



*China
and the global
financial crisis*



Bobo Lo



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1 Introduction

More than any other event in the post-Cold War era, the global financial crisis has highlighted the contradictions of modern China. On the one hand, the country appears to have emerged better than any other major (or even minor) economy. Growth in 2009 reached 8.7 per cent, close to the 30-year average that has marked one of the most remarkable transformations in history. The Chinese Communist Party (CCP) remains firmly in control, with fears of widespread social unrest proving exaggerated. Internationally, Beijing has become increasingly assertive, with talk of China's 'inevitable', not just 'peaceful', rise. For many, the issue is no longer whether China will overtake the United States as the leading global power, but when.

On the other hand, the crisis has shaken Beijing. Early confidence about the decoupling of the Chinese economy has given way to recognition that China continues to be affected by global trends and events. While the CCP is solidly entrenched, it remains nervous about the sustainability of economic growth, tightening resource constraints and ethnic tensions. It worries about its continuing capacity to deliver good governance and maintain regime legitimacy. Optimism about China's rise is counterbalanced by discomfort over the responsibilities – and heightened expectations – that come with global prominence. The outcome of these contradictions is a China that is at once confident and insecure, assertive and introspective, enterprising yet also deeply conservative.

Such a China presents enormous challenges for the rest of the world. In recent times, the United States and Europe have found it increasingly difficult to manage relations with Beijing *and* the expectations of their own domestic audiences. This has resulted in

the maximising of policy differences and a significant escalation of tensions. There is general consensus in China and the West that both have a vital interest in long-term co-operation. But there is no shared vision of how to achieve this, or agreement on the underlying principles and nature of co-operation. The global financial crisis has fundamentally changed – and complicated – the terms of engagement.

This essay centres on three questions:

- ★ **The impact of the financial crisis on the Chinese economy.** The government's huge fiscal stimulus package (RMB 4 trillion ~ \$585 billion) enabled China to maintain impressive growth during 2009, by far the best among the G20 economies. Yet there is vigorous debate about the sustainability of China's modernisation. Is Beijing's interventionist approach storing up problems for the future – such as industrial over-capacity and an excessive reliance on state investment – or will it afford the leadership the breathing space to implement major structural reforms? There has been much talk of China moving away from its traditional manufacturing base towards a greater emphasis on services and domestic consumption. Yet questions remain about the leadership's commitment to change, given its political and ideological conservatism.
- ★ **The outlook for political stability and regime legitimacy.** Since the beginning of *gaige kaifang* ('reform and opening') in 1978, the Communist Party has operated on the basis of an implicit social contract with the Chinese people. In return for the latter's obedience, the CCP has presided over a quiet revolution that has raised some 400 million people out of poverty, created a growing if still small middle class, and greatly expanded the personal freedoms of the vast majority of Chinese. Uninterrupted economic growth has enabled Beijing to minimise the consequences of potentially disruptive phenomena such as a huge migrant worker population. Some western

commentators insist that the Party has no choice but to become more democratically accountable. But China's leaders have drawn very different conclusions, choosing instead to consolidate the Party's authority and clamp down on political dissent and separatist sentiment.

- ★ **The implications for Chinese foreign policy and Beijing's relations with the West.** Over the past decade, Beijing's earlier focus on a narrow range of primary priorities has given way to a steadily more expansive agenda. Against this background, the global financial crisis has had a double-edged effect. On the one hand, it has encouraged a new bullishness in foreign policy – one that challenges the primacy of western values and interests. On the other hand, the Chinese leadership has been disconcerted by the shocks to the international system over the past 18 months. How will Beijing's mix of self-confidence, growing sense of strategic entitlement and continuing vulnerability translate into concrete policies? There are signs of a more militant approach – for example, over US arms sales to Taiwan, climate change and Iran – but does this reflect a strategic shift in China's approach to the world, or merely the 'emerging pains' of a confused power?

2 The economic scorecard

By almost any standard, the Chinese economy has performed spectacularly well over the past 18 months. At a time when economies the world over have been in freefall, China is among the very few nations to have achieved growth. Western critics enjoyed a brief moment of *schadenfreude* when it appeared initially that this would fall far short of previous years. However, such has been the impact of the government's stimulus package that GDP increased by 8.7 per cent in 2009, only slightly down from the double-digit rates of recent years. Despite the country's socioeconomic problems (see below), this is an impressive achievement.

Fears of economic and social ructions have been misplaced. Early on, there was considerable speculation about the consequences of 20 million new unemployed, in addition to 6 million college graduates a year seeking work. The heartland of China's consumer export industries, the Pearl River Delta, was said to have been decimated by mass factory closures. Today, however, we could be excused for wondering 'crisis, what crisis?' Factories are reopening and employment is up. Contrary to many western (and some Chinese) forecasts, China's estimated 200 million migrant workers have not proved to be a destabilising force. China's graduates are struggling to find careers commensurate with their qualifications, but they remain politically quiescent. There are frequent public protests about working conditions, local government corruption, land seizures and so on, but there is no evidence that the global crisis has undermined stability as a *whole*.

In some respects, the crisis has even turned out to be a blessing. The Party had previously worried about overheating of the economy, inflation and real estate speculation. Instead, the economy is

growing steadily and inflation remains modest (forecast to be 3 per cent in 2010). The decline in manufacturing exports has encouraged a reorientation of production to the domestic market. And the leadership's influence on economic policy-making is greater than it has been for years. As the well-known China hand Clinton Dines puts it, this is the 'crisis from central casting' – just what Beijing might have ordered.

Economic sustainability – misconception and reality

The real issue is not how well China has weathered the global downturn, but whether its economic model is sustainable. Conventional wisdom in the West says not, and indeed there is much to dislike. In 2008, manufacturing accounted for a

¹ *The contribution of services to GDP is far higher in some other emerging economies, such as Brazil (68 per cent) and India (63 per cent).*

disproportionately high 49 per cent of GDP, compared to services at only 40 per cent.¹ State and local government investment is biased towards heavy industry and often driven by vested

interests. Cronyism, corruption and bureaucratic interference are rife; China has excessive financial holdings in the US (conservatively estimated at \$1.5 trillion); the renminbi (RMB) is severely undervalued, causing major imbalances – and frictions – with China's trading partners; and inflationary and unemployment pressures are never far away. Critics claim that the stimulus package has simply masked underlying deficiencies in the economy, and indeed may be exacerbating them.

