

# CHINA UNWRAPPED

## La Trobe University Public Lecture

### Melbourne State Library

29 October 2014

Pro-Vice Chancellor, distinguished guests. Ladies and Gentlemen

Good evening

Delighted to be here at the State Library to give this lecture.

As my old alma marta, I am also pleased to participate in La Trobe events and to contribute to the life the University

I am bemused to think that I belong to an elite group comprising just a handful of people who have *three* degrees from La Trobe, studied successively!

I am proud to be a distinguished *alumnus*.

La Trobe was very good to me.

I owe it, its staff and fellow students a great deal.

As it is the end of the working day, I trust that I might be indulged to reflect a little on my days at La Trobe before turning to the subject of this evening's lecture.

It all seems so long ago and of course it was . . .

I studied Economics mainly because my father was opposed to my studying Political Science.

In the years before going to La Trobe, we had exhausted ourselves in arguments over the Vietnam War.

He had fought in the North Africa campaigns against the brilliant German General, Romell, during the Second World War and his father had been in the Australian Third Light Horse in Gallipoli.

Whitlam had just been elected. Conscription was abolished in the very month that I was to have registered for the draft, and our troops were being pulled out of Vietnam.

Whitlam also recognized Communist China, or Red China as it was more commonly called, as one of his first acts on becoming Prime Minister.

At the time it felt like my generation had won a great victory over my father's.

I no longer felt I needed to win another point over my studies. So I enrolled in what was grandly called the School of Economics at La Trobe.

Having grown up in Ivanhoe – which was almost an outer suburb of Melbourne in those days – La Trobe was convenient. It was virtually just down the road.

At the time, the young brash University was known as a “radical university”. It had a politically active student population opposed the war in Vietnam. Several of its student leaders had, until just before Whitlam was elected, been incarcerated in Pentridge Prison in nearby Coburg.

My first day at La Trobe was unforgettable.

As I wandered around the Donald Whitehead building, signing up for tutorials on bits of paper stuck on the office doors of our tutors, suddenly we were caught up in maelstrom of shouting pushing students and uniformed police officers.

A riot had broken out in protest over the visit to the campus of the South Vietnamese Deputy Prime Minister.

For some inexplicable reason he had decided to come to La Trobe, of all places, to give a public lecture.

La Trobe’s public lectures have a long and interesting history.

I wouldn’t say it was all down hill from there, but studying economics was much less exciting over the subsequent days and years.

I did relish my studies and La Trobe provided enormous scope for a young person who became more and more intellectually curious, the more I studied.

My math skills were barely up to scratch for the task and I struggled through core economic theory courses, but conceptually understood the subjects.

La Trobe in those days, however, offered an extensive menu of subjects in the discipline – many of which probably today are no longer taught due to lack of popular demand.

I relished subjects with what would today be regarded as quaint titles, such as the History of Economic Thought – which examined the individuals, their historical circumstances and philosophical underpinnings of economics as a science; Comparative Economic Systems (the study of the former Soviet Union and its East European satellites – a Cold War relic); Economic History in which I did my post-grad work and would now be thought of as the study of long-run economic growth – if anyone still studies such things these days; and Economic Development – the study of the economic challenges of what we once called, but today no more, the Third World.

They all seem like museum pieces today.

And I even snuck in a subject or two in politics in each of my undergraduate years.

Careers often entail a lot of serendipity – mine certainly did.

But as it turned out, nothing equipped me better for a career in public policy and diplomacy than those subjects studied at La Trobe.

I had no idea that China would account for such a big part of my professional life when I was at La Trobe.

But over the almost thirty years I have been involved on and off with China, my La Trobe education had given me sufficient technical skills, but more importantly intellectual breadth and reach.

It also never extinguished my curiosity.

And so to the subject of this evening's lecture

### China Unwrapped

The allusion in the title of this lecture – China unwrapped - is intended to be to Winston Churchill's description of the Soviet Union as "an enigma, inside a puzzle, wrapped in a mystery".

China is endlessly fascinating to watch and to engage with. Its political processes and government continue to be so opaque and its complex history does much to shape contemporary conditions, while its rich cultural traditions and manners crystalize assumptions by the Chinese about themselves and others.

Today China seems to be going through another extraordinary period of transition.

The extent of this and the risks involved for the leadership were not expected or anticipated before Xi Jinping assumed power.

In unwrapping China, I will suggest several somewhat contrarian interpretations of what is happening and where China might be going.

These are not intended to be contrarian for the sake of it. And they are not entirely mine alone. But perhaps taken together – covering China's political situation, economic trajectory and geopolitical stance – they will suggest a China somewhat at odds with conventional wisdom, especially that found in the easy assumptions of much of the news media.

