

Keynote: The Rise of the Middle Kingdom – Old Risks and New Challenges
Global and Domestic Threats to China's Economic Development

Some preliminary remarks

Since the olden times people consider that the present has become much more complex than the past ever had been. There is also a tendency to describe the olden times as times when things were not only better but also simpler.

Currently we seem to be living in what the Chinese call particularly "exciting times". These times are marked by economic, ecological and geopolitical complexities of a nature that had been alien to the 20th and 19th centuries. In retrospect we see the times, when the division between friend and foe, good and bad seemed to be so clear: think of World War II, think of the cold war, the end of which brought short-lived optimism about the "end of history" in the shape of a final victory of democracy over dictatorship and liberal market economies over planned economies. The "new age" was short-lived, and soon, i.e. after 9/11, the world was faced with a new global confrontation in which the free nations, according to the words of President George W. Bush, faced a new "axis of evil".

Today, the rise of China and India with all its ecological, economic and geopolitical implications confronts mankind with new complexities where good and evil cannot be so clearly marked as had been the case in the past. Obviously, the economic resurgence of India and China are developments that have to be greatly welcome. At the same time, people particularly in the established industrialized societies of the West see the new Asian competition as a threat. The debate about global warming is a symptomatic point. The advanced industrialized societies in the West want to put more emphasis on environmental protection. Not unnaturally, people in the Third World, who have overcome conditions of mere survival and who have left behind the phase of the simple accumulation of material goods, tend to put much more emphasis on the quality of life.

It is natural that the industrialized societies want the new emerging economies, particularly China and India, to make their contributions in the fight against global warming. Indeed, if India and China are not included in these efforts, no global accord can be really effective. While in terms of per capita pollution India and China rank far, far behind the industrialized countries, because of the massive size of their populations they have emerged as the most important contributors to global warming. It, therefore, makes sense to include them in all the efforts. However, there is the equally valid argument of India and China that they do not want to get their economic progress hampered by new conditions of restraint in favor of the world's climate. The two countries have only recently re-emerged in the world economy, while the established economies in the West have had their massive emissions since a long time. It must, so goes the argument of fairness, therefore, be primarily the task of the established economic powers to help fight global warming.

Challenges

On the background of all these complexities, which unfortunately are often overlooked by a media that is interested in sensational news and simple truths, the world faces new challenges: Mankind is faced with the gigantic task to re-integrate into the world economy and into the new world order two nations with a combined population of 2.3 billion. When it comes to the peaceful integration of new major powers into the existing order of things, the record of the two last centuries, of the 19th and 20th century, do not look particularly promising: think of the Napoleonic wars, think of Germany's ascent under Bismarck, think of the "Third Reich" and think of the short-lived Japanese imperialism.

Apart from the ecological implications already mentioned there is the intensified struggle for raw materials, energy sources and basic foodstuffs. Although a huge majority of India's and China's populations still lives in very modest circumstances, the re-emergence of the two countries has led to the creation of new middle classes that comprise dozens of millions of households. Like everywhere in the world, increased living standards in China's and India's case also mean more consumption. Around the globe the competition for limited resources has intensified. This leads to the central question: Are we at the beginning of an age, which brings a new distribution of wealth, power and resources in the world? The answer has to be an unequivocal "yes!", all the more so as profound weaknesses in the international financial system have – since summer 2007 – brought a new imbalance to the surface: The Asian societies, in particular the Chinese, Indian and Japanese, are based on the priority of savings, while the West, in particular the US have a tradition of spending and living on credit. It is obvious that the sub-prime crisis and other concomitant credit crises would have been much worse, were it not for the huge capital resources that have been accumulated by China and Japan.

Once again, the question is: Can we manage these changes by orderly transition or only by conflict? The latter would imply that the losses in the new order of things would be particularly painful for countries without a strong industrial base, without raw materials and energy sources, without a flourishing agriculture, without great innovative capacities and a top quality educational system, and without flexible and responsible elites.