There is no doubt that China faces huge challenges in moving from its current phase of industrial development to realising the Party's vision of an advanced, post-industrial and knowledge-based economy. Nevertheless, much of the western commentary on China's weaknesses is overstated, outdated and simply wrong.

The most popular misconception is that the Chinese economy is dependent on manufacturing exports. In fact, these account for only

a small part of GDP growth. Even in a good year, exports contribute only 10-20 per cent of China's economic growth, in effect, the difference between a high single-digit and low double-digit figure. This limited dependence on foreign trade was one reason why China continued to achieve impressive numbers in 2009. The claim that it cannot rely on ever expanding exports to the rich consumer markets of the West consequently misses the point. For not only is China's growth largely fuelled by domestic demand, but its export markets have diversified considerably in recent years away from Europe and America towards Asia, Africa and Latin America. Brutally put, the West's dependence on Chinese manufactured goods far exceeds China's need for western shoppers.

Admittedly, China will need to boost domestic consumption if it is to ensure long-term growth. And this will require a revolution in the spending habits of its citizens. During much of the post-Mao period, consumption has been dampened both by cultural conservatism and the concrete constraints of spiralling health, pension, housing and education costs. With the disintegration of cradle-to-grave social welfare – Mao's 'iron rice bowl' – most Chinese have naturally accumulated savings as a hedge against ill-fortune (such as poor health) and as a vehicle of social mobility (through education). Welfare provision has acquired added urgency given the rapid ageing of the Chinese population. By 2050, it is estimated that there will only be two workers for every pensioner, an equation that will impose a tremendous burden on the system.²

² *It is estimated that by 2040 China will have 400 million people over the age of 65.*

However, in proceeding from the mistaken premise that the Chinese economy is export-dependent, many commentators underestimate Beijing's commitment to boosting domestic consumption. Not only has the leadership long emphasised its importance, but by radically raising the population's living standards it has allowed hundreds of millions of Chinese to become consumers to an extent unimaginable as recently as two decades ago. This growing consumer class will be the prime engine of China's economic growth. The contribution of

domestic consumption to GDP may be low, but it is increasing rapidly. In 2009, it accounted for 52.5 per cent of GDP growth, up from 46 per cent in 2008 and 41 per cent in 2007. Household consumption showed a corresponding rate of increase over the same

³ *Andy Rothman, 'A wild ride', CLSA Asia-Pacific markets report, February 2010.* period, accounting for about 39 per cent of GDP growth in 2009, compared with 33 per cent in 2008 and 30 per cent in 2007.³

It is easy to overlook in the clamour about China's rise just how underdeveloped it remains in many respects. Only about 300 million out of a total population of 1.3 billion people (or 1.5 billion, according to some estimates) are regarded as relatively affluent, while most of the country's 200 million farm households are living on a subsistence income. The fact that domestic consumption is rising from such a low base indicates there is plenty of scope for growth. As the Chinese economy moves towards a post-industrial stage of development, the addition of tens of millions of people to the relatively affluent will ensure a lasting consumer boom, particularly as the government funnels ever more resources into health care and education.

⁴ *PPP (purchasing parity power) figure – <http://siteresources.worldbank.org/DATASTATISTICS/Resources/GNIPC.pdf>* The comparatively low income level of the Chinese population (GNI per capita of \$6,020 in 2008)⁴ suggests, too, that the dangers of excess capacity are exaggerated.

There is a tendency in the West to view the boom in hard infrastructure as something of an indulgence and a device to inflate growth figures. After all, how many 50-storey skyscrapers, highways, railways and airports can one country need? Yet the reality is that China is catching up on decades, even centuries, of underdevelopment. As its population becomes wealthier, more urbanised and increasingly consumerist, it will inevitably soak up much of this perceived 'over-capacity'. A \$5 trillion economy, growing at 9 per cent a year, is a mighty hedge against such notional dangers. In the meantime, the proliferation of large infrastructure projects helps alleviate unemployment, particularly among migrant workers.

Another common criticism is that the stimulus package – and the Chinese modernisation model more generally – favours inefficient and often polluting state-owned enterprises (SOEs), in the process accentuating structural imbalances in the economy. Again, however, this is a simplistic image. First, SOEs account for only a relatively small share of industrial output, less than 20 per cent according to most estimates. By contrast, small- and medium-sized enterprises (SMEs) contribute around 70 per cent of GDP, up from 17 per cent two decades ago, while nearly all job creation today is in the private sector.

Second, the popular image of the wasteful, coal-belching SOE is anachronistic. While there are undoubtedly many polluting enterprises, SOEs in general are subject to far greater fiscal, market and environmental discipline than ever before. They are vigorously taxed, they pay out dividends, and the larger enterprises are even required to have a majority of non-executive independent directors on their boards. They may not be as efficient as SMEs, but they are a far cry from the clichéd Soviet-style industrial enterprise. In this connection, the risk of non-performing loans to SOEs is overstated. Although the easing of credit through the stimulus package has raised the risk of non-performing loans (NPL), China's NPL ratio of 1.58 percent – even allowing for some under-reporting – is very low by international standards. Just to be sure, though, Beijing has tightened up on the allocation of credit, ordering commercial banks to increase their reserves on two occasions in the past 12 months.

The overly defensive performance of the Chinese delegation at the Copenhagen climate change summit in December 2009 exacerbated western suspicions that Beijing is not serious about sustainable development. In fact, the leadership has been conscious for some years that China cannot continue along the resource-intensive path that has characterised its economic revolution, particularly during the past 10-15 years. The combination of a huge population and scarce natural resources means that it has little choice but to become a more efficient, cleaner economy. The current (2006-2010) five-year plan envisages a 20 per cent improvement in energy efficiency, a

target that will be comfortably met. And Beijing has committed China to a 40-45 per cent reduction in carbon intensity by 2020 (compared with 2005). By then, renewables are expected to comprise around 15 per cent of national energy consumption. The move towards cleaner energy is not just a prerequisite of long-term, sustainable growth; it is intrinsic to the Party's vision of China as an advanced, post-industrial economy.