### The Xi Jinping Era

We didn't know it at the time, when, in November 2012, Xi took over the key positions of Party Leader and Chairman of the Central Military Commission that he would emerge as the most powerful leader in China since Mao Tzedong in the 1950s.

The era of Xi Jinping is well underway.

Unlike his predecessors, including Deng Xiaoping, Xi does not have to contend with powerful peers or former leaders, with the exception of the aged Jiang Zemin. And while Jiang is still a formidable political presence, Xi's promotion would have had his imprimatur.

Xi was handed the job with reasonably free reign to clean up the Communist Party, strengthen its grip on country that is undergoing profound economic and social change, and begin to assert China's standing in the world more forcefully.

To do this, Xi launched the Anti-Corruption and Party Rectification campaigns – in language, design and ruthlessness they hark back to political campaigns or purges of the past.

One of the great curiosities of the current campaigns, however, is that they're being carried out, at least in urban areas, in a modern, open and internationally connected society, where most people network and communicate directly via their mobile phones on social networking sites.

With a little more time, I believe we will see that the Anti-corruption Campaign in its early days was largely political. It was about dispatching Xi's actual and potential opponents.

When Xi said he was going to catch 'tigers' – senior political and business figures – as well as flies in his anti-corruption net, he meant it. At the time, few believed he would.

Xi has brought down former Standing Committee member, Zhou Yongkang, and the powerful networks of influence and corruption associated with Zhou. Xi has disrupted if not smashed Zhou's former power bases in PetroChina and Sichuan Province, as well in many municipalities around the country.

Having done so successfully, the first phase of this campaign is now probably over. Attention from now on will be focused on corruption for corruption's sake – political agendas, while ever present, will unlikely be at the fore as they have over the past two years.

It is important, as best we can, to try to understand what this is all about. What is motivating and driving Xi?

Although we're unlikely to ever know definitively, we know enough about Xi to hazard an informed guess.

Xi is clearly a patriot. He also believes that the Communist Party is the only institutional arrangement in China today that can keep China together and make it strong, with growing prosperity at home and international prestige and respect abroad.

Xi's father was also one of the fabled revolutionary leaders and heroes before 1949. He was commander of the Shanxi military region and was widely credited to have saved the Long March when it ended up in Shanxi and then was installed in the caves of Yan'an until the end of the war with Japan.

Many thought that Xi's father deserved a leading spot in the post revolution firmament.

But Xi's father was pushed aside by a jealous Mao and, like others of his stature, was victimized during the Cultural Revolution.

When Xi was appointed Vice President in October 2007, many thought that justice had finally been done to Xi's family.

So it is likely that filial piety – doing good works for his now deceased father – is an important force driving Xi. By the way, his mother is still alive and is in Shenzhen where Xi's father was sent by Deng Xiao Ping after the bloody June 1989 crackdown in Tiananmen Square.

This was to keep Xi's father out of the way and to do something useful – to drive experimental economic reforms in the Shenzhen Special Economic Zone. Xi's father had been one of a small group of elders who had opposed Deng's use of the military against the demonstrators.

Xi's policies then are intended to strengthen and entrench further Communist Party rule in China. I can imagine that every day when he is shaving, Xi is looking into the mirror and saying 'I am not Gorbachev'.

Xi has shown he's not a liberal or interested in political reform. The just concluded 4<sup>th</sup> Plenum of the Party last week was about fine tuning the legal system and limiting judicial abuse, not about protecting individual rights in the courts, let alone a rule of law.

Xi would want his legacy to be a strong and respected Communist Party ruling over a successful China.

## Economy

To that end, Xi needs to make the economy work and to keep delivering rising living standards.

At present, and especially outside China, a lot of pessimism is felt about China's economic outlook.

China has had an internationally, unprecedented, protracted period of rapid economic growth.

Since Deng tentatively launched the open door and reform policies in 1978, China has experienced thirty six years of growth over which the annual average growth rate was just under 10 per cent.

The Chinese economy also became deeply integrated into the international economic system. By the early 2000s it was more open and engaged with the global economy than either then contemporary Japan or Korea, even though at the time it was much poorer than them.

Following Tiananmen Square, the Party struck an implicit social compact with the people: it would deliver rapidly rising living standards, while at the same time getting out of the minutiae of people's daily lives.

This social compact has continued into the Xi Era.

Xi, however, has inherited an economy that looks as if it is starting to run out of puff.

Clearly China is going through a cyclical downturn, though with growth rates over the past three years of something over 7 percent per annum this is both impressive and significant.

