighbours as de facto subordinate states. It is doubtful that China would attempt to conquer any country but some Chinese might want to address the issue of territorial conquests which Russia achieved at China's expense two or three hundred years ago. The population of the Russian Far East is small and shrinking despite the region's large resource endowment, so some Chinese might be tempted to improve China's access to oil and other resources by reclaiming lost territory from Russia. China attempted to resolve most of its territorial disputes during the 1960s and 1970s, so the current government in Beijing does not have any claims to territory on the Asian mainland. The question is how Beijing's position would change in fifty years if China had an economy as large as America's and Russia was a weak state with a depopulated Far East.

Each Asian country has a different historical experience of China, so each will pursue its own policy for coping with the re-emergence of China as a great power. Korea has embraced China because of economic opportunities and the lack of an adverse colonial history comparable to Japan's. China dominated Korea in the past but it did not actively colonise Korea. China helped North Korea during the war of 1950–53 but South Korea no longer regards China as a military threat because she is actively promoting talks to disarm the north peacefully.

Singapore is a country dominated by people of Chinese ancestry which has a long history of promoting both trade and investment throughout the region. Singapore was an early investor in China and the government has long promoted further expansion of Singapore's companies in the country. Singapore has traditionally had a good relationship with Taiwan and trains its military forces on the island. But Singapore does not support Taiwan independence and has warned the government in Taipei that it should not provoke Beijing. As a result of Singapore's enthusiasm for FTA agreements, she will support China's ambitions for a regional FTA.

Thailand is anxious to promote trade and investment with China because there is so much potential opportunity for both sides from closer economic cooperation. Thailand's Chinese minority is also fully integrated in the population, so there are no ethnic suspicions of China.

China has also been promoting discussion about building a canal across southern Thailand in order to reduce her dependence upon the Straits of Malacca.

Malaysia and Indonesia have large Chinese minority populations which have produced tensions in the past. Much of Malaysia's Chinese minority supported the communist insurgency during the 1950s. Indonesia expelled thousands of Chinese traders during the late 1950s and China actually sent naval vessels to rescue them. There were also anti-Chinese riots during the East Asian financial crisis of 1998 but China did not actively intervene at that time. Malaysia is concerned about competing with China but she has enjoyed significant growth of her exports to China during the past decade. She will therefore support proposals for a China–ASEAN FTA.

As a result of China's need for raw materials, the odds are high that it will develop a much closer relationship with Indonesia in the future.

Indonesia's new president has been reaching out to China for both trade and investment. After the summit celebrating the 50th anniversary of the Bandung conference, President Hu Jintao stayed another day in Indonesia to confer with President Susilo Bambang Yudhoyono about a new Strategic Partnership Agreement. Under the terms of the agreement, Beijing will provide Jakarta with up to $507 million to build a bridge in East Java as well as a dam in the western portion of the island. The two leaders also pledged to increase the value of bilateral trade from $13.5 billion in 2004 to $15 billion in 2005 and $20 billion in 2006. Chinese companies later announced plans to invest $3 billion in Indonesia's energy sector on top of the $1.2 billion they have already committed to the country. As a result of China's need for raw materials, the odds are high that it will develop a much closer relationship with Indonesia in the future. Indonesia has large reserves of many raw materials, including oil, gas, copper, nickel, and coal. Since the fall of President Suharto, there has also been a significant liberalisation of the rules which govern the Chinese population. They are now permitted to celebrate their holidays and display symbols of their culture whereas in the past such behaviour was prohibited.

The Philippines is concerned about competing with China but has been enjoying rapid growth of trade. President Hu Jintao visited Manila during April to confer with President Macapagal-Arroyo. She had already visited Beijing earlier in the year. The two discussed proposals for a new strategic partnership of joint exploration and development of oil in the South China Sea. They also pledged to boost trade to $30 billion within five years. In May, the Philippine president also met with People's Liberation Army Deputy Chief of Staff Xiong Guangki to begin a regular dialogue on defence and security. As with Indonesia, China will be attracted by the opportunity of purchasing raw materials from the Philippines. The country recently changed its mining laws in order to allow foreign investment, so the odds are high that there will be a significant expansion of the minerals producing sector. Companies producing copper, nickel, coal and other minerals in the Philippines will naturally turn to the Chinese market.

Vietnam has a history of conflict with China over borders and is the only country in the region to currently run a trade deficit with China. President Hu Jintao recently visited

Vietnam and used the trip to promote cooperation in a variety of areas. Mr Hu proposed a survey of the land border in order to reach a new agreement on how to define the border by 2008. They also agreed to promote fisheries cooperation and to resolve a dispute over oil exploration rights in the South China Sea. In the past, both countries have claimed ownership over territory in the South China Sea which is thought to have great potential for energy development. Bilateral trade between China and Vietnam was $6.74 billion in 2004. Both countries pledged to boost it to $10 billion during the next few years. The growing economic links between Vietnam and China will make Vietnam supportive of proposals for a regional FTA.