It is true that the leadership faces a constant struggle in reconciling these strategic ambitions with more immediate goals. For much of China's post-Mao modernisation, quantitative growth – 'the tyranny of big numbers' – has been the main criterion by which commercial enterprises have been judged and, in many cases, political careers made (and broken). And during the first few months of the financial crisis, the government's most urgent priorities were to insulate Chinese industry from the effects of the global downturn through state investment and the facilitation of credit, to safeguard living standards and to contain unemployment. However, with the upturn in the economy – 10.7 per cent growth in the last quarter of 2009 – the previous emphasis on the environment and efficiency has returned. Regional and local authorities are under mounting pressure to deliver on these goals.

Finally, there are concerns that the fiscal stimulus package will reinforce the manufacturing bias of the Chinese economy at a time when Beijing needs to build up services. Such fears are exaggerated, and overlook the leadership's commitment to rebalancing. In the first place, a flourishing services sector is integral to the CCP's overarching goal of creating a knowledge-based, innovation-led economy. Only when this is achieved will China be deemed to have arrived as a genuine global power. Second, the next wave of services growth is likely to be in financial, media and legal services, which will help drive improvements in corporate governance and tackling corruption. The application of the rule of law, characterised by greater transparency and accountability, is critical if the Chinese government is to realise, for example, the (currently utopian) vision

of Shanghai becoming a global financial centre by 2020. Finally, the development of advanced services will help absorb surplus college graduates, many of whom are either out of work or employed in low-paying, low-status jobs.

At China's current stage of economic development, it is inevitable that secondary industry will continue to dominate. But as the country moves into a post-industrial phase, services will grow significantly. Just as industrialisation and urbanisation have revolutionised what was once an overwhelmingly agrarian society, so China's increasing prosperity will drive the tertiary sector. To some extent, this is already happening. A lot of manufacturing has already left the coastal provinces for the interior, to be replaced by the expansion of service industries.

Political obstacles to reform

Much western analysis of China is predicated on the assumption that marrying political authoritarianism with economic and social liberalisation is intrinsically unsustainable. Without democratisation, it is argued, there can be no effective modernisation. The reasoning runs as follows. The CCP's obsession with political control establishes an unfavourable context for the emergence of an advanced, post-industrial economy. Even if China catches up with the US in overall GDP, it will lag far behind in qualitative development, be crippled by waste and lack the capacity for innovation that typically drives a modern, democratic power. In these conditions, the leadership will find it increasingly difficult to maintain growth and preserve the Party's legitimacy.

The Communist leadership recognises the existence of a political dimension to social and economic transformation. More than two decades ago, Deng Xiaoping spoke about the risks of 'letting in the flies', that is to say, potentially subversive influences, through the open window of domestic liberalisation and receptiveness to the outside world. Deng thought the gamble worthwhile, particularly

⁵ *Mao represented the first generation of Chinese leaders, Deng Xiaoping the second and Jiang Zemin the third.*

given the absence of viable alternatives. The current 'fourth generation' of leaders, headed by Hu Jintao, is more cautious.⁵ Intellectually, they recognise the need for change, but their enthusiasm for reform is diluted by long-standing apprehensions about political and social stability.

The CCP's current approach to modernisation is reflected in the emphasis on 'scientific development', initiated by Hu and Prime Minister Wen Jiabao in 2003. This calls on the Party to 'synthesise' the contradictions between urban and rural development, rich and poor regions, economic growth and social welfare, human beings and nature, and domestic growth and an open door policy to the outside world. The overt paternalism of scientific development, embodied in the notion of a 'harmonious society', is different in mood and substance from the unabashedly capitalistic approach pursued by Jiang Zemin and Prime Minister Zhu Rongji during the 1990s. It also falls squarely within the Chinese tradition of benevolent autocracy.

Crucially, the CCP rejects the western premise that economic and social change requires political liberalisation. On the contrary – the global financial crisis has only confirmed its belief in the superiority of Chinese state-led modernisation over western liberal capitalism. While the Party worries about an ageing population, technological backwardness, improving social welfare and preventing asset bubbles, it believes that such challenges can and indeed must be met from within the existing system.

Sustainability versus transformation

Modern Chinese history tells us that it is only when the threats to growth and stability become compelling that there is a disposition towards radical reform. In 1978 Deng allowed the growth of private agriculture in order to feed the country and reboot the economy after the disastrous Cultural Revolution of 1966-76. Then in 1992

he encouraged private enterprise so as to boost growth and ensure the population's continuing allegiance to the Party following the trauma of the 1989 Tiananmen Square massacre. In both cases, the reformist cause benefited enormously from being driven by one of the most visionary leaders of the 20th century.

Today, such prerequisites are lacking. The slight decline in China's GDP growth in 2009 is hardly likely to persuade decision-makers to review, let alone regret, their policy choices. On the contrary, before the financial crisis they had been concerned about overheating of the economy and were already looking to reduce growth below 10 per cent. More generally, the Chinese model of authoritarian modernisation has proved surprisingly resilient and flexible. Particularly since 1992, the Party has managed to strengthen its position while allowing considerable economic and social freedoms.

There is no compelling reason to believe that the regime cannot continue this balancing act. Indeed, the financial crisis has given it greater room for manoeuvre, both because of China's success relative to other leading economies, and the country's pivotal importance in any global recovery. The more interesting question is whether China can make the quantum leap to a post-industrial economy. Large-scale restructuring would entail reorientation from areas where China has hitherto enjoyed considerable comparative advantages (low-end manufacturing), to sectors where it remains somewhat backward (knowledge-intensive industry and services). This is not easy for a leadership that continues to view performance in quantitative terms. That said, in recent years Chinese manufacturing has moved steadily up the value chain, supplying higher quality products for both the domestic and overseas markets.

It is also unclear how the Party will reconcile state interventionism with encouragement of private enterprise. Ever since Deng's 'southern tour' in 1992, modernisation in China has benefited from

⁶ *In the spring of 1992, Deng toured the southern cities of Guangzhou, Shenzhen and Zhuhai, as well as Shanghai. He gave a number of speeches calling for the opening up of the Chinese economy and the acceleration of reforms.*

a tolerant approach towards different forms of economic activity.⁶ Today, there is broad agreement that the Party must loosen bureaucratic restrictions in order to release the entrepreneurial energies essential to a vibrant services sector. Yet such behaviour is counter-intuitive to the leadership. It argues that the global financial crisis has discredited *laissez-faire*, 'Anglo-Saxon' capitalism and strengthened the case for greater state control. Moreover, compared to his predecessors Jiang Zemin and especially Deng Xiaoping, Hu Jintao is a true believer in the Party's leading role in economic management and the primary importance of SOEs.