China's economy in absolute size has more than doubled in the past eight years and is now the second biggest in the world. In terms of absolute increase economic output, an economy of China's size today, growing at 7 plus, is equivalent to a 12 per cent growth rate off an economy the size of China's in 2006.

If such growth rates are sustained, the Chinese economy is more or less likely to double in size again within the next ten years.

Increasingly concerns are raised that China's growth potential is weakening – some think rapidly – and that China may find itself in a low-level income trap with long-term growth flat-lining at only a fraction of the past thirty years' growth rate.

Two reasons are often cited.

One is that China's debt has risen rapidly in the post GFC period. It has more than doubled to 240 per cent of GDP, although this is still small relative to many developed economies, such as the US where total debt is 330 per cent of GDP. The burden of debt servicing is increasing, reducing capital available for investment.

The other is that the marginal efficiency of capital is in secular long-run decline, which means that China needs to invest more for an ever smaller increase in GDP.

This in turn will make debt servicing more difficult.

These pressures are compounded by continuing weak growth in the rest of the world, especially in the rich countries. Moreover, China's ageing population will see from next year the dependency ratio rising for the first time in China's history.

These concerns are valid, but they're not the whole story.

Debt, while large, is not unmanageable and China retains capital controls and holds foreign exchange reserves in excess of US\$4trillion. It is not vulnerable to capital flight in the way that Asian economies were during the crisis in 1997.

While China continues to run a current account surplus in most years – thereby contributing to sustaining its high level of reserves – net exports (exports minus imports) are no longer a major source of growth, as they were in the earlier stages of China's platinum age of growth.

China's growth is now much more domestically driven, relying on investment as in its traditional growth model, but increasingly based on consumption.

Offsetting pressures for diminishing returns to investment, however, are several powerful drivers of long-run productivity growth.

Productivity growth is the key to whether China avoids a low or even a middle-income trap.

In the interests of time I will just list four of these and then discuss the most important of all – Xi Jinping's economic reform program announced at the Third Party Plenum in November last year.

First, China still has a long way to go with urbanization. Some 300 million people will move to cities over the next 15-20 years – about the current population of the USA today.

Labour productivity in cities is higher than in rural areas and for those left on the farm their productivity rises because of the opportunities for farm consolidation and ensuing economies of scale.

China is still a poor country and so it has a lot of catch up ahead of it. It is the 84<sup>th</sup> poorest on the World Bank's league table, its per capita income is just 15 per cent of the US's, and its per capita consumption of steel, for example, is where the US was in the 1950s.

It is also way inside the global production possibility frontier, so it has years ahead of it in which to draw on the global stock of technology.

The Chinese government is investing massively in transport infrastructure. China is still a heavily transport constrained economy. Consider that some 60 per cent of all freight movements in China comprise just one commodity, that is coal.

Lowering transport constraints opens the opportunity for intra-regional specialization, which will further contribute to raising productivity.

While the greying of the population is an important head wind, in addition to the other drivers of long-run productivity growth just discussed, China has invested massively in education.

Everyone entering the workforce today and into the future for many years will be very much better educated and trained than those whom they replace.

Most critical of all will be for Xi to reinvigorate China's economic reforms to encourage greater competition in product and factor markets, to reform the financial system to allocate capital more efficiently, to wind back the plethora of controls and regulations that protect state-owned enterprises, and to open the capital account further – including renminbi convertibility – so that there is a better fit between the domestic and international economies.

Last November's plenum set a bold, ambitious, if not at times contradictory policy vision for doing just these things.

Xi has set out to once again – like Deng Xiaoping over three decades ago – to transform the Chinese economy again.

At its core is the objective of allowing the market to play the “decisive” role in driving the economy. This was the first time in the entire reform period that the market was given priority over the state.

Moreover, the private sector was to put on the same level as the state-owned sector. Again a first.

And state owned enterprises were directed to begin experiments with multiple forms of ownership, namely opening to private capital.

Much else was in the Decision, as it is know, from last year. In fact there was something like 60 policies.

Such is the breadth and complexity and the contradictions that it has been exceedingly difficult to work out what has been achieved so far. The track record looks patchy.

But a study by Dan Rosen from the Peterson Institute, that will be released at an Asia Society event in Sydney this Friday, provides a balanced and detailed assessment of the program’s implementation to date.

It finds that much has been achieved. And although advance is along an uneven front, deep changes are already starting to run through the Chinese economy as a result of Xi’s policies.

Forecasts of the end of the long boom in Chinese economic growth are clearly premature.

At the same time, as a consequence of the economy’s maturing, deeper structural changes are underway.

Last year, for the first time in China’s history, services accounted for the biggest share of GDP – 46 per cent, compared with 44% for manufactures and just 10% for agriculture.