China has long had a strained relationship with India because of the war they fought in 1962 but there has been great progress during the past three years in overcoming these barriers. There have been several visits by heads of government in both countries with each side proposing economic cooperation focusing on trade and investment. Many Indian software firms have recently opened offices in China. Chinese telecom equipment companies have been seeking business in India. Foreign trade has increased to $13 billion and could easily double during the next five years. Washington has been trying to boost India as an alternative power centre to China in the region but New Delhi has been reluctant to promote itself as a rival to Chinese power. India is instead emphasising cooperation while also reaching out to other Asian countries such as Singapore.

China's most tense relationship in the region is with Japan. Japan is America's most important Asian ally and has recently strengthened the relationship by announcing a new plan for deploying US forces in the region. The strains in the Sino–Japanese relationship reflect historical legacy issues, so they cannot be easily dismissed. The Japanese produce textbooks about their history which other countries regard as unacceptable. Prime Minister Koizumi insists on visiting the Yasukuni War shrine. Yet, the two countries have rapidly expanding trade links while Japanese firms are large investors in China. What remains to be seen is whether there can be breakthroughs on substantive issues to compensate for conflicts over symbolic issues. One potential candidate for cooperation is the dispute over the island chain where both countries have conflicting territorial claims. The new Japanese trade minister has extensive China experience and has promised to resolve the dispute with China through negotiations. If he can be successful, it could help to open the door to other forms of cooperation despite the problems with legacy issues.

The evolution of Taiwan's politics could also play an important role in shaping regional diplomacy. The DPP Government has experienced a major slump in popularity and could fare poorly in coming local elections. The next presidential election will be in 2008. As a result of the island's economic problems, there could be greater public support for pursuing a political rapprochement with China to allow direct air and sea links. If the KMT can win the election on a manifesto promising such links, there could be a major improvement in the relationship with the mainland. China realises that it will not be able to reestablish control over Taiwan so long as it has an authoritarian political regime but there could still be symbolic gestures promoting the theme of long-term reunification. One could even imagine scenarios in which Taiwan could reclaim a seat in the United Nations on the same basis that the Ukraine once had a seat autonomously from the Soviet Union. China could contend that Taiwan is an autonomous member of a larger Chinese homeland and thus deserves some form of international recognition.

Chapter 5

CONCLUSION

The rise of China as a great power is occurring within a different institutional context than did the rise of Germany and Japan during the early 20th century. The world had not yet begun to create international institutions to resolve disputes and manage tensions. Before 1914, all nations had achieved great power status either through military conquest or colonisation. There was no precedent for achieving great power status solely on the basis of economic achievements and rising living standards. As the 20th century was an age of great warfare, the world has attempted to create an alternative framework for accommodating changes in the balance of power. The system was able to adapt to a peaceful dissolution of the Soviet Union. The rise of China will be the first major test of whether it has the capacity to cope with a new great power. Despite the natural suspicions of China which exist in Washington, Tokyo, and elsewhere, the odds are high that the system will be able to accommodate China because it is in China's self interest to be a good global citizen. China has a level of engagement with the global economy and its primary potential adversary, the United States. This was never the case with Germany and Japan. There is no guarantee that China will allow economic self-interest to prevail over other priorities but it will certainly make the cost of a belligerent foreign policy very high.

As the nature of the challenge posed by China is unprecedented in human history, the response will have to be imaginative. The US and other countries cannot attempt to isolate or build alliances against her. They have to engage China and take advantage of her vulnerabilities by proposing new forms of cooperation on issues as diverse as trade, investment, military security, and managing global energy supplies. China will cooperate because she still has a limited capacity to influence the international economic system despite her growing

Photo opposite: Manufacturing #2, Shift Change, Yuyuan Shoe Factory, Gaobu Town, Guangdong Province, 2004. Photography by Edward Burtynsky. Image Courtesy: Charles Cowles Gallery, New York—Robert Koch Gallery, San Francisco—Nicholas Metivier, Toronto dependence upon it. The countries in the region have a strong interest in encouraging China's integration with the global economy because they are an integral part of the supply chain driving China's manufacturing boom. They would suffer from trade sanctions against China or a global downturn which depressed China's exports. The integration of China with the global economy will also intensify pressure on China to resolve any territorial disputes in a peaceful manner.

As the nature of the challenge posed by China is unprecedented in human history, the response will have to be imaginative. The US and other countries cannot attempt to isolate or build alliances against her.