The complexities in China

In the case of China the complexities are particularly difficult to assess. First of all we have a country whose population lives in different centuries. The People's Republic can be roughly divided into four economies:

- Some 200 million belong to the established middle and upper middle classes;
- Some 150 to 200 million belong to the aspiring lower middle classes;
- Some 800 million are poor and live mainly in the countryside with a very limited purchasing capacity;
- Some 100 million live below the poverty line.

This rough division of the Chinese populace is interesting not only from a sociological point of view. It must also interest foreign investors. The four economies have to be taken into consideration when looking for workers, for investment opportunities and for markets. However, while an investor can focus on a particular population segment with the purchasing power that matches his products or services, the Chinese government of course has to focus on the nation as a whole. Therefore, the wealth gap, which is implicit in the above mentioned segmentation of the Chinese population, is a challenge to the national leadership. Nobody will deny that China has made huge strides in its economic and social development since the dark days of Mao Zedong. Nevertheless there remains the problem of a growing wealth gap, not only between different segments of the population but also between different regions of the vast country.

On the back of this, China's process of modernization is today in a very important and demanding stage. For foreign investors and foreign enterprises, too, this implies ever new opportunities and ever new challenges. Following the rupture of 1989, the Chinese leadership had decided to direct the full emphasis of their policies at economic growth. In the early nineties Deng Xiaoping once again took the lead and by

his great authority re-launched the economic reforms and beat back conservative elements that had been skeptical of or even inimical to the process of economic opening. The nineties then became the decade of economic growth at any cost.

In 2002/3 the People's Republic witnessed the first orderly transition of power in its history. The third generation of leaders with Jiang Zemin at the core was replaced by the fourth generation with Hu Jintao at its core. Hu Jintao as Head of State and Secretary General of the Communist Party of China (CPC) and Wen Jiabao as Prime Minister were reconfirmed by the 17th party congress that took place in October 2007. They got another term of five years until 2012 when, according to party rules and the constitution, they must hand over power to the fifth generation of leaders. The potential contenders for this new leadership are most likely to be found in the current Standing Committee of the Politburo of the Central Committee of the CPC. The coming years will indicate who will be the "crown prince" for the succession of Hu Jintao. It is self-evident, that Hu Jintao will make sure that somebody of his choosing will succeed him. Obligations are a good tool to secure a peaceful retirement.

The last eight years did not only bring a change in the leadership of the country, they also brought significant modifications in the way the country and the Communist Party are run. Of course, changes in China do not take a high profile, unless they are initiated by a person of historical standing such as Mao Zedong or Deng Xiaoping. It is evident that both Jiang Zemin and Hu Jintao do not have the necessary background to provide them with the legitimacy to lead China, as had been the case with Mao and Deng.

Outsiders tend to see the CPC as a monolith. Nothing could be further from the truth. Obviously, in a system of central control of any political news, the public and the outside world is made to believe that there is unity at the top and in the rank and file of the CPC. China is still far from having a system of rule of law, of separation of powers and of democracy. Nevertheless, there have been changes here, too. One of them has been institutionalized by Jiang Zemin with his theory of the so called "three represents". Under this heading the character of the CPC got changed, from a party simply of workers and peasants to a people's party. Today even "progressive" entrepreneurs can join the ranks of the CPC!

This opening of the party is the legacy of Jiang Zemin as the core of the third generation leadership that had ruled China. Once the transition had happened it became soon evident that Hu Jintao himself had his own ideas. It had been mentioned that the CPC is not a solid block. One wing of the party belongs to the camp of economic modernizers, of competent technocrats. It is today the driving force and counts most of the top leadership. Another wing could be described as the "conservatives", i.e. forces within the CPC who are afraid that rapid economic and social change will endanger the undisputed rule of the CPC. Finally, there are the large bulk of pragmatists who will follow the group that holds the reigns of power.