This is just the pattern of growth that one would expect as incomes rise.

In China, however, given the continental size of the country this also has a pronounced spatial dimension.

China’s eastern seaboard is in some places already at middle-income country levels of per capita income, while other areas have achieved upper developing country levels. Other regions in China’s interior are catching up fast.

It is here that structural change into a services based economy is now already well advanced.

Another important aspect of China’s growth over the past decade is that it is increasingly being driven by the private sector. Major private sector firms of likes of Alibaba, Lennovo, or Huawei have emerged with a global presence.



A study last month by one of the most important economists working on China, Nicholas Lardy, has found that the private sector been the principle source of employment and income growth and now is significantly bigger than the state-owned sector.

Xi's reforms in many ways may be pushing on an open door, and will further extend and deepen this trend.

One of the biggest challenges I found as Ambassador was helping Canberra keep abreast of the contemporary realities of China. Studies like Lardy's should help, but it shows how far China has moved from the stereotyped view of China's economy as being dominated by relatively few big state-owned enterprises.

This is still true in a few sectors like petroleum, coal, power and telecoms, but it no longer is a useful generalization.

So China's economy still has a lot of growth left in it. And while investment and resource intensive growth will gradually decline in importance, while consumption and services take up the strain, these older sources of growth nonetheless remain important for a long time still.

So Xi's Era looks to consist of a great measure of political authoritarianism, with greater economic liberalism. It also seems that the economy will continue to deliver on the post-Tiananmen Square compact.

## Geopolitics

Xi's Era has also coincided with one of great geopolitical uncertainty. It is a major challenge for him to position China in this new international landscape as a major and influential power.

Under Xi we've seen a new assertiveness in foreign policy – notably in the South China Sea and with Japan – but also a greater open display of irritation with the United States. This latter has included a willingness to balance the US in its relationships, for example moving closer to Russia and its various positions in the Middle East.

Under Xi, China's new assertive foreign policy is here to stay. It will need to be treated as a permanent feature of the international landscape.

Xi will also, and has started to do so already, seek to change aspects of the international system so that they reflect the realities of the world economy in the twenty first century and not those of the mid- twentieth century.

We've seen this recently with China-led initiatives such as the BRICS Bank and the launch last week of the Asia Infrastructure Investment Bank.

But this does not mean that China will become an aggressive, destabilising power, seeking militarily to challenge the US strategic dominance of the western Pacific.

It might, but it is most unlikely.

While in the West we are very alert and sensitive to China's military modernization, as it is prudent that we should be, the view of China that sees it as inevitably expansionist, leading inexorably to military conflict with the US, overlooks the view from Beijing.

China's security priorities when viewed from Beijing look very different than when viewed from Canberra or Washington.

First and foremost, China is still an empire with unresolved territorial issues inside its borders – Tibet, Xinjiang, Taiwan and now Hong Kong. These are dominant security challenges Beijing has to address.

Second, China has 14 countries and 22,000 kilometers of land borders to defend. All except Pakistan have been sources of tension, sometimes conflict and abiding mistrust. China's warmer relations with Russia of late, cannot hide the deep mutual suspicion and mistrust that has long existed between them.

Third, is North Korea and its unpredictability and potential for instability.

Fourth, is Japan and the deep historical animosity that infects that relationship.

Fifth, is the fact that when, as in the South China sea, China seeks to assert itself, it drives those countries into a closer alignment with the United States thereby undermining its own longer term strategic objectives.

Finally and most fundamentally but often overlooked as it is a relatively recent event, China today is utterly dependent on world markets for all the resources, energy and increasingly food it needs for sustaining economic growth and rising living standards.

In this view then, China can be thought of as a highly constrained power.

That is, it is a great power with limited capacity to project power and influence.

This contrast with the United States during its ascendancy when it had no internal security issues, peaceful borders and all the resources it need for its economic growth except people which it sucked in – educated and trained – from Europe in vast numbers.

In summary then, China under Xi will continue to stand far apart from the global norms of political and social organisation. Its economy is likely to continue to grow strongly, albeit well below average rates of the past decade, but it will be more market oriented and draw more heavily on the deep entrepreneurial reserves of its private sector.

While its foreign policy will continue to be assertive, as this rising power seeks to define its position in the international system, it will not seek to change the regional order militarily but through diplomacy and new institution building.

For Australia, it means we will have to continue to deal with a stronger China - where differences over human rights and views on the structure of the regional order - will need to be managed skillfully, while our economic dependence continues to deepen and spread throughout our economy.

China will continue to be interesting.

Many thanks for your attention.