But fears that we will see a shift to corporatist capitalism, similar to that in Putin's Russia, are unwarranted. The CCP's self-interest trumps ideological considerations. China's leaders know that the key to regime longevity lies in their continuing capacity to deliver improved living standards, including better health care and education and a reasonable level of employment. In most cases, this means the state getting out of the way. Contrary to popular misconception, the biggest lesson from China's modernisation experience is not the success of authoritarianism, but of *liberalisation*. The leadership has been smart enough not to place too many constraints on the self-enriching capacity of the average Chinese. Hu Jintao, despite his relative orthodoxy, has shown that he understands this reality.

Ultimately, the main danger to the Chinese economy is not implosion, but atrophy. Things become so easy that the leadership underestimates the long-term corrosive effects of structural imbalances, pervasive corruption and the absence of rule of law. At the 16th CCP Congress in November 2002, Jiang Zemin spoke of the subsequent two decades as China's window of strategic opportunity – a period in which the country would aim to complete its modernisation under favourable domestic and international

conditions.⁷ The global financial crisis offers the leadership the chance to implement a reformist agenda at relatively little risk. The Party enjoys substantial legitimacy, particularly at the national level; China's international influence has never been greater; and the economy enjoys the cushion of high growth. Failure to take advantage of these circumstances would not, by itself, lead to economic decline or political instability, let alone regime change. However, it would considerably delay China's modernisation and emergence as a global power.

⁷ http://english.people.com.cn/200211/18/eng20021118_106983.shtml.

3 The challenge of legitimacy

In many respects, the CCP has never had it so good, with party membership booming and few real challenges to its authority.⁸ Whereas in the 1980s the 18-30 urban generation was at the vanguard of the democracy movement, today the same cohort has been largely co-opted by the regime. Its aspirations are materialistic and nationalistic. Far from being a force for radical change, China's educated classes have become the bulwark of the state, with a direct stake in its continuing capacity to exercise effective control. The regime is further protected by more than 2,000 years of Confucian elitist tradition – the belief that it rules by virtue of comprising 'the best and the brightest'. As long as the Party continues to deliver, few are disposed to challenge its legitimacy.

⁸ Party membership is nearly 76 million (June 2009), a 17-fold increase in the 60 years of the PRC. In 2008, there were some 19.4 million applications for membership.

Events over the past two years have reinforced the Party's position. Even before the financial crisis, it benefited from a series of domestic and external developments: the Sichuan earthquake in May 2008; ethnic riots in Tibet and Gansu a month later; confrontation over the Chinese Olympic torch relay in the UK and France; and the spectacular success of the Beijing Olympics. The policy responses of the regime, highly controversial abroad, reinforced its position where it most mattered – its core domestic constituency. Foreign criticism of China only accentuated the Party's popularity, feeding a profound sense of injustice towards the West.

Against this background, it is hardly surprising that the global recession has further strengthened the regime. China's continued growth has enabled Beijing, simultaneously, to blame the US and other liberal democracies for causing the crisis; talk up the Party's

path of scientific development; and highlight its resourcefulness in adapting successfully to difficult circumstances. The stimulus package has been a political as well as economic winner.

Of course, the CCP benefits hugely from its dominance of the media. When there is bad news, such as ethnic riots in Tibet and Xinjiang, blame falls on either ‘anti-social’ or ‘terrorist’ elements, deficiencies in local administration, or ‘foreign interference’. The top Party leadership is largely immune from criticism. Deep-seated problems – such as corruption and maladministration – are regarded not as the inevitable features of a one-party, authoritarian state, but the product of individual failings at the local level. Incidents of protest, or so-called ‘mass disturbances’, are common, but motivated almost entirely by parochial grievances. Beijing further preserves the aura of the ruling elite by making high-profile examples of particularly egregious cases of misgovernment.

Although the CCP is not democratically accountable, it nevertheless feels accountable to the population in the Confucian sense. *Legitimacy depends on results*. The Party is only too mindful of China’s tradition of peasant revolt and the frequency with which this has overturned ruling dynasties. It therefore has a dual stake in promoting good governance: to promote the welfare of the people; and to stay in power. This is the single most important reason why it acted so decisively in implementing the stimulus package.

The example of nationalism illustrates the singular nature of Chinese accountability. On the one hand, the leadership exploits nationalism to rally support around the Party; on the other hand, it worries about its ability to rein in patriotic and xenophobic sentiment, both on the streets and in China’s cyberspace, where there are an estimated 400 million netizens. Its concerns were apparent during the protests against the US bombing of the Chinese Embassy in Belgrade in May 1999; in the wake of the EP3 spy plane incident near Hainan in 2001; anti-Japanese demonstrations in 2005; and, most recently, the angry public response to the Olympic torch relay

incidents in Europe. For all the CCP’s apparent omnipotence, there is always a strong under-current of insecurity – that it cannot always control the wilder urges of the people. Today’s anti-American or anti-Japanese demonstrations could, potentially, transmute into tomorrow’s national protest movement.

Democracy – nice theory, distant reality

It is tempting to assume that democracy is fundamentally alien to Chinese traditions. And certainly it is difficult to envisage how western-style democracy could take root, with its emphasis on multi-party elections, direct electoral accountability and individual human rights. Nevertheless, some form of democracy could emerge in time. The CCP might evolve into something like the old Liberal Democratic Party of Japan – in other words, a dominant party with several distinct factions, operating within a pluralist system and under the rule of law.

In the short to medium term, however, the outlook for democratisation is unpromising. Hu and other Chinese leaders have talked about the importance of intra-party democracy as a means of ensuring greater accountability and good governance. Yet political reforms are stillborn. This is not so much a ‘retreat from liberalism’⁹ – since there was never much political liberalism from which to regress – than a reaffirmation of the traditional virtues

⁹ Charles Grant, ‘Liberalism retreats in China’, CER briefing note, July 2009.

of tight central control and strong Party leadership. Crucially, the CCP is under no pressure to become more liberal. Domestic and external circumstances have only confirmed its faith in the correctness of its overall approach to government and power.