Australia has adopted a pragmatic attitude towards the rise of China. She is seeking to take advantage of the economic opportunities offered by China while maintaining a political distance because of potential disagreements over issues such as human rights and the alliance with the United States. There is no alternative to this policy of pragmatism because China could displace Japan as Australia's leading trade partner within ten years while Beijing will play a leadership role in the creation of new institutions such as the East Asian free trade zone. Australia will need a good diplomatic relationship with China in order to have a good relationship with Asia. Australia should also take advantage of its close relationship with the United States to encourage an equally pragmatic policy in Washington. There is great ambiguity in Washington about China but the pragmatists have so far won because the US has other foreign policy concerns which have reduced its appetite for a confrontational policy in East Asia. Australia needs to remind the US that China does not have to be an enemy or a threat to its economic interests in East Asia. If Australia can play such a role, it will not only help to produce a benign policy in Washington. It could also enhance Australia's ability to influence Beijing and the new power structure emerging in East Asia.

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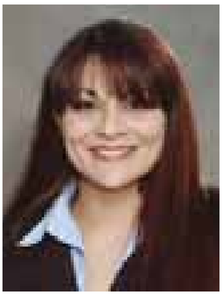

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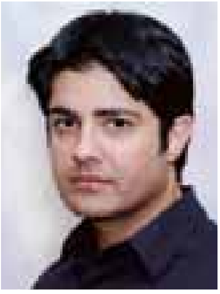

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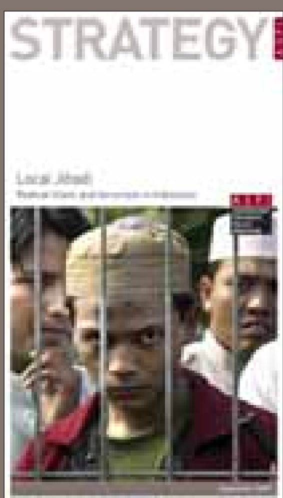

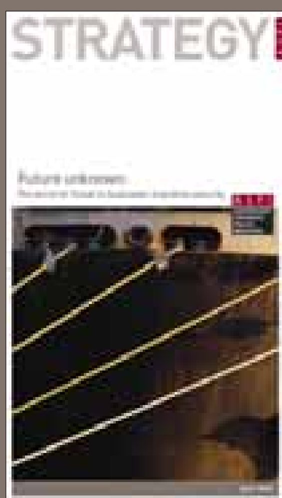

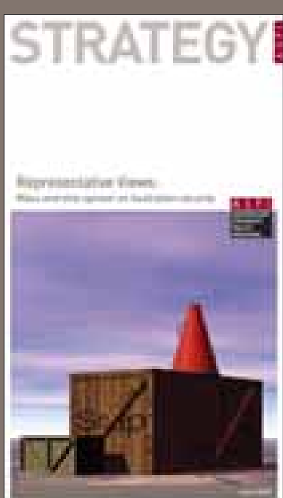

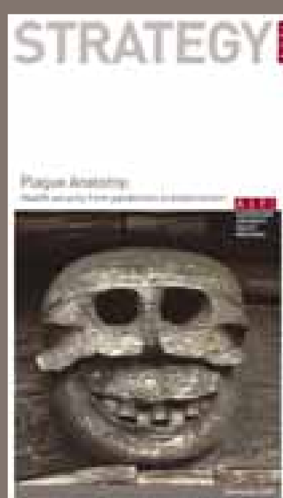

In the Balance
China's unprecedented growth and implications for the Asia–Pacific

Few issues are more important to Australia's long-term strategic position in the Asia–Pacific than the health of China's economy and the nature of Beijing's foreign and defence policies.

In this ASPI *Strategy* Chicago-based economist and prominent China watcher David Hale gives his assessment of China's economic prospects and the impact this will have on the Asia–Pacific region.

David Hale provides startling data to show how rapidly China is coming to dominate not only the Asia–Pacific economies, but also to be a fundamental driving factor in Europe and North America. Hale says: 'China could soon be the world's leading exporter, she has a great strategic interest in promoting an open multilateral trading system rather than a world characterised by regional trade agreements.

While David is generally optimistic about China's prospects his paper assesses some of the serious impediments in the way of continuing high growth. Most critically of all he argues that: 'The great challenge now confronting China is to complete the transition to a transparent market economy with a democratic form of government.'

What are the likely foreign and strategic policy implications? Hale's overall message is optimistic. He argues that: 'The rise of China will be the first major test of whether [the global system of states] has the capacity to cope with a new great power.'

China is increasingly active on the global diplomatic stage, pursuing resources in places as far afield as Zimbabwe, the Sudan and Venezuela. China has a growing strategic interest in Central Asia and the Middle East and this is creating a new dimension in Beijing's relationship with the United States and other major powers.

Hale points out: 'The experience of 1914 is a warning that one cannot depend upon economic factors to resolve political conflicts, but the situation in East Asia today contains fewer political risks than Europe during the early 20th century.'

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