It has been mentioned that the rapid economic progress in the nineties and in the early years of the 21st century had led to a widening of the wealth gap within the country and between social groups. Today China is the country with the worst record if one consults the Gini coefficient which measures wealth disparities in a given country. It is obvious that such a situation cannot last indefinitely. Party leader Hu Jintao had his party career largely in areas that have not profited from the rapid economic growth. He is, therefore, acutely aware of the social tensions that can emerge from worsening economic disparities. Wen Jiabao had witnessed the tragedy of Tiananmen in 1989 from close quarters. He, therefore, also has a very clear knowledge about the dangers that face the stability of the existing system and that threaten the rule of the CPC.

When the fourth generation of leaders took the reigns of power, particularly in the Western media there was extensive speculation about possible political reforms. In the last six years, however, it became evident, that the new leaders had no intention to move in the field of political reforms. Today, as before, it holds true that China has made remarkable progress in the field of the economy. The country and its elites also deserve high marks with regard to social change particularly in the urban areas. However, when it comes to the process of political modernization, the record is and continues to be dismal.

Hu Jintao and Wen Jiabao being pragmatists, they know that not to react to the social challenges would be dangerous for the system as a whole. In fact Hu Jintao himself had declared, when commenting on the evil of corruption, that if one challenge could bring down the system, it is corruption. Nevertheless, being the technocrats they are, neither Hu nor Wen can muster the courage to do in the political field what Deng Xiaoping had done in the economic field – i.e. to remove the shackles of the past. This is not only cowardice; it is also a correct assessment of their own strengths and of their power base. Out of this

impasse, the fourth leadership generation had to create a new concept for the economic development of China: sustainable growth.

What does sustainable growth mean? First and foremost it is a rebuttal, an alternative to the growth at any cost that had been advocated by the previous leadership. Sustainable growth is achieved by a policy that deals with the challenge of a growing wealth gap and directs economic growth in such a way that it reduces the gap, rather than increase it. The “Go West” policies, that are designed to help develop the neglected Western part of China, are an example of that. Secondly, sustainable growth is designed so as to give more respect to environmental concerns. It is evident that as a result of rapid economic growth, China has massive ecological problems. Many of these are not only or not primarily a threat to the world, but are a serious danger to China herself. The policies of sustainable growth are aimed at giving more attention to the ecological impact of economic development. Connected with this is the third major goal of these new policies: a better and more efficient usage of scarce resources, particularly in the field of energy. Finally sustainable growth is aimed at preventing the build-up of a speculative bubble, the bursting of which would have severe negative consequences for the stability of the system.

The main slogan, under which the new policies sail, is that of a harmonious society. In a number of fields, from foreign policy to environmental and social policies, the Chinese leadership emphasizes the importance of harmony. The interesting thing is that harmony is an important value in Confucianism. Since some time it is evident that Confucius has returned to favor amongst many Chinese. The collapse of Communism, the economic realities and the absence of any credible ideological legitimacy of the CPC’s rule have led to an ethical vacuum, which needs to be filled. That even the CPC has recourse to Confucian values is not without irony. Ma Zedong was a decidedly anti-Confucianist ruler. He had hoped to have eliminated Confucianism once and for all from Chinese society. This desire was in fact a powerful motive behind the so-called “cultural revolution”.

Now Confucius is back. The CPC, which saw itself as a class based party, which advocated the class struggle and which was at the forefront of the global revolution against capitalism, now preaches social harmony, has opened itself up to members from all walks of life and aspires for the establishment of an international political order based on harmony. Where all this will lead, only the future can tell. However, one thing already is certain: In the economic field it is extremely difficult to define what sustainable growth means. Which is the growth figure that has to be aspired to under this goal and is it possible to achieve a soft landing, i.e. to reduce growth without damaging the economy? Even more tricky is the question how such a policy can be implemented. It is no secret that – when it comes to the economy – the power of Beijing is limited. Particularly in the economically successful regions and provinces the cadres are reluctant to follow Beijing’s dictate to moderate economic growth. Therefore the danger of speculative overheating remains, particularly in financial markets and in the high-end real estate markets of the metropolitan cities.