As in the case of the economy, major change is only likely in the event of cataclysms that threaten the country’s stability and prosperity. One potential threat is that prolonged economic stagnation or recession could politicise China’s growing middle class by forcing it out of its materialist comfort zone. Some commentators

point already to the rising tide of discontent among young urban professionals, who cannot find affordable housing, and graduates for whom there are few good jobs. Yet these social groups are more likely to be a force for stability than upheaval, with their visceral fear of *luan* ('anarchy') arising out of the vast well of China's rural and urban poor. The 'century of humiliation' (1842-1949) remains fresh in the memory as a time of civil war, social and economic disintegration, and foreign occupation.

Another consequence of an economic slowdown might be a more unruly general population, one that expresses its discontent in mass and increasingly well co-ordinated protests. Perhaps the most plausible possibility is that China's ethnic minorities – especially the Uighurs in Xinjiang – become systematically rebellious. Such pressures could, in theory, force the CCP to undertake democratising reforms. However, it is more probable that they would provoke an authoritarian reaction. Beijing's response to the July 2009 riots in the capital of Xinjiang, Urumqi, was to crack down hard on separatist sentiment. Elsewhere, in Han regions, the authorities have been largely successful in defusing unrest through a combination of (mainly) carrots and sticks – punishing protest ring-leaders, disciplining local government officials, and offering financial and other incentives to the local population. In this way, Beijing has ensured that such protests do not coalesce into a more generalised opposition.

If China does eventually undergo a genuine process of democratisation, this is unlikely to resemble any western model. Even a progressive leadership would introduce incremental rather than systemic reforms. There would be a heightened commitment to intra-party

¹⁰ *The 11-year sentence meted out to the human rights activist Liu Xiaobo in December 2009 for 'inciting subversion of state power' indicates how allergic the authorities remain even to peaceful dissent.*

democracy, perhaps some space for 'acceptable' opposition parties, and better observance of the rule of law. But the CCP would remain dominant; there would be little tolerance of anti-regime protests¹⁰ or of alternative centres of power; and self-government for the Tibetans and

Uighurs would be strictly circumscribed. Any leadership, no matter how enlightened, would be extremely wary of the dangers of a rapid political liberalisation.¹¹

¹¹ *The Chinese contrast their experience of modernisation with the far more problematic transition of post-Soviet Russia.*

4 'Inevitable rise' – China and the world

It is hard to pinpoint when China moved from simply reiterating the doctrine of 'peaceful rise'/'peaceful development' towards a more assertive foreign policy stance – one that speaks of the country's 'inevitable rise'.¹² But the shift was already apparent in the lead-up to the Beijing Olympics. Looking further back, one can trace a steady increase in foreign policy activity since 2005 – around the time when US Deputy Secretary of State Robert Zoellick called on China to become a 'responsible stakeholder' in the international community.¹³

¹² 'Peaceful rise' and 'peaceful development' are essentially interchangeable terms. The latter, however, has been adopted officially because it sounds less threatening. Over the past 18 months, Chinese political commentators have spoken increasingly of 'inevitable rise'.

¹³ Robert Zoellick, 'Whither China: From membership to responsibility?', remarks to the National Committee on US-China Relations, New York, September 21st 2005.

The global financial crisis, however, has sealed the deal. Beijing's approach to the world is more confident today than at any time since the death of Mao in 1976. This China is no longer content to counter western criticisms about Tibet, human rights and freedom of the internet, or restrict itself to resource diplomacy. The leadership has decided that recent developments make it at once advantageous and *necessary* for China to play a global role.

The reasons behind this shift encapsulate many of the contradictions of China's recent development. In the first instance, it is a response to western complaints that Beijing is not pulling its weight in addressing international problems, such as the non-proliferation of weapons of mass destruction (notably in relation to Iran and North Korea), conflict resolution and counter-terrorism. The deployment

of Chinese peacekeepers to regions where Beijing has few direct interests, such as Lebanon, and its involvement in anti-piracy operations off the Horn of Africa, is intended to counter the charge that China is a free-loader.

At the same time, the Chinese have concluded from the financial crisis that the existing global order is not only unfair but dangerously dysfunctional. China must become a more active and influential player because it is no longer able to quarantine its national interests from wider international developments. The world has become too small, and China too globalised.

There is also a large element of self-righteousness. China has long been irked by criticisms not only of its political system and approach to human rights, but also its economic policies and moral values. It believes that western policy-makers and commentators fail to understand the vast challenges it faces in institutionalising political and civil rights. And there is considerable resentment at the lack of international recognition of the very real progress and *liberalisation* in China over the past three decades. It is unsurprising, then, that the Communist leadership has seized on the near-collapse of the global financial system and acute discomfiture of the West to labour the point that China has ‘got it right’.

The financial crisis has increased Beijing’s confidence in negotiating specific issues. With the western powers severely weakened, the Chinese feel better able to resist pressure in areas such as climate change, revaluation of the RMB, democracy and human rights. In highlighting the extent of western and particularly American dependence on China, the crisis has expanded Beijing’s room for manoeuvre. Although many countries, and not just in the West, are critical of its policies and suspicious about its intentions, they are also looking to China as America’s principal ‘other’ in world affairs.

Responsible stakeholder or global leader?

But despite a growing assertiveness, Beijing is by no means ready to assume the responsibilities of global leadership. There are several reasons for its reticence. First, the leadership is acutely aware of China’s weaknesses. It may be an emerging economic superpower, but per capita income is that of only a moderately developed country.¹⁴ China has built up its military

capabilities, but its capacity to project power through such means remains extremely modest. It is one of five permanent members of the UN Security Council and a leading member of the G20, but its political clout is constrained both by the innate caution of its leaders and the competing ambitions of other major players. The CCP is committed to developing a hi-tech, knowledge-based economy, yet China continues to be a backwater in research and innovation. Talk of eastern wisdom has become modish, yet Chinese soft power remains limited and the notion of a Chinese model for the world largely fantasy.

¹⁴ *China is the third largest economy by GDP, but its per capita ranking is 133rd out of 229 countries – see CIA: The world factbook 2009. This ranking also masks huge regional variations. Whereas the average standard of living in Shanghai approximates to that of Portugal, in the rural province of Guizhou it resembles Rwanda’s.*

Beijing may speak of a ‘multipolar world’, but it scarcely believes that one has yet emerged. For all the talk about the West’s decline, the Chinese continue to regard the US as the sole superpower.¹⁵ The financial crisis may have taken a few years off the schedule by which China catches up with the US, but co-leadership with Washington remains a long-term project nonetheless, with numerous obstacles along the way. And even if China achieves the economic and technological level of America, there will remain an unfinished psychological revolution – from a fundamentally introspective mentality to one that supports wholehearted engagement with the world.

¹⁵ *Chinese scholars believe that the axiom, ‘one superpower, several great powers’ (yi chao, duo qiang) remains substantially true, even if the crisis has narrowed the gap between the US and other major players.*

The conservatism – in every sense of the word – of China’s rulers means they are disinclined to take on commitments unless absolutely sure these are manageable. The logic behind Jiang Zemin’s 20-year window of ‘strategic opportunity’ for modernisation (see above)

¹⁶ *The Chinese define ‘comprehensive national power’ as the aggregate of territorial extent, military might, natural resources, economic power, social factors, domestic government and international influence.*

remains compelling: only when China has built up its ‘comprehensive national power’¹⁶ should it play a leading role in global affairs. This reluctance is reinforced by concerns that assuming such a role would excite opposition from other major players and discourage the emergence of a

‘harmonious world’ in which China is able to calmly pursue its national interests. Enhanced prominence could also constrain China’s options. One obvious advantage with being ‘the world’s largest *developing* country’ is that it enables Beijing to claim preferential treatment in the form of lower benchmarks. Pretensions of global leadership would have the opposite effect, ratcheting up the pressure to concede more in climate change and trade negotiations, strategic arms control and exchange rates.

Conditional globalism

Beijing finds itself in something of a quandary. It wants to reform the international system so that this is more responsive to Chinese interests and less dominated by the US and the western powers. It is also gratified that other nations – great and small alike – recognise China’s growing importance. On the other hand, it does not want foreign policy matters to distract it from urgent domestic problems. Talk of a Sino-American G2 is good for the ego, but also generates heightened expectations.

Beijing has attempted to manage this tension by adopting an attitude of *conditional globalism* – in effect, globalism on Chinese conditions. Practically, this means asserting China’s status as a global player, while absolving it of leadership responsibilities. In Clinton Dines’ apt phrase, the Chinese want to sit in the front of the car, but

don’t want to drive. Beijing’s mentality is exemplified by its handling of discussions on a new global financial architecture and in international climate change negotiations.

In the first case, Beijing has criticised the over-dependence of the international financial system on the US dollar and advocated greater use of SDRs (special drawing rights) as an alternative ‘currency’. Yet at the same time it has substantially increased Chinese holdings of US treasury bonds¹⁷, in effect propping up the dollar and the American economy more generally. It acts out of pure self-interest, conscious that China would suffer major losses if it followed through on its rhetoric of de-dollarisation. In fact, what the Chinese want is not so much a new global financial architecture, with all its uncertainties, but a greater say in the existing system.

¹⁷ *Between September 2008 and July 2009, Chinese holdings rose from \$618.2 billion to \$939.9 billion – <http://www.treas.gov/tic/mfb.txt>. They remained at this level until November, when they declined slightly to \$929 billion and then to \$894.8 in December 2009.*

It is a similar story with climate change. China’s external role is limited to constraining and counterbalancing western influence – reminiscent of its foreign policy in the mid-1950s, when it was a leading light in the Third World.¹⁸ Again, domestic considerations are paramount. The Chinese resisted binding emissions targets at the Copenhagen summit partly because they were determined not to be browbeaten by the West and partly because of concerns about the erosion of Chinese sovereignty through an overly intrusive verification regime. The most important reason, however, was an aversion to *any* external constraints on economic development at a time of uncertainty. The Chinese perspective here is national, not internationalist; Beijing could hardly care less about floods in Bangladesh or the sinking of the Maldives.

¹⁸ *Premier Zhou Enlai was especially prominent at the Bandung Asian-African summit in April 1955, which led to the establishment of the Non-Aligned Movement.*

China's three-pronged strategy

So far, the financial crisis has enabled Beijing to have it both ways: enhanced influence, but without assuming onerous responsibilities; and the dual status of emerging superpower and 'world's largest developing nation'. For a leadership still feeling its way in international relations, this is a near-perfect set of outcomes. So perfect, though, that it cannot be expected to last. In the long run, China's leaders know they will have to accept a much larger degree of burden-sharing – in developing a new financial architecture; addressing climate change; managing international security; and contributing to global governance. With this in mind, they are pursuing a three-pronged strategy for the future, based on (i) enhanced co-operation with the US; (ii) multi-vectored engagement; and (iii) active internationalism.

Sino-American partnership

The relationship with the US is by far the most important component of Chinese foreign policy. America is at once indispensable partner, global competitor, and benchmark. While other countries and issues are important, to the Chinese nothing matters as much as what America thinks, says and does. In Beijing's Americacentric world-view, the Europeans are a feeble and disputatious rabble; the Japanese are American allies; Russia is a

¹⁹ *Sino-Indian tensions are exacerbated by an ongoing territorial dispute over the Indian state of Arunachal Pradesh.*

has-been power; and India is a backward (if annoying) wannabe.¹⁹ The US remains the dominant power in the world measured by any major criterion – military might, political standing, economic influence, level of technology, and cultural and normative power.

As such, it is pivotal both to the overall management of Chinese foreign policy and the handling of key issues. The Communist leadership is committed to expanded political, security and economic co-operation with the US. It will challenge American positions and interests in some areas – most conspicuously on arms sales to Taiwan, sanctions against Iran, and climate change – but it

also seeks to ensure that disagreements remain issue-specific rather than broadly strategic. There is little disposition to challenge America's overall global leadership, let alone risk armed confrontation.²⁰ China finds it much more comfortable to influence Washington from within a larger international consensus than to attempt to supplant the US altogether.