New challenges for the Chinese leadership

Today’s situation in the Chinese economy presents challenges which are of an unprecedented nature. Never before have we had an economy which is under the political leadership of a one-party state, which still claims adherence to socialism and which is relevant to the world economy as a whole. Even at the height of its influence the Soviet Union was a military threat and an ideological challenge to the West. On the other hand it was of no importance for the world economy. The flip side of the coin is that never before have we had an economy, which is under the political control of a Communist one party state that is dependent on the state of the world economy. Obviously, with the important role played by the export industry and by foreign investments, the People’s Republic is not immune to what happens in the world economy. Should there be a significant global downturn, this would also afflict the Chinese economy.

When Deng Xiaoping initiated the monumental economic reforms that were going to transform China in an unprecedented way, he was aware that only the opening up of the Middle Kingdom to the outside world would enable it to overcome the decay and the marginalization that had afflicted it in the 19th and 20th century. After the disasters that Mao Zedong had brought over the country, China needed foreign capital, foreign technology and foreign markets in order to lift herself out of decades of misery. He started with small special economic zones, where foreign capital and foreign technology could be used to produce exclusively for export. Over time the economic system became ever more sophisticated, and

today China is a major player in the world economy.

However, the drastic increase in economic output and in living standards implied a massively growing dependency of China on raw materials, energy sources and capital from abroad. For some years this seemed to pose no special problems, but since last year we have been witnesses to an acceleration of prices in a number of fields such as energy, raw materials and basic foodstuffs. Inflation is back. Who or what is responsible for this is secondary, compared to the challenge of dealing with this problem. The Chinese are savers and traditionally high inflation has led to social and political instability. Massive inflation was a major contribution to the defeat of Chiang Kai-shek against the Communists. When the pro-democracy protests took off in spring 1989, China underwent a period of high inflation. Little wonder, therefore, that inflation must rank very high on the list of worries of the Chinese leadership.

A harmonious society, sustainable growth and the fight against inflation make indeed a very difficult cocktail of contrarian challenges that have to be managed. This could prove to be too much even for the skilful technocrats who dominate in the current Chinese leadership. The external value of the Yuan Renminbi is a good case in point to illustrate these difficulties. It is obvious that with respect to traditional macro-economic theories, the Chinese currency is undervalued. The US and the EU are indeed right to complain about this undervaluation, although their complaints carry little weight with the Chinese leadership. Repeated visits by the American Treasury Secretary as well as appeals by the Chairman of the Federal Reserve have had little or no effect. China continues to manage or one might say to distort the external value of her currency. It is evident that the decisions in this respect are not made by economic experts or by the People's Bank of China, but by the exclusive circle of the Standing Committee of the Politburo of the CPC.

The dilemma of the Chinese leadership is illustrated by the following: To fight inflation it would be useful to let the Yuan Renminbi appreciate against the major currencies, since this would reduce the price increase of imports that are priced in Euros or USD. In fact price increases through imports are one of the major elements in the rise of inflation in China. However, a significant rise in the external value of the Yuan would be a big burden for the Chinese export industry. Chinese exporters calculate with very small profit margins, which can be rapidly eroded by a significant rise in the value of the Yuan Renminbi. In addition, they are affected by the economic slowdown in international markets. The export industry is an important employer in the more advanced regions of the country. Therefore, the government must put special emphasis on its health.

Other countries in Asia, such as India and Japan, are also fighting inflationary pressures. In China's case inflation is a particular challenge because the country does not have safety valves, through which wide-spread discontent amongst the population can be released. In India it is most likely that the current governing coalition will lose the next elections, if it does not manage to bring inflation under control. The Chinese do not have the option to get rid of their leadership in an orderly manner. This in turn means that the CPC is under particular pressure to get to terms with the challenge both of inflation and sustainable economic growth. Not an easy task – and a challenge which will come to the fore, once the euphoria about the Beijing Olympics has receded into the past.