²⁰ *Military action against Taiwan is all the more unlikely given burgeoning cross-strait ties.*

This reality is hard to grasp at a time when Sino-American relations are going through an especially rough patch. While talk of a crisis is premature, there is no question that Beijing's interaction with Washington is more fraught and less constructive than during the George W Bush presidency. Several factors have contributed to the deteriorating atmosphere: domestic pressures faced by the Obama administration, in particular high unemployment and the consequent rise in protectionist sentiment; Chinese unresponsiveness to key US priorities such as Iranian sanctions and RMB revaluation; allegations of Chinese cyber attacks against western governments and companies; and, more generally, the failure to establish a common language and set of understandings.

But it is premature, at the very least, to see such tensions as signalling a strategic shift towards an overtly anti-American stance in Beijing. Chinese policy-makers know they have to work with the United States. What is 'under negotiation', however, are the basis and terms of this engagement. The advent of an activist and internationally popular president in the White House presents unusual challenges to Chinese leaders. Whereas they knew where they stood with Bush, Barack Obama is a much more confusing personality, at least in Chinese eyes. On the one hand, they view him as callow and even weak. On the other hand, he embodies a re-emergent America in international affairs. Historically, too, Beijing has found it difficult to deal with Democratic administrations, with their sometimes strange mixture of Wilsonian idealism and protectionist leanings.

Multi-vectored engagement

At the same time as pursuing engagement with America, the Chinese believe that the post-crisis world will inevitably become less westerncentric. The financial crisis has not only exposed the fragility of the advanced western economies, but also their underlying strategic vulnerabilities. Beijing is consequently pursuing a multi-vectored approach that assigns enhanced importance to East, Southeast and Central Asia, as well as to relations with Africa and Latin America. And whereas such diplomacy was once dominated by the quest for energy and raw materials, today it reflects a more comprehensive agenda whereby China builds up its political and strategic, as well as economic, capital.

This wider engagement confirms the increasingly global thrust of Chinese foreign policy. Speculation about China taking over the world misses the point; the purpose is not domination, but influence. Beijing aims to bring about an international environment that is *broadly* favourable to Chinese interests – the ‘harmonious world’ it has been promoting for the best part of a decade. To this purpose, it is demonstrating not only a greater commitment to relations with unfashionable parts of the globe, but also a less nakedly self-interested (and materialist) management of those relations.

China’s approach at the Copenhagen summit exemplified this approach. It portrayed itself as a member of the developing world consensus (the G77), in contrast to the industrialised West. Through such bandwagoning, it sought to deflect blame for the summit’s failure and reduce the pressure on China to accept burdensome commitments. It largely succeeded. Although it was roundly condemned by western politicians and media, in much of the rest of the world the onus for alleviating climate change continued to rest with America and Europe.

Active internationalism

The third aspect of Chinese foreign policy post-crisis is a heightened interest in global governance. However, this bears only a passing

resemblance to the western conception of China as a ‘responsible stakeholder’. Like many other emerging nations, it rejects the universalisation of western values, and supranationalism more generally. In the past, this took the form of a blanket rebuttal of western criticisms over human rights abuses, Tibet, and Chinese support for authoritarian regimes in Sudan, Myanmar and Zimbabwe. That defensiveness remains. But since the crisis Beijing has supplemented this with a more activist approach. The shortcomings of western-dominated structures and mechanisms have encouraged it to promote alternatives – within the framework of the G20, in proposals to increase non-western voting representation in the IMF and World Bank, and calls to scale down the US dollar as the international reserve currency.

Many of these ideas have not been thought through and are designed principally to test the waters. Nevertheless, there has been a shift in the Chinese mindset. Pre-financial crisis, China was a reluctant internationalist, content to do the minimum possible to defuse western criticisms that it was insufficiently active. Post-crisis, the problem for the West is almost the opposite: China has abandoned the somewhat demeaning condition of ‘responsible stakeholder’ *as defined by the West*, and assumed the more robust guise of active stakeholder on its terms – at once independent and unapologetic. This China continues to subscribe to ideas of an interdependent world and constructive engagement. But it will no longer tolerate being patronised. While it concedes that the US remains the sole superpower, it envisages much greater influence in global decision-making.²¹

²¹ The scholar Jin Canrong believes that the slogan ‘one superpower, many great powers’ should be amended to ‘many great powers, one superpower’ to reflect the US’s diminished capacity to dictate to others – Beijing Forum, November 8th 2009.

5 China and Europe – a worsening relationship

At the end of the Cold War, European policy-makers assumed that the West would retain its strategic, economic and normative superiority for the foreseeable future. If and when other powers emerged, such as Russia and China, they would absorb the appropriate lessons. Modernisation and normalisation, perforce, implied acceptance of western, now ‘universal’ values: democratic pluralism, the rule of law, accountable government, free and independent media, individual human rights and so on.

In recent years, however, large parts of the world have rejected the modernisation/westernisation nexus, and nowhere more so than in China. The two decades since Tiananmen have witnessed the consolidation of its brand of authoritarian modernisation, as the democratising forces that once threatened to overwhelm the Party have been neutralised. The global recession has strengthened its position, highlighting the changing realities of international power and encouraging Beijing to promote an ever wider range of national interests. Policy-makers believe that the tide of history is running in China’s favour.

This confidence makes for a difficult interaction with Europe. There are several problems. First, the speed and scale of China’s transformation have led, in some cases, to a cocksure, even careless approach in international dealings. This was apparent, for example, at Copenhagen when the Chinese delegation’s clumsy handling of climate negotiations obscured the constructive contributions China was making. There is a larger risk that Beijing may overplay its hand, whether in targeting sanctions against American companies involved in the sale of weapons to Taiwan, or threatening reprisals

against European leaders for receiving the Dalai Lama. The danger lies less in provoking specific retaliatory action than in fostering a larger reputation of China as a troublesome and threatening actor.

Second, the relationship between China and Europe is increasingly unbalanced. If China is the big winner from the global financial crisis, then the EU member-states are among its greatest casualties. Add to this the EU's undistinguished record in managing relations with China, and its general disunity on major foreign policy issues, and the result is a largely dismissive attitude in Beijing towards Europe as an international political actor. (The selection of Herman van Rompuy and Catherine Ashton as European Council President and High Representative, respectively, has done nothing to alter this perception.)

There is some residual respect for the EU as a trading bloc and as China's largest commercial partner and source of foreign investment. Yet, collectively and individually, Europe has minimal influence on Chinese policy. If the EU were, say, to throw up protectionist and non-tariff barriers (such as carbon taxes) against Chinese enterprises, the latter would look elsewhere: to the rapidly expanding domestic market, and to other emerging and developing economies. European leverage might be more effective if the EU were able to work more closely with the US in areas of common interest, such as revaluation of the RMB and opening Chinese markets to western goods and investment. But it is hard to imagine such co-ordination, even with a more multilateralist administration in the White House. Competing national agendas and Obama's diminishing interest in Europe give little cause for optimism.

Third, notwithstanding growing anxieties about the implications of China's rise, there is no sign of a more humble European approach on normative issues. Through force of habit, Europe still sees itself providing moral leadership to the world. In this respect, the global financial crisis appears to have changed very little. European leaders continue to lecture Beijing on democracy, the rule of law, human

rights and the Dalai Lama. They also dispense advice on economic issues: urging China to increase domestic consumption, rely less on exports, develop the services sector and be more energy efficient.

Beijing rejects such condescension. It believes that the West – and Europe in particular – has minimal understanding of Chinese conditions; gives insufficient credit for China's transformation and liberalisation in the post-Mao era; and targets China as a scapegoat at every opportunity. There is wonderment that the Europeans are so free with their criticisms when they are struggling – not especially successfully – to address their own serious problems. Inevitably, European representations have failed to encourage a more conciliatory approach to the Dalai Lama, greater tolerance of political dissent or uncensored access to the internet. The natural reaction of the Communist leadership is to dig its heels in – partly out of pique, but mainly because it cannot be seen to bow to outside pressure.²² The case of RMB revaluation is instructive. The Chinese will allow the yuan to appreciate, but they will do so for domestic reasons and according to a domestic timetable. Later this year Beijing is expected to resume a gradual appreciation of around 5-7 percent per annum, in order to give further impetus to the rebalancing of the economy. American and European accusations of currency 'manipulation', however, could hinder this process as the Chinese remain allergic to any suggestion of weakness.

²² *This contrariness is reflected in the harsh sentence given to Liu Xiaobo and the decision to execute the British national Akmal Shaikh, both in December 2009.*

More generally, there is a cultural chasm in Chinese and European approaches to international relations. Chinese policy-makers operate largely free from the scrutiny, let alone criticism, of a public that is overwhelmingly focused on domestic issues. For the most part, too, they prefer to keep disagreements with the West behind closed doors. (The only exception being when these impinge on issues of national sovereignty, such as Taiwan and Tibet.) Western politicians, by contrast, are directly accountable to a sceptical and often critical audience. Their conduct of foreign policy necessarily reflects

domestic imperatives; the relatively transparent nature of democratic politics makes everything a matter of potential public interest. In relation to China, this virtually obliges them to pressure Beijing not only on key priorities – Iran, climate change and rebalancing trade – but also in areas of secondary but high-profile importance, such as the Dalai Lama and operation of the internet in China. Unfortunately, in practice this approach tends to degenerate into a ragbag of opportunistic, allergic, poorly co-ordinated and panicky policy actions.

6 Looking ahead

China has done very well out of the global financial crisis. Economic growth is close to double-digit levels; the Communist Party enjoys unparalleled authority; and Chinese foreign policy is increasingly influential. At the same time, however, China is experiencing what might be described as ‘emerging pains’ – the tensions, confusion and even dislocation that are accompanying one of the most extraordinary transformations in history. Although China’s star is very much in the ascendant, it is having to cope with huge challenges, and it lags far behind the West in many respects. For all its undoubted success, it remains a power in transition with a long way still to travel.

It is hardly surprising, then, that Beijing’s interaction with the world has become somewhat unpredictable. Part of the problem is that there is no real tradition of Chinese foreign policy. Excepting only brief periods of outreach and conquest, successive Chinese dynasties over the past 2,000 years have been thoroughly introspective and self-obsessed. When there has been contact, it has almost always been a case of the world coming to China, not China reaching out to the world.

Many in the West see China as an unstoppable juggernaut, mowing down everything in its path with scant regard for the interests of others – emphatically *not* a ‘responsible’ stakeholder. In China, however, they see things rather differently. While they take considerable, perhaps inordinate, pride in its recent rise to global prominence, they are only too aware of the underlying weaknesses that constrain the country’s development. The West tends to dismiss Chinese claims to be a ‘developing country’ as special pleading, intended to shirk responsibility and take advantage of others. Yet

this is a country where nearly half the population earn little more than two dollars a day. It is entirely natural that the CCP leadership should be guided overwhelmingly by domestic imperatives and, as a consequence, adopt a 'selfish' approach to international relations.

China's combination of great strength and weakness, confidence and introspection, makes it a thoroughly awkward customer. How should the West engage with such a mass of contradictions? It has pursued quiet diplomacy, it has tried diplomatic pressure, it has gone in for browbeating, and it has indulged in noisy recriminations. But none of this has worked; indeed, it has sometimes made a difficult situation worse – notably when the US has pressed Beijing on RMB revaluation and in climate change negotiations. And perhaps there is no ready solution, particularly while China struggles to resolve its many outstanding problems.

Over the next decade or two, much of China's behaviour will seem at odds with that of a great power, as it comes to terms with its rapidly evolving status, capabilities and horizons. Inevitably, there will be periodic crises and downturns, when interaction with a once dominant West is characterised by confusion and mutual suspicion. Differences could well widen. For although there are common security and economic interests, achieving lasting co-operation will require a more mature and considered approach *from all sides*. In time, as China establishes itself as a modern superpower in an ever more globalised world, it will adapt to its changed situation. This China will be notably more prosperous and secure, while others will become reconciled to the particularities of its domestic and foreign policy. Until then, however, we are in for a bumpy ride.



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China and the global financial crisis

Bobo Lo

China has come through the global financial and economic crisis in a confident manner. Economic growth is strong and China's foreign policy has become more assertive. Bobo Lo's essay challenges many western assumptions about the rise of China. He argues that the economy is increasingly driven by domestic consumption rather than exports. At the same time, the Communist Party is consolidating its control while avoiding significant political reform. Lo regards friction between a more influential China and the West as inevitable, and concludes that American and European attempts to 'get tough' with Beijing will achieve little.

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